Companies Act likely to jolt realty firms

The recently-enacted Companies Act, 2013, is expected to give a jolt to real estate companies, already facing a severe fund crunch due to falling sales and high debt on books.

Section 185 of the Act, among other things, says a company cannot give loans to (or provide security on a loan taken by) a person in whom its director is interested.

According to the Act, "any person in whom a director is interested" could mean a director of a lending company or its holding firm, or a partner or relative of any such director, or a firm in which any such director or relative is a partner, or a private company of which any such director is a director or member.

Sai Venkateshwaran, partner & head (accounting advisory services) at KPMG in India, says promoter directors of several real estate companies could potentially be covered under this law, as many of them are directors of both parent and subsidiary companies. "It could become a liquidity issue for many realty companies. Earlier, funds raised by one company could be freely transferred to another group firm where there was need for liquidity. With the new rules, companies' ability to balance liquidity needs across group entities gets restricted," Venkateshwaran explains.

Though the corporate affairs ministry has clarified that a company can lend to its fully-owned subsidiaries, Venkateshwaran doubts this will apply on realty firms. That's because many real estate companies only partly own their subsidiaries — project partners, including land owners, private equity contributors and other investors bringing in capital, too, are owners.

ASK Investment Holdings Managing Director Sunil Rohokale suggests related-party transactions were earlier used as a way to siphon off funds, since developers floated different special-purpose vehicles for different companies. "There used to be a free flow of funds from holding companies to subsidiaries. The changes in the Companies Act will ensure each project will be capitalised sufficiently and surplus cash will not be given to directors or taken out of a company," he says.

J C Sharma, vice-chairman of realty company Sobha Developers, says it might affect some developers in the short term but will bring strength to investors and buyers over a longer period.

Consultants, however, say the clause that asks for issue of debentures to be secured through creation of a charge on properties or assets of a company, with value sufficient for payment of debentures and interests thereon, could also pose a challenge to real estate companies.

Typically, in real estate, land and properties are given as charge to banks, and debentures are secured with future receivables that are not shown on the company's balance sheet.

“If you are issuing secured debentures to non-banking financial companies, the Act requires it to be secured against properties or assets with value equivalent to that of debentures,” says Venkateshwaran, adding raising funds from NBFCs through debentures might become difficult now, as such financiers might not invest through unsecured debentures.

ASK’s believes the government needs to clarify on the clause. “The Act says you have to secure debentures with identifiable securities. But, many a time, that is not possible if you are giving a pool of securities to multiple lenders. It will be a burdensome exercise for realty companies,” he says.

For instance, developers sometimes give land as security to a bank and create secondary charge or ‘pari passu’ on the same asset if they are to take a second loan from another bank. “In such cases, it will become a challenge for developers,” Rohokale adds.

Real estate companies, which normally allot convertible shares to NBFCs or PE funds on a preferential basis, will also face a challenge in doing so. The Act says if shares are offered on a preferential basis with an option to apply for and get equity shares allotted, the price of the resultant shares will be determined beforehand. This will make use of convertible preference shares challenging, as the conversion price is usually linked to the expected return at the time of conversion (and not based on a price determined at the time of issue).

The Act also considers convertible preference shares as part of total share capital in determining the holding-subsidiary relationships. This, experts say, will make an NBFC or a fund parent in a project where the borrowing company has a small equity capital base. For instance, if a company has Rs 10 crore worth of equity share capital and issues convertible shares of Rs 50 crore to an NBFC on a preferential basis, the company will be considered a subsidiary of the NBFC or fund, and not a company with 100 per cent equity shares.

“NBFCs will find out new avenues to deploy their funds but it is more of a challenge for realty firms,” Venkateshwaran says. However, Sobha’s Sharma says this clause will improve debt-equity ratios of realty companies. “It will lead to a higher equity base and improve our ability to raise more money through debt,” he adds.

More importantly, the Companies Act also says that a company will be considered a “listed company” if any of its securities is listed on stock exchanges, against the earlier practice of treating one as a listed company if its equity shares are listed. “Even if your debentures are listed, clauses relating to a listed company will kick in and you have to live as a listed company, despite you being privately owned,” says Venkateshwaran. ASK’s Rohokale says the Act aims to bring in a new level of governance.

“Earlier, many unlisted companies did things in a hush-hush way. Now, everybody has to fall in line and be ready to be governed.”
(Business Standard)