Offer For Sale Through Stock Exchange (OFS) and Institutional Placement Program (IPP) Mechanism-Opportunities & Challenges

Bhavna Thakur
Director, Head-ECM
Citigroup Global Markets India Pvt.Ltd.

Vinayak Sanghvi
Vice President
Citigroup Global Markets India Pvt.Ltd.

Introduction

Prior to September 20, 1993, Indian companies (complying with certain prescribed conditions) could list on a stock exchange with a public offer of at least 40% of the issued capital. The minimum public shareholding requirement was reduced to 25% in 1993. In 2001, the Government of India ('GOI') amended the Securities Contracts (Regulation) Rules ("SCRR") and prescribed that a public offer should be for either 25% or 10% (subject to compliance with certain conditions). In June 2010, the SCRR was amended again to prescribe that the minimum threshold level of "public" (i.e. non promoter) ownership should be 25% for all listed companies. The minimum public shareholding requirement is comparable with several other global markets such as UK, China, Hong Kong and Brazil, that all have a minimum 25% public shareholding threshold.

Pursuant to a second amendment in August 2010, public sector enterprises were required to have minimum public shareholding of only 10%. A large number of sizeable public sector companies have limited trading history and liquidity. A 10% minimum public shareholding requirement gives them an ability to systematically monetize their shareholding without disrupting market prices.

All listed companies were directed to achieve the minimum public shareholding thresholds by June 3, 2013. In December 2010, SEBI amended clause 40A of the equity listing agreement and prescribed the following modes for companies to comply with the minimum public shareholding requirement:

- Issuance of shares to public through prospectus; or
- Offer for sale of shares held by promoters to public through prospectus; or
- Sale of shares held by promoters through the secondary market subject to approval from specified stock exchange

Issuing of shares to public through prospectus is time consuming and subjects the sellers to extended periods of market volatility. In addition, the permitted methods did not permit issuers to undertake the block trade route and QIP routes for fund raising, which gave issuers limited flexibility to tap the equity markets to meet the minimum public shareholding requirements.

SEBI, GOI and private issuers realised that the existing formats were not efficient for stake monetization and that there was a need for the introduction of new formats which would be quicker to execute and make it easier for companies to achieve the minimum public shareholding requirements. SEBI introduced two new stake monetization methods of IPP and OFS in early 2012.

IPP and OFS transactions can be launched and completed faster than the other methods of public offers and have become the preferred route for stake monetizations to meet minimum public shareholding requirements. In the following note we have provided an overview of the IPP and OFS mechanism and key benefits and challenges of these formats.

Institutional Placement Program

An IPP is similar to a QIP and has been introduced by way of amendment to the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009 ("ICDR Regulations'). However, in an IPP, instead of a preliminary placement document a Red Herring Prospectus ('RHP') is required to be filed with the RoC and submitted to SEBI and the stock exchanges prior to opening of the issuance and there is no requirement of a minimum offer price, as in the case of a QIP. An IPP is a suitable alternative to a QIP to raise funds to meet minimum public shareholding requirements.

Key Features Governing the IPP Process

Shareholding: Companies that are required to comply with minimum public shareholding requirements can use the IPP format for offerings. Only listed companies with public shareholding less than 25% can make a placement of shares under the IPP route.

Primary/ Secondary Share Issuance: The issuance can either be a fresh issuance by the company or a offer for sale by the promoters or both. Accordingly, both a primary and secondary share issuance can be executed through a IPP format;

This is similar to an accelerated bookbuild offering execution in Asia (HK, SG.)

Investor Participation: Only Qualified Institutional Buyers ('QIBs') are allowed to participate in IPPs;

An IPP is similar to a QIP format and participation is limited to QIBs

Pricing: Required to announce an indicative floor price or price band atleast one day prior to opening of the offer;

Post filing of the RHP, an issuer has adequate time to market the transaction and only announce a indicative floor price or price band once they are fully prepared to launch a transaction

Allotment: Every tranche shall have atleast 10 allottees and no single investor can receive more than 25% of the offer size. Reservation of a minimum 25% to mutual funds and insurance companies and allotment can be made on price priority, proportionate or on pre-specified criteria which must be disclosed in advance in RHP.

A minimum number of allottees at times act as a deterrent to a quick execution particularly for smaller size offerings. Most investors like to get a sizeable allocation which might not be available even though the Company(s)/ Promoter(s) are willing sellers because IPP can only be used to sell down upto 75% and no more, subject to increase in public shareholding of upto only 10%.

Key Advantages of the IPP mechanism

- **No regulatory review:** Like a QIP, the IPP process does not involve a SEBI review.
- **Pricing**: An IPP issuance pricing does not need to adhere to minimum offer price requirement. Availability of price band allows natural price discovery.
- **Marketing:** An IPP can be executed on a fully marketed basis, post filing of the RHP, and the issuer can make an announcement for launch of transaction to the stock exchanges at a later date, thereby not impacting the stock price adversely. Being able to market the deal also helps companies that are not well-traded and do not have significant research coverage. However, publicity and research- related restrictions similar to public offers as prescribed under the ICDR regulations are also applicable in case of an IPP.
- **Promoters Participation:** Promoters can use an IPP to monetize their shareholding. However, they cannot offer their shares for sale in a QIP.

Key Challenges of the IPP mechanism

- **Allotment:** Less flexibility for allotment and a higher minimum number of allottees as compared to a QIP process.
- **Use permitted upto 75%:** Promoters can use the IPP mechanism only to reduce their shareholding to 75% threshold and not lower. Ideally there should be more flexibility for further sell-down and upsizing.

Under the current IPP issuance format, Godrej Properties completed the first IPP of INR 470crs ($93.7mn) in March 2012. The issuer conducted an extensive marketing exercise post announcement (at it's shareholder meeting) of the IPP fund raising and it is important for the stock to season post announcement of IPP fund raising approval and find a natural level before the deal launch. During volatile market conditions, Godrej Properties managed to complete the offering due to a well calibrated marketing strategy, tying up anchor investors for participation and offering a meaningful discounted price range, the lower end of which acted as a hook to encourage investor participation.

Should IPP regulations be re-examined, we believe giving issuers added flexibility of more than 10% dilution or selldown and an option to go below 75% as a result of a promoter sell down through this process, along with a relaxation in the current allotment rules for an IPP would make the IPP format easier to use for issuers.

<u>Offer for Sale ('OFS') through Stock Exchange</u>

In order to enhance public ownership, increase liquidity in every listed company and to facilitate promoters to dilute/ offload their holding in a transparent and efficient manner, SEBI has decided to allow the sale of shares by promoters of companies, which are non compliant under the minimum public shareholding guidelines and the top 100 companies by market capitalisation through a separate window provided by exchange(s).

The OFS mechanism has unique characteristics as it combines a capital raising offer/transaction with secondary market settlement timelines thereby achieving a dual objective of providing promoters a fast and efficient mechanism (which is not subject to prior review by SEBI) to access capital markets and ensuring speedy settlement in accordance with secondary market timelines (T + 2).

<u>Key Features Governing the OFS mechanism</u>

Sellers Classification

(a) Promoter (s) / promoter group entities of companies required to comply with minimum public shareholding requirement (10% for public sector undertakings and 25% for private sector companies).

As highlighted earlier, globally a number of leading markets like UK, HK and Brazil have a 25% public shareholding threshold for minimum public shareholding

(b) All promoter (s) / promoter group entities of top 100 companies based on average market capitalization of the last completed quarter.

This provides for an efficient mechanism for promoters of top 100 companies to access the capital markets and further enhance liquidity of large cap. stocks.

Buyers Classification: All investors registered with brokers of BSE and NSE.

Unlike the IPP in which only institutional investors (viz. QIBs) can participate, the OFS mechanism further broadens a company's shareholder register by allowing participation from Retail and HNI investors. Promoter / promoter group entities cannot participate.

Type of Securities: Secondary shares only.

There is no prior review by SEBI and documentation requirement as this is treated like a secondary trade; A Company is not allowed to raise funds via primary issuance under the OFS mechanism.

Documentation and Announcement of Offer: No offer document(s) are required to be prepared and filed with any regulatory authority to undertake an OFS through stock exchange.

The sellers were initially required to publicly announce their intention to proceed with an OFS through stock exchange at least one clear trading day prior to the opening of the offer (T-2) and were required to also mention the size of the issue and floor price, if elected to disclose.

This allowed for sufficient time for all prospective investors to be informed of the offering and organise margin financing for the trade but placed a substantial price risk as the underlying stock continues to trade on the market all day on T-1 and even through the offer period on T date, as along with the auction window of the OFS, the stock continues to trade in the secondary market.

Once floor price was disclosed in the public announcement (released on T-2), the market price on T-1 had a tendency to correct to the floor price level. Hence the clear trading day removed the potential discount that sellers offered to investors and made the offering less attractive. As there is no control over the trading market price, the market price could also fall below the floor price- in the OFS providing investors an opportunity to purchase shares at a lower price from the trading market. This placed high risk on the success of the OFS transaction

Globally, to protect the market price from any adverse impacts from material events and stock sell down offerings, sell downs via bulk/block transactions are announced only after market hours on T-1 and global markets also allow for 'Stock Suspensions', i.e. suspension of trading of normal market window while the auction is open. To a limited extent, the 15 minute block trade window pre-market hours in India did provide this flexibility but since the discount levels permitted are only 1 per cent plus or minus from market price, the block trade window has been untenable for placement of large blocks, as such blocks generally require a larger discount. In any case, the block trade route is no longer available to promoters of non-compliant companies.

To address these issues and the potential of stock price correction on T-1, SEBI has in its circular dated July 18, 2012 amended the OFS guidelines (referred to as OFS Amendment Guidelines hereinafter) which now allow the seller to disclose the floor price after close of business hours on T-1 day (if sellers intend to disclose the price).If the seller intends to disclose the floor price, the OFS announcement should carry the date and time of the declaration *of floor price. This is now similar to the practice followed in the launch of an accelerated book- built block trade. (Only issuers having ADRs trading overnight in the US markets could potentially be affected with the OFS transaction announcement where there may be some sort of arbitrage available between the ADRs and the ordinaries depending on the difference in trading price between them).*

Price Disclosure*:* Sale of shares through OFS can be freely priced. However, the sellers are required to determine a floor price. Floor price is the minimum price at which the seller intends to sell the shares. Under the OFS mechanism, Sellers can decide whether they would like to disclose the floor price publicly or keep it undisclosed. In case not publicly disclosed, seller(s) has to provide the floor price in a sealed envelope to the designated stock exchange before opening the offer. If not publicly disclosed, the floor price is required to be delivered to the designated exchange in a sealed envelope. The floor price is disseminated by the stock exchange after the offer.

Most investors and market participants prefer to know the floor price before the offer is opened- as this provides clarity and guidance to investors rather than them putting in blind purchase orders (i.e. without any guidance on the pricing). The counterargument has been that most investors can look at the average trading price of the stock over the last three months and trading metrics of comparable listed peers and hazard a guess as to where the floor price will be. This is probably more true for institutional investors but retail investors specially would be wary of bidding blind particularly because if they don't get allocation, their margin will still have been blocked for a couple of days. Further, these valuation methodologies do not factor in expectations of the seller(s).

Secondly, during the course of an auction, investors do not get an idea of where the book is building and at what price points (particularly in a price priority auction). In anticipation of the indicative price (which was earlier only disclosed during the last half hour), investors placed orders only a few minutes before offer closure causing order bunching at brokers/custodian level. Due to this few orders were not uploaded on time or were missed out from the offer. In addition, indicative price would only be disclosed by the exchanges only during the last 30 minutes of the duration of the offer for sale subject to book being one time subscribed, whereas in practice due to the last minute order filling, indicative price did not appear until after the book had closed.

To address this concern of blind bidding and to ensure investors are incentivsed to place bids during the offer period (and not wait till the last half hour), SEBI's OFS Amendment guidelines now allow the indicative price to be displayed during the last 60 minutes of the close of bidding session irrespective of where the demand is thereby providing guidance to all prospective bidders and partially removing the concern of a blind auction. However, this is still inadequate as it still does not give investors guidance of quantum of demand at various price levels and any orders input cannot be amended in the last one hour. Due to these reasons retail investors have not participated in OFS transactions and instead find it easier to purchase their shares in the open market. Even at times when they choose to participate, there is not enough guidance from selling brokers which dissuades them from participating in a meaningful way. This is another distinction between a secondary block or a primary capital markets transaction which comes into the market and the OFS, where in the latter, all brokers on the street are buy-side brokers. Generally, in a large block or primary capital markets transaction, the sell side brokers sales team reaches out to investors and is able to educate them about the stock. Since the entire street is talking to investors on the buy-side in the case of an OFS, there could be a dilution of message and lack of consistent guidance to investors. In addition, the same investors are under tremendous pressure from different buy side brokers to put in orders through them and many foreign investors, in particular, have not found this particularly helpful.

Several investors compare the OFS mechanism to auctions. Globally there is a debate about the efficacy of the bookbuilding method versus auction for monetizations. While auctions come in many formats, it is generally accepted that they are aimed at maximizing proceeds for the issuer. There are broadly two methodologies followed in pricing of auctions:

- **Dutch Auction**: In a Dutch auction, pricing and allocation are removed from the realm of issuer or underwriter. Investors express their interest levels and price threshold and the offering price is set at the highest level at which all of the shares to be offered can be sold. However, several investors contest that fair value of the shares when sold in a Dutch auction. Like an OFS a dutch auction is not attractive for retail investors as they can purchase shares on the market as per their requirements and at a potentially lower price than the clearing price of the dutch auction. In a dutch auction the retail investor is also disadvantageously placed compared to institutional investors with regards to potential allotment

A classic example is the Google IPO (2004), conducted via a Dutch auction, wherein the company raised ~US$1.67 billion by selling ~20 million shares at US$85 a share. The rationale behind following the auction mechanism was that the price should reflect the reasoning of thousands of investors who will determine for themselves how much they are willing to pay for a share. The final price of the IPO was the lowest price at which all of the shares were sold. However a weak IPO market and the relatively complicated auction process kept many investors away from the Google IPO.

- **French Auction**: Bidders above the clearing price are allocated shares on a price priority basis – However, this could lead to the "Winner's Curse" – scenario in which the winner over pays for the stock. The winner may overpay or be "cursed" in one of two ways: 1) the winning bid exceeds the value of the auctioned asset such that the winner is worse off in absolute terms; or 2) the value of the asset is less than the bidder anticipated, so the bidder may still have a net gain but will be worse off than anticipated. Hence the French auction mechanism has not been very popular in equity offerings globally or in India.

Investors are more focused on the intrinsic value of a stock, which does not change based on the format of the offering.

Lastly, even under the modified guidelines, to address the floor price issue, sellers are still not allowed to place a price band to their offering. Similar to the IPP process, instead of a floor price, sellers should have the option of placing a price band. This would provide flexibility to sellers who can strategically decide the lower and upper end of the price band and give investors an option to place bids at various price levels within the price band. As OFS' are not marketed by the company, it is difficult to pin down the floor price without marketing feedback from investors, and a price band would allow the demand book to build at various price levels allowing for natural price discovery. Further, in a recent OFS where the floor price was not disclosed, many buyers put their bids below the floor price, in such situations, if the book is not completely filled, it should be left to the seller's option to also agree to allocate those shares and complete the sale. Currently, both sellers, and investors who have placed margin for their bids stand to lose if the investors estimate of the undisclosed floor price is not accurate.

Allocation Alternatives*:* The OFS mechanism provides the sellers the option to decide on method of allocation so as the allocation methodology chosen is disclosed to investors in the notice to stock exchanges. All bids above the floor price can be allocated under proportionate basis methodology (shares allocated at single clearing price) or under price priority methodology (shares allocated at multiple clearing prices).

Investors who have high interest in owning the stock would be incentivsed to bid aggressively. Hence, allocation under price priority methodology could enable the seller to achieve a higher blended price from the offer. Also, other than mutual funds and insurance companies, no single bidder can be allocated more than 25% of the offer size.

Size of Offer: *As per original guidelines* - at least 1% of paid-up capital of the company, subject to minimum of Rs 25 crores. However, in scenarios in which the 1% of paid-up capital is less than Rs 25 crores, the offer was required to be made for a minimum of 10% of paid-up capital or such lesser percentage so as to achieve minimum public shareholding in a single tranche. Additionally, sellers were not allowed to upsize their offer for sale (in the event unexpected demand is received from investors)

Sellers were earlier constrained to offer at least 1% of the stock on each OFS tranche, thereby not allowing them decide the transaction size based on fund requirements and indicative demand. There could have also been a scenario in which there was insufficient demand for even 1% of the company and the offer went under subscribed.

Therefore, to address the above SEBI's OFS Amendment guidelines now state that the minimum size of the offer shall be Rs.25 crore. The size of offer can be less than Rs.25 crore so as to achieve minimum public shareholding in a single tranche.

Also, the issuer now has the option to upsize the offer subject to appropriate disclosure in the announcement of the OFS and advance pay-in of shares. Having said that companies that are using OFS to comply with the 25% minimum threshold and are not in the top 100 may use the OFS only to comply and no more. These limitations on OFS and IPP relegate them as being tailor made only for minimum public requirements compliance whereas these formats have the potential, coupled with supportive markets, to offer more efficient alternative methods of offerings universally.

Margin Requirement*:* For an order to be valid, the original guidelines required that each order must be accompanied with 100% of the order value in cash. Hence this forced investors to incur additional funding and hedging charges on their order value and not the final allocated amount.

While the underlying stock continues to trade in the secondary market all throughout the offer for sale period, where investors can purchase shares by only putting up the VaR margin, asking for 100% margin- prior to allocation in the OFS transaction was a steep ask. Investors have to also incur funding and hedging costs on the entire order amount rather than only the allocated amount. Also each time investor wanted to revise their bids upward; additional margin money was required to be moved. In addition, the process of refunding unallocated monies is cumbersome

Placing of 100% margin for order conformation was a cumbersome task and potential investors in the recent OFS transactions faced difficulty in seeking internal approvals, the extended time taken during coordination amongst investor's global custodian and local counterpart and in transferring of 100% margin into stock exchange clearing bank account caused delays and orders were not confirmed in time. Now institutional investors are allowed to put in a lower margin of 25% of their order value. However, these orders are not permitted to be modified.

Investors participating in bulk/block transactions simply express demand interest and transfer money on allocated amount as per market settlement timeline of T+2. Other capital market transactions also provide investors with the ability to use the ASBA (Application Supported by Block Amount) facility

Considering these challenges, SEBI's OFS Amendment guidelines now provide institutional investors with an option to apply with 100% upfront margin in cash or 25% of the order value. In the latter case, the bids shall not be permitted to be modified in order to avoid frivolous bids. This brings the OFS somewhat in line with normal secondary market trades where retail investors fully fund (or their broker funds) their trades and institutional investors rely on broker margins which are placed with the exchanges.

Our recommendation was to permit only upward revisions for institutional investors who apply with 25% margin. The requirement of 100% margin even for upward revision does not match the expectations of institutional investors with regard to easing of margin rules.

However, as more and more OFS trades occur, investors and custodians will get more accustomed to the margin mechanics and will make all efforts to bid for a stock they are interested in.

Lock up (cooling off) period: The OFS mechanism required a lock up period of 12 weeks pre and post each OFS tranche. Considering volatile market conditions, internal blackout periods due to quarterly results and the June 2013 deadline to comply with minimum public shareholding norms, a 12 week lock up left very few windows of opportunity for a OFS transaction launch.

Considering this challenge, SEBI has relaxed the OFS guidelines which now state that within the cooling off period of +/-12 weeks, the promoter(s)/promoter group entities can offer their shares only through OFS or IPP while maintaining a gap of 2 weeks between two successive OFS or IPP. This is applicable to promoters who have already offloaded their shares through a OFS or IPP.

Operational Efficiency: To further streamline the OFS mechanism and to ensure there is sufficient time for all market participants (investors, brokers, custodians and stock exchanges) to work efficiently, SEBI has proposed additional time to complete operational tasks (e.g. transferring application money/margin money from custodian account to stock exchange clearing bank account and custodian confirmation of bids)

(a) **Modification / cancellation of bids**- shall not be allowed during the last 60 minutes from the close of bidding session instead of last 30 minutes and

(b) **Time for custodians** - 30 minutes post close of session shall be provided to the custodians to confirm the institutional bids during post close trading hours subject to the condition that the bids and payments have been received before closure of the bidding process.

Marketing: The guidelines are currently silent on whether the company or selling shareholders are allowed to conduct any marketing in relation to the OFS transaction. It might be challenging for company's which have low float, are not actively tracked by investors and are not covered by research analysts to complete a successful OFS transaction. Good disclosure, strong investor relations and extensive reporting in their quarterly and annual reporting is important for companies whose promoters are planning to monetize their stake through an OFS. Additionally, an active investor dialogue on non deal roadshow meetings provides the company with accurate ongoing feedback on market sentiments and pricing guidance.

From a marketing perspective, a company will probably not be involved in marketing an offer for sale by its promoters and its probably prudent for it to treat it as a pure secondary transaction with minimal company involvement as there is no prospectus required.

Key Advantages of the OFS mechanism

- **Efficient Hybrid product:** combines a primary capital raising offer/transaction with secondary market settlement timeline.
- **Regulatory review:** OFS being an undocumented trade attracts no prior regulatory review and is fast and efficient mechanism.
- **Approvals required:** OFS transaction does not require approvals from shareholders nor the company's board of directors as this is a promoter sale.
- **Pricing:** There are no pricing guidelines and sellers are given liberty to choose floor price.

- **Application via Margin:** Institutional investors will now be permitted to apply with 25% margin and not put up 100% of the order value prior to allocation. However, such bids shall not be allowed to be modified without placing 100% margin
- **Broadens liquidity:** All investors including retail, HNI and corporates can participate in an OFS transaction (unlike in an IPP wherein only QIBs can participate).
- **Settlement:** Unlike QIP and FPO, the OFS mechanism does not attract elongated settlement cycles and the trade is settlement as per secondary market settlement timelines (T+2). Several investors globally have hence appreciated the OFS mechanism for reducing the settlement cycle- as investors had to earlier wait for over 8 days for shares and trading.
- **Allocation:** Instead of discretionary allocation which is carried out in a bulk trade, the designated stock exchange computes the allocation as per the method chosen and is carried out in an error free electronic process.
- **Lock Up Period**: 12 week cooling off period pre and post offer. However, the OFS Amendment Guidelines provide for a brief 2 week lock up period between two successive OFS or IPP. This enables promoters access the capital markets more frequently.

Indian capital markets have already begun to witness stake monetization under the OFS mechanism. Govt. of India was the first to monetize 5% of their stake in ONGC ($ 2.6 billion) via the OFS route. Since then the Azim Premji Trust, DB Corp promoter group and Jaypee Infra Venture have used OFS mechanism to monetize $ 150 million, $ 32 million and $17 million respectively

Conclusion:

There are over 75 companies across the private and public sector that need to comply with minimum public shareholding requirements. Overall the promoters of these companies need to sell down their stakes, totaling over US$8.5 billion. Both the IPP and OFS are very important formats to facilitate the stake monetization by these promoters. Moreover these 'hybrid' formats are beneficial for investors and markets in general as they enable placement of primary or secondary shares with a shorter settlement timeline as compared to public offering formats.

The OFS Amendment Guidelines are aimed at making them more investor friendly and will go a long way in streamlining these formats. Going forward we expect increased levels of interest from institutional investors in these offerings and both the formats to be successfully used for stake monetizations.

However, the most important issue facing companies, despite these new speedy and efficient formats for stake monetizations, is the state of the Indian and global capital markets and demand for Indian company's shares as the June 2013 deadline approaches. Many companies are faced with either not being able to complete these sales or forcibly complete them at unattractive valuations in order to comply with the guidelines. Particularly for companies in some sectors which have seen a decline, such as infrastructure, power and metals and mining where the stocks have fallen by more than 50% in the last year, complying with these regulations is going to come at a very high cost. All eyes are trained on the Ministry of Finance to consider these issues and grant an extension of the timeline, thus alleviating these concerns.