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### UNLOCKING INFRASTRUCTURE POTENTIAL – SEBI'S NEW FRAMEWORK FOR SUBORDINATE UNITS IN INVITS

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#### **Introduction**

In an effort to enhance flexibility in asset acquisition transactions and facilitate ease of doing business, the Securities and Exchange Board of India (SEBI), has made a significant amendment to the regulations governing Infrastructure Investment Trusts (InvITs) *vide* the SEBI (Infrastructure Investment Trusts) (Amendment) Regulations, 2024 (Amendment). The Amendment introduces a new framework for issuance of 'subordinate units' by privately placed InvITs aiming to address the cash flow and valuation gaps, that emerge between the sponsor (as asset seller) and the InvIT (as an asset buyer). This gap arises due to differing value expectations of infrastructure assets. Subordinate units bridge this gap by offering a flexible payment solution. In case cash flow falls short due to differing valuation expectations, these units allow part of the consideration to be paid to sponsors, sponsor group and/or their associates (as seller(s)) (Eligible Entities) through issuance rather than ordinary units. This not only defers payment based on the asset's future performance but also preserves the existing unitholders' stakes from immediate dilution, aligning everyone's interests in the asset's long-term success.

#### **Breaking down the Jargon: what are subordinate units?**

Prior to the Amendment, InvITs were permitted to issue only one class of ordinary units to all the investors to ensure pro-rata and pari-passu rights of all unitholders with equal voting and distribution rights proportionate to their unitholding. Additionally, the InvIT regulations contemplated issuance of subordinate units to the sponsors and its associates, where such subordinate units would carry only inferior rights compared to ordinary units. However, there was a lack of structured approach or detailed guidelines concerning various aspects, including their issuance, disclosures and safeguards for upholding the interest of the unitholders. The introduction of a framework for subordinate units has thus, led to standardisation of procedure and conditions for issuance of subordinate units and disclosure requirements.

This framework pegs subordinate units as a distinct class, explicitly inferior to ordinary units, with zero voting and distribution rights, exclusively available for issuance by privately placed InvITs, serving as a form of consideration only to the Eligible Entities in the course of an infrastructure asset acquisition. The regulations ensure that all subordinate units share these inferior characteristics, thereby preventing the creation of multiple classes within an InvIT's capital base. To maintain transparency and security, subordinate units are to be issued only in dematerialised form and will carry separate ISIN number.

#### **The Amendment: A closer look**

##### **Issuance conditions**

The regulations outline specific conditions for the issuance of subordinate units, ensuring a structured process. Subordinate units can be issued either by way of an initial offer or

any offer subsequent to initial offer, with the latter requiring unitholders’ approval. These are to be issued only to the Eligible Entities, either along with or without the issue of ordinary units. Further, the pricing of such subordinate units are required to adhere to the established pricing guidelines for the ordinary units. As subordinate units are inherently inferior to ordinary units, they shall not contribute towards the mandatory minimum unitholding requirement applicable to the sponsor and sponsor group.

To further protect investor interests, the issuance of subordinate units is capped at a maximum of 10% of the acquisition price of the asset. This cap prevents excessive valuation gap and ensures that any potential capital appreciation benefits the broader investor base rather than exclusively the sponsor.

Additionally, the aggregate number of outstanding subordinate units shall not, at any time, exceed 10% of the total number of outstanding ordinary units. This regulatory ceiling is designed to limit potential dilution of existing unitholders, thereby safeguarding their investments and maintaining equity within the InvIT.

#### **Reclassification of subordinate units**

Subordinate units are mandatorily locked-in till they are reclassified into ordinary units. They can be reclassified into equal number of ordinary units on a *pari passu* basis, contingent on achievement of a predefined performance benchmark, which needs to be quantified in an objective sense at the time of issuance.

SEBI has prescribed a minimum time period of three years between the issuance of the subordinate units and entitlement date for their reclassification. The entitlement date for reclassification can be extended for a maximum period of one year and not more than two times in total, by approval of the unitholders.

If the performance benchmark is not met at the end of entitlement date (including extension period, if any), the subordinate units shall be extinguished without any payment to the holder of subordinate units. Further, zero voting and zero distribution rights will also ensure that sponsor and its group entities / associates do not get any economic benefits out of the subordinate units until the pre-determined performance benchmarks are met.

Once reclassified, the ordinary units issued on reclassification of subordinate units can be listed on the stock exchanges.

#### **What happens in case of change in sponsor?**

While ordinary units are freely transferable, subordinate units may only be transferred or encumbered by the sponsor, its associate and sponsor group amongst themselves. This ensures that the control of the InvIT remains within the sponsor group, thereby preserving the control structure of the InvIT, which could be critical to the InvIT’s decision making and operations. Accordingly, in case of change in sponsor, the outgoing sponsor shall transfer subordinate units held by it, if any, to a sponsor, including an inducted sponsor, its associates or members of the new sponsor group.

However, in a situation where the investment manager is transitioning from being externally managed entity to being self-managed, the transfer of subordinate units by an outgoing sponsor to the self-sponsored investment manager is not permitted.

#### **Conclusion**

The Amendment, represents a pivotal development in the regulatory landscape for InvITs. By introducing the concept of subordinate units, SEBI has provided a sophisticated tool for bridging cash flow and valuation gaps in infrastructure asset acquisitions. This amendment not only enhances transactional flexibility and efficiency but also safeguards the interests of existing unitholders by preventing immediate dilution.

Although at this point, SEBI has allowed only privately placed InvITs to issue subordinate units, based on the experience gained. SEBI may consider extending the ambit of the regulation to cover publicly placed InvITs also. As the infrastructure sector continues to evolve, these regulatory advancements will play a crucial role in facilitating seamless and balanced investment transactions, ultimately contributing to the growth and stability of the market.

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