Regulatory Alert

April 27, 2020

SEBI proposes measures to ease fundraising by financially stressed companies

The Securities and Exchange Board of India ('SEBI') has issued a consultation paper[1] and invited comments on proposals to relax the pricing norms applicable for a preferential issue by financially stressed listed companies. It has also proposed to grant an exemption to investors from making an open offer for acquiring a stake in such companies.

Background

Listed companies facing financial stress invariably require fund infusion to overcome the stress and avoid insolvency proceedings. Such companies may find it difficult to raise funds from conventional sources such as bank borrowing. However, certain financial or strategic investors may be willing to provide funds in exchange for acquiring a stake in the financially stressed company by way of a preferential issue.

Typically, when a company faces financial stress, inevitably, there is a reduction in the valuation of such a company and fundraising based on pricing methodology which is typically applied in growth scenario would be very challenging. Furthermore, valuations have also taken a hit due to Covid-19 pandemic. In such an environment, with a view to facilitating fundraising by financially stressed companies certain relaxations are proposed.

SEBI proposals

The SEBI consultation paper primarily deals with the following aspects, which are analysed in this alert:

- Criteria for determining a listed company as 'stressed';
- Pricing criteria for preferential allotment in a stressed company;
- Exemptions from open offer obligations;
- Conditions to avail these benefits.

[1] https://www.sebi.gov.in/reports-and-statistics/reports/apr-2020/consultation-paper-preferential-issue-in-companies-having-stressed-assets_46542.html

Determination of a ‘stressed’ listed company

The relaxations proposed by the SEBI are to be made available only to a listed company which qualifies as a ‘stressed’ listed company. Therefore, the criteria of determination of a company as ‘stressed’ assume significance.

According to the consultation paper, a listed company will be considered ‘stressed’ if it satisfies any two of the following three conditions:

- It has made disclosure of defaults on payment of interest or repayment of the principal amount on loans from banks, financial institutions or listed and unlisted debt securities for two consecutive quarters[2];
- There exists an inter-creditor agreement in terms of Reserve Bank of India framework for resolution of stressed assets[3] in respect of it;
- The credit rating of the listed instruments of the company is downgraded to “D” i.e. in default or expected to be in default soon.

Relaxation of pricing norms for a preferential issue

A preferential issue by a listed company is regulated by SEBI (Issue of Capital and Disclosures Requirement) Regulations, 2018 (‘ICDR Regulations’). ICDR Regulations prescribe pricing methodology for issuing shares to the identified investors under a preferential issue.

Under the pricing methodology, shares which are frequently traded, cannot be issued at a price less than the higher of the following:

- The average of the weekly high and low of the volume-weighted average quoted price of such equity shares during the twenty-six weeks preceding the relevant date;
- The average of the weekly high and low of the volume-weighted average quoted price of such equity shares during the two weeks preceding the relevant date.

It may be noted that listed companies which are undergoing insolvency proceedings under the Insolvency and Bankruptcy Code, 2016 (‘IBC’) have been, inter alia, exempted from applying the above pricing methodology. However, for listed companies which are facing financial stress but not facing insolvency proceedings under the IBC, the pricing guidelines pose a major challenge in raising funding through a preferential issue.

The share price of a company facing financial stress is typically on a downward trajectory and there could be a wide gap between the share price at the beginning of the twenty-six week period and the current market price. Therefore, the minimum price determined according to the methodology tends to be significantly higher than the current market price, making it impossible for such companies to raise funds through the preferential issue route.

In light of this, it is proposed to relax the pricing methodology for eligible stressed companies whereby the minimum price at which the equity shares can be issued under a preferential issue shall be the average of the weekly high and low of the volume-weighted average quoted prices of the equity shares during the two weeks preceding the relevant date.

[2] Refer SEBI Circular dated November 21, 2019 (https://www.sebi.gov.in/legal/circulars/nov-2019/disclosures-by-listed-entities-of-defaults-on-payment-of-interest-repayment-of-principal-amount-on-loans-from-banks-financial-institutions-and-unlisted-debt-securities_45036.html)
[3] Refer RBI (Prudential Framework for Resolution of Stressed Assets) Directions 2019 dated June 07, 2019 (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580&Mode=0)

Exemption from open offer obligations

Another challenge in funding a financially stressed company is that a financial or a strategic investor may be required to infuse a large amount of capital and may also want to acquire a large stake to steer the company out of financial stress. Such a large acquisition may result in the investor breaching the limits under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ('SAST Regulations') and may be required to make an open offer to acquire at least 26% equity shares from the public. Such an open offer could create a substantial financial obligation for investors and increase the cost of providing funding to the financially stressed listed company.

Considering this, it is proposed to exempt investors in the preferential issue of an eligible financially stressed listed company from the obligation of making an open offer under SAST Regulations. It may be noted that acquisition of substantial stake pursuant to a resolution plan approved under the IBC is already exempt from the open offer obligation.

Conditions to avail exemptions

It is proposed that a listed company shall be eligible to benefit from the proposed relaxations only if the following conditions are fulfilled:

- Investors participating in the preferential issue should not be part of the promoter or promoter group on the date of the board meeting to consider the preferential issue;
- The preferential issue should be approved by the majority of minority shareholders (i.e., excluding the promoters, the promoter group and any proposed investors in the preferential issue);
- Shares allotted under preferential issue to be locked-in for three years;
- Proposed use of proceeds of the preferential issue are to be disclosed in the explanatory statement sent for purposes of the shareholder resolution;
- A monitoring agency is to be appointed to monitor the use of the proceeds of such a preferential issue.

Dhruva Comments

This consultation paper from SEBI is very welcome and is aptly timed as it will help many listed companies which are undergoing financial stress.

The consultation paper correctly identifies pricing methodology for a preferential issue as a constraint in fundraising by a financially stressed listed company. While the proposals in the consultation paper significantly relax the pricing norm, it would be better if some further flexibility is provided in the pricing of the issue (for instance allowing issuers to offer a discount of up to 5% from the weighted average price – similar to a qualified institutions placement) with appropriate safeguards such as shareholder or SEBI approval.

Furthermore, it is proposed to provide a lock-in period of three years in respect of the shares issued under such a preferential issue. Again, some flexibility here would also be beneficial where shares in excess of a certain percentage are locked-in for a shorter period of, say, one year.

On the whole, the measures in the consultation paper, if implemented, will facilitate fundraising by way of a preferential issue in the current economic scenario and may aid such financially stressed companies from being subjected to insolvency proceedings under the IBC.

ADDRESSES

Mumbai
11th Floor, One IndiaBulls Centre,
Tower 2B, 841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate Road,
Ahmedabad - 380 015
Tel: +91-79-6134 3434

Bengaluru
Prestige Terraces, 2nd Floor
Union Street, Infantry Road,
Bengaluru 560 001
Tel: +91-80-4660 2500

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana - 122 002
Tel: +91-124-668 7000

Pune
305, Pride Gateway, Near D-Mart, Baner,
Pune - 411 045
Tel: +91-20-6730 1000

Kolkata
4th Floor, Unit No 403, Camac Square,
24 Camac Street, Kolkata
West Bengal – 700016
Tel: +91-33-66371000

Singapore
Dhruva Advisors (Singapore) Pte. Ltd.
20 Collyer Quay, #11-05
Singapore 049319
Tel: +65 9105 3645

Dubai
WTS Dhruva Consultants
U-Bora Tower 2, 11th Floor, Office 1101
Business Bay P.O. Box 127165
Dubai, UAE
Tel: + 971 56 900 5849

KEY CONTACTS

Dinesh Kanabar (Mumbai)
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Vishal Gada (Mumbai/Ahmedabad)
vishal.gada@dhruvaadvisors.com

Ajay Rotti (Bengaluru/U.S.)
ajay.rotti@dhruvaadvisors.com

Vaibhav Gupta (Delhi/NCR)
vaibhav.gupta@dhruvaadvisors.com

K. Venkatachalam (Pune)
k.venkatachalam@dhruvaadvisors.com

Aditya Hans (Kolkata)
aditya.hans@dhruvaadvisors.com

Mahip Gupta (Singapore)
mahip.gupta@dhruvaadvisors.com

Nimish Goel (Dubai)
nimish.goel@dhruvaadvisors.com

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