

Takeover and Corporate Governance in India

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Executive Summary

- Takeover plays an important role in corporate governance from agency perspective.
- SEBI SAST 2011 attempted to amend the takeover code to provide a legal and transparent framework for takeovers and to ensure a mandatory exit for investors.
- Impact of the amendments on open offers indicates that the regulations have been able to ensure regulatory compliance but not an active market for takeovers.
- There is a considerable convergence to international takeover regulation, but often at the cost of the institutional perspective of the country.
- There is a need for a simplified regulation which extends to safeguard interests of all stakeholders and create an environment for hostile takeovers.

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I. Case for Takeover Regulation

Takeovers are considered to be corporate events with tremendous implications for the shareholders. Some of the benefits to the shareholders include better allocation of resources, synergy gains, better management discipline, and more accurate market valuation¹. However, often takeovers fail to yield these benefits due to the risks associated with takeover, broadly emanating from “agency” problems. There are two kinds of agency problems: one between the management and the shareholders and the other between the major and minor shareholders.

From the perspective of takeover, the conflict of interest between shareholders and management can occur when a potential acquirer firm wants to take over a firm to change control. Acquirers would be willing to pay a premium over market price to effect a takeover. In principle such a takeover would be value maximizing for the shareholders. However, the management of the target firm might thwart such takeovers to avoid being fired from the firm once the firm is acquired.

Conflict of interest can also occur between the firm’s major and minority shareholders in the context of takeover. Suppose an acquiring firm believes that it can achieve synergy gains by taking control of the target corporation. One of the least expensive alternatives would be to acquire the shares in the open market or to purchase it from a majority shareholder. In the event of a negotiation between the acquirer and majority shareholder, the minority shareholder might be left out.

In both situations, there is a loss accruing to shareholders of the firm. This provides a case for introduction of takeover regulation with the objective of creating a market for takeovers and the protection of investors, particularly, the minority shareholders.

II. SEBI Takeover Code and Corporate Governance

The SEBI Substantial Acquisition of Shares and Takeovers (SAST) regulations was first introduced in 1994 and revised once in 1997 and in 2002. Thereafter, in September 2009, SEBI constituted the Takeover Regulations Advisory Committee (TRAC) under the chairmanship of Mr. C Achuthan with the mandate to comprehensively examine and review takeover which lead to the amended SEBI SAST 2011. The SEBI SAST 2011 regulations specify exact guidelines for various steps of the takeover process including limits of the creeping acquisition, trigger points which lead to automatic open offers, the minimum percentage of open offers and the minimum process of such open offers. Some of the key provisions that were amended in 2011 include:

1. Regulation 8 of the SEBI SAST provided a floor to determine the offer price. As per SEBI SAST 2011, the determination of offer price for frequently traded shares is based on four parameters, namely, (a) the highest negotiated price of the shares of the target company in an acquisition involving public offer, (b) volume weighted average price paid by the acquirer or any of the PACs in the fifty two weeks before the public announcement, (c) the highest price paid by the acquirer or any of the PACs for the shares of the target company in the twenty six weeks preceding the public announcement and (d) the volume weighted

¹ Magnuson W (2009)

average market price of the shares in sixty days preceding the public announcement. Provisions (a) and (c) have been retained from SEBI SAST 1997. However, the parameter (d) based on market price was shifted from 26 weeks prior to public announcement date in SAST 1997 to 60 days prior to public announcement date in SAST 2011. It also introduced the term volume weighted average price in provision (d) which was earlier based on the average of opening and closing prices.

2. The minimum offer size to be acquired during an open offer was increased from 20 per cent to 26 per cent in SAST 2011.
3. SEBI SAST 1997 provided under the Takeover Regulations that control shall include the ability and the right to appoint majority of directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholder agreements or voting agreements or in any other manner. In SEBI SAST 2011, “ability” has been removed and control is defined as the right to appoint directors or to control the management or policy decisions. The definition of control excludes mere holding of a position as a director or officer of a company. The SEBI SAST 2011 does not have provision for any specified percentage for acquisition of control.
4. The initial trigger point for mandatory open offer for change of control was increased from 15 per cent to 25 per cent.
5. Under SAST 1997 as amended in 2008 in creeping acquisition provided that if an acquirer already holds more than 15 % but less than 55 %, he may acquire additional shares carrying not more than 5 % of voting rights within a financial year without having to make an open offer. Further, where the holding is above 55 % but less than 75 %, a one-time allowance to increase their shareholding by 5 % through market purchases or pursuant to a Buy back by the target company, without having to make an open offer has been permitted provided that post acquisition holding of acquirer does not go beyond 75 %. In 2011, the creeping acquisition provisions were simplified wherein shareholders, holding shares or voting rights between 25 to 75 percent in the target company, could acquire up to 5 percent shares or voting rights in the same financial year.
6. SEBI SAST 2011 provides for the role of board of directors of the target company. When an open offer is made, a committee of independent directors is constituted to assess the offer and provide a written assessment based on reasoning. Board of directors are otherwise responsible for providing all information to acquirer and to other potential acquirers in case of competing offers. They are also responsible for the day to day running of the firm during the tendering process.

The takeover regulations attempt to ensure that public shareholders of a listed company are treated fairly and equitably in the event of a substantial acquisition in or in case of a change of control of a listed company. In particular, the takeover regulations also aim to ensure that the public

shareholders of a company were mandatorily offered an exit opportunity from the company at best possible terms in the event of a takeover. Specific provisions of takeover regulation apply to control transactions, to regulate conflicts of interest between the management and shareholders of the target and bidder. Therefore, the SEBI SAST provides a framework through which takeovers can influence governance within a firm but it does not include specific provisions regarding protection of interest of non-shareholding stakeholders.

SEBI SAST 2011 also does not mention hostile bids or takeovers. The SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 made way for regulation of hostile takeovers and competitive offers for the first time. However, the subsequent regulatory experience from such offers brought out certain inadequacies existing in those regulations and consequently SEBI SAST 1997 replaced the 1994 regulations. The hostile bid is generally understood to be an “unsolicited bid by a person, without any arrangement or MOU with persons currently in control” and the same rules of SEBI SAST 2011 apply in case of hostile takeovers.

III. Impact of the Regulation

Using a sample of 500 plus open offers during 2002-2015 (source: SEBI website), we analyze the takeover trends in India in relation to the SEBI SAST 1997 (2011) regulation and discuss its implications for corporate governance. In particular, we consider the regulatory changes in relation to offer size, initial trigger of acquisition, creeping acquisition, offer price, and objective of open offer.

Some Salient findings are as follows:

- The offer price change in 2011 was to ensure a better outcome for the existing shareholders, however, there is no significant difference between the average offer premium in the period before and after the regulation is introduced² (Figure 1). The only exception is the year 2009, when the offer premium is very high, which is attributed to a deal where the offer premium was 23 times the 30-day prior closing price.
- Further, the data shows a negative correlation between the offer premium and pre-acquisition stake suggesting acquirers with less stakes prior to acquisition tend to pay higher premium than those who have more stakes in the firm.
- In most cases the post 2011 offer size is 26 percent, while in the period before this, the offer size would range from 15 to 20 percent on an average, with an exception of one or two acquisitions where the offer size was more than 50 percent of the equity capital. This clearly shows that it is regulatory compliance that drives the offer size.

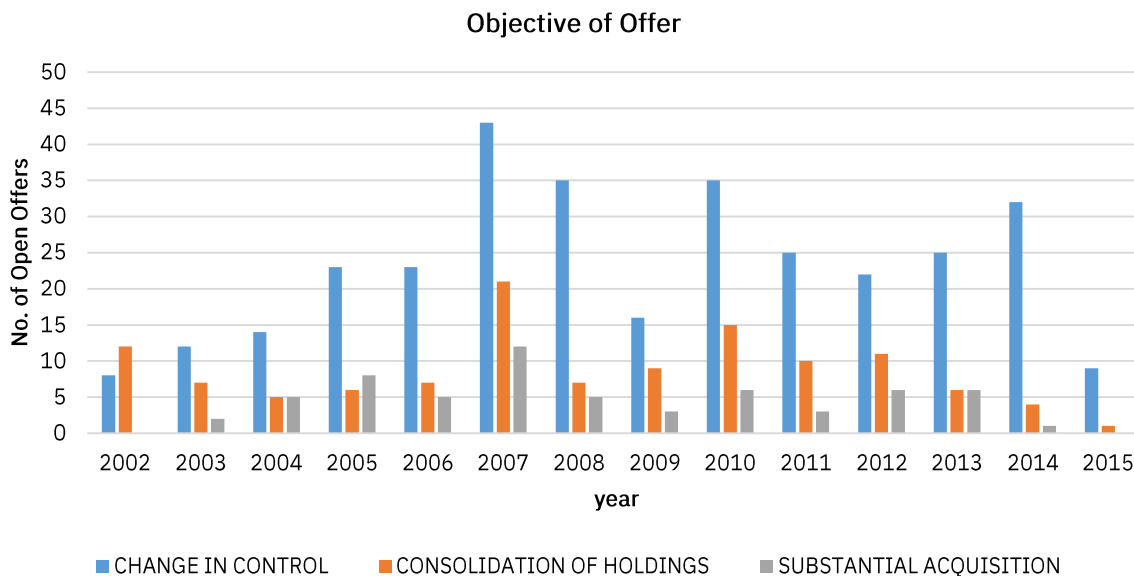
²Following literature, offer premium is defined as the ratio of the offer price to the closing price 30 days prior to the public announcement date i.e. average offer premium = $\frac{\text{final offer prices} - \text{closing price 30 days prior to the public announcement date}}{\text{closing price 30 days prior to the public announcement date}} \times 100$

- The mode of payment almost all transactions is cash. Out of 454 deals during the period 2002 to 2014 for which deal status is available about 93% deals are closed.
- Acquisition of shares through open offer involves various objectives for the acquisition, divided into three main categories: change in control, substantial acquisition, and consolidation of holdings. Change in control involves change in voting rights such that the “control” goes to new shareholders. Substantial acquisition involves acquisition of a substantial quantity of shares or voting rights of the company, which in SAST 1997 is defined as 15% or more of voting rights in the target company, increasing to 25% or more voting rights in SEBI takeover code 2011. Consolidation applies to persons holding a substantial stake of shares or voting rights between 55% and 75%, desirous of consolidating this shareholding. 60 per cent of the transactions are done for change in control (see Figure 2). However, the offer premium for change in control has reduced since 2011, whereas it has increased for consolidation of holdings and substantial acquisition.
- There are no hostile takeovers in our sample.

Figure 1: Year wise trends in Average Offer Premium



Figure 2: Distribution of Year-wise open offers across different objectives



IV. A Comparison with International Takeover Codes

“Protection of the interests of minority shareholders is a fundamental principle of corporate governance”. Takeover laws in most jurisdictions prescribe a systematic framework for acquisition of stake in listed companies in order to ensure that the interests of the shareholders are not compromised in the event of an acquisition or takeover. Table 1 shows the provisions in takeover codes corresponding to offer price, offer size, mandatory bid rule and creeping acquisition in three developed countries, namely, US, UK and Australia and two BRICS countries, namely, Brazil and South Africa.

Offer price regulation: Australia and South Africa link the offer price with some past price of the shares. This is like the provision prescribed in Regulation 8 of the SEBI SAST 2011. However, in case of India, the offer price is linked to the market price of the shares prevailing in the period between the public announcement date and sixty days prior to the public announcement date as compared to past four months price in Australia and six months in South Africa. In contrast, in US and UK no such provision exists. Brazil, too does not set any floor for the offer price, it only says that price for shares under tender offer must be equal to at least 80 percent of the price per target share paid by the purchaser to the controlling shareholders.

Minimum offer size: In the US it is specified to be at 5 percent, while the SEBI SAST 2011 increased this offer size to 26 percent. In Australia, the minimum offer size needs to cover all securities pertaining to a particular class or a specified proportion. In case of UK, it is conditional on holding or attaining 50 percent control rights, while in Brazil the minimum offer size includes all voting shares held by non-controlling shareholders of target firm.

Mandatory Bid Rule: SEBI SAST 2011 does not provision for any specified percentage for acquisition of control, like the UK. However, for initiating Mandatory Biding Rule (MBR), the limit in India’s SEBI

SAST (2011) is set to be at 25 percent, this is 20 percent, 30 percent and 35 percent respectively in Australia, UK and South Africa. There is no MBR in the US.

Creeping Acquisition: Creeping acquisition up to 3 percent is provisioned in Australia every 6 months, which is similar to SEBI SAST 2011 provision of 5 percent, however in a year's time. None of the other jurisdictions discussed has provision of creeping acquisition.

Role of Board of Directors: Role of board directors during takeovers as provisioned in UK takeover code are similar to those in India. In the US, the open offers are determined by lawyers. The Australian takeover code does not discuss any role or duties for the board of directors with special relation to takeovers. The South African takeover code emphasizes on the duties of the board of directors to work in the interest of the shareholders. The board is responsible for providing independent opinion about the offer. Further, while all the other jurisdictions discussed here are concerned with the interests of the shareholders, the US takeover code is a contrast provides for elaborate provisions for takeover defences.

In addition, the US, UK and Brazil have detailed provisions relating to hostile takeover. However, we do not find focus on other stakeholders like employees in any takeover code. Recent studies³ emphasize the importance of safeguarding the interests of all stakeholders, like employees, suppliers and senior management in a takeover.

Table 1: A Comparison of provision of Takeover Code across jurisdictions

Variable	US ⁴	Australia ⁵	UK ⁶	South Africa ⁷	Brazil ⁸	India SEBI SAST 2011
Offer Price	No link to past prices paid by Bidder. All holders/best price rule	Highest price paid for target company shares by the bidder (or its associates) in the four months before the bid.	-	Mandatory offers: highest price paid for the relevant shares in the six months preceding the offer.	Voluntary Tender Offer: No Regulation. Tag Along Tender Offer: price must be equal to at least 80 percent of the price per target share paid by the purchaser to the controlling shareholders.	Combination of past negotiated price, highest price based on 52 week high price, average price paid by acquirer in past 26 weeks and the volume weighted market price based on sixty days.

³ Kacperczyk (2009)

⁴ [sec.gov/rules/final/33-7760.htm#P623_155558](https://www.sec.gov/rules/final/33-7760.htm#P623_155558)

⁵ <https://data.allens.com.au/pubs/pdf/ma/takeovers-handbook.pdf>

⁶ <http://www.thetakeoverpanel.org.uk/the-code/download-code>

⁷ <https://iclg.com/practice-areas/mergers-and-acquisitions-laws-and-regulations/south-africa>

⁸ [ICLG.com/practice-areas/mergers&acquisitions/Brazil](https://iclg.com/practice-areas/mergers&acquisitions/Brazil)

Minimum Offer Size	5 percent	All securities pertaining to a particular class or a specified proportion	Conditional on holding or attaining 50 percent control rights	-	All voting shares held by non-controlling shareholders of target firm	26 per cent
Initial Trigger for MBR	No MBR	20 percent	30 percent	35 percent	Majority voting rights to gain board control	25 per cent.
Creeping Acquisition	-	3 percent (in 6 months)	-	-	No legal provisions setting a minimum percentage threshold	5 percent in the same financial year.

V. Discussion

The SEBI SAST 2011 has been operating for more than nine years now. The analysis of a sample of takeovers from 2002 to 2015 indicates that the regulation has ensured compliance but has not been able to either fuel the growth of an active take over market or ensure an attractive exit for the investors. For instance, post 2011, we do not find any increase in the offer premium, although one of the floor for the offer price was shifted from market price prevailing 26 weeks before public announcement to market price 60 days before public announcement. Therefore, an offer price closer to the actual market price reflecting the current status of the firm, does not necessarily yield a better premium for the existing shareholders. In fact, there is evidence to show that investors tend to anchor to historical prices if readily accessible like the 52 week high price of the target firm in the year preceding the public announcement, rather than the regulatory floor price⁹. Moreover, some jurisdictions like Australia and South Africa also refer to past prices paid by the acquirers in earlier transactions. Therefore, a simple, past stock price becomes more relevant for determining the offer premium, than a complex combination of multiple prices as currently provisioned in Regulation 8 of SEBI SAST 2011. At the same time, we find that the offer premium has reduced in the post 2011 period for deals associated with the objective of change in control, though the number of deals is maximum in this category. This implies that while the regulation has encouraged deals involving change of control, the exit offered to investors in that case are not attractive.

Further, all offers under the mandatory rule comply to the minimum 26 percent requirement, there is no takeover deal that involves an offer size of more than 26 percent. It should be noted that the TRAC recommendations in 2009 were to increase the offer size to 100 percent, however in the Indian context, given the capital constraints large offer size seems to be infeasible. The downside of the lower size of the open offer is that it does not guarantee exit for all minority shareholders,

⁹ Ranganathan and Singh (2018)

which would have implications for “squeeze outs”. At the same time, a relative low limit for offer size can open doors for hostile takeover, which may lead to better allocation of shareholders’ investment, particularly in an institutional setting with concentrated promoter holding. Moreover, we find a negative relationship between the acquirer’s pre-acquisition stake in the target firm and the offer premium, implying acquirers with already existing stakes provide a less attractive exit to the minority shareholders. This might provide a rationale for lower trigger limit in SEBI SAST (2011) as compared to other countries as seen in Table 1.

The argument of capital constraint seems, on the other hand, to be inconsistent with the choice of payment mechanism in the deals. All the deals in our sample involve cash payment implying either the acquirers have high cash reserves or can debt finance their deals easily, thereby suggesting no capital constraint. Of course, one argument from the corporate governance perspective could be that payment by issuance of stock can dilute dominant shareholders’ voting power. If preserving control is important for the acquirer, they have an incentive to select cash financing over stock financing¹⁰. Hence in open offers with objective of change of control or substantial acquisition, especially one can expect more transactions involving cash payment. Currently, the regulation too mandates that if the acquirer has bought stocks in the last one year in the target firm, the payment has to be necessarily in cash. This could be one important reason behind cash-based deals.

Further the trigger point for mandatory bid offers for change in control in India is 25 percent which is less than the corresponding trigger points of UK (30 percent) and South Africa (35 percent). Given the concentrated ownership pattern in India and diffused ownership in the UK, this seems to be imply a contradiction. Ideally, a concentrated ownership pattern should involve a higher threshold to trigger open offer¹¹.

VI. Way Forward

- (i) The takeover regulation needs to take account of the institutional setting of India while determining the various thresholds like creeping acquisition, MBR, definition of control etc.
- (ii) There is a need to apply simplified rules to determine prices which investors can associate with, and comprehend easily, rather than complex methods. The floor price needs to be a single price, rather than a combination of prices.
- (iii) The takeover code needs to adopt a more balanced approach taking into account various stakeholders like shareholders of the acquiring firm, the non-shareholding stakeholders of the target firm etc. This holds true not only for India but in other jurisdictions as well.
- (iv) Steps need to be taken to create an active market for takeover, particularly hostile takeover. A potential hostile takeover or threat of change of control can be an effective mechanism to align managerial interest with the ownership.

¹⁰ Faccio and Masulis (2005)

¹¹ Varottil (2015)

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