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Rise of 'control transactions' in private equity space

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The past couple of years have witnessed several buy-outs or control transactions in the private equity (PE) space. There has been a sudden increase in interest among PE funds to acquire strategic and operational control in their target entities.

Market sources indicate that India witnessed a 25% growth in the number of PE buy-out deals in the first 6 months of 2019 as compared to the corresponding period in 2018, illustratively, Advent International's acquisition of controlling interest in Bharat Serums and Vaccines, Blackstone's acquisition of majority stake in Aadhar Housing Finance and Essel Propack Limited, and KKR's buy-out of EuroKids.

This gradual shift in investment pattern has emerged due to various factors such as liberalisation initiatives of the government, change in the mindset of Indian promoters, succession issues and increase in the risk appetite of PE funds.

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Interestingly, companies looking to raise capital from PE funds have been equally inclined towards the operational expertise and human capital that the PE funds bring to the table. While control transactions are on the rise, these come with their own set of challenges, some of which are set out below:

1. **Interplay of rights between PE fund and promoters:** Operational freedom typically rests with the promoters in buy-out transactions, where the promoter retains a stub shareholding and manages the day-to-day affairs of the company. Given this, the controlling PE fund's role as the majority shareholder is required to be balanced against the minority protection rights sought by the promoters typically in terms of voting, exit and upside sharing.

2. **Exit considerations:** In a control transaction, the PE fund gains the ability to facilitate its own exit from the investee company. However, in case of an exit by way of an initial public offering of the shares of the investee company, this benefit gets coupled with the risk of the PE fund being classified as a 'promoter' of the investee company, which imposes several restrictions and obligations on the PE fund. Here, one may also consider externalising investor holdings and exiting offshore, which can bypass the challenges faced by PE investors in exiting from the Indian market.

For exits through secondary sales, a question which is very often discussed and negotiated is the source of business and operational warranties and corresponding indemnities to the potential buyer. The promoters argue that they, being the minority shareholders, are not in a position to subscribe to such obligations. At the same time, it is not practical for the exiting PE fund having a limited life span to extend such warranties and corresponding indemnities (except in situations where control was being exercised entirely by the PE fund). In this regard, insurance products are gaining momentum and are increasingly being used by PE funds not only to mitigate exit risks and exposure to indemnity claims but also to accelerate the negotiation process and facilitate a smoother exit.

3. **Conflict of interest and heightened liabilities:** Directors nominated by the controlling shareholder must bear in mind that they owe fiduciary duties to the company, and not to the shareholder nominating them. To that end, conflicts of interest must necessarily be avoided. For example, the nominee director should not disclose any confidential or unpublished price-sensitive information to the appointing shareholder without the consent of the company.

At the same time, it becomes difficult for a PE fund nominee director on the board to absolve itself from liabilities and obligations imposed on officers and executive directors of a company, which is controlled by the shareholder nominating such director.

Emerging Trends

1. **Balancing rights and mitigating liabilities:** The landscape of control transactions is evolving continuously and issues around minority protection rights, liabilities and exits associated with such transactions (highlighted above) are being dealt with through various approaches. Off-late, professional senior-level managers are being appointed to run the operations of the investee company such that the nominees of the PE fund, as well as the promoter, are shielded from statutory liabilities attached to directors and promoters. In terms of backstopping indemnity obligations, parties are increasingly looking at representation and warranty insurance from third party insurance companies.

2. **Prospects in family-promoted businesses:** Another driving force for control transactions among family-promoted businesses is the succession-oriented uncertainty affecting the continuity of the business, which creates avenues for PE funds to leverage their financial and managerial expertise to buy-out these businesses. Even where there is robust succession planning, reports indicate that most family-owned businesses are keen on growing their operations by bringing onboard PE funds, thereby creating opportunities in the buy-out space.

3. **Collective control by PE funds:** In situations where multiple PE funds propose to collectively exercise control over a company, the matrix of rights and liabilities inter se the PE funds also become important to determine. While co-investing allows for sharing of financial and operational risks, each fund will have its own set of limitations and priorities and for all of them to get on the same page can at times become challenging. Having a professionally managed board and 'promoter-less' model of shareholding has become

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