

*De Jure*

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## Stressed? Some Preferential Treatment



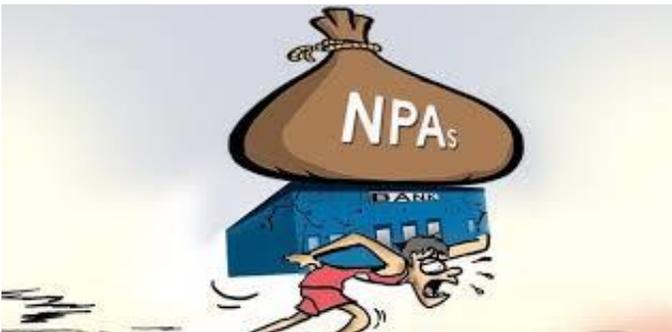
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## I AM NOT BAD! I AM STRESSED! I NEED PREFERENTIAL THERAPY.

SEBI heard this prayer and now proposes to relax not only the pricing norms applicable for a preferential issue by financially stressed listed companies, but also grant exemption from making an open offer if the acquisition results in the acquirer acquiring more than 25% voting rights in the investee company. It is about time. This relaxation is long overdue and not related to the pandemic. No doubt, because of the pandemic, valuations have taken a hit and the share prices of stressed companies have further contracted.

Companies which face financial stress need fund infusion to subjugate the stress situation and avoid insolvency and/or bankruptcy. Investors keen to invest in distressed companies are scarce and are also subject to hurdles and practical difficulties under various laws.



Companies with "stressed assets" experience further fall in their share price. To add salt to the wounds, the disclosures made by such companies, such as financial results and defaults in debt servicing aggravate the fall. The lack of funding at such a crucial stage leads to disruption in functioning of the company.

Recognising these difficulties, SEBI proposes to offer avenues and encourage investors and other funds, such as stressed asset funds and buyout funds, to invest money into these stressed companies by providing certain exemptions.

The current price at which investors may acquire shares issued on a preferential basis is based upon the weighted average price of last 6 months or 2 weeks, whichever is higher. This pricing mechanism became onerous for financially stressed listed companies, which on the one hand were subject to the global slowdown and on the other hand, lack of liquidity from banks and NBFCs; add to that the rout triggered by the pandemic.

SEBI now proposes that shares issued by financially stressed listed companies on preferential basis be priced based on the weighted average price during 2 weeks preceding the relevant date. SEBI also proposes that if the acquisition results in breaching the threshold of 25% as set out in

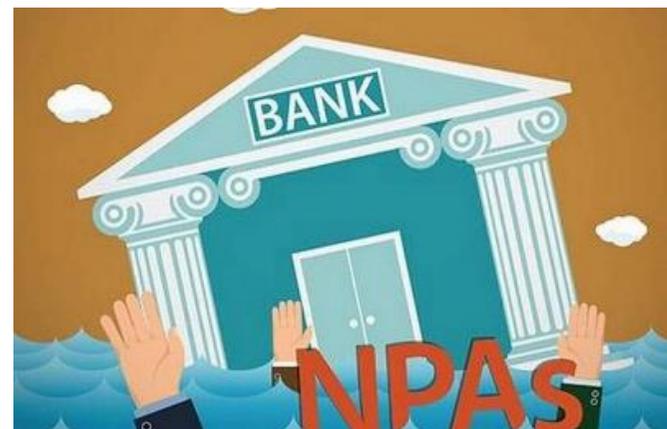
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Regulation 3(1) of the Takeover Regulations, then the acquirer be exempt from making an open offer.

The relaxation from the current preferential issue pricing guidelines is subject to adherence of few conditions, which if not complied with will take one back to the pricing mechanism of 26 weeks and 2 weeks.

**What is a stressed company? As per the SEBI Consultation Paper (proposing these exemptions), a company will be considered a "stressed company", if:**

- it has disclosed defaults for 2 consequent quarters on interest and/or principal payments availed from banks and/or financial institutions and on its listed and unlisted debt securities;
- the lenders of such a company have executed an inter-creditor agreement providing guidelines for finalisation and implementation of a resolution plan;
- the credit rating of such a company has been downgraded to "D", which rating is given to a borrower that is not of investment grade and implies the highest degree of risk, since the borrower has defaulted on its debts.



**There are more conditions!**

- promoters cannot participate;
- the resolution proposing the preferential issue, availing relaxation on pricing and seeking exemption from open offer must be approved by majority of the minority shareholders, i.e., no promoters and no shareholder desiring to subscribe to the preferential issue;
- the shares must be locked-in for 3 years;
- the use of proceeds of the preferential issue must be disclosed in the explanatory statement;
- a monitoring agency must be appointed to monitor the use of proceeds.

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SEBI has sought to align the exemption under the Takeover Regulations with an acquisition pursuant to a resolution plan approved under the Insolvency and Bankruptcy Code, 2016. While an acquisition exceeding the threshold limits is exempted from open offer under the IBC, no exemption is available for acquisition of securities of stressed companies, since that are not under any resolution plan.

Without an exemption from open offer, investors and acquirers willing to infuse money into these stressed companies face open offer obligations, acting as a deterrent to investors wanting to take any controlling interest in such companies.

This proposed relaxation and exemption will increase the bunch of investors willing to infuse money and acquire controlling stake in the company. The open offer exemption will lessen the additional burden on an investor to comply with the stringent requirements, thereby opening up investment opportunities.

**Let us examine whether the conditions will encourage an investor to instantaneously identify stressed companies and acquire controlling stake in them.**

- While the requirement of disclosing defaults is acceptable, a period of 2 quarters may be a significantly long time in circumstances where investors are willing to infuse funds and the stressed company desperate to receive funds. SEBI may consider reducing the time period to 1 quarter;
  - An inter-creditor agreement mandates all creditors to unanimously agree to a proposal, which will involve commercial negotiations. Whether all the creditors of stressed companies are on the same page? Why not cap the creditor approval to 66% (or 75%) voting share as set out in the IBC?
  - Another key suggestion that comes to mind is why not extend this relaxation and exemption to companies which have been referred to IBC?
  - Why do stressed companies have to wait to be downgraded to D? Why not begin at C?
  - The lock-in of 3 years may be a deterrent. Investors may want to revive the stressed company and cash out (at least partially) when the company is out of stress. These Investors usually have a risk appetite and would generally look for an early exit. The lock-in
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period should ideally be the current 18 months, with about 20% of the new issue without lock-in (or 6 months lock-in) to allow the investor for an early cash out. This investor is a white knight, neither a promoter nor a long haul investor.

- Perhaps approval by majority of the minority shareholders, may be dispensed with, since the principal stakeholders who would benefit with this round of investment would be the promoters (who may have given guarantees), the lenders (who may have given loans, usually 3x to 4x the networth of the stressed company and employees, who may lose their job). No doubt, the public shareholders have invested in the stressed company, but then comparatively they have less to lose, and in case the minority shareholders vote against the resolution, the promoters, the lenders and employees have more to lose.

The proposals issued by SEBI are timely and very welcome, more particularly in the current market scenario. Once implemented, it will enable stressed companies to raise funds and avoid being taken to the cleaners.



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