Pre-IPO Deals Haunt Companies

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Investments made by private equity funds, hedge funds and other investment vehicles in companies that had been planning to raise money from the capital markets through initial public offerings (IPOs) have come back to haunt the founders of many such firms.

Companies owe their investors at least Rs4,000 crore for their inability to come out with IPOs within a specified time frame, a precondition for such investments, according to a Mint analysis of data provided by Nexgen Capitals Ltd, the investment banking arm of Delhi-based stock broker SMC Global Securities Ltd.

This condition is built into share subscription agreements between promoters and shareholders, typically through put options, which give investors the right, but not the obligation, to sell back their shares in the company to its promoter if an IPO does not happen by a specified date.

"A number of pre-IPO rounds where an IPO was a clearly articulated expectation within a short period of time, are under pressure," said Harsha Raghavan, managing director of Candover Advisors India Ltd, the Indian arm of European private equity group Candover. Where covenants have been breached, companies have their backs against the wall, he said.

According to Jagannadham Thunuguntla, head of equity at Nexgen Capitals, Rs4,000 crore is a conservative estimate. "There are many companies which received pre-IPO funding, but have not yet filed their draft prospectuses with SEBI," he said. The Securities and Exchange Board of India, or SEBI, is India's capital market regulator. Details of pre-IPO placements in such companies are not publicly available.

In a few cases, the deadline for an IPO has not yet passed, but not too many firms are planning IPOs in the near future because of the downturn in the stock market.

Many pre-IPO deals were entered into in late 2007, when the Sensex, Bombay Stock Exchange's bellwether equity index, was still on its five-year winning streak and IPOs were attracting investors. In 2007, 105 companies raised a record Rs39,387 crore through public offers. That year, the Sensex gave an annual return of 47.15%.

But since January 2008, equity markets have slumped and the Sensex, after hitting its lifetime high that month, lost 52% in the year. This has dampened investor appetite for IPOs. There were only 28 IPOs last calendar year, raising Rs830 crore.

The first three months of 2009 have not brought much cheer either, with the Sensex remaining relatively flat – it is up 4.2% from the beginning of the year – and just one IPO that raised Rs23.84 crore.

Nexgen scanned 53 prospectuses of companies that have filed their draft offer documents, or IPO documents, with the capital markets regulator, but are yet to hit the markets.

Some firms still have time to meet their IPO deadlines, but not too many of them are planning IPOs.

Where precise details on the price at which promoters expressed their willingness to buy back shares in case an IPO did not materialise by a specified deadline were not available, Nexgen has taken value at cost or the value of the investment when it was made. "The other caveat is that for some companies, the date when promoters have to buy back, if the investor so desires, is sometime in the future," said Thunuguntla, who led the analysis.

Further, in some cases, a put option is not explicitly stated in the prospectus, though the date by which an IPO should go through is indicated. For instance, Reliance Infratel Ltd, which sold a stake worth about US$335 million (Rs1,691.75 crore) to seven investors on 30 July 2007, had said in its prospectus that it would make the "best efforts" to achieve an IPO within 18 months of the date of the agreement, according to Nexgen.

That means that the IPO should have happened sometime before 29 January this year.

However, the prospectus has not indicated the consequences if there is no IPO by that time, Nexgen data revealed.

“At the time of announcing the private placement of 5% minority equity to leading institutional investors, we had stated in our press release that Reliance Communications Ltd (which promotes Reliance Infratel) will pursue opportunities for further unlocking of value through RTIL (earlier avatar of Reliance Infratel, which was called Reliance Telecom Infrastructure Ltd) IPO and/or strategic sale at appropriate time,” said a spokesperson for Reliance Communications in an email.

He added that there was no put option in the agreement.

Other companies that made pre-IPO placements and also indicated a buy-back option was available for at least one of their investors include Acme Tele Power Ltd, Pipavav Shipyard Ltd, Persistent Systems Ltd, Ashoka Buildcon Ltd, Khadim India Ltd, Emaar MGF Land Ltd, Cellebrum Technologies Ltd, Virgo Engineers Ltd, Ramky Infrastructure Ltd, Tecpro Systems Ltd and India’s largest commodity exchange, Multi Commodity Exchange of India Ltd.

Two persons familiar with the matter who did not want to be named said that some investors in Acme Tele Power had exercised their options to sell shares back to promoters, but the promoters had not paid back as yet.

According to Nexgen data, three investors – DB International Asia Ltd, Earthstone Holdings Pvt Ltd and Kotak Mahindra Capital Co Ltd – had an option each to sell shares to the promoters if an IPO did not go through by 8 November 2008.

Since all three had exercised their options, the promoters of Acme Tele Power owe them about Rs197 crore.

A spokesperson for Acme Tele Power said that Earthstone and Kotak had been paid in full, while the Rs157 crore payment to DB International is being processed.

Mint could not independently reach out to all firms that have entered into such pre-IPO deals.

“In some cases, the promoters are saying ‘take me to court, I’m not giving your money back.’ But in most cases, the investor does not go for litigation because he does not want to be seen as hostile,” said Raghavan of Candover.

A court case could also go either way. “There’s not much of a precedent of litigation in such cases, so one really doesn’t know how binding the initial agreements are,” said Yashojit Mitra, a lawyer at Economic Laws Practice (ELP), a Mumbai-headquartered corporate law firm.

In some cases, where the investor does not want to move the courts, it is also looking for third-party buyers, according to the head of a Mumbai-based private equity fund, who did not want to be named.

In fact, it is not just the pre-IPO deals that have come under a cloud.

Most private equity deals done at a time when equity markets and company earnings were heading up seem to be undergoing some sort of restructuring.

“There are hundreds of cases coming to us with the mandate to restructure and fine-tune the initial terms of the agreements,” said Mitra of ELP.

One of the reasons for this is clauses, known as ratchets, which were built into a number of agreements between the investor and the promoter.

“One form of ratchets allow for variable pricing determined by a multiple of net income from a few years ahead. If the income is lower than projected, the private equity investor could end up taking a much larger stake in the company than originally planned,” said Raghavan.

In effect, that could mean the promoters of the company end up with such a small stake that they are left with no incentive to run it.

"Well-bounded deals, in which there is a ceiling on what the investor stake can go up to even if earnings of the investee company dip, don't need that much restructuring. That said, there's still a lot of give and take happening on the terms (of the initial agreements)," said the managing director of an India-dedicated private equity fund that has US$140 million under management. He did not want to be named.

Ashwin Ramarathinam contributed to this story.

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