



Surveying the field

Predators eyeing India's listed companies have been empowered by new takeover rules

Nandini Lakshman in Mumbai reports on key changes

For some years now, the growing challenges and complexities confronting companies globally have seen regulators tweak laws and regulations to promote competition and attract investments.

In September 2009 India's markets regulator, the Securities and Exchange Board of India (SEBI), set up a Takeover Regulations Advisory Committee (TRAC). The 12-member committee was headed by a former presiding officer of the Securities Appellate Tribunal, C Achuthan, and its remit was to suggest amendments to the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

TRAC submitted its report in July 2010, fuelling widespread debate over impending changes to the regulations.

A new era

On 23 September SEBI notified the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, triggering a much-awaited makeover of mergers and acquisitions (M&A).

While the new regulations – effective from 23 October – will change the corporate landscape of India, they have also raised the threat of hostile takeovers for listed companies.

“The new code, most certainly overdue, is a step in the right direction, seeking to address objectives ranging from alignment with international takeover norms, more realistic percentage for trigger and open offer, minority

The new code, most certainly overdue, is a step in the right direction

Rohit Berry
Partner
BMR Advisors



protection measures and various gaps developed in the existing code implementation,” says Rohit Berry, a partner and leader of the M&A practice at professional services firm BMR Advisors, which provides tax, risk and M&A advice.

Others also believe that India needed to realign its policies. “As a growing economy, India had to align its investment and takeover laws in accordance with global best practices,” says Madhu Nair, president, legal and secretarial, at Piramal Healthcare.

Triggering change

The game changer of the new takeover code is the initial open offer trigger, which has been raised to 25% of voting rights of a target company. Under the earlier regulations the open offer trigger was 15%, but as TRAC observed, it “had been fixed in an environment where the shareholding pattern in corporate India was such that it was possible to control listed companies with holdings as low as 15%”. Shareholding patterns have changed and the 15% trigger was found to have outlived its relevance.

As a result of the upward revision of the open offer trigger, investors – especially strategic investors who have yet to make up their mind about taking over a company – may acquire up to 24.9% of a listed company without being obliged to make a mandatory open offer.

This is significant because unlike in the West, where most companies are widely held, most of India Inc is still held by the promoters who founded the company. Only a small minority of companies – HDFC, ICICI, ITC and Larsen & Toubro, to name a few – are widely held.

Easy targets?

The changed initial offer trigger will make many Indian companies vulnerable to hostile takeovers.

According to TRAC, which studied 4,054 listed companies before it submitted various proposals to SEBI in July 2010, promoter stakes were below 25% in 594 companies and below 15% in 340 companies. Of the 459 companies with a market capitalization of over ₹10 billion (US\$200 million), the promoter holding was below 15% in 15 companies, and below 25% in 31 companies.

On the Bombay Stock Exchange 500 index, promoter

holdings in 210 companies are 51% or less, and in 24 companies they are below 26%. As a result, these companies are ideal buyout targets.

Shoring up

In the short term, the changes could send promoters and significant shareholders scrambling for funds as they try to raise themselves above the 25% threshold. A mandatory open offer requires an acquirer to put in place firm financial arrangements for the entire amount payable in the offer.

“Companies like Mahindra & Mahindra, the Mumbai-based automotive and farm equipment major, whose promoter shareholding is below 25%, will have to contend with the fact that the new law does not have a ‘grandfathering’ provision that would give them time to cross that threshold without triggering an open offer,” says Madhurima Mukherjee, a New Delhi-based partner at the law firm Luthra & Luthra.

Minority investors too will be significantly affected: “The 25% threshold enables much more private equity investment to take place, which would formerly have been hindered by the prospect of an open offer,” adds Mukherjee.

Lying low

There is also a consolidation trigger in the 25% to 75% band of a target company. A shareholder who already holds at least 25% of the target company can consolidate its holding through a 5% creeping acquisition each financial year till they reach the 75% voting rights mark. They can do this through preferential allotments, negotiated transfers, or non-market transactions and do not need to make an open offer while they are making such an acquisition.

Observers remark that the two bands – below 25% and 25% to 75% – give acquirers who are at both ends of the spectrum substantially improved headroom.

Upping the consolidation limits is likely to boost promoter and investor confidence to commit more capital. “The increasing threshold will encourage existing investors holding less than 15% to shore up, and it’s a larger limit for the new guys resulting in more FDI,” says Sandip Bhagat, a Mumbai-based partner at S&R Associates.

As a growing economy, India had to align its investment and takeover laws ... with global best practices

Madhu Nair
President, Legal
Piramal Healthcare



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Partner
Luthra & Luthra



Foreign collaborators and minority foreign partners too are expected to flex their muscles to increase their stakes in listed companies without triggering an open offer.

Level field?

The regulator has also augmented the minimum size of an open offer to 26% from the previous 20%. This provides an easier exit for investors and also ensures that those who hold 25% in a listed company can acquire control by making an open offer of 26% to reach 51%.

"This move will bring in serious and strategic acquirers," says Dev Bajpai, who is executive director (legal) at Hindustan Unilever (HUL). He says that the 26% offer size provides a level playing field for Indian and foreign investors.

But there is no guarantee that the increased 26% offer size will give public shareholders a complete exit, even if they tender all their shares. "The acquirer is under no obligation to acquire more than 26% of the voting capital," adds Bajpai.

One of TRAC's main recommendations was a 100% mandatory offer as a means to address the concerns of minority shareholders.

"Should a shareholder desire to exit a target company at the offer price mandated under the takeover regulations, there ought to be no reason for the law to pre-empt him from a complete exit," said TRAC, observing that such a requirement would be "equitable, just and fair". TRAC also pointed out that this is the norm in several international jurisdictions.

However, this was not to be and corporate executives say they are glad that SEBI did not accept this recommendation. If it had, Indian promoters would have struggled to raise funds for a huge public float, as banks in India are not allowed to fund the acquisition of shares.

Inherent risks

Despite the consolidation limits, experts predict that buyouts will become a reality because the thresholds in the new code make it easier for an acquirer to obtain a controlling stake in a target company.

"Promoters with low holdings may need to be watchful since the new limits allow the acquirer a 51% stake [25% plus open offer for 26%]," says Vijaya Sampath, group general counsel and company secretary at Bharti Enterprises.

Neeta Sanghavi, a partner at Mumbai law firm Wakhariya & Wakhariya, adds: "Increasing the open offer size provides the acquirer the ability to block special resolutions, which are mandatory for critical corporate decisions."

Even a high-profile company like Infosys would be vulnerable as the promoters of the Bangalore-based tech major hold barely a 16% stake. But while technically the Infosys promoters' low holding leaves the door ajar for an acquirer, the company's war chest of over US\$3 billion and a market capitalization of US\$25 billion could inhibit acquirers. "To fork out that kind of money is no joke. Only a foreign investor like IBM may be able to pull it off," says an investment banker.

But is this change in regulation really pro-acquirer? Not if you read the fine print of the regulations, argues Somasekhar Sundaresan, a Mumbai-based partner at J Sagar Associates in a column in *Business Standard*. Sundaresan, who was a member of TRAC and one of only two lawyers on it, points to the little publicized fact that the new regulations prohibit delisting for a period of twelve months. As such, an acquirer whose stake crosses 75% purely because he had to make an open offer for 26%, will be forced to first sell down his shareholding and then build it up again if he chooses to delist after 12 months. This is "in fact a punishment to the acquirer for having done a transaction that triggered an open offer".

Creeping into control

The new regulations for creeping acquisitions also provide an avenue to increase holdings in a venture. The old regulations restricted promoter groups with stakes of at least 55% but less than 75% to a one-time 5% per cent acquisition. They too can now take their shareholding to 75% by creeping up by 5% every year.

"The new law is more logical. Once the law has decided that 25% is enough public shareholding for liquidity, then there should be no room for half measures like the earlier mezzanine ceiling at 55%," says Mukherjee at Luthra & Luthra.

What happens if promoters are cash strapped? This is clearly the case with PRS Oberoi, the son of the founder

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of East India Hotels (EIH) who is currently its chairman. Oberoi holds a 34.6% stake in EIH, which owns and operates the Oberoi chain of hotels. When tobacco-to-hotels major ITC began buying the EIH stock, Mukesh Ambani

of Reliance Industries stepped in as a white knight and bought stock held by the Oberoi family. Today, Reliance and ITC each have stakes of nearly 15% in EIH. With EIH shares trading below ₹90 in a volatile market and the promoter's low holding, the company makes an easy takeover target.

ITC, which has been purchasing peer stocks from the market over the past three years and has a 12.96% stake in Hotel Leela Ventures, has already indicated it is hungry for more. At ITC's annual general meeting in Kolkata in July, its chairman, YC Deveshwar, said he is open to raising the company's stake in other hotel companies if the opportunity arises and the price is good.

Armed with over US\$1 billion in liquid funds, ITC can increase its stake in rival hotels to 25% without triggering the open offer and then either stay put or do creeping acquisitions. "Even at this level ITC could be a major nuisance value to the EIH and Leela promoters," says Krishnavia Dutt, a partner at Argus Partners.

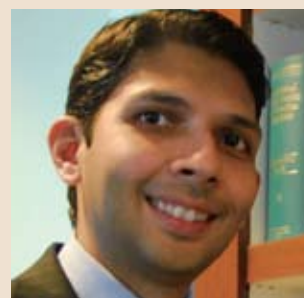
Clarification on creeping

The new code provides an important clarification with respect to how the 5% annual creeping acquisition limit is computed. Under the old code, one could argue that a

Practitioner's perspective

Defending your turf

As India's new takeover regulations take root, Akil Hirani provides practical tips for corporate counsel



On 23 September the Securities and Exchange Board of India (SEBI) notified the new SEBI (Substantial Acquisition of Shares and Takeovers) Regulations. These regulations, – known as the takeover code – are effective from 23 October, ushering in the following key changes.

- The threshold for the initial open offer trigger has been increased from 15% to 25%.
- To ensure fair value for all shares tendered in an open offer, the minimum price payable has to be the highest of the following: (i) the negotiated price triggering the open offer; (ii) the volume-weighted average price paid by the acquirer in the preceding 52 weeks; (iii) the highest price paid by the acquirer during the preceding 26 weeks; or (iv) the market price based on volume-weighted average market prices in the preceding 60 trading days.
- Shareholders holding shares entitling them to exercise 25% or more of the voting rights in the target company may, without breaching minimum public shareholding requirements under the listing agreement, voluntarily make an open offer to consolidate their shareholding (minimum 10%).
- The minimum open offer size has been increased

from 20% of the total issued capital to 26%.

- Provisions regarding non-compete fees have been scrapped, so that all shareholders are given an exit at the same price.
- In cases of competing offers, the successful bidder is allowed to acquire shares of other bidders after the offer period without attracting open offer obligations.
- The board of the target company is required to make a mandatory recommendation on the offer.
- An indirect acquisition of a company will be treated as a direct acquisition for all purposes if the indirectly acquired target company is a predominant part of the business or entity being acquired, comprising at least 80% of the target company's assets or net sales or market capitalization.

Analysis of three changes

Increase in the mandatory offer threshold from 15% to 25%: This will align the takeover code in India with regulations in places such as the UK and Hong Kong (where it is 30%). As a result, existing shareholders and new investors can invest up to 24.99%

public offer should not be triggered if a promoter with a 40% stake acquired an additional 10% via a preferential issue, but sold 5% in a parallel secondary deal, leaving him at 45%. The new code does not permit this, as the 5% acquisition is based on a gross acquisition of 5% voting rights and disregards sales or dilutions.

A key change has been made to assist shareholders with a stake of at least 25% to consolidate their holding. Under the new code, such shareholders can voluntarily make an open offer for a minimum of 10% of voting rights in a target company, provided their final stake does not exceed 75%.

“This minimum size is to ensure that the takeover code is used as a consolidation platform only through serious offers,” says Sundaresan at J Sagar Associates.

Under the previous rules, shareholders with a stake of at least 55% could make a voluntary open offer as long as they did not breach the minimum public shareholding requirement.

Non-compete fees

Significantly, the new code has done away with “non-compete fees” to any of the selling shareholders, including promoters, in an open offer. The new regulation

in a listed company without triggering the takeover code. However, they will still have to ensure that their acquisition does not give them de facto control of the company. If it does, a mandatory open offer will be automatically be triggered.

The higher threshold significantly increases the risk of hostile takeovers. Financially strong promoters holding below 25% will be able to acquire more shares and increase their hold, but promoters who cannot afford to do this may be at risk. In such cases, strategic acquirers will be able to easily acquire up to 24.99% and then consolidate their holding by negotiating an open offer with minority shareholders.

Increase in the open offer size from 20% to 26%: An increase in the initial threshold to 25% and the open offer size to 26% creates the possibility of an acquirer getting a simple majority and control (51%).

While the Reserve Bank of India does not permit Indian banks to finance acquisitions on the strength of a target’s balance sheet, a foreign acquirer with access to foreign debt is not restricted in this manner. This means that foreign acquirers may find it easy to initiate acquisitions in India and gain control over Indian companies.

Change in size of voluntary offers: To facilitate the consolidation of holdings in excess of 5% (creeping acquisition) by substantial shareholders (holding 25% or more), SEBI now allows voluntary offers for a stake of 10% or more. This will provide flexibility to shareholders to increase their shareholding without being obliged to make an open offer for an additional 26% stake. However, as open offers are often not fully subscribed, companies will have to watch as a desired increase in shareholding may not be fully achieved.

Increasing the open offer size provides the acquirer the ability to block special resolutions, which are mandatory for critical corporate decisions

Neeta Sanghavi

Partner

Wakhariya & Wakhariya



states that if any additional payment is made to the promoters, it needs to be factored into the open offer price, and paid uniformly to all the selling shareholders.

The way forward

In-house counsel of companies in which the promoters have a low holding will have to focus on takeover defences. For a starter, they will have to assess competitors in the industry, both in India and abroad, and check on the financial capacity of each one. They will also need to closely monitor trading patterns.

After an initial assessment, such companies may wish to put poison pills in place. These can be in the form of options under employee stock ownership plans to be converted into shares as soon as a certain number of shares are acquired by any third party. The issue of rights or bonus or discounted shares to shareholders can also have the same effect. In addition, shares with different voting rights can be introduced, thereby making it difficult for an acquirer to get voting control over a company.

Golden parachutes are another option. These involve giving senior management significant cash and stock grants in the case of a hostile takeover, which will make it expensive for an acquirer to run the company post-acquisition. Companies can also amend their charter documents to introduce a supermajority vote requirement for approval of an acquisition, instead of the 51% vote that is usually needed.

Eventually, white knights may need to be brought in to defend the company. In the Indian context, if the sector is restricted and requires government approval for foreign investment, the foreign acquirer may be subject to regulatory delay. This can work in favour of the target and give it time to defend itself.

Akil Hirani is the managing partner and head of the transactions practice at Majmudar & Co. The firm has offices in Mumbai, Bangalore, New Delhi, Hyderabad and Chennai.

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Somasekhar Sundaresan
Partner
J Sagar Associates



Dutt at Argus Partners believes that putting promoters on par with minority shareholders isn't fair. "Unlike the US and UK where managements take home whopping salaries, Indian managements hardly get anything. They have to be rewarded for their sweat and toil," he says.

Others think that not discriminating between promoters and shareholders is good. Sanghavi at Wakhariya & Wakhariya says: "It's a bonanza for the public shareholders. This provision has been made after observing the payments made to the promoters in the guise of non-compete fees under the old takeover regime."

This impending change had an impact on the non-compete clause in the recent Cairn-Vedanta deal, where Cairn PLC, which owned 62.36% of Cairn India, sold 51% of its stake to the London-based metal conglomerate Vedanta. Apart from paying ₹355 a share to Cairn's shareholders for the mandatory open offer, Vedanta was to pay Cairn's promoters an additional ₹50 per share as a non-compete fee. With the acquisition plunging into a political quagmire, Cairn waived the non-compete fee to sweeten the deal for Vedanta.

Making a call

To enhance corporate governance, the new code requires independent directors appointed by the board of a potential target to provide a reasoned recommendation to shareholders about an open offer. The directors are allowed to seek external professional advice.

"This is in line with the practice and regulation in most economies including some countries in Africa," says Sampath at Bharti Enterprises. Last year, Bharti Airtel acquired the sub-Saharan assets of Zain Telecom to expand its global footprint.

Bajpai at HUL also sees this as a positive change. "This is a fair and transparent initiative in the regulations in the interest of the shareholders," he says.

Acquire and delist?

In a bid to protect minority shareholders, the new regulations have made it tougher for companies to delist. This has been prompted by acquirers who have on occasion

used the benefit of a fixed offer price to consolidate their shareholding to the maximum possible under the open offer, only to launch a delisting offer later.

In May 2008, Hong Kong and Shanghai Banking Corporation (HSBC) acquired a controlling (73.21%) stake in IL&FS Investmart, making it the first foreign bank to control an Indian retail brokerage. The bank subsequently made an open offer to public shareholders for an additional 20% and raised its stake to 93.86%.

According to the regulations then in force, HSBC had to dilute its stake below 90%, or initiate delisting. In June 2009 the board of IL&FS Investmart informed the Bombay Stock Exchange and the National Stock Exchange of India that it was delisting. Two months later the company was renamed HSBC InvestDirect.

But a similar delisting attempt by BOC India, a Kolkata-based industrial gas company, failed when it was launched in January. BOC had been acquired by Linde of Germany. Market analysts attributed the poor showing to growing shareholder resistance to multinational firms that take their local subsidiaries private.

Now, following an open offer, if the acquirer's shareholding exceeds 75%, the acquirer cannot make a voluntary delisting offer for a year after the completion of the offer. Promoters have to reduce their shareholding to 75% before launching a delisting offer. Observers say the new rule is a deterrent to delisting as it pushes up costs and is time consuming.

Early concerns

While it is too early to tell if the new takeover code will pass muster, a few provisions have already raised concerns.

Mukherjee at Luthra & Luthra mentions "inherent contradictions" surrounding open offers. These are triggered by any breach by an individual shareholder of the 25% threshold, irrespective of its impact on the aggregate shareholding of the shareholder and persons acting in concert. This could lead to a situation where an increase in the holding of an individual shareholder will trigger an open offer even though the increase is within the 5% creeping acquisition limit when aggregated with persons acting in concert with the shareholder.

[Promoters of Indian companies] have to be rewarded for their sweat and toil

Krishnava Dutt
Managing Partner
Argus Partners



The new code also says that an open offer is triggered when the holding of individual shareholders increases due to their non-participation in a share buyback, unless they vote against or abstain from voting on the resolution relating to the buyback or sell within 90 days in order to bring their holding below the 25% threshold. Observers say that it seems to be inherently unfair to force an existing shareholder to sell out in the event of a buyback, or to acquire an additional 26% under an open offer.

Overlap in regulations

There is also inconsistency between the various regulations that will come into play during an acquisition, lament practitioners. For instance, the Competition Commission of India (Procedure in regard to the transaction of business relating to combinations) Regulations, 2011, under the Competition Act, 2002, require a notification on acquiring 15% of the shares of a listed enterprise. This has to be harmonized with the increase in threshold limits under the new takeover code.

“There is a need for all connected regulations to be consistent and rational, so that adhering to one does not lead to an absurd situation in another which was never intended,” says Bajpai.

Under competition law, a combination that is created by way of acquisition of shares and is above specific asset or turnover thresholds cannot take place unless the Competition Commission of India (CCI) approves it.

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Dev Bajpai
Executive Director (Legal)
Hindustan Unilever



This will mean that any open offer made under the new takeover code cannot be implemented until it is cleared by the CCI.

Despite problems like this professionals working in the M&A sphere agree that the new takeover code will go some way in levelling the field for all shareholders. And most would agree with Bhagat at S&R Associates when he says: “Let’s wait and see how it plays out.” ■

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