Debt To Equity Conversions in Nigeria: The Etisalat Case Study

By ADESEGUN AGBEBIYI

The 2015/2016 global crash in the price of crude oil caused a severe shock to the Nigerian economy, reliant as it is on this commodity for most of its foreign exchange earnings. The value of the Nigerian Naira is intricately linked to crude oil revenues, and the relationship is responsible for Nigeria's strength and stability in high oil price markets and its weakness and turbulence when the price of crude oil declines. A low oil price environment, particularly where the fall in price is precipitous, spells trouble for the Nigerian economy and introduces uncertainty into commercial transactions.

The oil price drop inevitably led to the Central Bank of Nigeria ("CBN") devaluing the Naira by about 30% over the course of the turbulence and rates on the parallel or "black market" fell as much as 50%, at its worst. The cost of dollar-denominated debt being much lower, at about 7%, than Naira debt, which is between 20% and 25%, caused Nigerian corporates to go on a dollar-denominated debt binge during the boom years for the Nigerian economy. The devaluation of the Naira means that these corporates are now left with a large portfolio of dollar-denominated debt and higher debt repayments in Naira

terms. This coupled with a difficult operating environment and increased accounts payables, has left corporates struggling to repay creditors and maintain healthy debt and financial ratios.

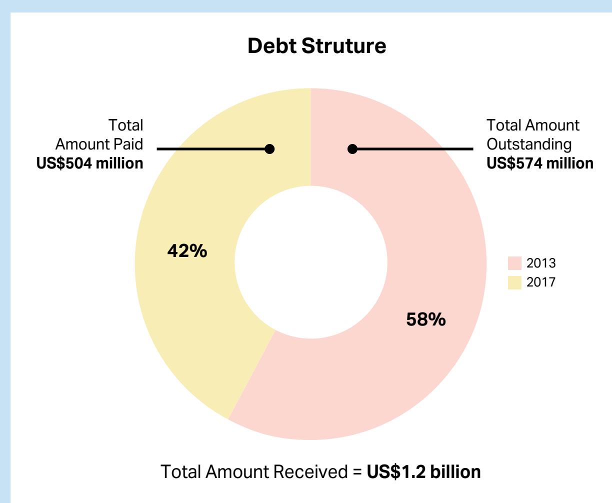
The creditors are equally hampered by this situation. The loans can only be restructured so often, and ultimately, prudential guidelines, regulators and banks will demand hefty provisions for restructuring transactions involving what were once thought of as prime banking customers. As a result of these challenges, many Nigerian companies are left with few debt restructuring options and creditors are left with fewer options for recovering debt. The conversion of debt to equity is an option that may be considered to provide a lifeline to Nigerian companies, particularly those with good fundamentals but that are having solvency issues as a result of the devaluation of the Naira. Creditors are also impelled to consider the conversion of debt to equity as a realistic debt restructuring option when dealing with such distressed companies.

CASE STUDY

Etisalat U.A.E

The Etisalat EMTS Debacle

In 2013, Emerging Market Telecommunication Services (“EMTS”), the Nigerian subsidiary of Etisalat U.A.E. (“Etisalat), obtained a U.S.$1.2 billion (N377.4 billion) syndicated loan from a consortium of 13 Nigerian Banks (the “Banks”). The loan, which involved a foreign-backed guaranteed bond and a pledge of shares of all the shareholders, was to be used to finance a major network rehabilitation and upgrade and the expansion of its operational base in Nigeria.



EMTS had repaid 42% (about U.S.$504 million) of the original U.S.$1.2 billion loan with a total outstanding sum of about U.S.$574 million when the oil price crash began. The loan was fully restructured in 2015 but EMTS defaulted on a payment due in February 2017. When the Banks threatened to take over the company, the relevant Nigerian regulators, the Nigerian Communications Commission (“NCC”) and Central Bank of Nigeria (“CBN”), intervened. The Banks were persuaded to stay all actions and allow more time for further negotiations, to which all parties agreed and set a date of May 31, 2017 as the final deadline for repayment.

EMTS and Etisalat made an offer to convert the Banks’ outstanding dollar-denominated debt into 5% of the company’s equity. The syndicated loan on which EMTS missed a payment had a U.S. dollar portion of U.S.$235 million outstanding, which EMTS wanted to convert into Naira in order to overcome hard currency shortages on Nigeria’s interbank market. The details of the offer were not made public but a valuation of 5% equity at U.S.$235 million would have valued the company at a massive U.S.$4.7 billion. The Banks did not accept the valuation or the offer and made good on their threat to take over EMTS after negotiations aimed at refinancing the debt failed. Etisalat announced that the Banks had exercised enforcement rights, requesting the transfer of 100% of the EMTS shares to the appointed trustee of the Banks. According to Etisalat’s filing at the Abu Dhabi Securities Exchange on June 20, 2017, Etisalat transferred all of its shares in EMTS (a 40% equity stake in the company) to United Capital Trustees Limited following receipt of a notice of default and security enforcement from the Banks on June 9, 2017. Mubadala, which reportedly owned 40% of the ordinary shares in the company, and the Nigerian shareholders that owned the remaining shares were also affected by the Banks’ exercise of their enforcement rights over their shares. All the shareholders were forced to transfer all their shares in EMTS to the Banks.

Negotiating the Conversion of Debt into Equity

The aim of conversions of debt into equity is to strike a balance, not only between the relative amounts of debt to equity in order to ensure the company has an optimal capital structure for profitable operations, but also between a creditor and a debtor to ensure that the creditor is not essentially penalized for compromising its right to demand immediate payment and enforce its debt. However, issues may arise where the company in distress offers its creditors a negotiated amount of equity in exchange for their debt, which could lead to the creditors in turn driving negotiations by imposing particularly stringent requirements for the amount of equity they are to receive in exchange for their loan repayment and interest amounts.

EMTS, as a company in distress, would have hoped to lower its debt overhang and ultimately to avoid insolvency and the associated costs. From the perspective of the creditors, however, if they accepted an equitization of their debt, the best they could hope for would be that they become equity holders and strive to find a strategic or financial investor interested in acquiring EMTS with its valuable telecommunications license and 20 million subscriber base.

With the pressure from the CBN to classify ETMS's loan obligation as non-performing and increase their accounting provisions against non-performing loans, understandably the Banks' preference was for Etisalat to inject additional capital into EMTS to repay the portion of the principal and interest on the loan that had fallen due. The prospect of accepting equity and their right to repayment becoming patient capital would not have been appealing to the Banks as they are not private equity investors with the option of 5- to 7-year investment periods and would not be inclined to wait while ETMS tried to turn around its prospects. For a meaningful equity conversion offer to have been considered by the Banks, the first hurdle would have been to agree on an acceptable valuation for EMTS. The parties were very far from an agreement on this point. The offer of 5% of equity in EMTS in exchange for the U.S.$235 million debt outstanding could not have been viewed as a serious offer as this would have valued EMTS at U.S.$4.7 billion, as noted above, which was a clearly unrealistic value for the company at that time. These factors may have hastened the Banks's insistence on the enforcement of the share security.

In addition, the looming pressure from regulators did not create an ideal negotiating environment. The possibility that they would be allowed the time and space needed to negotiate and agree on a mutually acceptable structure for what is, even in favorable circumstances, a difficult and time consuming process was very slim. When EMTS initially defaulted on the loan in February 2017, the CBN and the NCC stepped in to prevent the Banks from immediately enforcing the security, but instead of focusing on resolving this fiasco, the NCC began making uncompromising statements about the Banks not being permitted to run a telecommunications company. The Banks were likely very reluctant to defer the process any longer and risk further regulatory interference and negative exposure. They likely determined it would be better to bite the bullet and enforce than risk losing the right to enforce all together. The approval of the Nigerian Securities and Exchange Commission ("SEC") may also have been required if the Banks sought to acquire control of EMTS since, though EMTS was a private company, it was a largely capitalized entity subject to the rules and regulations of the SEC .

Issuing new shares or exchanging unalloted shares for debt would have diluted Etisalat's shareholding in EMTS as well as the percentage holdings of other shareholders. The Nigerian shareholders of EMTS may also have had pre-emptive rights and, given reports in the market that they were yet to receive any dividends on their investment in the company after close to a decade of investment, the Banks would have been rightly weary of embarking on a process that would require their involvement or a waiver of any rights. Considering the issues above, the Banks refusal to acquiesce to the debt to equity conversion deal proposed by Etisalat and EMTS is perhaps understandable.

EMTS blamed its distressed situation on the economic downturn, and particularly the sharp devaluations of the Naira, which contributed in part to its repayment obligations increasing by almost 30% overnight. EMTS claimed that the business performed well in 2016 and had positive EBITDA. While the EMTS gambit failed miserably in this instance, the option to use debt to equity conversion was highlighted and perhaps if better handled may have helped to avoid the enforcement action by the Banks and preserved Etisalat's shareholding in EMTS, which at the time had 20 Million subscribers and represented 14%

of the telecommunications market in Nigeria. Specific circumstances aside, a company with a profile like EMTS would seem to be a good candidate for a debt to equity conversion.

The Banks are likely to try to sell EMTS as soon as possible and there have been media reports that international advisers have been appointed to manage the process and find a new investor willing to purchase the Banks' shares in Etisalat. It remains to be seen if there is any appetite in the market for strategic telecommunications investors or financial investors to acquire EMTS. As mentioned above, EMTS's fundamental position is very strong and it would be an appealing target for investors looking to enter the Nigerian market. It is unlikely that the most willing buyer, the South African telecommunications operator, MTN, the largest operator in Nigeria representing 36% of the market, would be allowed to acquire EMTS on the grounds that this might enhance its already dominant position in the market. Etisalat and Vodacom, two international telecommunications operators with deep pockets, have exited the Nigerian telecommunications market and other international investors will be aware that it is a very competitive market and earning a return on investment will demand a great deal of skill and resilience.

The Banks may find that it would have been more beneficial to pursue the debt to equity conversion option with Etisalat more seriously. Etisalat may have been willing to accept a more reasonable valuation and the parties may have been able to agree on commercial terms that were mutually beneficial. A sale process may be time consuming and expensive and wouldn't be guaranteed to result in a viable buyer willing to accept the Banks' valuation of EMTS.

Legal Regime for Debt to Equity Conversions in Nigeria

A debt to equity conversion in Nigeria may be implemented through a court-supervised process. Section 539 (1) of the Companies and Allied Matters Act ("CAMA") establishes a process for a Nigerian company to enter into a compromise or arrangement with its creditors or shareholders, whereby the rights and liabilities of members, debenture holders or creditors are governed by the provisions of CAMA or by the unanimous agreement of all parties affected. This process is subject to the approval of the Federal High Court in Nigeria after confirmation from the SEC that it is satisfied with the fairness of the applicable compromise or arrangement.

In practice, the court-supervised process is typically adopted in larger and more complex transactions, typically involving asset transfers. With more standard transactions, a simple contractual exchange to extinguish the debt of the creditor in exchange for equity in the borrower, a court supervised process would not be required.

Documentation

Depending on the structure of the transaction, an amended facility agreement whereby parties recognize that the debt is reduced, a debt conversion agreement and a share purchase agreement may need to be executed by the parties. These agreements would reflect the outstanding debt of the debtor company (a portion of which would be converted as part of the debt to equity exchange agreement), the shareholding of the investor/creditor as well as the terms governing the shareholders interest in the debtor company.

Notable Regulatory and Legal Issues

SHARE CAPITAL

In a debt to equity conversion, it is important that the debtor company has sufficient authorized but unissued share capital that can accommodate the debt conversion. Where the debtor company's share capital cannot accommodate the debt to equity conversion, a resolution of the shareholders increasing the capital will be required, authorizing the increase to an appropriate level. The shares would then be allotted and the necessary filings would need to be made at the Nigerian Corporate Affairs Commission ("CAC"). This capital increase is a corporate and administrative process that comes with an administrative cost implication as there are stamp duty and registration fees payable for the increase in share capital. These costs can however be moderated by the company reclassifying and issuing its new shares at a premium.

REPATRIATION OF PROCEEDS

If the creditor is an offshore entity, the creditor may encounter difficulties in the conversion of the Certificate of Capital Importation ("CCI"). A CCI is the document that gives a non-Nigerian investor access to the foreign exchange market in order to repatriate dividends and proceeds from its investment in Nigeria. The applicable foreign exchange regulations provide that debt CCIs are issued in respect of the inflow of debt

from an investor to a local beneficiary and prescribe the specific document requirements to be complied with, in order for the interest and principal to be repatriated in accordance with the tenor and terms of the applicable underlying loan agreement. Similarly, with regard to equity investments by an investor into a local beneficiary, the specific document requirements are prescribed to permit repatriation of dividends and the proceeds of the sale of the shares to the non-Nigerian investor.

Consequently, if a debt to equity conversion occurs during the life of a loan, an incongruity arises between the investor and the beneficiary documents, as the investor will have the initial documents required to repatriate debt while its investment would have been converted into equity. The debt CCI will thus be required to be converted into or replaced with an equity CCI in favour of the investor. This conversion process may pose challenges as the CBN will be required to approve and authorise the conversion. This may delay the debt to equity conversion process as the CBN will typically require a detailed documentary history to prove that the funds were actually repatriated into Nigeria and that the investor/beneficiary of the funds complied with the provisions of the foreign exchange legislation at the time of the inflow of the funds.

TAXATION

Debt to equity conversions may also give rise to tax concerns, which should be analyzed on a transaction-by-transaction basis. For instance, Section 11(6) of Companies Income Tax Act ("CITA") provides that interest on foreign loans that is not less than N150,000 would be exempt from tax, subject to certain conditions. The third schedule to CITA details the repayment period and the respective tax percentage exemptions allowed on the interest of foreign loans as follows:

Repayment Period including Moratorium	Grace Period	Tax Exemption allowed
Above 7 years	Not less than 2 years	100%
5 – 7 years	Not less than 18 months	70%
2– 4 years	Not less than 12 months	40%
Below 2 years	Nil	Nil

Therefore, where the loans are initially structured to benefit from the above tax exemptions under CITA, a reduced withholding tax ("WHT") liability would accrue on the interest payable on the loans based on the table above. A debt to equity conversion is deemed to constitute a discharge of the loan on the date of the conversion and WHT is assessed on the assumption that the principal and interest accrued on the loan have been repaid on the date of the conversion. If the conversion occurs outside of the repayment period originally contemplated by the debtor company, it is possible that the debtor company would lose the tax exemption it would otherwise have been eligible for on the repayment of the loan. For example, a debtor company that would have qualified for a 70% WHT exemption on a loan that should have been repaid between 5 and 7 years would lose this tax exemption if a debt to equity

conversion occurs after the seventh year of the loan. This could lead to unanticipated costs if parties are not mindful of the tax effects of such a debt to equity conversion.

A Capital Gains Tax ("CGT)" of 10% is levied pursuant to the Nigerian Capital Gains Tax Act on the proceeds of assets disposed of by a person. However, proceeds of the sale of shares are exempt from CGT, so creditors engaging in a debt to equity conversion would be able to take advantage of this tax exemption and would not be subject to any additional tax liabilities upon the disposal of their shares.

Note also that the valuation on the conversion of debt to equity must be commensurate with the actual price of the debt, otherwise, a conversion in which debt is exchanged for less equity than the value of the debt could be viewed as an unrealized gain for the debtor company, which would be treated as income and which would be subject to corporate tax.

Conclusion

The oil price crash and the ensuing foreign exchange crisis that afflicted the Nigerian economy created difficulties in the repayment of foreign currency-denominated loans. Corporates and their financiers have been required to consider various options for debt restructuring in order to reduce the increased repayment burdens. A debt to equity conversion is an option worth considering in order to lift companies out of the financial dilemma generated by the devaluation of the Naira.

A debt to equity conversion is not without its challenges, as discussed above, but the benefits of a successful conversion would generally be worth the difficulties that may be encountered in the negotiating process. In the EMTS case, the Banks are left with the option of seeking investors to acquire EMTS and obtain a price proportionate to their outstanding debts owed by EMTS. These hurdles could have been avoided if the parties had agreed on commercially acceptable terms for a debt to equity conversion. It may be that there were simply too many parties involved for the debt to equity conversion option to have been viable with EMTS. Highly regulated commercial banks trying to restructure a regulated telecommunications company will inevitably face time and cost constraints that may end up sabotaging the transaction for all parties. Similarly, the unnecessarily high level of involvement of the CBN and the NCC in the EMTS case likely contributed to the Banks' reluctance to move forward with the transaction at various stages. We expect that, in the future, regardless of the level of influence from regulators, more creditors in Nigeria will consider the debt to equity conversion option as a restructuring solution, and will be able to learn from the EMTS case rather than dismissing the process as too cumbersome or fraught with regulatory hurdles. In turn, hopefully the Nigerian regulatory bodies will take a more hands-off approach to these types of transactions, which could ultimately contribute to a revitalization of the Nigerian economy as a whole. ■

1. Please note that the facts of this case where to a large extent culled from the reports of Nigerian daily newspapers, in particular, (*Business Day*).
2. The filing reference number is Ho²/GCFO/152/85.
3. The loans had originally been extended by the Banks to EMTS on the credit of Etisalat and Mubadala. The other shareholders, mainly local investors, lacked the financial strength or appetite to make additional investments in EMTS.
4. A patient capital investor is willing to make a financial investment in a company with no expectation of turning an immediate profit. Instead, the investor will forgo an immediate return, but will expect a more substantial return in the future.
5. Section 118 of the Investment and Securities Act, Cap I Laws of the Federation of Nigeria 2004 and Rule 434 of the Securities and Exchange Commission Rules 2013.
6. EMTS's financial distress issues, laid out publically on the pages of national daily newspapers, appear to have affected its operations as well. As of September 2017, its subscriber base had fallen to 17.2 Million and its percentage share of the market had decreased to 12.33%. See Nigerian Communications Commission, Industry Statistics, available at: https://www.ncc.gov.ng/stakeholder/statistics-reports/industry-overview#view-graphs-tables-5.
7. Camillus Eboh, Chijoke Ohuocha, *Nigeria's 9mobile Seeks Concessions to Boost Revenues Ahead of Sale*, REUTERS (July 27, 2017), available at: https://www.reuters.com/article/nigeria-9mobile/nigerias-9mobile-seeks-concessions-to-boost-revenues-ahead-of-sale-idUSL5N1KI6U9.
8. Stamp duty fees of 0.75% of the increased amount and a graduated CAC fees commencing from N5,000.00 for every N1 million in share capital or part thereof to; N10,000.00 for every N1 million in share capital or part thereof for increases in share capital above N1 million and up to N500 million; and N7,500.00 for every N1 million in share capital or part thereof for increases above N500,000,000.
9. The foreign exchange market in Nigeria is regulated by the Foreign Exchange Monitoring and Miscellaneous Provision Act ("FEMM Act"), the CBN Foreign Exchange Manual and directives and circulars published pursuant to the FEMM Act and the Manual.
10. Laws of the Federation of Nigeria, Cap C1, 2004.

▼ **Adesegun Agbebiyi** is a Senior Associate at Aluko & Oyebode and a member of the Firm's Corporate Finance and Commercial team. He holds an LL.B (Hons.) from the University of Lagos and an LL.M from the University of Pennsylvania Law School.

Adesegun has over 9 years of experience in advising on matters such as local and foreign currency syndicated lending, structured finance, project finance, private equity, mergers and acquisitions, structured trade finance, due diligence issues and advisory services, foreign investment advisory , private equity, real estate and the regulatory framework of various growth industries including TMT and FMCG.