Takeover regulations

A fine balance

Scrapping non-compete fees and expanding the open offer size to 100% favour small investors

Is the over-the-counter payment of non-complete fees to promoters of an acquired company really an under-the-counter deal to get their acceptance? The Anil Agarwal-led Vedanta group plans to acquire 51%-60% of Cairn India for US$ 8.5 billion to US$ 9.6 billion in an all-cash deal. The price to be paid by Vedanta to the promoters is Rs 405 per share compared with the price of Rs 355 per share to be paid to the public shareholders, Rs 50 per share being the non-compete fee. Thus, the promoters will get non-compete fee of around Rs 6000 crore, while the non-promoter shareholders will lose out Rs 3570 crore as they will not receive any compensation equivalent to the non-compete fee.

The rationale behind payment of non-compete fee to promoters is to prevent them from once again starting the same line of business. In many takeover offers, the amount per share paid to promoters is up to 25% higher than the amount paid to public shareholders.

To provide a level-playing field to the public shareholders, the Takeover Regulations Advisory Committee (Trac) set up by market regulators Securities and Exchange Board of India (Sebi) has recommended that the flexibility of paying up to 25% of the total purchase consideration to promoters as non-compete fee be withdrawn. This will prevent payments to promoters couched as 'control premium' or 'non-compete fee'. Thus, all payments made to promoters will have to be factored in while calculating the price to be paid to public shareholders under the open offer. The proposed change will be a great relief for the public shareholders, who quite often get a raw deal in the takeover transactions even as promoters laugh all their way to the bank.

Under the proposed regulations, voluntary open offer for 10% of the equity capital as well as the creeping acquisition limit of 5% every year will be available only to the promoters whose shareholding is more than 25%. This proposal, therefore, may create problem for promoters presently managing the show with little over 15% stake because as soon as they hit the threshold limit of 25% shareholding, they will be under obligation to make a mandatory open offer to buy the entire non-promoters' shareholding. At present, the promoters have to make an open offer for 20% of the equity capital only if the annual creeping acquisition is more than 5% or their aggregate shareholding crosses 55%. It will be beneficial for such promoters to increase their shareholding to at least 25% before the new regulations set in. Otherwise, they will be deprived of the flexibility to shore up their shareholding in a phased manner either through creeping acquisitions or through the voluntary open offer.

Regulation 20 of the Sebi takeover code provides the parameters to be considered for determining the minimum price to be paid to public shareholders under an open offer. The offer price depends on the frequency of trading of shares of the target company. 'Frequently traded shares' means shares that have annualised trading volume of 5% or more of the listed share capital in six calendar months preceding the month in which the public announcement is made.

If the shares are frequently traded, the open offer price will be the highest of the negotiated price paid by the acquirers to the promoters, under the agreement for acquisition of the target company, that triggered the open offer. The offer price could also be higher than the price paid by the acquiring company or persons acting in concert with it for acquisition of shares, if any, including by way of allotment in a public or rights or preferential issue in the 26-week period prior to the date of public announcement, also termed as 'look back period'.

Another benchmark will be the average of the weekly high and low of the closing prices of the shares of the target company on the stock exchange, where the shares are most frequently traded, in the last 26 weeks or in the last two weeks preceding the date of the public announcement, whichever is higher.

Under the current takeover regulations, the look-back clause requires the acquirer to take into account the highest price paid by him or by persons acting in concert in a public, rights or preferential issue, over 26 weeks prior to the date of the public announcement. The relevant provisions on look-back period in other countries range from three months for voluntary offers in Singapore and Hong Kong to 12 months in United Kingdom. Trac, therefore, felt that a look-back period longer than the currently

applicable 26-week period will ensure that the acquiring company does not get an opportunity to postpone the public announcement at a marginal carrying cost just to overcome paying public shareholders the price it has actually paid in the proximate past. In view of this, a look-back period of 52 weeks has been recommended.

While considering continuing the linkage between market price and open offer price, Trac concluded that the 26-week average of the high and low of the closing prices of the share at the stock exchange is too long a period, whereas the two-week average is too volatile. The 26-week average price can diverge considerably from the spot price on the date of announcement of an offer and such a distortion would impact the ability to strike merger & acquisition (M&A) transactions in bear markets. For example, there were periods in the 2008-09 bear market when the 26-week average price was over 60% above the spot price of several individual stocks. Thus, even if acquirers were willing to pay premium of 10%-20% over the spot prices to carry out M&A transactions, they were regulated by a regime due to which minimum offer price was as much as 60% higher than the spot price. Accordingly, M&A transactions would not take place, which would be detrimental to the interest of all the stakeholders.

On the contrary, in bull markets, the 26-week average was significantly below the prevailing market price, rendering the parameter irrelevant, as acquirers tend to be guided by the spot prices while taking decision. Based on the data and deliberations, Trac decided to use the 60 trading days volume weighted average price (VWAP) as a market price parameter instead of the 26-week average market price. The parameter of the average of last two weeks' closing prices has been dispensed with.

The concept of the average of the weekly high and low of the closing prices is proposed to be substituted with VWAP to ensure that the resultant price is more representative and accurate as it eliminates the outlier effects of high and low prices.

Trac has recommended that the acquirer pay the highest of the negotiated price under the agreement that triggered the open offer, or VWAP paid by the acquiring company or persons acting in concert with it in the preceding 52 weeks, or the highest price paid by the acquirer in the preceding 26 weeks, or 60 trading-day VWAP price.

Trac has further proposed that there should be a reference date for calculating the open offer price. 'Reference date' is the date on which the acquisition of the parent company is announced in the public domain, or the date on which the parent enters into any agreement, whichever is earlier. In a way, the acquirer will get protection from the volatility in the share price of the Indian listed company on the stock exchanges as soon as the deal is announced. Hence, the foreign acquirer will have much more certainty with respect to the price to be paid under the open offer.

When the Netherlands-based company, Disa Holdings, was acquired, no official public announcement was made overseas as the company was unlisted in the Netherlands. Therefore, Disa Holding's listed Indian subsidiary, Disa India, claimed there was no reference date linked to the parent transaction at all. Hence, no such date had to be used for calculation of price under the open offer. The Securities Appellate Tribunal upheld that view.

Trac has proposed that the reference date could be any date on which the parent's acquisition comes into the public domain, and not just an official public announcement date. Interest at 10% per annum will have to be added to the open offer price if the time gap between the announcement of the parent deal and the public announcement for the target company listed in India exceeds five days.

Ringing in the new

The takeover panel on trigger, open offer size and tax treatment

The takeover regulations framed by the Securities and Exchange Board of India (Sebi) are all set for a makeover, with a committee set up by the market regulator under the chairmanship of C Achuthan, former presiding officer of the Securities Appellate Tribunal, virtually rewriting the Sebi (Substantial Acquisition of Shares & Takeovers) Regulations, 1997. The Takeover Regulations Advisory Committee (Trac) has proposed sweeping changes, which would change the way of takeovers of listed companies. The recommendations of Trac are not only in line with the global best practices but also lay special emphasis on the protection of the interests of the minority shareholders.

- Trigger point for the mandatory open offer to the public shareholders has been raised from the existing 15% to 25% of the voting capital of the listed company.
- Open offer have to be made even if an acquirer through the acquisition of ADRs or GDRs acquires 25% or more voting rights.
- Overall timeline for open offer has been reduced from 97 days to 57 days.
- Acquirer(s) will have to give open offer equivalent to 100% of the paid-up equity capital of the company instead of open offer of just 20% of equity capital under the existing Regulations.
- To consolidate their shareholding, promoters can come out with a voluntary open offer representing at least 10% of the paid-up share capital of the company instead of the present requirement of minimum 20% open offer.
- The upper limit for creeping acquisitions by promoters has been increased from the existing 55% to 75% of the voting capital. The annual ceiling for creeping acquisitions will continue to be 5%.
- Trac has recommended to bring about parity in the tax treatment of the shares sold at the stock exchanges and those tendered under the open offer as long-term capital gain on shares sold at the stock exchanges after payment of the securities transaction tax (STT) is fully exempt from tax whereas no such tax exemption is available in respect of the shares sold through the open offer route, as STT is not levied. This recommendation will have to be separately considered by the, Ministry of Finance.

Two-in-one transcation

The proposal that the open offer must equal the aggregate number of shares held by all the non-promoter shareholders may breach the minimum public float of 25%

All listed companies except government entities have to maintain minimum public float of 25% as per recent amendment in the Securities Contracts Regulation Rules, 1957 (SCRR). The Takeover Regulation Advisory Committee's (Trac) proposal that the size of the open offer must be equal to the aggregate number of shares held by all non-promoter shareholders may lead to breach of the minimum public float of 25% specified under SCRR if the response to the open offer is good.

Trac has suggested that, when the delisting clause is triggered, the acquirer may either opt for delisting of the company from the stock exchanges or may bring down its shareholding to 75%. Thus, if the acquirer lands up with more than 90% shareholding, the delisting threshold, on closure of the open offer, the company can be delisted at one go.

If the open offer, however, results in the acquirer holding between 75% and 90% of the target company, the acquirer can either choose to delist by increasing the shareholding beyond 90% through subsequent acquisition of shares or may acquire the shares in the current open offer on a pro-rata basis so that the promoters' shareholding does not exceed 75%. If delisting of shares takes place, public shareholders who had not participated in the earlier open offer will be given an opportunity to tender their shares at the same price during the next 12 months.

To delist the target company, the acquiring company has to state its intention upfront. If the delisting threshold is reached without any prior disclosure in this regard in the open offer document, the acquiring company will be required to either proportionately reduce both its acquisition under the agreement that triggered the open offer and the acquisition under the open offer or bring down its shareholding through alternative means so that minimum 25% public float is maintained.

The union of takeover and delisting offers as part of the same transaction will save acquirers from the cumbersome and expensive reverse book-building method required pursuant to Sebi (Delisting of Equity Shares) Regulations, 2009. However, delisting of companies through the takeover route is not desirable. Although shareholders get one-time decent gain, the long-term wealth creation opportunity is lost forever. It seems quite contradictory that, on the one hand, government has amended the SCRR, on 4 June 2010 to increase the public float in listed companies to at least 25% but, on the other hand, Trac has in its report dated 19 July 2010 recommended delisting of companies as part of the open offer pursuant to the takeover regulations.

When there are separate regulations framed by Sebi to deal with delisting of companies, with lot of in-built safeguards such as approval of non-promoter shareholders by means of a special resolution passed through postal ballot and in-principle approval of the stock exchanges, it is very unfair to compromise on such investor protection measures just for the sake of facilitating simultaneous takeover and delisting of the target companies.

In 2005, a Ruia-controlled Singapore-based special purpose vehicle, Wealth Sea, had indirectly acquired 74.5% voting power in Dunlop India through the acquisition of its British Virgin Islands-based parent. As the transaction was structured as an indirect acquisition, no open offer was made until 2007, when Sebi stepped in and ruled that an indirect change of control must result in an open offer.

Trac has recommended that a 100% open offer must be made for all indirect acquisitions, whenever there is a change in control in an Indian listed company, irrespective of the indirectly acquired company being material to its parent. That is unlike most of the foreign jurisdictions, which have specified materiality thresholds. Foreign acquirers in the UK, for example, need not make an open offer if the target company constitutes less than 50% of its parent's assets or profit. Hong Kong has a 60% threshold. In Singapore, it is based on significant contribution. In Germany, it's 20%. Just because a company is not a material part of a larger transaction, does not mean that a change in control should not lead to an open offer. Any change in control under all circumstances has to lead to an open offer as the guiding principle behind the code is that there should be provision for exit opportunity for public shareholders whenever there is a change of ownership or control.

The only 'materiality' criteria that Trac has specified is for determination of the open offer price. If the indirectly acquired company forms a significant part, that is, more than 80% of the net asset value or sales turnover of the parent company, or 80% of the deal value, then such an acquisition will be treated as direct acquisition and the price for the 100% open offer will be determined accordingly. If the indirectly acquired company is less than 80%, then the 100% open offer will be priced based on separate indirect acquisition pricing norms.

Trac has strived to strike a fine balance between the interest of promoters, acquirers and minority shareholders. Minority shareholders, so far neglected in takeover transactions as the promoters got privileged price in the form of non-compete fee or control premium, will have a lot to cheer. Not only this, all investors will have equal opportunity to sell their shares to the acquirer. The proposed changes will go a long way in the protection of the interest of public shareholders.

— Rajesh Relan