Indian Family Businesses: Risks for Investors

India's rapid economic progress is in large part due to the dominance of successful family-run conglomerates. While these companies have become some of India's most successful, several have been tainted by corporate governance scandals that have harmed minority shareholders. Corporate governance is an important issue for all listed firms; however, Indian family-owned companies face some unique challenges due to their distinctive structure. We outline the key risks facing investors below.

Conflicts With Minority Shareholders

Some transactions launched by Indian listed companies may strike shareholders as benefiting the controlling family (the "promoter") at their expense. One recent such controversy was the attempt by London-listed Indian mining and metals group Vedanta Resources PLC (VED:LN), which is controlled by the Agarwal family, to acquire the minority interest of its subsidiary Cairn India (CAIR:IN), an Indian oil and gas exploration company listed on the Bombay and National Stock Exchanges.

Vedanta acquired a 58.5% stake in Cairn India in late 2011. However, the acquisition left Vedanta in considerable debt, and a decline in oil prices made financing the debt increasingly difficult.

In June 2015, Vedanta announced that it intended to acquire the remainder of Cairn India. However, in July, two minority shareholders in Cairn India, Life Insurance Corp and Cairn Energy PLC (CNE:LN) opposed the deal, claiming that Vedanta wanted to acquire Cairn India for its USD 3.5 billion cash reserves, and that the merger would benefit Vedanta at the expense of Cairn India.

In this case, shareholders were given the last word: Vedanta was eventually pushed into upping its offer and in July 2016, the deal was approved.

Related-Party Transactions: A Shifting Regulatory Landscape

As in any country, family-controlled businesses in India are prone to related-party transactions (RPTs) of questionable value to shareholders. In 2014, Jindal family-owned conglomerate JSW Steel (JSTL:IN) suddenly revealed to shareholders that the "JSW" brand was owned by a private company, JSW Investments Pvt. Ltd., and sought shareholder approval to pay 0.15-0.50% of the group's total operating income to this company. JSW Investments was 99.99% owned by Sangita Jindal, the wife of JSW group promoter Sajjan Jindal.

Furious minority shareholders noted that JSW had been a public company for more than 20 years, and that the sudden and arbitrary transfer of the group's brand to the control of the promoter's family ignored the fact that for most of its history, the brand was developed as part of the listed group. Minority shareholders claimed that they were in effect being asked to pay the Jindal family directly for the use of a brand whose development had been funded by all shareholders.

RPTs in India are regulated by the Companies Act of 2013 (under the oversight of the Ministry of Corporate Affairs (MCA)), and by rules promulgated by the Securities and Exchange Board of India (SEBI). The rules have changed frequently in the past five years, have often been inconsistent with each other, and go back and forth between loosening and tightening:

- Section 188 of the Companies Act of 2013 initially forbade all related parties from voting on RPTs. SEBI rules followed this by requiring RPTs to be approved by special resolution, which requires a two-thirds majority of minority shareholders. All related parties had to abstain from the vote.
- However, between 2014 and 2015, both MCA and SEBI relaxed their rules, requiring an ordinary rather than a special resolution to approve RPTs. Since ordinary resolutions require a simple majority of minority shareholders to pass, RPTs became much easier to approve.

Shareholders linked with a promoter (such as companies owned by relatives) are now allowed to vote on RPTs provided they are not participating directly in the transaction. This may increase the risk of promoters proposing RPTs that are not in the interest of minority shareholders.

Executive Compensation

Multiple family members on the board or management of an Indian company presents a risk for foreign investors since it also provides an opportunity for promoter-family members to determine their own compensation. Minority shareholders have alleged that this leads to self-dealing and the chance to drain assets from an ailing company.

In 2016, pump manufacturing company Kirloskar Brothers (KKB:IN) proposed to increase the salary of its managing director and promoter-family member, Sanjay C. Kirloskar, by 50%, despite the company reporting losses over the previous fiscal year. Hindustan Construction Company (HCC:IN) doubled the salary of one of its promoters while the company was undergoing a debt restructuring in 2013. While Jindal Stainless (JDSL:IN), another Jindal family business, was in debt restructuring, the promoters claimed that they could not inject additional funds, while at the same time increasing the salary of the main promoter by large increments each year.

Risk of Fraud

When corporate governance best practices are not followed, family members holding multiple board and executive positions in a company can increase the risk of fraud.

In India's most infamous corporate scandal, B. Ramalinga Raju, the founder and chairman of Satyam Computer Services, confessed to manipulating the accounts of the group by USD 1.47 billion. Family connections facilitated this fraud at several stages:

- Satyam had separate chairman and CEO roles, but the CEO was Raju's brother, and the two were convicted of conspiring to falsify Satyam's finances.
- The brothers also pledged shares in Satyam held by their spouses to raise loans.
- In a vain attempt to plug the holes left from years of generating fake sales, Raju tried to "use" the fake cash generated by these sales to acquire two real estate companies owned by his two sons, effectively replacing fake assets with real ones. When the attempt failed after minorities questioned the terms of the proposed deal, Raju revealed the fraud and Satyam collapsed.
- In total, at least ten members of the Raju family were accused of benefitting from the fraud.

Hope for Corporate Governance?

Many potential risks involving investing in family-controlled companies in India are corporate governance-related. Much of the progress in regulatory oversight of these companies has come from recently-improved corporate governance regulations for Indian listed companies:

- Stricter qualifications for independent directors
- Mandatory online voting on shareholder resolutions (companies previously held meetings in remote locations to make it difficult for non-employees to attend)
- Increased financial disclosure requirements
- Regulations regarding RPTs (see above)

India has also benefitted from the rise of aggressive proxy firms, who provide analysis and recommendations to minority shareholders on company resolutions, as well as directing questions to promoters on specific policies. Family businesses have begun to take these firms seriously, often responding to their queries in detail.

While the risks of investing in family-controlled companies in India remain, there is some evidence that governance standards are slowly improving. "CG Watch 2016"[1], the leading independent analysis of Asian corporate governance standards, ranked corporate governance standards among Indian companies seventh out of 12 markets, with a marginally-improved score of 55%, noting some improvements in regulation and enforcement, impeded by vested interests. Clearly, there is some way to go.

[1] ACGA CLSA "CG Watch 2016: Ecosystems matter – Asia's path to better home-grown governance": http://www.acga-asia.org/research-detail.php?id=1

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