KPI-ING UP WITH THE TIMES - SEBI SWINGS BIG, HITS HOME?

1. INTRODUCTION

In our last update in October this year on the Securities Exchange Board of India ('**SEBI**') press release[1] dated September 30, 2022 ("**September PR**"), we wrote about critical regulatory changes on (i) disclosure of additional information for basis of valuation in an Initial Public Offer ("**IPO**"), (ii) introduction of confidential pre-filing of draft offer documents in an IPO; and (iii) monitoring of use of proceeds raised through a preferential issue and Qualified Institutions Placement ("**QIP**"), among others approved changes. On November 21, 2022, SEBI notified the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Fourth Amendment) Regulations, 2022 ("**November Amendment**") formalizing these changes. In this note, we examine the feasibility of the amendments, and potential challenges that issuers and merchant bankers are likely to face in implementing them. Although the November Amendment introduces numerous other changes, in this note, we restrict our analysis to these three topics mentioned above.

2. NEW RULES FOR VALUATION

After a year of discussions on valuations, we now see institutional implementation of certain measures by SEBI to bring transparency in IPO pricing.

2.1 *New on valuation*

The November Amendment has introduced the following key changes to the disclosures on the 'Basis of Issue Price' section in the offer documents:

2.1.1 *KPI disclosures*: Issuers must, in their IPO offer documents, disclose *all* Key Performance Indicators ("**KPIs**") that have been disclosed by it to its investors in the last three years, along with explanation on how they have been historically used to analyse, track, and monitor performance. Issuers may, in consultation with the merchant bankers, also choose to disclose additional KPIs. All KPIs must be disclosed for the same periods as the financial statements included in the offer document.

2.1.2 *Comfort on the KPIs and valuation*: The November Amendment seeks to ensure completeness and accuracy of these KPI disclosures in two ways: (i) confirmation by the audit committee that all KPIs presented to the investors in the last three years have been disclosed in the offer documents and that such KPIs are verified and 'audited'; and (ii) certification of KPIs by statutory auditor, or peer reviewed chartered accountants or peer reviewed cost accountants.

2.1.3 *Peer comparison*: KPIs disclosed in the "Basis of Offer Price" section have to be compared with Indian and global listed peers (wherever available), with explanations where comparison is not possible.

[1] SEBI Press Release no. 29/2022 dated September 30, 2022

2.1.4 *Continuing obligations*: After listing, issuers must at least annually disclose updates to KPIs disclosed in the "Basis of Offer Price" section, till the later of (a) one year from listing date or (b) full utilization of the IPO proceeds, with explanations for changes.

2.1.5 *Share acquisition data*: Issuers must disclose the price per share in primary and secondary transactions during the last 18 months where transaction size is five percent (5%) or more of the diluted share capital of the issuer, either individually or in aggregate with other transactions over 30 days, and calculation of the weighted average cost of acquisition ("**WACA**") of this data with comparison to IPO floor and cap price. Secondary transactions in this context are limited to transactions by promoters, promoter group, selling shareholders or shareholders with board nomination rights. In case no transaction qualifies for this, the price per share of the last five primary or secondary transactions within the last three years, regardless of size, shall be disclosed, along with a comparison of their WACA to the IPO price band.

2.1.6 *Price band recommendation*: The price band advertisement is required to include a recommendation from a committee of independent directors of the issuer stating that the price band is justified.

2.2 ***What do we think?***

SEBI had released a consultation paper in February 2022 on the 'Disclosures for 'Basis of Issue Price' section in offer document under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018' ("**SEBI KPI Paper**") that laid a background for these disclosures, i.e., the sufficiency of the existing disclosure requirements in case of new age technology companies ("**NATCs**") or companies without a strong financial track record. Historically, the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("**ICDR Regulations**") prescribed disclosure of critical accounting ratios, i.e., earnings per share, price to earnings, return on net worth, and net asset value, along with a comparison of such ratios with comparable industry peers of the issuer. Though these factors are relevant for companies with strong financial track record, for NATCs these parameters for 'basis for issue price' seemed to fall short. For their private placements, NATCs do rely on unconventional KPIs to give potential investors an idea of their prospective growth opportunities. Therefore, the need for additional disclosures in the "Basis of Issue Price" section, for NATCs or companies without a strong financial track record was well understood. However, despite the background set in the SEBI KPI Paper, in an attempt to standardize disclosures with global standards, the November Amendment has applied these requirements to all issuers, including those with strong historic financials.

What are the challenges issuers can face? We discuss below:

2.2.1 *Identification problems and data dumping*: The first challenge to this disclosure obligation is the scope of the data considered as KPIs. Pre-listing investors are typically privy to a wide range of data from the issuer, depending on the size of their investment. These may include business plans, projections, board notes etc. It is pertinent to draw a line considering that some of these, neither relevant nor meant for public consumption, are disclosed as a part of strategic investments, and may also be prohibited for public disclosure under SEBI regulations (for instance – financial projections or unaudited management accounts). Before its IPO, a company may have shared a significant amount of confidential data to only a few large investors, with no intent to distribute it widely. This information can be business-competitive and is typically used by pre-listing investors to help the management grow and monitor their investments. If issuers have to share such information in public documents, it is likely to reach competitors, which would not be in the best interests of the issuer or its stakeholders. Accordingly, an issuer should be allowed to

limit the KPI-disclosure mandated under the November Amendment to only relevant and 'key' performance indicators it believes will have an impact on its valuation, and not the universe of business data/ metrics shared by it with its investors in the last three years. Pertinent here to note is that while the SEBI KPI Paper had actually proposed this limitation (by mandating disclosure of '*relevant* 'or '*material'* KPIs shared with pre-listing investors), the November Amendment appears to have scuttled this materiality-based proposal by mandating disclosures of *all* KPIs shared in the three-year period.

Further, while the spirit of the November Amendment is in the right place, a large number of IPO investors are non-institutional and retail investors, unlikely to make meaningful sense of a gamut of technical and sector specific KPI data in an offer document. Despite the stipulations that historic KPIs and their use in tracking the issuer's progress must be explained in layperson terms, in the absence of strong investor education and awareness, these disclosures may cause information overload for retail investors - particularly for issuers with strong financial track records who have other financial data to testify to their investment worthiness.

Finally, given the broad nature of this disclosure obligation, this will significantly increase the effort on part of the issuer to collate and provide auditable KPIs for disclosure. The cost of making these disclosures appears to outweigh the possible benefits to the potential investors, with the current scope of disclosures.

2.2.2 *Peer comparison:* Much like the peer comparison for the financial ratios disclosed prior to the November Amendment, now disclosures of KPIs in the "Basis of Issue Price" section must also be accompanied with comparisons with Indian or global listed peer companies, 'where available'. With an undefined scope of 'global listed peers', issuers and merchant bankers alike will face a challenge in identifying the peers and confirming if such comparables do not exist.

2.2.3 *Responsibility of independent directors:* The November Amendment has added to the responsibilities of independent directors. Typically, appointment of independent directors and constitution of statutory committees (including an audit committee) is undertaken once the issuer is in the IPO mode. With these newly appointed independent directors and the audit committee taking responsibility for historic KPIs as well as the justification for the IPO price band, issuers will need to plan on incorporating sufficient systems in place to satisfy the audit committee and committee of independent directors on both these points. Independent directors would also be well served to evaluate the level of their review, diligence, and back-to-back comfort from the issuer before signing off on these matters.

2.2.4 *Abridged prospectus*: A welcome clarification in the November Amendment is limitation of disclosure of past acquisition price through secondary transactions to those undertaken by the promoter, promoter group, selling shareholders and shareholders with board nomination rights in the issuer, instead of all secondary transactions above the de-minimis threshold of five percent (5%) in the past 18 months. However, SEBI has through a separate circular dated February 4, 2022[2] ("**Abridged Prospectus Circular**") prescribed the disclosures to be made in the abridged prospectus and the cover pages of offer documents. The Abridged Prospectus Circular requires disclosures of WACA of all shares of the issuer transacted over the eighteen months preceding the date of the offer document. Further, through emails to the Association of Investment Bankers of Indian ("**AIBI Emails**"), SEBI has also instructed merchant bankers ensure to

[2] SEBI circular number SEBI/HO/CFD/SSEP/CIR/P/2022/14 dated February 4, 2022, on Disclosures in the abridged prospectus and the front cover page of the offer document.

disclosure of additional information on WACA over the last one year and three years period in the price band advertisement. These neither have the de-minimis threshold nor are limited to transactions by the aforementioned categories of shareholders. As a result, issuers may now be expected to include up to six different types of disclosures of WACA, for different parties and over multiple periods, in the offer documents. While the intent may be to restrict these disclosures to the de-minimis threshold (both in terms of value and in transacting shareholders), in the absence of a clarification aligning these differing disclosure requirements, issuers may want to err on the side of caution and disclose all of this information.

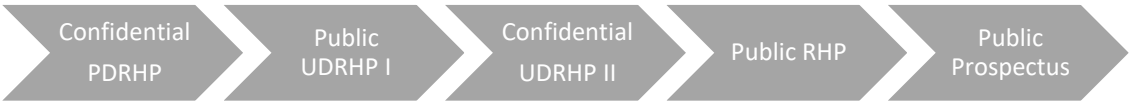
2.2.5 *Applicability*: The November Amendment on KPIs are applicable for all fresh filings of draft offer documents by issuers, as well as ongoing transactions where the draft offer document has been filed, but the offer document (red herring prospectus) is yet to be filed with the relevant registrar of companies. This is likely to have a significant impact on the timelines for issuers looking to file their red herring prospectus in the period immediately following the notification of the November Amendment.

3. PRE-FILING OF OFFER DOCUMENTS

In an attempt to allow issuers an option to explore IPOs without making premature public disclosures of sensitive information, SEBI has now offered a pre-filing of a non-public draft offer document ("**PDRHP**") with SEBI and the stock exchanges, along with detailed procedural guidelines. In a nutshell, this option envisages a filing of a non-public PDRHP with SEBI, followed by a public filing of an updated draft offer document ("**UDRHP I**"), a subsequent filing of an updated UDRHP I ("**UDRHP II**") with SEBI, and there after the red herring prospectus and prospectus.

Existing route

New pre-filing route



Principally, this is a welcome change that will offer an opportunity to an issuer to take an informed decision in case any SEBI observation on the PDRHP poses a challenge to the issuer's business plans or strategies or alters its plan of undertaking a public offering and also assess interest from qualified institutions buyers ("**QIBs**") without having to disclose sensitive information to the public. So far issuers have explored informal pre-consultations with SEBI on occasion for certain critical issues. This optional route will legitimize these consultations without sounding off the public (including competitors) on sensitive strategies and plans.

3.1 What else is different?

Although conceptually pre-filing is an exciting prospect, and also globally tested, the procedural guidelines for this new optional approach may require some examination. We discuss below certain important matters on the pre-filing approach:

3.1.1 *Applicability of existing regulations:* The November Amendment introduces Chapter IIA to the ICDR Regulations, marking certain additional compliances to be followed over existing Chapter II of the ICDR Regulations. Although provisions of Chapter II of the ICDR Regulations must be complied with at the time of filing the PDRHP, the November Amendment does consider certain exemptions: (i) one year holding period for eligibility for offer for sale ("**OFS**") shares; and (ii) holding period and eligibility of the nature of shares to be used for promoter's contribution ("**PC Shares**"), will be tested at the stage of filing the UDRHP I. Further, SEBI has allowed flexibility to alter the capital structure of the issuer until the receipt of the final observations, such as conversion of convertible securities (other than stock options and compulsorily convertibles which can be converted until UDRHP II), issuance of new securities, without prior disclosure in the PDRHP. SEBI has also allowed flexibility to change both fresh issue and OFS after receipt of the SEBI final observations up to a maximum of fifty percent compared to the current restrictions on change in fresh issue more than twenty percent (20%).

3.1.2 *Marketing and testing the waters ("**TTW**"):* Along with the PDRHP, the issuer and merchant bankers must also provide an undertaking to SEBI stating that they will not conduct marketing or advertisement in relation to the IPO. As an exception, SEBI has considered allowing an exemption for interaction with QIBs for 'testing the waters', based on the contents of the PDRHP, until the receipt of the final SEBI observations on the PDRHP. However, other publicity may continue in line with past practice until the UDRHP I is filed. While the November Amendment is silent on whether TTW can resume at a later point, the SEBI board agenda for the meeting dated September 30, 2022 ("**September Board Agenda**") indicates that there can be some engagement with investors on the proposed IPO or the KPIs of the issuer after filing the UDRHP I.

3.1.3 *Public announcement*: While the PDRHP is filed only with SEBI and the stock exchanges, the issuer is required to make a public announcement to inform the PDRHP is filed, without providing any other details.

3.1.4 *Conditions precedent for SEBI final observations*: In line with the timeline for SEBI observations for the existing filing route, the November Amendment also introduces an outer timeline for receiving SEBI final observations. Two interesting conditions precedent are linked to the receipt of final observations from SEBI, which can be provided up to 30 days from the dates of these milestones, are (i) confirmation on completion of interaction with the QIBs for TTW; and (ii) intimation about conversion of all outstanding convertible instruments (other than those categories of convertibles that can be converted until filing of the red herring prospectus). SEBI has also mandated a cooling off period of seven days from the date of receipt of the confirmation under (i) and the filing of UDRHP I. The final observations will be valid for 18 months provided the UDRHP I is filed within 16 months of the final observations.

3.2 What should change further?

With the new procedure now codified and issuers looking to exercise the option of confidential filing, stakeholders should be mindful of the following:

3.2.1 *Applicability of regulations:* While the holding period and eligibility of OFS shares and PC shares will now be tested for compliance as on UDRHP I, at the time of filing the PDRHP, the issuer and merchant banker are required to ensure that at the time for filing the UDRHP I, they will be in a position to ensure compliance with these regulations. This is a great comfort for shareholders who are looking to exit but do not satisfy the minimum one-year holding period at the time of filing the PDRHP. However, this does not allow

addition of any new selling shareholders between the PDRHP and UDRHP 1 – who may be either new shareholders of the issuer after the filing of the PDRHP or existing shareholders who did not choose to be named as sellers in the PDRHP at the UDRHP I stage. Shareholders seeking to exit in an IPO should therefore firm up their plans to exit at the PDRHP stage itself, while taking into account the fact the PDRHP-UDRHP period will be counted for towards the one-year eligibility period for shares they wish to sell.

In line with these changes, SEBI may want to consider pushing the test for determining selling shareholder exit size in case of NATCs or issuers without strong financial track record until the filing of UDRHP I, which will help account for any change in shareholding between PDRHP and UDRHP I. Similarly, SEBI may also consider allowing issuers with partly paid-up shares to file the PDRHP and push such compliance to the UDRHP I filing.

3.2.2 *Market gauging and TTW:* With the November Amendment, SEBI has for the first time provided a legal basis for TTW interactions. However, by proving an end date to the TTW exercise (*i.e.,* issuance of SEBI's final observations on the PDRHP), SEBI has created potential challenges in investor interactions after this milestone.

Currently, issuers engage with institutional investors in the DRHP- RHP period through pre-deal investor education roadshows in compliance with the applicable regulations. With SEBI formally mandating a date at which TTWs (hence, potentially all engagements with investors) must cease, it is unclear whether issuers can continue such roadshows after issuance of the final observations and until the deal launch. While the intent may be to avoid "gun jumping", the November Amendment does not envisage the impact of a significant delay in filing of the UDRHP I or deal launch (potentially between 16 to 18 months from the final observations). Investor-interaction by the issuer in this period may be crucial for envisaging the right climate and time to launch.

Filing of the UDRHP I and thereafter, the RHP without knowing the potential market for launch of the IPO could lead to a circumstance where after filing of UDRHP I, the issuer is forced to wait for an ideal market and the exercise of pre-filing becomes irrelevant. Hence, it is imperative that the current practice of pre-deal investor education roadshows and other forms of investor engagements is allowed to continue.

Further, while the November Amendment is silent on the impact on the TTW restrictions on research reports, the September Board Agenda indicates that no publication of research reports will be permitted until ***after*** the public filing of UDRHP I. Research analysts will need to consider the impact of the change in timeline considering that in a non-pre filing route, research reports are always released prior to public filing of the draft red herring prospectus.

3.2.3 *Public announcement*: The rationale for making a public announcement while filing the PDRHP seems unclear. While it may give merchant bankers basis for engaging in TTW, it is more likely to give rise to a lot of speculation about the potential IPO which may be misleading considering that the UDRHP I can be filed until 16 months from the receipt of final observations and the issue closure may be as late as 18 months from the date of receipt of final observations from SEBI. This also creates significant complexity for IPOs marketed outside India. Internationally, the black-out period for publication of research reports is linked to the first public announcement of the transactions and the merchant banks' engagement on it. Coupled with the guidance in the SEBI Board Agenda that restricts publication until *after* filing of UDRHP I, this

creates a challenge for research analysts and merchant banks will need to internally debate and update their internal controls.

3.3 Who should consider this?

Although there are some obstacles to navigate, the pre-filing route may be beneficial in certain circumstances such as where the issuer requires preclearance of certain disclosures, the issuer can file a PDRHP for formal observations from SEBI without disclosing sensitive information to the public until the filing of the UDRHP I. Further, the new disclosures on KPIs may also encourage issuers to consider the pre-filing route, in an attempt to keep business data from their competitors for as long as possible. For example, Tata Play has already become the first to follow the pre-filing route, and it is very likely that other issuers may also find commercial benefit in doing so.

4. MONITORING PRIVATE PLACEMENT PROCEEDS

In order to improve accountability of the management of the issuer towards shareholders who approve raising of capital through a preferential allotment or a QIP, SEBI has through the November Amendment mandated monitoring of hundred percent of use of proceeds raised through preferential allotment and QIPs by credit rating agencies registered with SEBI.

5. CONCLUSION

While the November Amendment aims to address much spoken about challenges on valuation and disclosure related sensitivities, it is also likely to create new hurdles for issuers to consider and adapt to. The additional disclosures in relation to valuation will add to the quantitative basis for valuation, however, in an IPO, issuers will be forced to share sensitive information, flood non institutional investors with data not relevant to them and incur high costs in doing this.

Likewise, while confidential filing will provide some comfort to issuers on select sensitive disclosures, it will likely add to the gestation period of an IPO, and parties will expect for certain procedural kinks to be addressed. We look forward to clarifications from SEBI on the issues outlined in this note and to see testing of the new disclosure standards and confidential filing routes.

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