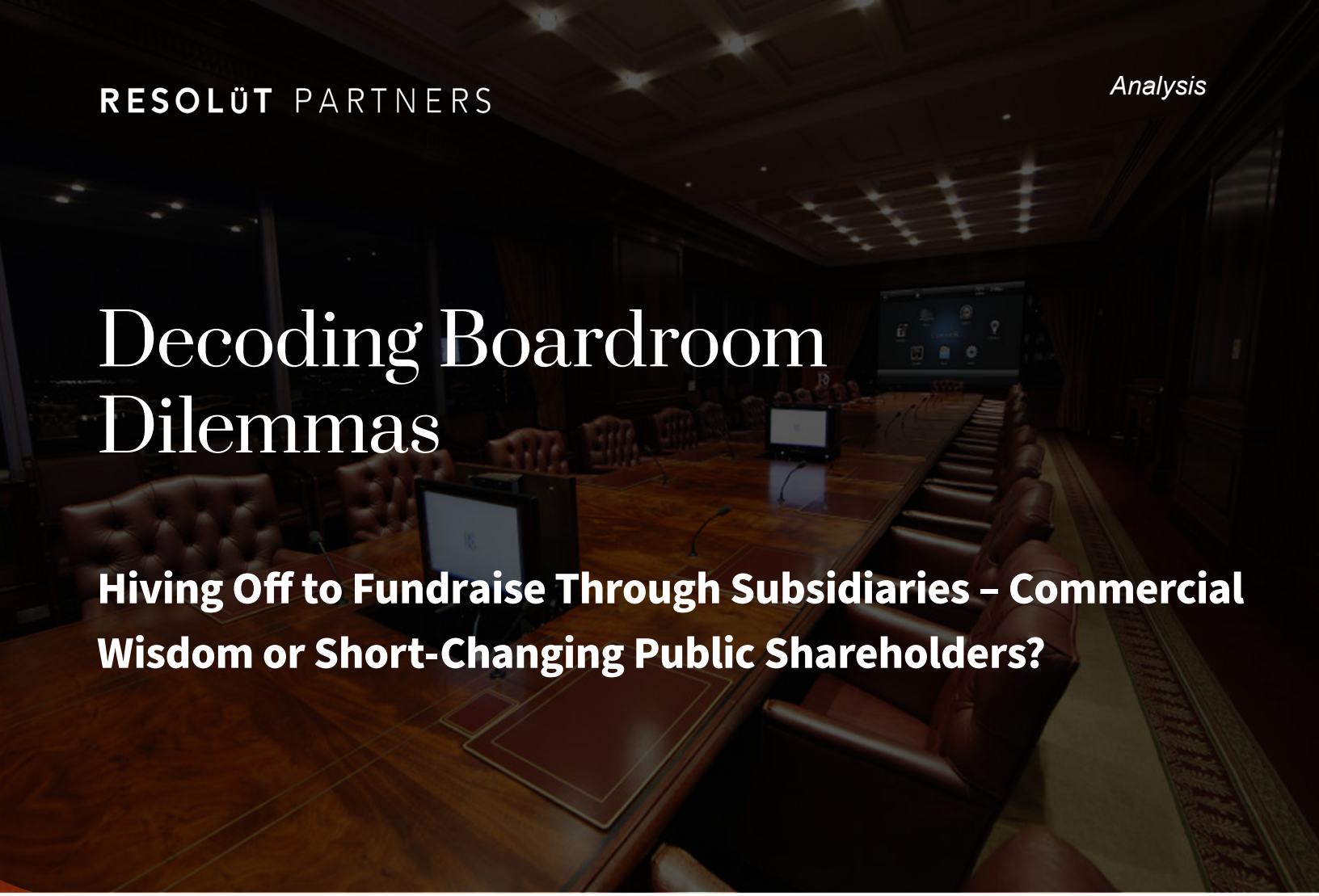


Decoding Boardroom Dilemmas

Hiving Off to Fundraise Through Subsidiaries – Commercial Wisdom or Short-Changing Public Shareholders?

Key Takeaways

- Transferring a majority-revenue generating business into a private subsidiary (hiving off) and raising funds at the subsidiary level is increasingly seen as a preferred alternative to direct listed acquisitions or slump sales
- Hiving off may result in a 'holding company discount' and public shareholders lose out on value
- Public shareholders' involvement in moving businesses downwards or raising further funds is extremely limited, permitting promoters to proceed unhindered with such transactions
- Directors should exercise diligence and business judgement, reconcile commercial imperatives with shareholder interests, record robust reasoning and put in place necessary mitigants before approving such structures

About ‘Decoding Boardroom Dilemmas’

Placed squarely between the imperatives of maximising shareholder value and protecting stakeholder interest, Indian directors can no longer claim the benefit of a one-dimensional approach to governance. The transfer of revenue-generating businesses to subsidiaries, dissemination of unpublished price sensitive information to nominating shareholders, and undervalued fund raises are just a few of the key dilemmas faced by directors of listed companies which underscore this position.

Elsewhere, enhanced scrutiny from shareholder activism has already reframed approaches to corporate stewardship. Directors have come under fire for failing to meet environmental targets (eg: the board of Shell being sued for failing to prepare for the net zero transition). Large shareholder/promoter-centric approaches have been criticized for enabling corporate functioning at the expense of public shareholders, compromising long-term value and holistic wellbeing.

How then should the modern director make a decision? What must they consider? Whose interests must they protect?

Part of this answer is rooted in Indian company law (s. 166) – which requires directors to apply independent judgement, exercise diligence and maximize value for all stakeholders. Balancing this with conventional commercial considerations may be more challenging.

This article is part of a series examining key dilemmas faced by Indian directors, culled out from our experience as advisors to boards and investors in listed companies. In each of these cases, the bottom-line is clear: when taking decisions, the buck does not stop at protecting corporate interest – decision-making must visibly enhance value the most for stakeholders, or be backed by strong reasoning for failing to do so. Otherwise, directors risk market condemnation, regulatory scrutiny and shareholder (perhaps even appraisal) litigation.

Background – Listed Companies Hiving Off Businesses to Subsidiaries

What happens when a large investor believes in the underlying business of a listed company but refuses to invest directly into the listed stock on account of regulatory/ commercial limitations? This is a question that directors in listed companies often face. One straightforward solution is for the listed company to demerge its value accretive businesses into a separate entity and then raise funds. However, the other emerging alternative is to have the listed company transfer its majority-revenue generating business into a private subsidiary i.e., ‘hiving-off’, followed by a subsequent fundraise at the subsidiary-level. This move naturally avoids a tender offer for the incoming investors and ring-fences their exposure to the subsidiary. But is such a move truly beneficial for all the stakeholders, especially the public shareholders?

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To Hive or Not to Hive?

Hiving off for the purposes of fundraising in a listed company raises clear concerns for public shareholders. First, hiving off is typically done with the comfort that 'value consolidation' will take place i.e., it should not matter if the business of the company is held in the listed parent or within its subsidiary, since the value of the business remains consolidated. Unfortunately however, many listed companies which house businesses in subsidiaries suffer from significant 'holding company discounts'. The tax implications on any returns upstreamed by the subsidiary two levels up to the public shareholders (via the listed parent) are severe – with at least two layers of corporate tax and one layer of distribution tax. Net-net, the public shareholders in some cases ultimately receive nearly 25-30% lesser returns comparatively. Hiving off may therefore be value-diminutive at the very threshold.

Second, ratification by public shareholders is significantly limited in such structures, on two counts. Listing regulations in India exempt transactions between a listed company and its wholly-owned subsidiary from typical related-party transaction requirements. Thus, there is no requirement for promoter/controlling shareholders to sit out of voting on subsidiary hive-off transactions. While business-transfers may still require a special majority approval from shareholders, opposition by public shareholders, who generally hold only ~25-30%, is unlikely to have an impact on the final decision (since the promoter shareholding significantly outnumbers public shareholders').

Shareholder voting is again constrained at the time of fundraising – when done at the private subsidiary level, consent is only required from the subsidiary's immediate shareholders, i.e., the listed parent company, and not from the ultimate public shareholders. Public shareholders will therefore have no say on deal mechanics, namely the price and extent of business being sold. They also lack control or visibility over how the funds are used by the subsidiary. Presumably, the law exempts holding company-wholly-owned subsidiary transactions from related-party rules on the premise that value will remain consolidated within the group. However, divesting a stake in the subsidiary after acquiring a business from the listed parent seems to fall short of fulfilling the spirit of the law since value is no longer locked in, especially when the holding company discount is considered. Optically, such a transaction also invites scrutiny into why processes under the SEBI Takeover Code have been sidestepped (though this is not legally prohibited).

Commercial Justification and Directors' Duties

Sales to subsidiaries and follow-on fund raises need not always be viewed adversely. Listed companies may seek to push well-performing verticals into separate businesses to attract flagship investors, invite high premiums, and avoid regulatory red-tape. With necessary commercial justifications in place, a not-so-optimal structure may also be reconciled with the interests of public shareholders.

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How can directors achieve this, especially considering the heightened fiduciary duty expected of them in contemporary public markets? First, directors should record clear, cogent and comprehensive commercial reasoning for why such a transaction is being undertaken. One aspect which needs to be proactively addressed is the holding company discount (i.e., the loss in value when upstreaming returns/sale proceeds to public shareholders) and how value maximization and growth is actually achieved in excess of/despite such discount. Directors must engage experts, deliberate thoroughly and document the processes they have adopted while undertaking such a decision. There is no one-size fits all answer for this, and the law would do well to avoid over-prescription for obvious reasons. It is therefore incumbent upon directors to demonstrate where the value addition arises.

Second, even where it is not legally required, directors should seek a shareholder approval for both the hiving off and fundraise transactions. Considering the significant stake involved and the avoidance of related-party rules on a technicality, there is a strong argument for promoters to consider sitting out from voting. Directors must keep in mind that public shareholders may realize lesser value in their hands than they would have had the investment taken place at the listed company directly. It is therefore critical to provide shareholders regular notices/updates. Directors should aim to be completely transparent through the deal process, including inter alia providing visibility on the reasons for adopting the hive-off route, end-use of fund raise proceeds, future growth plans and the ultimate play to generate returns for public shareholders. Similar visibility should also be provided to key suppliers, customers and employees of the company as well.

Third, directors should consider actively engaging with proxy advisory firms and press management agencies. Following robust processes and thorough reasoning is only half the story – directors should be able to aptly communicate the value of what they have done. Else, public shareholders are unlikely to see merit in what is being done, even if it is in their best interests.

Directors must keep in mind that while the sale of a listed company's majority revenue-generating business through a subsidiary may be commercially attractive, the move appears as a means to sidestep rules in takeover regulations, though this may not be the intention. The above mitigants are tools to ensure that directors fulfil duties expected of them, as arbiters of various stakeholder interests and as custodians of corporate governance, a subject which is increasingly within the purview of market participants.

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Conclusion

The above analysis presents critical mitigants to a dilemma frequently observed in the public markets space. While there are many others, especially in light of an activist ecosystem and an (over) vigilant regulator, several lessons run undercurrent across all. There is an urgent need to provide shareholders visibility on how important decisions are being taken and how shareholder interests are likely to be impacted, especially in cases where the impact is significant. To this end, it is critical for directors to follow through on their commitments to transparency. The mantra for directors in such situations - take well-reasoned steps and prioritize stakeholder interests over selective shareholder interests.

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