Intelligent Legal Risk Management LLP

Rules of Playing with Debt:
Why to get into business debt and how to get out when things go wrong

People across various geographical locations differ from one another in their tendency to save and borrow. Some never take loans at all, while others are indebted to almost obscene levels. Given that there is always a possibility of not being able to repay debt in case your business plan doesn't work out, does it make sense borrow to expand your business? Have you considered that you can borrow against your business to take it to the next level? A very large number of successful businesses in the world have expanded on debt. From Goldman Sachs to probably your local transport tycoon, many businesses thrive on debt. Debt is not necessarily the last resort of an entrepreneur; there are some strong reasons for which a company must prefer debt even when it has other sources of capital available. On the other hand, aggressive debt backed expansions often land otherwise sound businesses in grave trouble. Here are the rules of playing with debt along with a case study of Vishal Retail.

An introduction to debt capital basics

Rules of Playing with Debt. Why to get into business debt and how to get out when things go wrong?

A company needs capital to expand. Capital is broadly available from two sources – debt and equity. Every corporation finances its activities using various proportions of debt and equity to raise capital for its operations. The proportion it will choose to raise will depend on its cost of capital – which depends on how difficult or costly it is to tap one source compared to another depending on factors such as rate of interest required to be paid to the source and tax treatment of the interest on that capital.

Using these factors, a business will be able to arrive at a rationalized and optimal mix of debt and equity for itself. In corporate finance, the theory presented by Modgliani and Miller states that in the absence of any taxation, the source of capital, be it equity or debt, is immaterial to the company. In reality, however, due to the presence of taxation, bankruptcy costs, and an imperfect market, a company needs to pay attention to its capital structure.

Two Reasons why you should raise debt for your company

For publicly traded companies, Earnings per Share (EPS) is a very important determinant of their stock price. It is always lingering in the mind of a CEO or CFO while making a decision. Hence, for the same amount of capital, a company would prefer to have a higher proportion of debt than equity as the Earnings Per Share in such a case is higher.

Interest paid on debt and loans on the other hand, can be deducted from income as cost and no tax is payable on the same. In case of equity capital, amount paid out as dividend is not allowed to be deducted from the income of the company while deducting tax liability. Hence, the amount spent as dividend is included in the income of the company, on which tax is levied. Next, tax is to be paid a second time when the dividend is paid, either by the company in the form of a dividend distribution tax, or by a shareholder as part of his income, depending on the tax law of the country.

What you can do when you are unable to pay debt

In the retail sector, the chain 'Subhiksha' decided to shut down its 1600 retail stores in 2009 because of a credit crunch and financial slowdown. Its inability to meet its debt obligations occurred in the midst of the financial slowdown, so it could not keep itself afloat and had to follow the conventional route of closing down. Another company in the same sector facing very similar problems has managed to tackle its debt problem and turned around this year. Before we go into the lessons to be learnt from the success of 'Vishal Retail' let us be clear with some basics.

I am comfortable with debt. When and why do I need to restructure?

There can be situations where the companies face declining profits or a temporary cash crunch. When a company has insufficient money to make payments in respect of its debt, because of losses and/or due to poor management of cash flow, it runs the risk of being declared insolvent by a Court. If that happens the assets of the Company will be sold off and the proceeds distributed amongst its creditors. The business of the company will be wound up. The Company, in such a case, has an option – it can try negotiating with its creditors so that it does not have to make the desired interest payment. In return, it may have to offer the creditors an incentive, possibly a long-term one, as the company does not have enough resources in the short term. This process is known as debt restructuring.

Why would a creditor agree to a compromise?

The incentive usually offered to lenders to agree to a restructuring proposal is by way of a convertible instrument – either a convertible preference share or a convertible debenture. The convertible instrument gives the lenders an option to convert their debt into equity at a certain price. Till the option is exercised the money is treated as debt and fixed payments are made on it, normally at a reduced rate, since the company is not able to make the full interest payment. Of course, it is important to win over the confidence of the lenders in giving the business a second chance. Sometimes, their consent may need to be taken if changes are made subsequently to core business policy.

The lenders agree to accept less payment, possibly a lower rate of interest in the immediate short term. This is a better option for them, compared to theirs not getting the full value of money owed to them, if they opt for a full-fledged Court insolvency route.

The lenders enjoy two kinds of upside. In the short term, if they have been issued convertible preference shares which are of a 'participating' nature, they would get the right to enjoy a percentage share of the company's profits. In the medium to long term, they would look at the option to convert their preference shares or debentures into equity, and sell them off at a huge profit. For conversion, it is important to note the price at which the lenders will be allowed to convert in future. This price is mentioned in the restructuring proposal. A lesser price implies that the investor will be able to get a large number of shares for his initial commitment. Depending on the performance of the company, if the market price of the share at the time of exercise of the option is higher than that stipulated in the contract, the profit made by the investor is greater. Hence, a lower price stipulation in the contract means that there is greater chance of the market price being higher, if the company does well.

If the company does not do well, the lenders may choose not to exercise the option to convert and will subsequently redeem the preference shares or debt, that is, they would be repaid the principal amount with interest, *as long as the company is solvent*. They would have also received periodic interest payments until the time of redemption. Although this circumstance would not yield superprofits for a lender as the interest rate in the restructuring plan is likely to be less than the interest rate of the original loan, it would be better than a situation where no restructuring had been attempted, as in the latter case, the investor ran the risk of losing all his money in the event of the company's insolvency.

Negotiation strategy to get a favourable deal

Companies may note here that it is important to make a study of the outstanding loan amounts payable in advance before they go for restructuring, so that they are aware of what options can be beneficial for lenders as well as themselves in the short term. As there are chances that the company may still not be solvent it is important to convince the investors or creditors of the future plans and how the company will now be able to succeed where it once failed in the past.

Operational aspects of the framework in India

In India, the Corporate Debt Restructuring (CDR) scheme has been framed by the RBI. It can be resorted to by a bank or a corporate creditor (if supported by a bank), having 20 percent or more share in working capital or term-finance of the borrower company which is facing default or looking to restructure. Under this mechanism, the parties can approach the CDR Cell, headed by a bunch of leading Indian banks, to study the viability of a restructuring plan and assist in framing one. A debt restructuring scheme has to be approved by 75% of the creditors (in terms of value) and is then binding on all the creditors associated with the transaction. The remaining 25% would have the option to exit by selling their share to existing or fresh lenders. It is executed by drafting a fresh Debtor-Creditor Agreement (DCA) and an Inter-Creditor Agreement (ICA). Hence, the entire transaction is done on the basis of contractual agreements.

The case of Vishal Retail

Vishal Retail is a Delhi based multi-brand retailer with stores in north and central India. Looking into the company's growth trajectory it seems that the company took up a lot of short-term debt on its books to finance its aggressive growth but was unable to service this debt because of the market slump and owed around Rs. 730 crores to its creditors. This forced the company to approach the CDR cell in November 2009 for a restructuring plan.

Vishal Retail's restructuring plan had a minor tweak in comparison to the plan elaborated above. It involved external investors (such as a private equity group) as well, in addition to the company and the lenders. The investors would be issued new instruments and the money infused into the company pursuant to their entry would enable the company to pay off its commitments to the existing lenders.

Introducing an external investor may have its own advantages. Lenders may have a rigid policy, because of which they may not be amenable to giving up their short term interest for a possible long term gain. In such a case, an external investor can be approached, so that the commitments made to the existing lenders are met from the funds infused by the new investors, who agree to take a small risk for a chance of profits in the medium to long term.

The CDR cell was approached by two investors, *(1) The Texas Pacific Group (TPG)*, a Private Equity Investor; and *(2) Future Group*. Let us analyse these two offers.

Offer #1: TPG's 500 crore plan with Convertible Debentures

TPG offered to convert Rs. 176 Crores of debt into Convertible Debentures carrying a 0.5% interest rate, to be converted into equity at the rate of Rs. 108/share in 2015. To comply with regulatory norms (restriction on foreign investment in the retail sector) it was decided to hive off the wholesale/warehousing business of the company into a separate entity which would be acquired by

TPG. The retail end of the business was to be handled by a domestic investor. TPG offered to invest Rs. 200 crore up-front in the business and also set aside another 300 crore as additional investment.

Offer #2: Future Group's 432 crores with redeemable preference shares

On the other hand, the offer made by the Future Group included a proposal to issue redeemable preference shares worth Rs. 176 Crores. These shares would carry an interest component and could later be converted into equity at the prevalent market rate. Future Group also offered to transfer 256 crores of debt into the accounts of various future group subsidiaries to reduce the debt burden of the creditors.

Comparing the Offers

The major difference between the two offers was in the way the business was to be structured. TPG could not acquire a majority stake in the company because of regulatory hurdles as it was involved in multi-brand retail. It therefore proposed to acquire the wholesale business of the company and bring in a domestic partner to acquire the front-end assets of Vishal Retail. TPG committed to invest heavily in the business and make it profitable.

The Future Group, as it was already an established player in the retail space, proposed to transfer all the assets of Vishal into a separate company (known as a shell company in business law terminology) and transfer some part of the debt into books of other companies within the Future group. It did not commit to any equity investments into the operations of Vishal. Integration of the operations between the two retail chains could accrue cost and efficiency benefits and make the transaction financially viable for the creditors.

The winning stroke

The CDR cell, comprising the leading creditors of Vishal Retail have selected TPG's offer over the Future Group. This was done despite the regulatory hurdles faced by foreign investors when it comes to investing in multi-brand retail. The Texas Pacific Group sweetened its offer by reducing the interest repayment moratorium by a year and also increasing the cash component of the deal. This offer was selected by the creditors over the offer made by the Future Group which did not include any substantial equity investments into Vishal Retail.

The CDR mechanism was set up to pre-empt the insolvency of the debtor company and take measures so that such a situation could be avoided and the creditors could get their money back without getting into long drawn tribunal or court proceedings. In the present case, the TPG offer included substantial investments in the operations of the company and an interest repayment moratorium of two years, as compared to a moratorium of three years as demanded by the Future Group offer. This was appreciated by the CDR cell and therefore the TPG offer was accepted.

Conclusion

Chances are that your business is probably not as big as Vishal's but the fundamental lesson will apply to your business as well irrespective of scale. The rule is that you should always look for financing through debt, and then keep the possibility of restructuring the debt open. Is there something you can offer to a creditor in the long run for which he may be willing to forego some short term profits? Is there a possibility of roping in a fund to share some of the risk? In most cases, if you have a sound business plan, none of this should be difficult. Good businesses that have good growth potential are difficult to find. Please note that I am not saying they are rare, but they are incredibly difficult to find as far as investors and creditors are concerned. So much so that they are ready to pay millions to reasearch firms and consultants and stock brokers to find them good deals.

That is why, if you have a good business model, a positive cash flow or potential for the same and a market to be captured, finding capital should be more than possible. However, you shall commit a mistake if you are not reviewing the capital structure of your company, not considering the possibilities that can be thrown open by taking on some more debt or by issuing some equity to your debtors.

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