Preferential Warrants to Promoters

Followed in letter rather than in spirit

Sebi should impose a ban on issue of fresh warrants to promoters if they have failed to exercise their earlier warrants

Preferential issue of shares is one of the favorite options of promoters to increase their controlling stake. Preferential issues are governed by Chapter VII of Sebi (Issue of Capital and Disclosure Requirements) Regulations, 2009. Instead of directly subscribing to equity shares, promoters can avail another alternative by subscribing to preferential warrants convertible into equity shares. Promoters have to pay only 25% of the total amount upfront and the balance 75% can be paid during the next 18 months while exercising the option for conversion of warrants into equity shares. For subscription to equity shares, 100% of the amount has to be paid on allotment of shares.

The pricing formula for issue of preferential warrants is the same as that of preferential allotment of shares: the average price of the last 26 weeks or last two weeks, whichever is higher. Preferential warrants enable promoters to book the shares at the current market price. In case the promoters decide not to subscribe to the shares, the initial 25% amount paid by them is forfeited by the company.

When the BSE Sensex was below the 10,000 mark, most of the scrips were trading at very low levels. Therefore, promoters were quite optimistic that the shares can give decent return over the next two years. Accordingly, promoters made the best use of this opportunity by getting approval of shareholders for allotment of preferential warrants in their favor at prices arrived at as per the aforesaid pricing formula. Allotment of preferential warrants only requires approval of the shareholders by means of a special resolution passed at a general meeting. It is a child's play for promoters to obtain shareholders' approval as they not only hold substantial voting rights but also because general meetings are attended by a handful of the shareholders. Thus the approval of shareholders is a mere formality.

To prevent misuse of preferential warrants, Sebi increased the upfront amount to be paid at subscription from 10% to 25%. A circular issued on 24 February 2009 amended the erstwhile Sebi (Disclosure & Investor Protection) Guidelines, 2000. This was a step in the right direction. Promoters now have the fear of losing the 25% upfront margin paid if decide not to convert the warrants into shares. Still the 25% upfront payment is not a deterrent in view of the probability of windfall profit that promoters can make by booking the shares at the prevailing market price if every thing goes as anticipated. No wonder companies like Unitech, Ruchi Soya and KS Oils rushed to allot preferential warrants to their promoters immediately after the stock market started rallying in May 2009 enthused by the results of Lok Sabha elections.

Preferential warrants can also be issued to investors other than the promoters

If the promoters get a special resolution passed for allotment of two crore preferential warrants convertible into two crore equity shares at a price of Rs 50 per share (i.e, Rs. 10 face value share at a premium of Rs 40 per share), then they can subscribe to two crore equity shares at any time during the next 18 months at a fixed price of Rs 50 per share. The promoters would have to pay Rs 25 crores upfront at the time of subscribing the warrants and thereafter Rs. 75 cores at the time of exercising the option for conversion of warrants into shares. Suppose the share price rises to Rs. 120 per share during the next 18 months, then the investment of Rs 100 crores would be worth Rs 240 crores. In other words, by paying Rs 25 crores initially, the promoters can clock huge profit of Rs. 140 crore (Rs 240 crore–Rs 100 crore) within just 18 months. Although Sebi regulations stipulate lock-in of shares allotted on conversion of warrants for three years from the date of allotment, the fact is that preferential warrants still provide an excellent opportunity to promoters to play on the market because promoters can easily sell from the pre-preferential allotment shareholding as such shares are locked in for six months only from the date of conversion of warrants into equity shares.

The regulations permit issue of preferential warrants to investors other than the promoter group. But rarely have preferential warrants been issued to any entity other than promoters. The million-dollar question is: what is the logic of having an instrument that enables the promoters to give themselves preferential treatment as compared to other investors? The government ought to ensure a level-playing field for all investors. No one can refute the fact that the promoters are always in an advantageous position as compared with ordinary investors as they are privy to price sensitive in-

formation that is not in the public domain. Thus, whenever promoters feel that the company's share price is depressed or the company is on the threshold of rapid growth path, they can book large quantity of shares through preferential warrants by paying just 25% of the total purchase consideration.

Sebi must appreciate the fact that if promoters want to increase their controlling stake in the company to avoid takeover threats, they can easily do so by directly subscribing to the equity shares through preferential allotment instead of adopting preferential warrants. A benefit that is advocated in favor of preferential allotment is that it helps in garnering quick money needed by a company without much expenditure as compared with follow-on public offers and rights issue, which involve numerous formalities and high costs. Moreover, if the concerned company is not doing well financially, then public and institutional investors will be highly reluctant to risk their money by subscribing to the equity shares, whereas promoters always come forward to subscribe to the shares of their company as they are committed to support the company even under adverse circumstances.

No doubt, these arguments hold good to some extent for preferential allotment of shares. Preferential allotment indeed provide quick money to the company at minimal cost. But promoters only pay 25% of the total amount for preferential warrants and there is no certainty as to when they would pay the balance 75% amount. If the company needs the balance amount, say, within the next six months and the promoters do not have the surplus funds, they would opt for the conversion of warrants at their own sweet will. Thus, the company is not in a position to plan its cash flow. Further, if a company has good future prospects, then all the existing shareholders would be interested in subscribing to the new shares offered by the company. In other words, issue of preferential warrants to the promoters block the way for rights Issues, thus, denying an opportunity to retail investors to increase their shareholding in well managed companies at an attractive price.

Preferential warrants can be compared with stock option contracts that are traded on the stock exchanges. In both the cases, the gain of the holder of options and warrants is unlimited but the maximum loss is limited to the premium paid (upfront amount paid for preferential warrants). The

Promoters should pay 50% on subcription

major advantage of preferential warrants is that they enable the promoters to exercise the option for conversion into shares at any time during the next 18 months. In stock options, the contract has to be rolled over every month into the next series before the expiry. Every time a new stock option contract is purchased, the buyer has to pay premium. For preferential warrants, promoters have to pay only 25% of the total consideration upfront on subscribing the warrants and that too is adjustable against the total consideration amount when they opt for conversion of warrants into shares. Ordinary investors have to pay heavy premium if they wish to buy stock options to play on the market. Promoters, thus, have a decent instrument that provides them far better benefits at lesser cost.

Investors are better off opting for companies that are going ahead with preferential allotment of shares to their promoters rather than those that are issuing preferential warrants. This is because direct subscription to equity shares reflects far greater commitment on the part of the promoters as compared with preferential warrants that just give the option to the promoters to increase their stake, if thought appropriate, during the next 18 months.

The stock market trend is highly uncertain. Hence, there is always a possibility that the share price may dip below the conversion price. In such a situation, the promoters may not at all opt for conversion of warrants into equity shares as has already happened during the stock market meltdown in 2008. Promoters of companies such Reliance Infrastructure, Aditya Birla Nuvo, Usha Martin and Monnet Ispat did not opt for conversion of their warrants. If the sole objective of the promoters is to increase their controlling stake, they can easily do so by purchasing the shares from the stock market at comparatively lesser cost. For example, if warrants have been issued at Rs 50 per share and the share price falls to Rs 25 per share, then the promoters can acquire further shares from the market at Rs 25 per share instead of paying the balance amount of Rs 37.50 per share (75% of Rs. 50) for conversion of warrants into shares.

Promoters quite often resort to another option: to get a fresh shareholders' resolution passed for issue of new warrants at reduced price. Thus, they can try their luck once again through the new warrants. An important fact that has come to light is that the whole idea behind subscribing to preferential warrants is to book the shares at the current market price so that any uptrend in the stock price can be fully enjoyed. If the real intention is to provide funds to the company for financing its expansion and modernization projects or for meeting working capital requirements, then the promoters would in any case opt for conversion of warrants into equity shares and pay the balance 75% amount irrespective of the market price of shares.

A better alternative to the preferential warrant route is to allow the promoters to subscribe to the shares directly and pay 50% amount as application and allotment money and the balance 50% amount can be called by the board of directors in one or more calls, depending upon the fund requirements of the company. Sebi has replaced Sebi (Disclosure & Investor Protection) Guidelines, 2000 with the Sebi (Issue of Capital & Disclosure Requirements) Regulations, 2009 from 25 August 2009. This was the best opportunity to scrap or amend the provisions relating to the issue of preferential warrants to promoters. However, Sebi has opted to continue with the same provisions governing preferential allotments. At least, Sebi should impose a ban on issue of fresh warrants to the promoters if they have failed to exercise the earlier warrants because re-issue of fresh warrants at reduced price is blatant misuse of the regulations. This small step on the part of Sebi can go a long way in boosting the confidence of retail investors.

—Rajesh Relan