HUGH SANDEMAN

The author is a senior advisor to Langham Capital. He can be reached at hugh.sandeman@ langhamcap.com

Floating free of dilution

Vedanta raises funds, with minimal loss of ownership in India

Sterlite Industries' $1.5 billion ADR in mid-July brought to around $5 billion, the total equity raised on international markets by Anil Agarwal's companies since he completed the IPO of his holding entity Vedanta Resources in London in late 2003. A further $3 billion has been raised through international bond and equity-linked issues – all this, at the cost of minimal dilution of his ownership in the original Indian-listed companies in the group. No wonder other promoters keep doodling with box diagrams to figure out whether a new Vedanta can be conjured from their own holdings.

Agarwal and his bankers have pulled off an exceptional feat of financial engineering over the past six years, and in doing so, they were clever, bold and lucky, not necessarily in that order. The listing of a holding company that itself owns stakes in listed companies can only deliver value for shareholders and extra financing capacity for the promoter, if at least four challenging conditions are met.

The first requirement is that the holding company has to be more than the sum of the parts of its listed subsidiaries. Vedanta started off with its own equity story, but at the time of the IPO, this was simply a promise to expand into a global mining and resources group. At the start, investors could in theory have avoided the IPO and replicated a holding in Vedanta by buying shares of its listed entities Sterlite Industries and Madras Aluminium, provided they were authorised in India as foreign institutional investors. But the investors who bought in the IPO and afterwards believed, rightly, that Vedanta could deliver on its strategy, which has now added Konkola Copper Mines, Vedanta Aluminium and Sesa Goa to the top company's holdings.

The second essential ingredient is size. Vedanta had to start life as a London-listed company large enough to get into one of the FTSE indices. The company joined the FTSE 250 a few months after the IPO, but the real breakthrough was in June 2006, when the natural resources boom, and Vedanta's own expansion, took the company into the FTSE 100 Index. This made it a stock that every major UK institution had to own, and created a new group of investors entirely distinct from the FIIs that could consider buying into the Indian-listed components of Vedanta's portfolio.

Indexation in an equity market outside India was crucial to Vedanta's financial strategy, because by creating a different investor base, the UK company was protected against the risk that, in the early stages of implementing its strategy, a setback in the valuation of the top company could result in a permanent discount to the see-through valuation of its listed subsidiaries in India. There are cases in the Indian equity market of India-listed holding companies trading at a large discount to the underlying value of their subsidiaries listed on the same market. Once caught in this trap, there may be no way out. Delisting, the option that companies consider whilst seeking to overhaul their capital structures, is still a dead end in India.

The third ingredient in Vedanta's recipe is growth. Rapid growth was important for persuading investors to keep faith with the promise that Vedanta could do more than its listed subsidiaries on their own. Growth was also essential for getting into and staying in the FTSE 100 Index.

The final but not the least important requirement was luck. Vedanta's financial strategy was launched just before the biggest commodity boom that the London market could remember. By the time it was over, Vedanta had already become one of the world's leading mining companies.

All of which is hard to replicate. The closest that Indian-listed companies generally get to accessing an investor base they cannot reach through domestic investors and FIIs is the ADR offering. There is plenty of duplication between the growing FII investor base and the institutions buying ADRs, but an ADR still brings some on-shore institutions that can only buy US-listed stocks, and (in some deals) the US retail investors that some of the big brokers can easily allocate in their deals without extra time or expense. It is consistent with Agarwal's financing strategy that two of the largest ADRs by Indian companies have been raised by Sterlite Industries.

There was considerable strategy, behind this latest blockbuster ADR. The qualified institutional placement mechanism in India is hobbled by SEBI's rule limiting the number of investors to 49 institutions, while a reported 80-100 institutions took up the Sterlite Industries' offer. It can still make sense to do the largest follow-on equity deals abroad. ◆