Mezzanine Financing and Hybrid Capital Instruments for Small Entities and Startups

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About Us

- Vinod Kothari & Company, Company Secretaries in Practice
  - Based out at Kolkata, Mumbai & Delhi
- We are a team of consultants, advisors & qualified professionals having over 25 years of experience

Our Organization's Credo:

Focus on capabilities; opportunities follow

What is mezzanine financing

Meaning of mezzanine financing

- Funding which is mid-way between traditional debt and equity
  - Pure debt is a fixed obligation to pay, with no stake in residual profits
  - Pure equity is no obligation to pay or distribute, but with stake in residual profits
  - Mezzanine capital is partly fixed obligation to pay, coupled with stake in equity
- Benefits of mezzanine financing to the borrower
  - Reduces equity component, thereby increasing return on equity
  - Reduces fixed burden on revenues; becomes coextensive with performance
- Benefits of mezzanine financing to the investor:
  - Substantially higher yields than in traditional debt

Different mezzanine financing instruments

- Convertible preference shares
- Revenue-linked debt instruments or structured bonds
- Optionally convertible debentures
- Optionally exchangeable debentures
- Compulsorily convertible debentures
- Compulsorily exchangeable notes
- Share warrants
- Share appreciation rights
- Convertible notes

Relevance of mezzanine financing to start-ups and small businesses

- Mezzanine financing very well suits the business needs of small businesses and start ups
  - Related to performance -does not create financial burden
  - Less burdensome than debt in the event of failure of business model
  - Mostly does not have security interest/personal guarantees

Share Warrants

Session Coverage

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Meaning of Share Warrant

- Share warrant is an **option** issued by the company that gives the warrant holder a right to subscribe equity shares at a pre determined price on or after a pre determined time period;
- Share warrants are a common source of funding used by companies, both public and private;
- Share warrants are similar to the concept of stock warrants used in United States;
- In the United States, warrants are also referred to as '**sweeteners**';
- Share warrants entitle the issuer to take advantage of future appreciation in the price of stock;
  - If the issuer issues the shares right away, the issuer will get the current pricing. The warrant, on the other hand, defers the issuance of the shares to a future date.

Essential elements in a Share Warrant

- Share Warrant comprises of following :
  - **Option** issued by the Company
    - option to exercise is with the option holder/investor.
  - Right to **subscribe equity shares** at a pre-determined price on or after a pre- determined time period
    - The warrant holder is given a right but not an obligation to subscribe equity shares;
    - In case, right not exercised by option holder, the option will lapse;
    - Consideration paid upfront will stand forfeited in case of listed entity;
    - In case of other entities, premium component is forfeited, principal component remains.

Whether Share Warrant is a Security?

- Share Warrants are "**securities**"
- Securities defined in Section 2(h) of Securities Contract Regulation Act, 1956
  (h)"securities" include—
  - *shares, scrips, stocks, bonds, debentures, debenture stock or **other marketable securities of a like nature** in or of any incorporated company or other body corporate;*
    xxx;
  - ***rights or interest in securities;***
- Stress is clearly on marketable securities
  - Underlying instrument in warrants are equity shares which are marketable;
  - Hence, warrants are also be marketable in nature.
- Further, RBI vide notification dated June 30, 2014 clarified that warrants shall be treated as security within the meaning of Section 2(za) of FEMA.
- For NBFCs share warrants form part of Tier-I capital

SINCE 1988
COMPANY SECRETARIES

Why invest in share warrants?

- In option theory every option has a value based on the difference between the fair value of the share at the time of the exercise of the option, and the strike price, that is, the price at which the option is granted.
- Therefore, if the share appreciates in value, the option/warrant holder stands to gain.
- It is stated in option theory that more the volatility of the underlying share more is the chance for making a gain.

Share Warrants vs ESOPs

	Share Warrants	ESOPs
Nature	Option given to subscribe to equity share	Compensatory in nature
Eligibility	Can be issued to anyone	Eligible employees
Regulation	Governed by Section 42 and 62(1)(a) or 62(1)(c) of Companies Act, 2013 and SEBI (Issue of Capital and Disclosure Requirements)Regulations, 2015 in case of listed entities	Governed by Section 62(1)(b) of Companies Act, 2013 and SEBI (Share Based Employee Benefits)Regulations, 2014 in case of listed entities
Upfront Payment	Upfront payment needs to be paid	No
Forfeiture of amount	Option premium may be forfeited	No amount paid by the employee which can be forfeited

Share Warrants vs Compulsorily Convertible Debentures(CCDs)

	CCDs	Share Warrants
Nature	Deferred equity instruments	Option lies with the holder
Conversion	There is certain conversion in to equity	Warrants may expire without conversion into shares in case option not exercised
Interest	May be paid	No payment of interest
Liquidation preference	Is in the nature of debt	Not in the nature of debt, but may be treated as debt if liquidation occurs before conversion

Share Warrants vs Compulsorily Convertible Preference Shares(CCPs)

	CCPs	Share Warrants
Nature	Compulsorily convertible into equity	Option to convert into equity
Share capital	Form part of total share capital	Does not form part of share capital
Dividend	Dividend is mandatory until converted	No requirement to pay dividend until converted
Liquidation preference	Preference has statutory priority	Depends on the terms of issue if liquidation occurs prior to conversion

Share Warrants vs Optionally Convertible Debentures(OCDs)

	OCDs	Share Warrants
Nature	Debt which have option to convert with the debenture holder	Option entiling the holder to subscribe equity shares
Convertible/ Exchangeable	Partially or Fully convertible into equity	Fully exchangeable into equity
Interest	May be paid	No payment of interest
Liquidation preference	Is in nature of a debt; hence, legal preference	If liquidation occurs before the conversion of the share warrant, warrant may be regarded as debt

Premium component and convertible component in a share warrant

- Two types of premium attached to the issue of share warrant i.e. Option Premium and Share Premium.

- Option Premium is usually paid upfront by any potential investor and entitle him to receive share warrant

- The warrant holder partly pays the premium for the option i.e. Option premium and partly pays the price for the share that ultimately will get allotted to him if he exercises the option.
  - In case of listed entity at least 25% of the consideration amount has to be received upfront.
  - In case of other entity, not prescribed in the Companies Act, 2013. Left with the discretion on the Board.

- Once the option is exercised, the convertible component is appropriated towards value of equity shares.

Difference between share premium and option premium

15 - 5 = 10

- 15: Subscription of warrants
- 5: Contribution towards capital
- 10: Option premium

15 - 10 = 5

- 15: Issue Price of Shares
- 10: Face Value of shares
- 5: Share premium

Pricing of the premium component of share warrant

- A warrant does not obligate the warrant holder to buy, but rather merely gives the holder the option to do so. Hence as the warrant isn't mandatory, its value can never go below zero;
- There is no standardized guidelines for structuring of warrants, so each warrant has unique characteristics.
- Vale of share warrant depends on the predicted value of share prices upon maturity.
- Warrant is a long term call option on the equity of the firm and can be valued using option pricing models.
- Pricing of warrants is based on the implied volatility assigned to the underlying stock; greater the volatility, the greater the value of the option.
- Warrant price will reflect the difference between the future expected value of the share and the strike price.

Pricing of the premium component of share warrant contd…

- Pricing of the warrants can be done by using following Option pricing models.
  - Black Scholes Option Pricing Formula
  - Binomial Valuation of Options

- The following caveats to be taken care of while using option pricing models for warrant valuation
  - Conversion options are long term, making the assumptions about constant variance and constant dividend yields much shakier
  - Conversion options result in stock dilution, and
  - Conversion option are often exercised before expiration, making it dangerous to use Eurpoean option pricing models.

- The aforesaid problems can be partially alleviated by using a binomial option pricing model, allowing for shifts in variance and early exercise, and factoring in the dilution effect

Legal aspects in Issue of Share Warrants

- Regulations applicable
  - Section 23 of the Act, 2013
    - Since share warrants are regarded as security, company needs to ensure compliance of Section 23 and other applicable provisions of Chapter III Part I in case of public issue of warrants
  - Section 42 of Act, 2013
    - *In case share warrants are issued on private placement basis*
  - Section 62 of Act, 2013
    - *In case of right issue of share warrants*
  - Section 62(1)(c) and Section 42 of Act, 2013
    - *In case of preferential issue of share warrants*
  - SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
    - *In case of public issue of share warrants and qualified institution placement of non-convertible debt instruments along with warrants*
  - FEMA (Transfer or issue of securities to a person resident outside India) Regulations, 2000
    - *In case share warrants are being issued to person resident outside India*

Can there be a shareholders' agreement in case of share warrants

- Yes. Since the warrantholder eventually intends to convert his warrant into shares
- Typical provisions of an SHA:
  - non disposal undertaking or maintenance of control
  - Pre emptive right to buy shares
  - Tag/drag rights
  - Anti dilution rights
  - Voting powers –
    - While warrants don't have voting rights, but in appropriate cases, vero rights may be granted

Conditions for issuing warrants under SEBI(ICDR) Regulations, 2009

- Regulation 4 (3) of SEBI (ICDR) Regulations, 2009 permits issue of warrants subject to following conditions:
  - tenure not to exceed 18 months from the date of allotment;
  - not more than one warrant shall be attached to one specified security;
  - the price or conversion formula of the warrants shall be determined upfront;
  - at least 25% of the consideration amount shall be received upfront;
  - in case option does not exercised by warrant holder, the consideration paid in respect of such warrant shall be forfeited by the issuer.
- Regulation 77 (2) of SEBI(ICDR)Regulations, 2009 mandates that an amount equivalent to 25% of the consideration determined in terms of regulation 76 is to be paid against each warrant on the date of allotment of warrants.
- The balance of the consideration shall be paid at the time of allotment of equity shares pursuant to exercise of option against each such warrant by the warrant holder.

FEMA Regulations for issuing Share Warrants

- Issue of share warrants is governed by FEMA (Transfer or issue of securities to a person resident outside India) Regulations, 2000;
- RBI vide notification dated June 30, 2014 clarified that warrants shall be treated as security within the meaning of Section 2(za) of FEMA.
- Under FEMA provisions the amount of consideration payable upfront is the same as stipulated under SEBI (ICDR) Regulations, 2009 i.e. 25% of the consideration.
- Balance consideration towards fully paid equity shares needs to be received within 18 months.
- Price at the time of conversion shall not be less than fair value at the time of issuance but can surely be more than the pre-agreed price.

Disclosure in Balance Sheet

- Money received against share warrants are disclosed separately in the balance sheet under 'Shareholder funds' on the liability side and does not form part of paid-up share capital unless converted into shares;
- In case of warrants issued at a premium, the amount of share premium received will form a part of securities premium account;
- Amount of option premium received against warrants will form part of the profit and loss account in case amount not forfeited;
- Amount of option premium received against warrants will form part of the capital reserve in case amount forfeited.