Pledging by Promoters: Issues and Challenges

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Pledge is the bailment of goods as security for payment of a debt or performance of a promise. Owners of companies have used pledging of shares as a mechanism for raising funds required for various business purposes.

In India, many promoters control large chunks of the shareholding of the companies founded by them, and such holdings usually represent a large portion of their wealth. As per the filings for the quarter ended March 2020, the market capitalization of the companies comprising BSE 500 index (excluding government companies) stood at ~Rs. 121 lac crores, and the holdings of promoters in these companies stood at ~Rs. 60 lac crores, representing holdings of ~49%. These promoters, when in need of money, pledge their shareholding in these companies with lenders (NBFCs, mutual funds or FIIs) to get loans against such holdings, while in some cases, shares are pledged in favor of a consortium of lenders to the operating company itself, where the primary security falls short of consortium expectations or pledging pursuant to loan restructuring, etc.

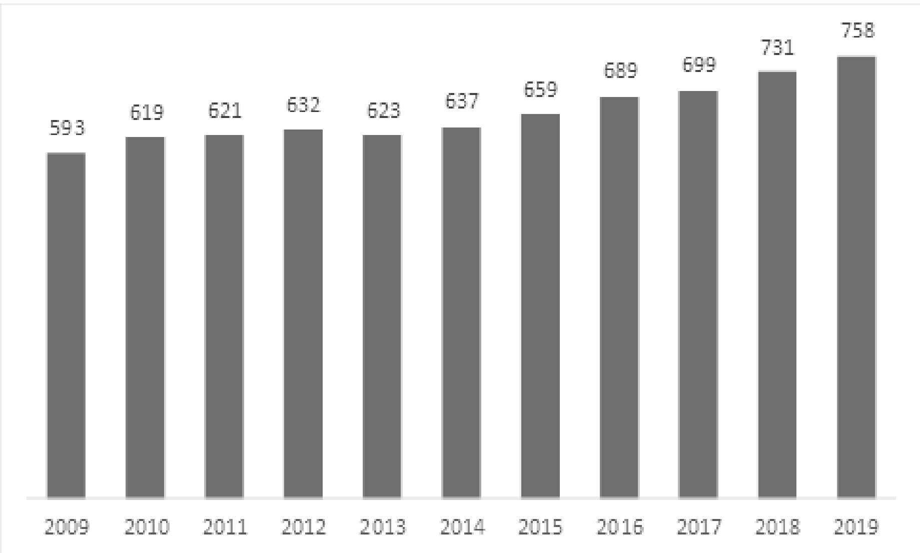
Pledging is done for various objectives and end uses:

1. Conversion of warrants / Creeping acquisition: acts as a signal that the promoters find share prices of their companies in the secondary market quite lucrative for fresh purchases / stake increases
2. Funding new ventures: pledging in a controlled manner is arguable for diversification of business, however uncontrolled pledging for unrelated business is seen as relatively riskier
3. To raise funds for the company itself (the funds are raised to meet exigencies of the listed company itself): typically, a last resort funding
4. Personal purposes

Last few years have seen borrowing against shares by promoters catching on aggressively with more promoters taking this route of raising money as it is a faster route of raising capital while retaining their ownership in the company. Pledging also allows raising cheaper financing when other means of credit are unavailable or expensive. The growth of promoter pledges as a means of financing can be attributed to the following:

1. Lack of cash flows at promoter holding companies that make such companies ineligible for traditional bank financing
2. Acceptance of liquid equity shares as security by NBFCs and mutual funds owing to lender perception of extremely liquid collateral

Number of companies with pledged shares



Source: Value research

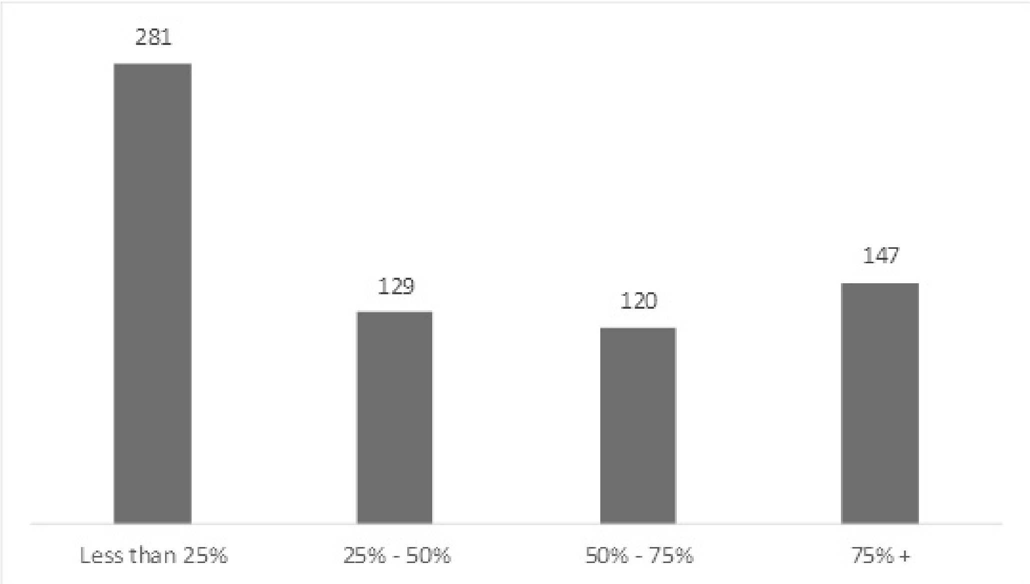
How the product has developed over the years?

In India, promoter pledging came into the limelight during the Satyam scandal in 2009. It was then that SEBI came out with a mandate for companies and their promoters to disclose their share pledging. The disclosures revealed that many promoters had been engaging in raising funds through pledging for a long time. Since then, SEBI has been continually monitoring the pledged shares of listed companies. There has been a continual rise in the number of companies who have raised money by pledging.

Till 2014, there were no norms standardizing the covenants for lending against shares. The Reserve Bank of India, in August 2014, removed this anomaly by stipulating a maximum LTV (loan-to-value) ratio of 50% for lending by NBFCs. Subsequently in 2019, the SEBI also announced standard measures for mutual funds' investing into NCDs with listed shares as security.

The regulators continue to remain watchful of the emerging scenario w.r.t share pledges. The Financial Stability Report published by the RBI in June 2019 mentions: High level of pledging by promoters is seen as a warning signal, indicating the company's poor health and probably a situation where the company is unable to access funding through other options. In a falling market in particular, pledged shares are under pressure as diminished share prices bring down the collateral value, prompting lenders to either demand additional margins or sell the shares to protect their interests. Either of the actions can have a negative impact on stock prices, thereby eroding the wealth of the investors.

Pledge levels (as a percentage of promoters' holding) observed for approx. 677 companies where promoters have pledged their shares:



Pledging of Shares: Cause for Concern

Volatility: Pledging is not dependent on whether the markets are stable or are rising, but when the markets turn volatile as was seen during March and April of this year, it causes concern both for the promoters as well as the lenders. Shares of companies with high pledge levels tend to witness higher volatility. Higher the pledging, greater could be the risk of volatility in the company's share price. This is because, as share prices fall, the overall value of the pledged collateral falls. This puts an enormous pressure on promoters to either repay the loan or put up more shares as collateral. If the company manages to pay the loan abruptly before its tenure, that puts a strain on its resources. On the other hand, if the promoter decides to put more shares as collateral, that puts out a very negative view to investors and dents the credibility of the promoter as well as the firm.

Management Shakeup: In times of falling markets and price corrections, the value of the pledged shares reduce drastically which requires the promoters to pledge more shares or repay the loan. In case of failure by the promoters to meet their obligation, the financier is constrained to invoke and start selling off the pledged shares if the promoters fail to meet the margin triggers which may lead to unwanted panic selling and volatility in the stock. When the financier decides to offload the entirety of pledged shares because of the inability of promoters to address the margin call triggers, it may lead to an unwanted change in shareholding. This change might not be in the best interest of the promoters and investors.

Exposing shareholders to credit risk: In cases where promoters are not able to respond to margin calls by the lenders, the lenders then have to resort to selling off the pledged shares to recoup their money. When multiple lenders start selling off the pledged shares, this creates a downward pressure on the stock price. The excess supply created due to invoking will further reduce the share prices, thereby leading to huge losses for the retail and institutional shareholders alike. The comfort drawn from a liquid collateral many a time, is challenged during such a situation.

Pledging of Shares: Challenges for Financiers

No cash flow coverage: The promoters typically pledge shares to raise debt in their holding companies, which lack sufficient cash flows to repay the debt. These company’s rely on divided income as their main source of cash flow, which is often insufficient to meet interest burden on the loans. Then the debt repayment is dependent on refinancing based on the strength of the promoter’s holding in the listed operating entity or through divestment of equity holdings.

Market corrections: Deep correction in equity markets erode the value of share pledges. Drastic market movements, the kind we witnessed in March and April 2020 leads to losses for the lenders and also puts their assets under stress.

Legal challenges: When faced with enforcement possibilities, borrowers often approach courts to seek an injunction against the lenders which often goes against the spirit of the product which is predicated upon 2 times of liquid collateral at all points of time.

Too many sellers at the same time: When the lenders seek to sell the shares, too many sellers simultaneously drive away the buyers who are waiting for a bargain price which results in continuous fall in share prices. This results in continuous fall in security cover with no realization from share sales coming in.

The Way Ahead

Right end use: loans taken for the right use (creeping acquisition, conversion of warrants) tend to be value accretive. However, pledging for unrelated expansion, riskier ventures and personal purposes should flag a concern.

Covenants: right covenants around overall pledge levels and triggers to unwind the transaction on crossing a particular pledge level are a must.

Monitoring of pledge levels: promoters as well as lenders to monitor the pledge levels rigorously. SEBI has widened the scope of encumbrance include pledge, lien or any other transaction by whatever named called. Promoters will have to disclose separate reasons for encumbrance if the combined hindrance crosses 20 percent of the share capital or 50 percent of the total promoter holding. A company's audit panels will have to be kept informed of any undisclosed encumbrance. All these are steps in the right direction.

Alternate means available to the borrowers: Selection of borrowers who have alternate sources of repayment goes a long way in ensuring credit quality of such loans.

Pledging of shares has emerged as a strong alternative to regular financing and allows promoters to raise quick financing. However, such lending should be done only with the right safeguards in place.