Valuation of Differential Voting Rights (DVR) Shares

By Vr. Kapil Maheshwari and CA Saugat KC

Background

The Securities and Exchange Board of India (SEBI) has taken certain notable decisions at its board meeting on 27 June 2019. Among other decisions, Sebi has approved a framework for issue of differential voting rights (DVR) shares. Differential voting rights have disproportionate rights as compared to their economic ownership, and as such, go against the principle of one vote one share. DVRs can mean shares carrying superior voting rights (i.e., multiple votes on an equity share), inferior voting rights (i.e., a fraction of the voting right on an equity share, or shares with differential rights as to dividend. DVRs have gained popularity with founders/promoters that are key to the success of their companies, since it enables them to retain control over the decision making process and rights and to raise funds through shares with superior voting rights.

As per Section 43(a)(ii) of the Companies Act, 2013, a company incorporated under the laws of India and limited by shares is permitted to have equity shares with differential voting rights as part of its share capital. The differential rights appended to such equity shares may be with respect to dividend, voting or otherwise. Such equity shares may be issued by a company as per Rule 4 of the Companies (Share Capital & Debentures) Rules, 2014 prescribed under the Companies Act, 2013. Private companies can issue shares with differential voting rights in the manner prescribed under their Articles of Association, provided the Articles exempt the applicability of the Companies Act, 2013, s 43 read with Companies (Share Capital & Debentures) Rules 2014, r 4 on such private companies.

Benefits of DVR Shares

- A company may choose to issue shares with differential voting rights for obtaining investments without offering voting rights to the investor and thereby avoiding any attempts at a hostile takeover.
- Similarly, an investor intending to invest into a public listed company, may avoid the implications of the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011 (Takeover Code) on acquiring a substantial portion of the voting rights in a company. The Takeover Code requires an acquirer to make an open offer to the public in the event that the acquirer intends to acquire such number shares which amount to more than 25% of the total voting rights in the company.
- Retail investors limited to purchasing only inferior classes of common stock for a given company can still enjoy a proportionally equal claim to the company's profits.

However, an investor seeking to invest substantial amount of funds into a company would also want at least some control to ensure that the company utilises the supplied funds judiciously. Such control cannot be exercised by virtue of the diminished rights attached to the shares issued to the investor. Therefore, the transaction documents contemplating the issuance and subscription of the shares with differential rights must provide for ample affirmative rights to the investor and detail the manner of exercise of the affirmative rights.

Valuation Issues

The valuation of shares with Differential Voting Rights shall not be equal to ordinary shares. However there are various factors which influence the difference in the valuation:

- In case of stable management company where there is concentration of voting power and absence of any takeover activity, the observed market prices of the share classes typically reflect the marginal valuation of investors who do not control the firms operations. In such cases, where there is little or no prospect of incremental profits for these investors, the variance between the DVR and ordinary shares shall be low.
- Changes in the value of control may be associated with significant investment and financing decisions. For example, a suboptimal investment or financing decision or a decision that conveys bad news about the firm's earnings prospects may increase the likelihood that the firm will be a takeover target. As a result, the value of control and the variance between the DVR and ordinary shares shall increase.
- An announcement of acquisition increases the value of control and the variance between the DVR and ordinary shares.
- A possible determinant of the relative pricing of the two share classes is the differences in liquidity or trading activity between the classes. Sometimes it is difficult to find as much supply of a particular class of share, due to lower public float, which leads to increase in the market price of that class of share.

Provided the large stakeholders who own the disproportionate voting shares are successful in running the company, DVR should be of little concern to investors, especially the typical retail investor who has a very tiny stake in the company anyway. Normally, the existence of dual-class shares would only be a problem if an investor believed the disproportionate voting rights were allowing inferior management to remain in place in spite of the best interests of shareholders.

Examples of Multiple Share Class

There are various domestic and international examples of companies having DVR shares. For Google and its parent entity, **Alphabet, Inc.** there's three classes of shares - Class C shares (GOOG) have no voting rights, while Class A shares (GOOGL) have one vote each. These classes were instituted after a stock split resulting from the formation of Alphabet as the parent company. There are also Class B shares of Google stock, but these do not trade on the stock market Instead, the Class B shares are owned by Google insiders and early investors and each get 10 votes, making them super-voting shares.

Listed Scripts with differential voting rights in India

Script	Differential Voting Rights	Differential Dividends
Tata Motors Limited	One Vote for every 10 DVR Equity Shares	5% higher than the rate of dividend declared on ordinary Shares
Jain Irrigation Systems Limited	One Vote for every 10 DVR Equity Shares	Same as Ordinary shares
Future Enterprises Limited	Three Votes for every four DVR Equity Shares	2% higher than the rate of dividend declared on ordinary Shares2

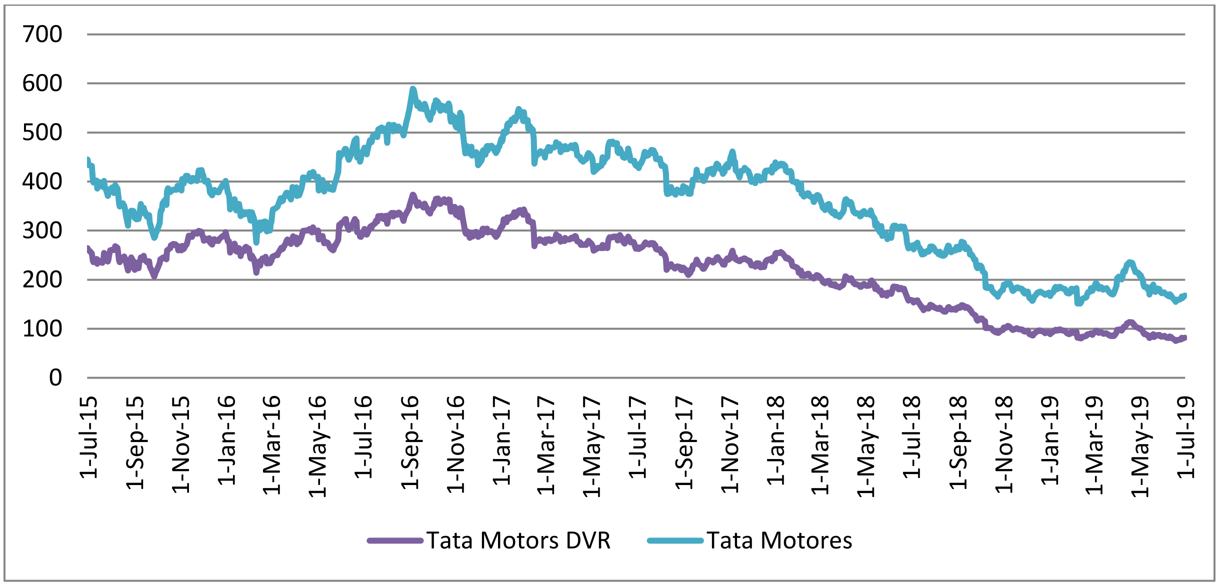
Historically, the discount between the ordinary shares and DVR shares of public limited companies in India has been between 35-45%. However, as shown herein below, this discount has narrowed considerably for Future Enterprises Limited in recent times.

Name	Market Price as on 31.3.2019	52 week high	52 week low	Differential Voting Rights	Differential Dividends	Difference in MP as on 31.3.2019	Difference in 52 week high	Difference in 52 week Low
Tata Motors DVR	85.55	159.4	72.05	One Vote for every 10 DVR Equity Shares	5% higher than the rate of dividend declared on ordinary Shares	-51%	-43%	-49%
Tata Motors	174.25	282	141.9					
Futures Enterprises Ltd DVR	37.14	49	28.8	Three Votes for every four DVR Equity Shares	2% higher than the rate of dividend declared on ordinary Shares2	-2%	-4%	-3%
Futures Enterprises Ltd	38	50.95	29.75					
Jain Irrigation Systems Ltd DVR	40.14	59.3	17.55	One Vote for every 10 DVR Equity Shares	Same as Ordinary shares	-32%	-33%	8%
Jain Irrigation Systems Ltd	58.9	89	16.3					

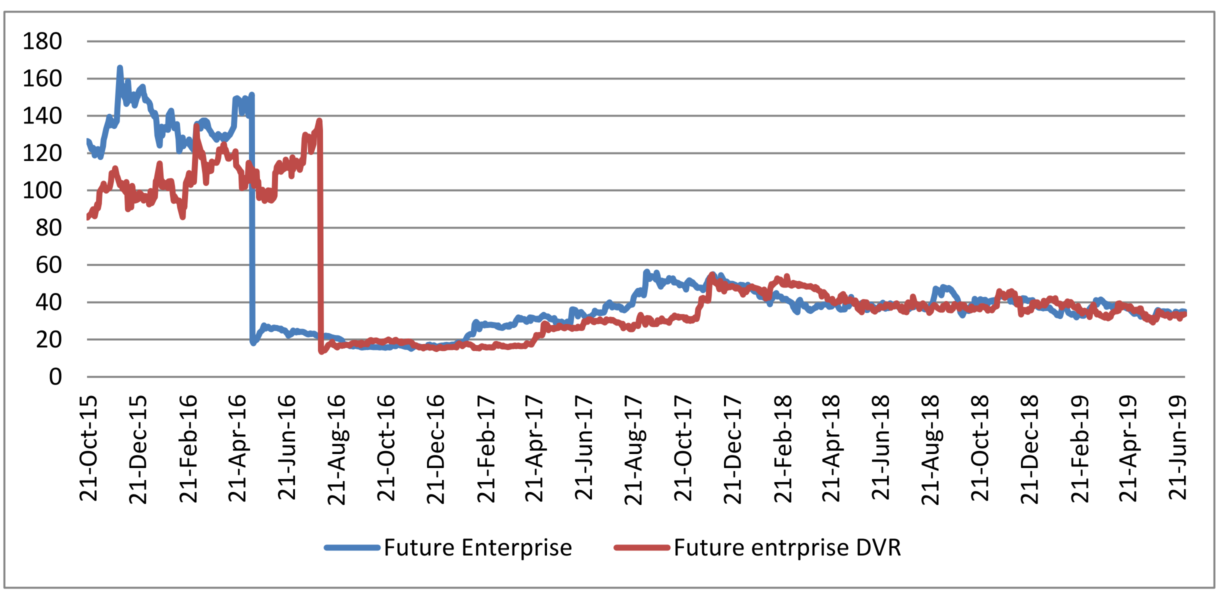
Correlation on Share Price movement between DVR and Normal Share

We analyzed the share price movement of Tata Motors DVR ,Tata Motors Futures Enterprises Ltd, DVR Futures Enterprises Ltd, Jain Irrigation Systems Ltd DVR and Jain Irrigation Systems Ltd for last 4 years ending 1st July 2015 to 1st July 2019 .The graphical presentation of the same has been shown herein below.

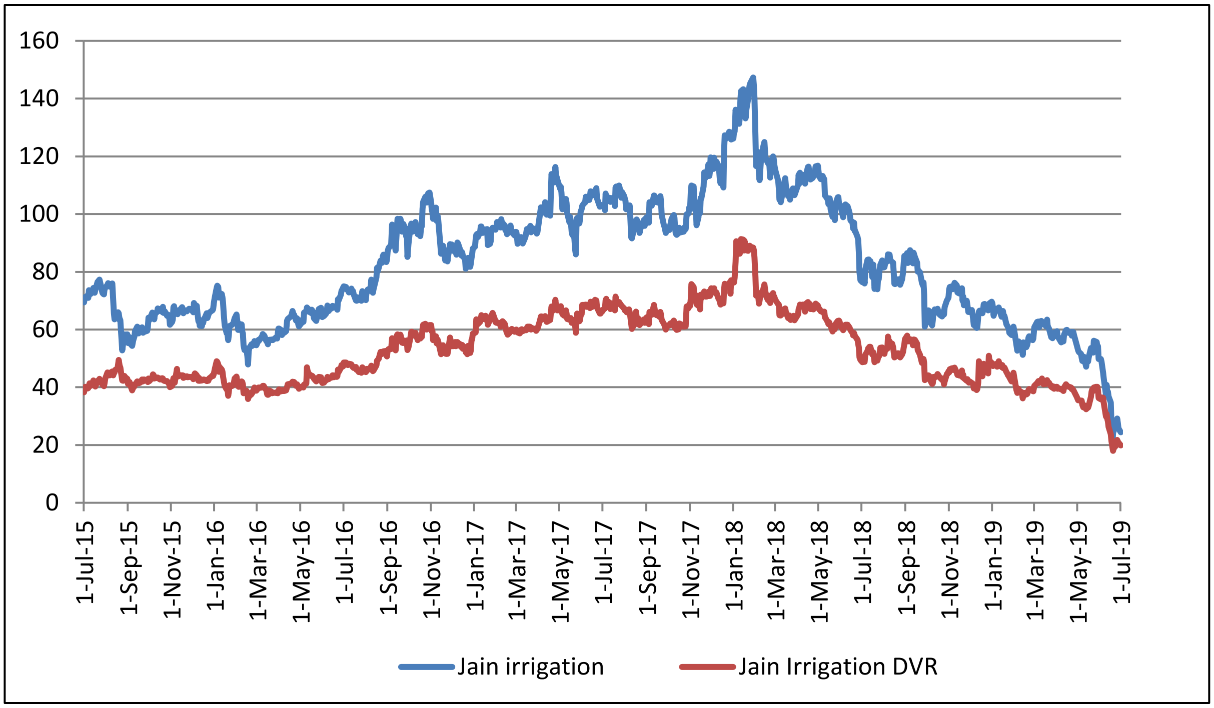
Tata Motors vs Tata Motors DVR



Future Enterprises Ltd Vs Futures Enterprises Ltd DVR



Jain Irrigation Systems Ltd vs Jain Irrigation Systems Ltd DVR



Summary sheet

S.N	Company Name	Correlation on Share Price movement betweeen DVR and Normal Share	Average	Median
1	Tata Motors	96.35%	88.23%	96.35%
2	Future Enterprises Ltd	70.32%		
3	Jain Irrigation System	98.01%		

Observation

The movement in the two shares, i.e. ordinary share and DVR share, should mirror each other. In India, on an average the Correlation on Share Price movement betweeen DVR and Normal Share is around ~88% which explain a perfect positive correlation between the share price movement between these two class of shares

Tata Motor DVR have been an anomaly because of the large gap between the DVR and ordinary shares – its shares with Differential Voting Rights (DVR), have been listed on Indian bourses since 2009, when Tata Motors took over Jaguar. These shares were issued at Rs. 60 when Tata Motors was quoting at 68. The holders of Tata Motors' DVR shares can cast one vote for every 10 shares held. However, they are entitled to an extra 5% dividend. As on 29/07/2019, Tata Motor DVR was quoting at INR 66.70 vs Ordinary equity shares of Tata Motor quoting at INR 137.60 on the same day. **The significant discount of over 50% on DVR does not apparently get justified as the probability of hostile takeover or management change does not arise in case of Tata Motors. One of the major reasons for discount of Tata Motors DVR is the higher liquidity in the case of DVR.** When the DVR's were issued the Promoter shareholding was high at 84% (last quarter of 2008) – now it is less than 1% with a higher percentage of Tata Motor DVR shares available to public.

For more details or discussion on DVR structures or business valuation matters reach us at kapil.maheshwari@k-zen.in or saugat.kc@k-zen.in