Lakshmi Vilas Bank – Silent majority must suffer!

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BACKGROUND

Last week of September will be remembered as watershed period for Indian corporate governance movement, as investors/ Shareholders of Lakshmi Vilas Bank ('LVB') created history. They rejected/ ousted 7 Directors and Statutory Auditors who were proposed to be appointed / re-appointed at the AGM held on 25th September 2020. In history of Indian corporate democracy, hitherto such an unprecedented revolt by shareholders was rarely seen, where such extreme measures were used by shareholders to voice their concerns against the Board.

SES is of the opinion that this appears to be just the beginning and one cannot rule out many more cases in future. It is certainly result of many reforms and developments in area of corporate governance and is culmination of pent up anger or frustration against ineffective boards and numerous instances of corporate frauds. One can say that shareholder activism in India which began almost a decade back has come of age. Although, shareholders are turning a new leaf in taking their rights in earnest and demanding corrective actions from the management, however, in case of LVB, there is a looming question on the future course of the Bank and the after effects of removal of majority directors.

The Bank had proposed 10 resolutions regarding appointment and re-appointment of Directors and out of these, 7 resolutions were rejected by the public shareholders of the Bank along with resolution for appointment of Auditors.

In this note, SES intends to raise relevant questions, analyse and answer the same:

A. Are promoters divided & if yes, why?
B. Are majority shareholders AGAINST the resolutions?
C. What led the shareholders of the Bank, to take such a harsh decision of knocking out directors?
D. Perils of low investor participation
E. Is the Bank in bad shape?
F. Were the ousted Directors responsible for the present condition of the Bank?
G. Were the steps taken by institutional investors only option available to them at this stage?
H. What could be the aftermath of the actions taken by institutional investors?
I. Are we seeing true picture or is there another story, behind?

Executive Summary

Findings of this Report are summarized hereunder.

- Shareholders voted out a former General Manager (GM) of RBI who was appointed only on 2nd December 2019, while approving other two IDs, appointed on same day. Was ex GM RBI tag, the reason? Is it a coincidence that RBI was targeted as MD & CEO and Statutory Auditors appointed by RBI were also voted out? Was this voting a revenge for RBI's decision rejecting merger of Bank with Indiabulls?
- Promoters are divided in two groups and one group appear to have abstained in 2019 AGM, however, in this AGM, they have voted AGAINST management proposals.
- Promoters lack skin in the game, yet control the Board with miniscule shareholding
- The voting pattern of LVB from 2016 to 2020 AGM reveal that Institutional investors participation has slowly reduced from 100% in 2016, 2017 & 2018 to 20% in 2019 and 40% in 2020.
- Voting results till 2018, needs scrutiny as these results indicate 100% participation by public shareholders which is difficult to believe.
- An increase of 20% participation by institutional investors along with dissent from other public shareholders resulted in defeat of Resolutions**. In effect minority participated and defeated silent majority**
- The Financial performance of the Bank has been deteriorating for past many years, there appears to be no trigger for sudden anger of shareholders especially when the bank was negotiating a merger deal.
- What would institutional Shareholders achieve by disruption? Removing majority of Directors on the Board without replacing them with new? Voting out a temporary RBI approved MD, 65 days before tenure end?
- Did these investors intervened or expressed dissatisfaction earlier and escalated the matter to the management before voting out?

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- However, in LVB case it appears that institutional investors directly jumped to last stage without a solution to the problem, how will the Bank function with a vacuum in the Board with no MD or CEO.
- All the above indicates that performance alone may not have been the key issue behind AGAINST vote.
- Was the decision of shareholders to vote against, individual or it was a collaborative action?
- Is such dissent in any manner connected with failed attempt of India Bulls Housing Finance for merger, which was rejected by RBI.
- Or dissent is expressed over prospective deal with Clix Capital for merger.

This leads to a question, is there a section within the promoter group and along with a group of institutional investors/ other investors who are unhappy with the Clix deal and did not want a stable Board to continue negotiation on Clix deal and take it to culmination?

One cannot comment with certainty, however, a division with promoter group and a Group of shareholders, sharing common purpose within the Public Shareholders led to ousting of majority of the Directors, the purpose of which is unclear. The investors did not replace the Board with a new Board instead left the Bank in a Limbo!

Why would investors whose motivation is return on investment take such an impactful decision without any clear motive?

ANALYSIS

A. Are promoters divided & why?

If yes which faction **Voted Against the Appointments and why?**

The table below depicts the shareholding and participation of Promoter Shareholders in AGM 2019 vs AGM 2020.

Category of Shareholders	Voting Results - Directors' & Auditors' appointment (%)					
	AGM 2019			AGM 2020		
	No. of Shares Held	No. of Shares Polled	% of Shares polled	No. of Shares Held	No. of Shares Polled	% of Shares polled
Promoters	2,29,46,775	1,85,83,593	**80.99**	2,29,09,972	2,28,66,629	**99.81**

- Promoter voting in AGM increased from 81% in 2019 to 99.81% in 2020, an increase of 19% or 42.83 lac more share.
- In 2020 AGM, approx. 43.55 lacs promoters' shares made the real difference to defeat the Resolutions.
- Is this a mere coincidence that, the number of shares voted against is almost equal to increase in promoter's participation?
- Did all those who abstained from voting in AGM 2019, now voted AGAINST the Resolution in AGM 2020? One can certainly guess, but can't be sure.
- However, this voting pattern clearly states that promoters are indeed divided in factions.

SES by logical analysis could attempt to identify shareholders of promoter group who voted against the resolutions.

- Promoter Directors viz. Mr. N Saiprasad (holding 0.02%) and Mr. K R Pradeep (holding 2%) failed to get elected
- Mr. K.R. Pradeep and Mr. N. Saiprasad groups would not have voted against their own appointment, in all probability.
- SES mapped affiliation of promoter shareholders, the Table summarizes relationships.

Body Corporates	June 2020 Shareholding in %	Directors
Kare Electronics and Development Private Limited	0.50	K.R. Pradeep, Anuradha Pradeep
Pranava Electronics P Ltd	1.35	K.R. Pradeep, Anuradha Pradeep

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Cauvery Motors Pvt Ltd	0.40	Ms Nivedita, Meda Pandurangasetty Shyam, Anupama Gupta, Venkata Sathya Subramanyaguptha, Ms. Sharmila Shyam Meda
Advaith Motors Pvt Ltd	0.78	Meda Kasturi Ranga Panduranga Setty, Venkata Sathya Subramanyaguptha, Anupama Guptha
Ariston Capital Asset Holdings Private Limited	0.76	Prajnesh Gunneswaran Prabhakharan, Ravishankar Balasubramanian
Tangerine Capital Asset Holdings LLP	0.77	Ravishankar Balasubramanian (*Nominee is Ariston Capital Asset Holding Private Limited*), Sowmyanarayanan Paranji Kuppuswamy
XS Real Properties Private Limited	0.01	Usha Rani Prabakaran, Prajnesh Gunneswaran Prabhakharan

Based on the above affiliations, SES could identify 3 set of promoter groups.

- Group I (3.85%) - **K.R. Pradeep (2%)** – Includes **Kare Electronics and Development Private Limited** (0.50%) and **Pranava Electronics P Ltd**. (1.35%). Total shareholding together is estimated to be 3.85%
- Group II (1.28%) - **Ms. Nivedita, Ms. Anupama Gupta, Ms. Sharmila Shyam Meda (0.05%) M K Panduranga Setty and MP Shyam (0.05%)** - Includes holding of **Cauvery Motors Pvt Ltd** (0.40%) and **Advaith Motors Pvt Ltd**. (0.78%) Total Shareholding together is estimated to be 1.28%
- Group III (1.61%) - **Usha Rani Prabakaran (0.05%) Prajnesh Gunneswaran Prabhakharan (0.02%)-** Includes **Xs Real Properties Private Limited** (0.01%), **Ariston Capital Asset Holdings Private Limited** (0.76%) and **Tangerine Capital Asset Holdings LLP** (0.77%). Total Shareholding estimated to be 1.61%

SES analysis reveals that following shareholders most likely voted AGAINST the proposals:

MP Shyam	1,82,186
MS Nivedita	13,333
MS Sharmila	1,59,826
Cauvery Motors Pvt Ltd	13,48,645
Advaith Motors Pvt Ltd	26,30,020
P Vasantha	18,905
M K Panduranga Setty	2,761
Total	**43,55,676**

This indicates that there is some sort of disputes amongst Promoters and Promoters group, and one does not want to see representatives from other side, on the Board of the Bank.

Lesson #1: Promoters dissent and lack of skin in the game is definitely a bad sign and signifies trouble. All bank failures of past have two common things-**Lack of skin in the game** and on top of it **dispute**- Most Co-op & Private banks fail due to lack of skin in the game, Yes Bank is an example of lack of skin and promoter dispute. Therefore, for RBI as a regulator these are vital signs of lurking danger.

Lesson #2: Should RBI allow Bank promoters to pledge their shares? Should permission of RBI be sought? SES is of the view that Banks are financial assets of any economy and involve funds of a common man. Therefore, nothing can be taken for granted in case of Banks, hence, RBI should not allow as it gives voting power but removes skin from the game.

B. Are majority shareholders AGAINST the Resolutions?

SES research says **no**, it is the minority vote which has resulted in defeat of resolutions. SES compared the voting pattern of LVB

Change in Voting Pattern AGM 2020 vs 2019

- There has been drastic change in voting pattern between AGM 2019 & AGM 2020.
- No major dissent in AGM 2019, whereas significant AGAINST votes in AGM 2020.

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Details of shareholders' Against voting in AGM 2019 & AGM 2020 is provided in table below:

Category of Shareholders	Voting Results - Directors' & Auditors' appointment (%)			
	AGM 2019		AGM 2020	
	FOR	AGAINST	FOR	AGAINST
Promoters	100	0	80.96	19.04
Public Institutions	100	0*	0.29	99.71
Public Non-Institutions	99.99	0.01	37.90	62.10

**Only one resolution, in which Institutional shareholders' voted 2.93% AGAINST.*

In AGM 2020

- almost all the participating institutional shareholders voted AGAINST
- Non-Institutional shareholders were divided, only 62% of participating shareholders voted AGAINST.

- Dissent is a new phenomena at LVB, reasons for which needs to be analysed.

Pertinent Questions are-

- Did shareholders dissent due to governance issues?
- Or because of falling performance?
- Or is there any other reason which is not in public domain?

The question is whether Institutional and non-institutional Shareholders' activism in knocking out Directors? SES believes that a half picture never gives the correct story.

SES dived deep into shareholding pattern of the Bank during AGM 2019 and AGM 2020.

Votes polled comparison:

Category of Shareholders	2019		2020		Difference	
	Votes Polled	Against	Votes Polled	Against	Votes Polled	Against
Promoter & Promoter Group	1,85,83,593	0	2,28,66,629	43,55,676	42,83,036	43,55,676
Institutions	1,41,91,658	0	2,10,17,721	2,09,58,378	68,26,063	2,09,58,378
Non-Institutions	3,54,91,955	4,229	8,50,37,769	5,28,13,158	4,95,45,814	5,28,08,929

- participation by public shareholders increased in 2020 over 2019, overall non-promoter votes increased from 4.95 Cr shares to 10.60 Cr shares (more than 100% increase), Non-Institutional shareholders votes increased by 140%.
- In 2020, almost entire institutional investors voting was AGAINST the proposed Resolutions.
- Almost entire **increase** in Non-Institutional participation was also AGAINST resolutions, a relevant question is what was the trigger for sudden rise in Shareholder participation to express their dissent.
- Was there anything specific in FY 2019-20 that led to Shareholders suddenly expressing their dissent or was it due to some other factor or influence of some group of shareholders.

C. What led the shareholders of the Bank, to take such a harsh decision of knocking out directors?

Possible Factors for dissent

- Significant change from 2019 to 2020 AGM? What changed?
- Was this financial performance? Very unlikely as poor financial performance was there in 2019 as well. Or 2020 performance deteriorated so much that shareholders had no time to wait? (Read More)
- If that be the case, logical decision would be to vote out those who are responsible for mess and not those who are new and can't be held responsible?
- Do you throw out a person who was appointed as MD by RBI till November 2020? Just 65 days away from retirement and leave the Bank leadership (whatever was left of leadership) rudderless?

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- Shri Gorinka Jaganmohan Rao, was appointed as ID only on 2nd December 2019 and was hardly been on the Board for less than a year. He is Ex-employee of RBI. Incidentally he is also on the India Bulls Trustee Company Limited. Can one single him out as responsible, although 3 other IDs were appointed?
- Do you throw out Auditors whose appointment was approved by RBI and who have already done duty & given qualified opinion? What one expected from Auditors? Turn-around of the bank?
- In opinion of SES, there were two changes since last AGM, besides continually deteriorating operating and financial performance.
  - Proposed deal with Clix Capital, and possible change in control of the Bank.
  - Failed attempt of India Bulls Housing Finance to take control of bank, which was rejected by RBI

SES is of the view that it couldn't have been financial performance but these above two events which led to defeat of resolutions. Those voting AGAINST, probably were unhappy with the fact that deal with India bulls failed and are unhappy with Clix deal? Points to keep in mind

- Indiabulls Housing Finance holds 4.99% of the Share Capital as on 30th June 2020, did they vote AGAINST?
- The other two major Non-Institutional shareholders are JM Financial Services Ltd (3.88%) and SREI Infrastructure Finance Limited (3.34%) as on 30th June 2020, did they also vote AGAINST?

Therefore, based on above facts, the shareholding pattern and sudden activism by public shareholders, it appears that decision to oust major Directors and Auditors could impact the financial position of the Bank further, which is in dire need to capital equity infusion and a merger. With the Bank's Board in a limbo getting further equity and finalisation of the merger with Clix Capital appear to be a herculean task for current Board or whatever is remaining of it.

D. PERILS OF LOW INVESTOR PARTICIPATION

Was the low Investor Participation the reason for defeat of resolutions?

SES has further analysed the voting participation from the shareholders since AGM 2016. Details of the total voting participation under each category is provided below:

Category of Shareholders	Votes Polled (%)				
	2016	2017	2018	2019	2020
Promoter & Promoter group	100.00	100.00	100.00	80.99	99.81
Public Institutions	100.00	100.00	100.00	20.94	40.32
Public Non-Institutions	100.00	99.99	100.00	14.43	32.50

Source: *Voting Results disclosed on BSE.*

- Till 2018, there was almost 100% participation of all category of shareholders. Which in opinion of SES is a bit unbelievable as such voting pattern has not been seen in any company and should really be investigated.
- However, it is only in 2019, when the voting % fell drastically, although none of the resolutions were rejected
- AGM 2020 seen increase in voting % and major resolutions got defeated.
- Can one say that investors participated with full involvement till 2018 and realised that since everyone was voting, their vote was not making any differential impact, hence they did not vote in 2019 as well as in 2020, although may be in favour of resolution or against, one would not know
- However, in 2020 a bunch of investors got together (although in minority), voted against and achieved success.
- Could they have achieved this feat if participation was 100% as was in past- almost impossible to comment, however looking at past voting pattern, probably none of the resolution would have been defeated if voting was at 100%?
- Did India Bulls group vote AGAINST and was supported by other like-minded investors?
- Was a section of Promoter unhappy with the proposed deal with Clix?

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- Was a section of promoter disappointed by RBI's rejection of India Bulls merger?
- Silent majority has been defeated by an active minority
- SES has been a votary that investors must participate in affairs of the companies in which they hold shares

We would not have any definite answer unless one knows details of votes polled and piece together a story.

E. Is the Bank in bad shape?

While looking for rationale behind drastic measures taken by the shareholders, SES asked a question as to whether bad financial performance was the reason for dissent? A look at year-end financial parameters is a must.

(In ₹ Cr)	2016	2017	2018	2019	2020
Total Revenue	2,872	3,349	3,388	3,090	**2,558**
Net Profit/ Loss	180	256	(584)	(894)	**(836)**
Deposits	25,430	30,553	33,309	29,279	**21,443**
Advances	19,643	23,728	25,768	20,103	**13,827**
Net Worth	1,763	2,136	2,327	1,892	**1,229**
Gross NPA	1.97%	2.67%	9.98%	15.30%	**25.39%**
Net NPA	1.18%	1.76%	5.66%	7.49%	**10.04%**
CRAR	10.67%	10.38%	9.81%	7.72%	**1.12%**
Shift in CRAR	-	**(2.72%)**	**(5.49%)**	**(21.30%)**	**(85.49%)**

Source: *Annual Report*

Even if one looks through a microscope, it is impossible to find any positive signal about performance and health of the Bank in last 4-5 years.

- From FY 2017-18 to FY 2019-2020, continuous decline in all parameters.
- Bank reported a loss of ₹ **836** Crores in FY 2020.
- Bank's CRAR stood at abysmal 1.12% (as against the RBI requirement of 10.875%) and Tier-I Capital was negative.
- RBI placed the Bank under the Prompt Corrective Action in September 2019 [BSE Corporate announcement], on account of high NPA and insufficient capital.
- As per unaudited financial results for quarter ended as on 30th June 2020, the CRAR deteriorated further to 0.17% [Financial results].
- The Gross NPA of the Bank has shown significant rise from 15.30% in FY 2018-19 to 25.39% in FY 2019-20.
- The Statutory Auditors who were appointed in AGM held on 8th August 2018 had provided a **Qualified Opinion** in its Audit Report for FY 2018-19 & 2019-20.
- Auditors raised their concern over **material uncertainty related to going concern of the Bank**, due to mounting losses, steady decline in the deposit base since September 2019 and increase in NPA ratios.

Conclusion-I: There is nothing in performance parameters, which gives comfort to investors about capability of board and its performance, hence on this parameter investors vote AGAINST is justified. However, such a drastic action is not without any negative impact.

Although, Auditors have raised red flags in previous two years Audit reports when they were the Auditors of the Bank, the Shareholders of the Bank have never rejected Resolution for re-appointment of Statutory Auditor earlier. Why this time? And how only a small section is affected? And how a section of promoters have voted?

Why Now?

- The relevant question to ask is why now and why such a drastic action?
- The Bank's performance was deteriorating since long, therefore why the investors did not act earlier?
- Was this drastic action best solution?
- How all investors acted in unison?
- Is stewardship code an answer to avoid such messy results/ outcome, which can threaten existence itself?

F. Were the ousted Directors responsible for the present condition of the Bank?

SES examined the Directors whose appointment/ re-appointment was rejected and has divided in three categories:

I. **RBI approved-Short term**
   - Mr. Subramanian Sundar MD & CEO since 1st January 2020, term approved by RBI till 30th November 2020

II. **Long serving directors- NED**

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- Mr. Narayanan Saiprasad NED, Promoter, director from 1990 to 1998 and from 2006 to 2014. Appointed again in 2019
- Mr. K R Pradeep NED, Promoter, director from 2009 to 2017 and appointed again in 2020.
- Mr. Raghuraj Gujjar NED, Non-Promoter, director appointed in 2019. He was the NED Chairman from 2013 to 2015

III. Independent directors' fresh appointment and Re-appointment

- Mr. Y N Lakshminarayana Murthy, ID, director since 10th June 2016 and re-appointed as ID w.e.f. 30th July 2020
- Mr. B K Manjunath, was an Independent Director on the Board from 2008 to 2015 and then again from 2017. He was proposed to be re-appointed as ID in AGM 2020.
- Mr. Gorinka Jaganmohan Rao, ID, director since 2nd December 2019

SES agrees that performance of bank is nothing to be proud of, however, investors while voting have to realise on whom to affix this responsibility? Can one hold IDs who were appointed only last December, when the Bank was already in deep trouble accountable for the past Financial issues of the Bank? And vote out only one out of three IDs who were appointed on same date i.e. 2nd December 2019, that too ex General Manager of RBI? Was it a revenge for rejecting India Bulls merger proposal that shareholders rejected RBI former GM, RBI appointed MD & CEO and RBI appointed Auditor? If that be the case, should shareholders vote with that mindset?

Can one affix responsibility on MD who is temporary?

However affixing responsibility on **Category II & III**- *Long Serving Directors* above is absolutely correct and undisputed.

Impact of sudden cessation of term of Board Members:

- Banks, while they deal with money, more than money, it is capital of 'Faith/ Trust' that is core to success. Any impact on trust can bring down biggest of banks in no time and reviving or winning back a lost trust is almost an impossible task. Therefore, voting en-masse against appointment of directors carried the risk of causing a run on the Bank, which in the present case appears to have been nipped in bud by prompt action by RBI.
- Sectoral regulator, Reserve Bank of India ("RBI") approved that day-to-day affairs of the bank be run by a Committee of Directors (CoD) composed of three independent directors, who will exercise the discretionary powers of MD and CEO in the ad interim. [Press Release] in opinion of SES not a very happy situation.
- The Bank was in negotiation with prospective investors, and if the deal goes through then in any case Board would have changed. The question comes why sudden rush to remove Board and run the risk of jeopardizing the deal and the Bank itself?

G. Were the steps taken by institutional investors only option available to them at this stage?

Was no other alternative available?

Companies Act, 2013 provides for Shareholder rights for proposing resolution for removal of Directors. If the Investors concerns were not being heard and the Investors could have proposed for removal of existing Board and appointment of directors of their choice on the Board on the Bank. However, by voting against reappointment and appointment of Directors the Bank is left with no MD & CEO to manage the affairs of the Bank, thereby putting the entire Management in a vacuum.

Is the stewardship code an answer?

Stewardship code prescribed by all regulatory organisations (SEBI, IRDAI and PFRDA) has levels of interventions/ actions wherever investors find that there is a governance issue.

The Circular issued by SEBI on stewardship code states that *"The mechanisms for intervention may include **meetings/discussions with the management for constructive resolution** of the issue and in case of escalation thereof, **meetings with the boards**, **collaboration with other investors**, **voting against decisions**, etc. Various levels of intervention and circumstances in which escalation is required may be identified and disclosed. This may also include **interaction with***

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***the companies through institutional investor associations** (E.g. AMFI). A **committee may also be formed to consider which mechanism to be opted**, escalation of matters, etc. in specific cases."*

Hence, the intervention could be staged at different level and escalated from one level to another such as highlighted above. However, in case of LVB, it appears matters were quickly escalated and the final step of intervention came before news of any other intervention.

H. What could be the aftermath of the actions taken by institutional investors?

I. **Impact on ongoing Clix deal**?

SES is of the view that some of the outgoing Directors would have been actively involved in the discussion with the prospective investor since the discussion were fairly recent. Therefore, knocking them out of the management at this juncture could cause delay in consummating the deal. Why shareholders would do that, unless shareholders are unhappy with the deal? But deal contours are not yet finalised so it could not have been the reason. Any way that deal would have come for shareholders approval in normal course, shareholders could reject the deal at that time if not happy? Why pre-empt dissent?

II. Impact on valuation

By ousting a major number of Directors' uncertainty was caused. Any uncertainty carries risk and gets reflected in price. In case of bank, risk is tremendous, therefore action of shareholder begets a question, why take such a drastic action, which has potential to cause collateral damage? Why would institutional investors and public shareholders hurt their financial interest, as such negative news in market may lead to downfall in share price of the Company and making further merger deals difficult?

III. A run on the bank?

Such an action could have caused a run on the bank, making entire value to evaporate in a moment.

I. Are we seeing true picture or is there a story behind?

SES is unable to find any cogent reason for such an action, except that it is division between two groups of promoters and a group could motivate few public investors to vote against, while a sleepy majority did not participate, resulting in minority shaping the destiny of majority.

CONCLUSION

- The present case sets an example in the realms of Indian corporate, explaining the importance of having effective Stewardship code in place and placing the intervention parameters in the Code.
- The Institutional Investors and Mutual Funds should get into detailed discussion with the Investee companies, whenever there are serious governance concerns that are being identified, or if they are disappointed with the performance of the management.
- Voting rights by the Institutional Investors is one part of their Stewardship activity, but another part is that of having a constructive and detailed discussion with the management, which not only help the Investors to understand the challenges that are being faced by the management, but it will also enable the management to understand what Investors expectations and deliver accordingly.

Therefore, SES is of the view that there is no substitute for constructive discussion and detailed understanding between the Investors and the management. For which, effective Stewardship Code and implementing the intervention parameters, into the affairs of the Company should be used as means to communicate with the management, about the concerns and objectives.

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