PRIVATE EQUITY FUNDS: A CASE STUDY

INTERNSHIP PROJECT SUBMITTED TO R & A ASSOCIATES, HYDERABAD- IN MAY 2014

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During the month of May, 2014, I, Sadia Zeb, B.A, LL.B (Hons.) Vth Year, Damodaram Sanjivayya National Law University, Visakhapatnam, interned with R & Associates, Hyderabad under the tutelage of Mr. Prashant Jain, Senior Associate, R & A Associates, Hyderabad. As a part of my internship, I was asked to critically examine the various emerging cases in India between private equity funds and Promoters / Portfolio Companies. This project report, "**Private Equity Funds: A Case Study**", is an attempt in this direction.

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WHAT IS PRIVATE EQUITY FUNDS?

Private equity and venture capital ("PE") has been a driver of growth in the world economy for decades. While growth and profitability remain the primary goals of the PE industry, the contribution of the PE industry to economic development is undeniable.

Furthermore, the ability of timely investment to sustain and gestate ideas into economic realities has permitted the PE industry to take on a parental role in the economy. A number of standard terms of PE deals have not yet been tested in dispute and exits are only now starting to take place. There is still a lot to learn in terms of how PE transactions work in India

Around a couple of years back, India was the beloved child of most private equity funds across the world. A large number of private equity funds had earmarked ample funds for investment in India. In terms of investments, the Indian Private Equity story was second to China. However, the private equity story hasn't comparatively panned out as expected. Success stories for private equity funds in India are Flipkart, Bharti Airtel, ABG, Pantaloons, and Snapdeal among others. Private equity funds that invested in sound growth companies around 2000-2002 earned handsome returns on their investments. However, in recent times this sector in India is facing many challenges in terms of regulatory, economic and political perspective. Including such as inability of PE funds to raise capital from LLPs, declining interest from foreign investors in the India growth story, promoter- private equity discord, experienced private equity professionals venturing out on their own, inability to exit investee companies, low returns on investment, clash between promoters and investors, low standards of corporate governance in investee companies, private equity investors and promoters failing to reach consensus on management issues, certain issues are peculiar to India such as uncertain tax regulations etc. Thus, these aspects are paving way towards various clashes between promoters and investors and leading to various cases in India.

This project critically examines the various emerging cases in India between private equity funds and Promoters / Portfolio Companies.

1. LILLIPUT GIANT PROBLEMS: CASE STUDY

Facts:

It was one muggy June day last year when the first mails on the possible acquisition of one of its key rivals Gini & Jony started doing the rounds at Lilliput Kidswear Ltd. The former had received an offer from a strategic investor but the company was looking for other options, and a partial stake sale to Lilliput was one – signaling to the world that Lilliput was on its way to top dog status. Those were heady days at Lilliput. Its founder, Sanjeev Narula, who held 53.55 percent of its shares, had grown the company almost four times over from Rs. 127 crore in 2007 to Rs. 560 crore in 2011. And the company was fast approaching a major goal with its initial public offering that was estimated to net Rs. 1000 crore. It really could have not got any better for Narula. But like they say, when things look like they are too good to be true, they probably aren't.

Trouble Comes By Calling:

The fall was swift. It took only months to go from the heady days to the cancellation of the IPO and finally today to the legal battle in the Delhi High Court between Lilliput and its investors. The crash was hard and too fast for most to comprehend. The first signs of trouble came from an unexpected source for Lilliput: its private equity investors. And they are formidable names. Bain Capital had picked up a 30.99 percent stake in Lilliput through BC India Private Investors and TPG had picked up a 14 percent stake through Star Markets Asia Inc. in April 2010, for a total of $86 million. Both Sanjeev Narula and Bain Capital remained unavailable for comment despite repeated attempts, but court documents accessed by Entrepreneur help piece together a story that confounds and would depress anyone banking on the India growth story.

As per the affidavits filed by both parties, the Lilliput board, including the investors' nominee directors, met on September 23, 2011, where the decision to move towards an IPO was taken and the draft red herring prospectus (DRHP) was also approved. The board met the next day too, to discuss the IPO in greater detail.

But merely two days later on September 26, at about 6.25 am, a mail was sent to Narula from Mathew Levin, a nominee director, which sent a juggernaut of events snowballing into the path of Lilliput's amazing growth story. In the mail, Levin for the first time alleged that financial irregularities in the conduct of affairs of Lilliput had been found. Levin wanted Narula to call a board meeting to discuss the matter and to appoint an independent agency to conduct a "forensic investigation" of the accounts, books and records of Lilliput, its subsidiaries and related parties. Levin in his mail, as mentioned in BC India's affidavit to the court, also stated that Narula should ensure that Lilliput does not incur any more debt, nor does it draw down existing facilities any further until discussions on the matter at the board meeting. Levin revealed here that they had received an anonymous phone call about financial and related irregularities in the conduct of affairs of Lilliput and its financial statements. Lilliput on its behalf, as per the affidavit it has filed, states that the decision taken on the basis of one anonymous phone call was surprising since financial decisions were taken with the active knowledge of the investor's representatives who were also involved in day to day control of finances of Lilliput.

Initial Public Offer Pops:

On September 26, Narula received another letter from the investors withdrawing their consent to the DRHP. Subsequently, in a board meeting held on September 28, nominee directors of the investors wanted that S R Batliboi & Co. should be asked to re-audit the annual accounts of the company and also an overseeing independent agency should be appointed to conduct the investigation into the financial activities at Lilliput. *"The purpose seems to be to stall the growth of the company which would be ensured through an IPO on the stock exchange since with capital infusion, the company could reach world corners with its brand name and products,"* argues Lilliput in the affidavit.

Narula was also of the opinion that he should be allowed to conduct an internal investigation and report to the board within 15-30 days as involving an outside agency to conduct an investigation in the financial activities of the company when an IPO was due would create panic within the organization and hamper work. But his word was discounted. The board passed a resolution to direct S R Batliboi & Co. to re-audit the accounts and appoint Deloitte Haskins & Co as the independent agency to investigate the accounts. It was also decided that the accounts of Lilliput for financial year 2010-11 be disapproved. The investors also wanted to inform the banks and financial institutions about the developments, but the proposal was struck down as it was seen to *"destroy the company's reputation, hampering its operations and financial prospects."*

Situation Turned To Worse:

Things were unraveling fast at Lilliput now and getting worse by the day. On September 29, 2011 Narula was informed that the entire board had resigned barring him and another board member from the company, Arun Jain. The dream run was now over.

Lilliput has argued that the investors worked in a manner which would destroy its reputation and make it very hard for the company to raise funds. Terming them as buy-out firms, Lilliput states that both the investors actively participated in the affairs of the company, and that they *"resorted to illegal and malafide measures to denigrate the image of Lilliput so that the value of the company and its shares fall to such an extent that the promoters have no option but to sell their shares to the investors at nominal price."*

Pushed to a corner, Narula and Lilliput took the case to the Delhi High Court in October 2011 and filed a petition under Section 9 of The Arbitration and Conciliation Act, 1996 to restrain BC India and Star Market from interfering in the business and working of Lilliput. Lilliput also looked at restraining BC India and Star from taking any action that would harm the image of the company, act contrary to the minutes of the meeting dated September 28, 2011 and restrain BC India and Star from selling, alienating, transferring or creating third part rights in any manner.

No Clarification to Certain Questions:

There are no doubts in the minds of many watching the current developments that some pertinent questions remain unanswered. Firstly, who made that anonymous call to the investors? Lilliput has maintained that the entire furor based on an anonymous call was uncalled for, adding that the investors have not been able to provide any evidence on financial irregularity as alleged in that phone call. The company also alleged that the investors led the board to disapprove the financial statement for 2010-11 without any real reason to do so. Some sections feel that the board of Lilliput, led by nominee directors of the investors, may have erred in disapproving the books of accounts. According to Accounting Standard 5, accounts once adopted in an annual general meeting (AGM) cannot be reopened. It is normal for a mistake, fraud or any prior period error to be adjusted in the next financial year. The investors, on the other hand, maintain that the books of accounts had not been approved at an AGM in the first place.

At the centre of controversy is the role of the investors in the day-to-day operations of the company. The investors cite Clause 7.2.4 of the shareholder agreement which states that "for avoidance of any doubt it is clarified that each of Bain Directors and the TPG directors shall be non-executive Directors and shall have no responsibility for day-to-day management of the company." Lilliput, however, maintains that the directors were closely involved with the working of the company. Documents with Entrepreneur show that the investors were updated with monthly progress reports, on which they gave their feedback, as well as data analysis, monthly results, business plans etc. However, all the statements and data were presented by Lilliput and not obtained by the investors independently. The real picture, therefore, is somewhere in the middle.

Why Was Lilliput Stonewalling?

Emails dated October 29, 2011 show that when a team from S R Batliboi went for a re-audit, it was only provided with limited information and later, it was denied permission to enter the premises of Lilliput altogether. Subsequently in an e-mail dated October 1, 2011, S R Batliboi resigned as the statutory auditor of Lilliput. Lilliput, on the other hand, contests that banks have an exposure of over Rs. 500 crore and they should be the ones to suggest the name of the auditor for an investigating audit. After a meeting with the bankers on October 20, 2011, Anil Aggarwal & Associates were nominated to look into the books of accounts. However, after many deliberations, S.S. Kothari Mehta and Co. was finally appointed. In the courts, however, counsel for the investors argued that Narula was not supplying the relevant papers to the auditors and submitted a communication dated January 3, 2012, from the auditors to prove the point. Therein, both the parties agreed that all relevant papers would be supplied to the auditors to enable them to conclude the audit in terms of the order passed by the court.

Questions remain on Lilliput's reluctance for a re-audit. What could have, perhaps, been a logical step for Lilliput to do would have been to go for a re-audit, satisfy the investors and proceed with the IPO? While it resisted, fearing that its reputation would be tarnished, today it stands to lose much more.

The Way Ahead: Present Status

On the Delhi High Court's order, the case has now gone to the arbitration panel, which will be a long and expensive procedure. Arbitration can run for about six to nine years and each arbitrator charges about Rs. 2.5 lakh from each party per sitting. Such proceedings can be stretched across anywhere between 30 to 40 sittings. The auditors have filed their report in a sealed cover and since the arbitral tribunal is seized of the matter, the auditors' report has been sent to the Presiding Arbitrator. The entire Lilliput case, however, raises several serious issues, including some about the future of private equity in India. If two major PE firms have been locked in a messy legal battle with a company which was once seen to be a winner, what does the future hold for others betting on such companies? The case has been in the courts for over nine months and the Company Law Board has also been involved.

The Lilliput case, PE circles say, has already dented sentiment and exposed the vulnerability of investors in such situations. For Lilliput, the entire dream is now hanging by a thread. Banks and financial institutions have stopped lending. There were talks of a possible deal with French PE major L Capital, but according to sources, the PE firm is no longer interested in a deal. But as the troubles mount, more than Bain and TPG, it is public sector banks like Allahabad Bank, which has the maximum credit exposure to the company, who would have a lot to lose. Tata Capital and China Trust Bank, two others which have exposure to the company, have already filed separate cases in Delhi High Court against Lilliput to recover their loans. Clearly, things are getting messier for Lilliput.

For Bain, which has a sizeable stake in Lilliput, this is certainly a body blow. But despite this, sources say it's not the end of the road for the PE major as it has other investments in the country and this one case is unlikely to dampen its overall outlook for investments in Indian startups. For a PE investor, when such a scenario takes place and corrective actions are too far in the future, it is a norm to write off the investments made in a company. This may also be the case here. Recent news reports say Lilliput is now seeking a bilateral or corporate debt recast of its Rs. 875 crore debt and is talking to its bankers. While both Narula and the PE investors will be hoping for a resolution to this tangle, if Lilliput's problems were to worsen, it could well be an unfortunate blot on the otherwise exciting Indian entrepreneurial story which has caught the imagination of some of the world's biggest investors. To that extent, Lilliput's entrepreneur-PE faceoff will serve as a vital case study. The world will surely be watching very closely.

2. FAILURE OF SUBHIKSHA

In January 2009, around the time that Satyam Computer Services was collapsing in a heap, Subhiksha too was falling to pieces. In all the noise generated by Satyam's crash, India's biggest discount retailer's downfall was muffled, heard merely as a whisper.

Facts:

In 1997 Subhiksha Trading Services is set up as a private limited company. It became a public company in 2005. In 2000 ICICI Venture makes its first investment in Subhikhsa, which has grown to a chain of 50 stores. It buys about a 15% stake for Rs.15 crore. ICICI Ventures' Bala Deshpande joins Subhiksha's Board. Renuka Ramnath is nominated to the Board 2 years later.
In December 2007 Initial Public Offer plans called off after legal firm Amarchand Mangaldass refuses to sign off.

Whereas then in 2008, Azim Premji's Zash Investment acquires 10% stake in Subhiksha from ICICI Ventures for Rs. 230 crore. Later, Azim Premji promoted Zash Investments signs deal to buy 10% in Subhiksha for Rs. 230 crore.

In June 2008, Subhiksha proposes a reverse merger with Blue Green Constructions to get listed.
Complaints, reports appear in media about delay in payment of salaries, arrears in PF dues. Subhiksha shareholders' meet clears proposal for reverse merger, creditors also approve proposal Story Board meet called by shareholders and directors meet to discuss problems. Subramanian is asked to prepare accounts for 2007/08, appoint a CFO in consultation with the Board. KPMG is asked to conduct a complete audit. Premji Invest lends Rs 50 crore to Subhiksha to tide over acute financial crunch. But, yet Subhiksha was not able to repay it back.

Moreover, Mr. Subramanian admitted that some bankers are opposed to the merger. *"There has been some debate with some of the banks on whether the merger needs to be held in abeyance till the CDR (corporate debt restructuring) is closed. We have been advised by financial investors that the merger should be held in abeyance till the CDR is finalized in view of this request of the banks,"* he said. Even one of the Lenders said that*: "The purpose of the reverse merger was to get Subhiksha listed with the stock exchanges, which has lost relevance now. So, the merger doesn't make sense to us now."* In addition to Premiji Invest and ICICI Venture, the list of Subhikha's lenders includes HSBC, Axis Bank and Yes Bank.

Thus, Subhiksha owes over Rs 800 crore to a consortium of 13 banks. As of March 2009, it also owed up to Rs 190 crore in non-bank dues, including Rs 32-35 crore towards rentals and equipment suppliers, Rs 80 crore as shareholder loans and Rs 6-7 crore in statutory payment dues, such as PF and taxes.

As a result of such scenario, in 2009, ICICI Venture and independent directors resign from Subhiksha Board. Most of company's 1,650 shops are shut. Kotak Mahindra Bank files petition for winding up and also filed its objections to the merger between Subhiksha and Blue Green Construction and Investment Limited.

Court's Decision:

Madras High Court appoints provisional liquidator. Decision stayed: but proceedings of winding up can continue. Whereas meanwhile Registrar of Companies, Chennai, orders a probe into Subhiksha affairs. Then the Supreme Court asks Madras High Court to dispose of reverse merger petitions.

In 2010, Madras High Court rejects Subhiksha-Blue Green merger, paves way for winding up

3. GENERAL ATLANTIC, INDIA EQUITY PARTNERS CASE

In yet another case of private equity investors standing up against poor corporate governance, global fund General Atlantic and India Equity Partners have filed a petition in Company Law Board against Fourcee Infrastructure Equipment Pvt Ltd.

Facts:

The petition requests the Company Law Board to appoint its administrator to take control of the infrastructure services company alleging the promoters have been siphoning money. The funds have also requested the Company Law Board to conduct further investigations into the company's financial affairs, a joint press release from both the funds said. General Atlantic invested $104 million in Fourcee Infrastructure, a provider of bulk logistic solutions in specialized tank trailers and equipment, in January 2012. A year before in January, 2011, India Equity Partners had invested $10 million in the company. In 2010, others like SIDBI Venture Capital and Mayfield Fund had invested $10.98 million in the company. The allegations of extensive forgery and willful deceit, by the company's current management came to light after an audit by BSR & Company's, an affiliate of KPMG. Post the audit of the books of accounts for year ended March 2013 and uncovering of fraud, the funds, along with the board of directors of the company appointed Ernst & Young LLP for forensic audit.

Present Status:

The CLB filing accuses Rajesh Lihala, promoter and executive chairman and Vinay Singh, promoter and managing director of the Company of the alleged financial irregularities. "EY's work is ongoing, but has been substantially impeded by the Company's promoters," the release stated. The two fund's non-executive representatives on the Company's board of directors have resigned from the board. "In conjunction with the CLB filing, GA and IEP are evaluating several litigation options against those responsible including Lihala and Singh and will pursue them vigorously in India and other jurisdictions, based on advice from our legal counsel. We are working closely with auditors and advisors and doing everything in our power to protect our investors' interests and those of the Company's stakeholders," the funds claimed in the release.

Therefore, is third such instance in India where private equity investors had to bite the bullet after there have been alleged corporate governance issues in the company. Earlier in 2011, global funds Bain Capital and TPG had dragged the promoters of children's apparel retailer Lilliput to court for mis-appropriations of accounts. In 2008, PE funds ICICI Ventures had filed case against bankrupt retailer Shubhiksha.

CONCLUSION

Thus, to conclude it’s now time for PE funds to do a 360 degree assessment of their set-ups and take some bold decisions: to let go of people who defend and extending past failures and bring up those who could position for rapid, profitable growth when the cycle turns up. Yes, an up cycle. Because it’s not all gloom and doom even though the macro environment looks very challenging: India's economy is growing at its slowest pace in nine years, the rupee is the worst performing currency in Asia this year, inflation remains high, industrial production has stalled and the country faces the threat of having its credit rating downgraded to junk. Rating agencies Standard and Poor’s (S&P) and Fitch Ratings Inc. have already lowered India’s outlook on a slew of economic concerns. No one can pin down the accurate blend of reasons why PE firms succeed or fail?

There is no magic formula, only a long list of known ingredients. PE players have to do relationship driven deals, desist from paying a higher entry price and ‘value-add’ in the true sense, apart from institutionalizing the set-up. They have to be also bold enough to return the money to the LPs.