Concerns among PE firms over enforcing realty share pledges

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May 2--Astay obtained by Unitech Ltd against the sale of shares it had pledged has made real estate-focused private equity (PE) funds uneasy, concerned that they could face similar opposition if they need to exercise similar rights.

Unitech said the shares were no longer under pledge.

"Promoters of Unitech obtained the injunction due to the unreasonable notice period given to them," the company said in an email release. "Outstanding loan amount was repaid in full by the promoters within a few days of obtaining the injunction and ahead of the schedule. The pledged shares got released nearly three months ago."

The pledging of shares is a mechanism through which an investor or a lender can ensure a company or a borrower delivers a promised return or repays a loan within the stipulated period. When the company defaults on the pledge, the shares are sold. PE funds that focus on real estate have got such pledged shares from their portfolio companies.

"The Unitech case has raised concerns among PE investors about the enforceability of the pledge," said Ruchir Sinha, co-head, real estate investments practice, at law firm Nishith Desai Associates. "Many funds are looking to enforce the pledge today, but are concerned if the company can take them to court and obtain a stay order."

Realty valuations have been declining as some companies have been facing allegations of wrongdoing relating to bribes given for loans and the allocation of telecom spectrum, besides falling home sales and rising interest rates.

On 30 January, Unitech's promoters approached the Delhi high court and secured an injunction against a move by debenture trustee Axis Trustee Services Ltd to sell pledged shares. The promoters of Unitech had raised '250 crore from high networth individuals (HNIs) in 2010 through the issue of non-convertible debentures and had pledged their shares in the firm as security to raise these funds.

However, on 28 January, Unitech's stock price dropped to '51 per share, marking a 38% decline since November 2009 and triggering the default. The same day Axis Trustee Services informed the promoters that it would sell the pledged shares on the next working day, as per their agreement. Unitech moved the high court, which said that if the stay was not granted, the company would suffer "irreparable loss".

Invoking a pledge can be challenging even in a publicly traded company, since the law requires that a fund must immediately sell the shares upon invocation; funds are often faced with the dilemma of whether to invoke the pledge or not, said Sinha.

"If they invoke the pledge, then they must ensure that the shares are sold, which may, apart from hammering the stock, earn a bad name for the fund," he said. "If they don't, and the share value falls, an argument can be made that they suffered the loss due to their failure to exercise their rights on time."

The situation is even worse in a private company as there is generally no market for such shares, Sinha said.

"Any lender who has pledged shares as collateral runs the risk of ending up in court," said a fund manager at one of the large domestic real estate funds, who declined to be identified as it was a legal issue.

Ideally, in a case where the lender decides to invoke the pledge even before the company defaults because of weak market conditions, the company should immediately provide for adequate additional security to avoid legal proceedings, he said.

There are three major forms of security that are available to lenders--mortgages, guarantees and share pledging. Realty funds are increasingly making investments through structured debt instruments and are looking at stringent security mechanisms and stock pledges are one of the most liquid form of security.

"This is a strong tool being employed by institutional investors today who are worried about their returns from their investment," said Amit Goenka, national director of capital transactions at Knight Frank (India) Pvt. Ltd.

According to him, what is prompting investors to enforce pledging of shares is that the risk associated with real estate has risen and investors don't believe they can get their returns on time.

There have been 10 investments worth $514 million ('2,282.16 crore today) in real estate this year, according to VCCEdge, a financial research platform. Last year, there were 34 investments worth $1.16 million compared with 28 investments worth $870 million in the year earlier.

Some of the big investments in the sector include $450 million investment in DLF Assets Ltd by Symphony Capital Partners Ltd, $296 million invested in Phoenix Mills SPV by MPC Synergy Real Estate AG and $200 million invested in Indiabulls Real Estate Ltd by TPG Capital.

"Unfortunately, it is true that real estate funds want to invoke pledges," said the general counsel of a local PE fund that has raised foreign money. He declined to be identified considering the sensitivity of the issue.

"If you see all the real estate companies, the extent to which shares have been pledged is increasing day by day," he said. "In some of those companies, it has reached the limit and they have nothing else to leverage. So, there is no other choice for those lenders, but to invoke the pledge."

However, Sinha of Nishith Desai cautioned that enforcing a pledge will affect the reputation of the company as borrowers will become apprehensive of taking PE money.

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