Assessing the IPP and OFS Methods

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Background

Change is the only constant, and this adage has immense relevance even for the Indian capital markets. Indian markets have a large number of companies that are listed on the national stock exchanges but are not actively traded. Hence, it was with a view to improving liquidity and price discovery in listed companies that the Ministry of Finance ("MoF") sought to amend the Securities Contracts (Regulation) Rules 1957 (SCRR). The revised SCRR rules stipulate that all listed companies with public shareholding below 25%, have to increase public shareholding to at least 25% (10% for public sector undertakings) within a certain time period. Such minimum public shareholding is to be achieved prior to June 4, 2013 or three years from the date of listing, as the casemay be.

Prior to this, companies with a minimum issue size of Rs. 100 crore could get listed with a minimum public holding of 10% which translated into a market capitalisation of Rs. 1,000 crore. These companies and public sector undertakings could get listed and stay listed with the 10% public holding threshold. For all other companies, the threshold was 25%.

Companies could achieve the minimum public shareholding using any of themodes prescribed under clause 40A of the Listing Agreement. The modes mentioned in the Listing Agreement included (i) further issue of shares to the public through issue of new capital or offer for sale by promoters; and (ii) through secondary market operations (block or bulk sales of promoters' shareholdings), however, with the prior permission of the Stock Exchanges. This led to a situation where private block or bulk deals were preferred by the promoters of companies that did not need to issue fresh equity. This, however, was not achieving the desired objectives of *transparency*and *broad-basing*, as these were negotiated dealsplaced with a select group of investors. Moreover, as these investors were usually institutional buyers,who were either consolidating their holdings or entering a company afresh, there was not a significant increase of liquidity. Additionally, the companies that needed to issue fresh equity and were at a public shareholding level of less than 25% had to necessarily do a Follow-on Public Offering and could not raise capital through the Qualified Institutional Placement (QIP) route or preferential issue route.

As the capital market regulator, SEBI does appreciate the challenges of a public issue given the time and cost involved; the concerns around pricing; the inadequate retail response, etc. This led to deliberations with stock exchanges and market participants to think of alternate routes that corporates/ promoters can use efficiently to enhance public shareholding, keeping in mind the two fundamental principles of *Broad Basing*and *Transparency*.

The public issue formats followed in India are probably the most progressivein terms of broadbasing and transparency. Public issues in India permit all investor categories to participate directly in an offering.There are substantial portions of the offer carved out for retail participation, in addition to non-institutional and institutional investors. We also have a very public and transparent book building system where investors, issuers and advisors alike can stay updated on the status of the offering, at any given point in time.

Hence, while not deviating from these two tenets, the 'Institutional Placement Programme' and 'Offer for Sale through the Stock Exchange Mechanism' were two new products that were developed and notified. These products can be used only by listed companies that are not compliant with minimum public shareholding norms of 25% (10% for public sector undertakings). The Offer for Sale Mechanism can additionally be used by the top 100 listed companies by market capitalization.

The Institutional Placement Programme ("IPP")

The Institutional Placement Programme, IPP for short, is a public issue targeted at qualified institutional buyers, which include mutual funds, banks, insurance companies, foreign institutional investors, venture capital and private equity funds, among others. This route can be used by promoters/ promoter group to divest their shareholding in a listed company to the extent required to achieve minimum public holding of 25%. The mechanism is similar to a public issue and involves preparation of an offer document; filing the same with the Registrar of Companies; complying with marketing and publicity restrictions; issuing public advertisements on issue announcement, etc. However, unlike a QIP which is a private placement to QIBs, there are no floor price requirements in IPP. Also, the fleet footedness of the product makes it significantly superior to a full-fledged public issue as it saves on both time and cost. Godrej Properties was the first company to use the IPP route to dilute promoter stake through issue of new capital.

Via the IPP route, companies can increase public shareholding by raising fresh capital, thereby dilutingpromoter holding. Alternatively, the promoters can offer for sale their shares through the IPP process, thus reducing promoter holding. The choice of allocation methodology rests with the issuer – be it based on proportionate, price priority or any other pre-specified criteria, provided it is disclosed in the offer document.

One of the challenges of the IPP product, especially when the market sentiment is not buoyant, is that while the product is targeted at institutional investors, it may be not always be possible to haveatleast 10 allotteesin every deal, irrespective of size or float available. While the disclosure requirements are reasonable, the process features are similar to that of an IPO; including the need to issue advertisements; send forms and prospectuses to all stock exchanges, have a bidding centre in all cities where there is a stock exchange, etc. Some of these requirements are probably worth reconsidering, given the fact that an IPP is targeted at QIBs, and all applications have to be made in ASBA mode.

The Offer for Sale (OFS) Mechanism

The OFS mechanism is akin to a public issue on the floor of the exchanges.It can be used by promoters/ promoter group to divest their shareholding in a listed company to the extent required to achieve minimum public holding of 25%. In addition, promoters/ promoter group entities of the top 100 companies by average market capitalisation of the last quarter can also use this route to dilute promoter holding. This product was used recently by the Government of India to divest their stake in ONGC as a part of the disinvestment plan.

All categories of investors can participate in purchasing shares in the OFS. While there are no specifications on floor price, the seller has to declare a floor price in advance or choose to give the floor price in a sealed envelope to the stock exchange to be opened post issue closure. Allocation can be either on a proportionate or price priority basis. However, the seller has to notify the market about the offer for sale atleast one clear day before executing the OFS. This notice has to carry details with respect to the size of the offer, names of the selling shareholder(s), basis of allocation, among others.

To ensure that some broadbasing is achieved, no single investor (other than mutual funds and insurance companies) can get allotted more than 25% of the offer size. Further, subject to demand, atleast 25% of the book will be allocated to mutual funds and insurance companies.

Based on experiences of a few launched deals, thefact that investors are required to back bids with 100% cash marginhas acted as a deterrent for investors to come into the book. This may have been accentuated by the fact that allocation was being made on a price priority basis and hence, even after giving 100% cash margin, investors were not sure if they would receive any allotment, especially if the floor price is not announced. Hence, in the interest of investors and for the success of transactions, the requirement for full margin has been re-looked atby SEBI and there is now a provision for institutional investors to pay a lower adhoc margin (to be determined by the stock exchanges) instead of 100% cash margin. However, this comes with a restriction that such investors cannot modify or cancel their bids. It was also observed that the stock price of companies have been -adversely impacted by the fact that the OFS price announcement was made one clear day before the transaction and on that clear day, particularly for scrips that trade in the F&O segment, there were speculative trades, affecting the stock price. Hence, delinking the announcement of the deal from the announcement of the floor price was the solution proposed by the regulator.

Companies have time till June 2013 (or three years from the date of listing, if listed after June 2010) to comply with minimum public shareholding norms. For companies with large market capitalization, compliance would need to be achieved through tranches. With the requirement of a 12-week blackout period between two OFS issues, there ismost probably insufficient time for companies to achieve full compliance within the set deadline. Hence, reduction of this blackout period from 12-weeks to 2-weeks was considered by the regulator and that amendment has also come through.

Way forward

Keeping the larger objective in mind of having broad-based shareholding in listed companies in India, what needs to be seen is whether these two new mechanisms will indeed help in increasing public shareholding in the specified timeframeor whether the deadline will have to be extended. In a scenario that companies have to adhere to the June 2013 deadline, regulators and policy makers have to be mindful of the current market environment. There are approximately a hundred companies with marketcapitalisation of over Rs. 100 crore that have public shareholding of less than 25%. Based on current market prices, an aggregate of more than Rs. 20,000crore of stock has to move from promoters to the public. With a number of companies trading near their 52-week lows, coupled with a grimglobal and domestic macro-economic environment, the state of the currencyand with low inflows by FIIs into this country, it is a tall ask.

Suitable amendments to the regulations as outlined above will make the IPP more appealing. Required amendments to the OFS product were announced by SEBI in June 2012. However, that in itself may not suffice given the fact that there is limited investor interest in helping this cause of companies/ promoters. In fact, a number of multinational companies that have remained listed without much engagement on this front will be forced to make a choice on the path they will take – Delisting or Staying Listed.

Every new product has to go through a process of evolution and development and for both the IPP and OFS, we are currently at that stage. Having introduced it for a well-defined purpose, with most pegs in place, we have to wait for companies' and investors' experiences to play out and have an open mind to introducing meaningful and necessary amendments. Subject to stable market conditions, this will surely give the listed companies a great platform to achieve the objective of reasonable public shareholding and liquidity.

This might also be the right time to consider the objectives and solutions afresh, keeping experiences and market realities in mind. A blanket requirement of 25% public holding can be onerous to comply with,atleast in the short term. A combination of factors such as market capitalization, number of existing shareholders, liquidity in the stock, traded volumes over a reasonable period of time etc. could be considered while determining eligibility of a company to adopt the route to achieve minimum public shareholding. The threshold of minimum public shareholding should also be debated in the light of the parameters considered. The routes available to the companies/ promoters could include follow-on public offerings, IPPs, OFS, block/ bulk sales, acquisitions, preferential allotments, etc. Deliberations on these considerations can be carried out between the regulators, industry representatives, investor representatives as well as market intermediaries. That should help achieve a win-win solution for all concerned.