The CFO's Many Faces: Shepherding Expansion

Sanjay Jain, Group CFO of Future Capital, looks at the opportunities and pitfalls involved in the M&A process

Mergers and acquisitions come with a whole check-list of issues that must be resolved before any deal can go through – from the valuation process and having to engage with advisors, to the actual modalities of execution. Even more critical, however, is the post-acquisition integration stage. This includes, first and most importantly, issues related to culture – such as whether the acquirer, and not just the acquiree, needs to fundamentally change itself and the way it operates. In this respect, one cannot overstate just how important the first 100 days truly are. Like molten lava, culture and people issues take shape during this period, and if management is not quick to act, they will fall into a 'cast' that is hard to change. There are also, in any M&A scenario, multiple stakeholders whose needs have to be met, both before and after the transaction goes through. Due diligence is a third, crucial aspect, because failing to dig deep enough can ultimately sink even the most promising acquisition. Capital structures also play a major role in determining success or failure, as does intent – whether the 'top brass' is looking to create value, or instead, engage in 'empire building'. Two major Indian companies – Future Group and Crompton Greaves, both of whom Mr Jain has worked with and observed closely – illustrate the many 'dos and don'ts' of the acquisitions process.

A TALE OF TWO COMPANIES...

Crompton Greaves (CG) and

> Future Group's focus has been entirely on the Indian 'Bird of Gold', while Crompton Greaves has shopped abroad, mainly in Europe

the Future Group (FG) are two very different organisations. One operates in the electrical and infrastructure space, manufacturing everything from transformers to switch-wear, and executing EPC projects. The other services India's burgeoning retail market, selling food, fashion, and nearly anything in between. However, they also have a lot in common: they have successfully come out of a period of severe balance-sheet stress, and they have both acquired firms like there was no tomorrow. FG's focus has been entirely on the Indian 'Bird of Gold'. In just two-and-a-half years, it bought Walmart, Nilgiris, Kara, Heritage, WH Smith, Hypercity, Big Apple, Fabfurnish, Vulcan, and Cold Chain – literally one company every two months. CG, in comparison, has done all of its 'shopping' abroad, in counties like Belgium, Ireland, France, Hungary, the US, Canada, and Indonesia. Yet while their routes have differed, both have managed to create significant value: FG has seen its market cap grow at a 100 per cent CAGR over the last four years, while CG has seen a 133x rise over 20 years.

Empire building – or value creation?

To understand whether these M&A sprees were driven by value creation, or instead, by the need for 'empire building', it is important to look at the thought process that lay underneath. For Crompton Greaves, it was a question of mathematics. On a variety of ratios – MSR (material to sales ratio), EC (employee costs), and OC (overheads) – it saw significant arbitrage opportunities in making acquisitions in Europe. It had skilled employees in India who would bring down the employee cost ratio of the merged entity; on the other hand, target firms such as Pauwell's had strong buying procedures and practices that enabled them to enjoy lower raw material costs. Moreover, they were operating in countries that were, at the time, promising to ramp up their infrastructure spends – which would have created huge new market opportunities. The synergies were clear.

For retail businesses like Future Group, scale, and the ability to offer an end-to-end value chain, are the keys to profitability. Its costs of doing business are huge: it must pay for expensive real estate (so as to be close to where its customers live), run glossy front-page ads and buy prime-time radio slots, do up its stores nicely, and run air-conditioners and cold-storage around the clock. On the flipside, margins – particularly for strong FMCG brands – are low,

so it is important to have private brands that are produced in large volumes, and to sell them not just at FG stores, but also at competing ones. Without scale to amortise cost, it is exceedingly hard to make money – and building or acquiring as many stores as possible was thus an imperative. FG's promoter, Kishore Biyani, rightly believes that while online retail has a place, physical stores are here to stay. At the environmental level, meanwhile, the prospect for formal-sector retail players has received a boost from demonetisation and the GST. All considered, then, the future for FG lies in expanding its pan-India brick-and-mortar footprint, which means buying up the competition.

...AND HOW THEY MANAGED THE POST-ACQUISITION PHASE

Capital structures: creativity has a role

When it comes to structuring a deal, the main covenants include the debt-EBITDA and debt-equity ratios, free cash flows, and FACR. For Future Group, an added consideration, when it was looking to acquire Walmart's India business, was that it was just emerging from a period of stressed balance sheets. With banks putting pressure to resolve these issues, and the promoter hesitant to dilute his equity stake, raising the money was tricky. The solution Mr Jain negotiated was to exchange Future Retail stock for Sunil Mittal's holdings in Walmart, but to get him to agree to cap his returns at 2.5x. The 9.3 per cent stake he received is currently worth Rs 2,900 crores, but if he sells it, his share would be Rs 1,700 crores, while the balance Rs 1,200 crores would go back into Future Retail. Crompton Greaves took a different route, borrowing mainly from European banks to fund its Pauwell's acquisition. By bringing strong brands under its wing, it managed to drive up its market cap. Subsequently, CG sold equity to capitalise on these gains,

> A supportive capital structure deployed for an acquisition can sometimes make the difference between earning a return on the investment, and not

thereby drawing down its debt. In both cases, creative fund-raising helped maximise the returns on the acquisition.

'Digesting' the acquiree

Just like eating too much can strain a human body, buying up too much, too quickly, and without due consideration to integration issues, can stress the acquirer's balance sheet. Management bandwidth can get stretched, resulting in sub-optimal execution. CG struggled to generate the cost efficiencies it had forecast, which were already built into its stock price. With its books under strain, it later had to dispose of its consumer business. The acquirer, in this case, became the acquiree.

Stakeholders: different strokes

At each stage of the acquisition process, the needs of different stakeholders must be considered. In negotiating the deal, it is the owners or CEOs – on both sides of the fence – that have to be brought into the picture, and made to feel comfortable about the process, as well as about the value they might expect to gain. (Even where stressed assets are involved, and particularly so in India, few deals go through unless the owner consents.) Simultaneously, one must work closely with analysts, the Board, and the legal authorities to ensure that they are in consonance. For many targets, being able to 'relate' to the new owners is critical – particularly with overseas deals, cultural issues come into play. Crompton Greaves actually failed in its first two European bids for this reason – one even ended up selling to another firm for 1 million Euros less than what CG offered, mainly because of 'comfort' issues. Learning from its mistake, CG, in its third bid, first got the owner on board, and then used him to front the negotiations with banks, taking a backseat in the entire process.

When the acquisition has all but gone through, it is vital to bring customers, vendors and employees on board – after all, they should not be hearing about the deal first from the media, but from the management. Arguably, though, for CFOs, the single most stakeholders in the process are themselves. Before submitting a proposal, they have to introspect, asking whether the deal makes sense, whether it is the 'right thing' to do. They must be the organisation's conscience-keepers, and then, when the matter is decided, they must stick their

necks out, finding the best way to execute the deal. Otherwise, quite simply, they are not doing their job.

Due diligence: How deep?

Like with an iceberg, 90 per cent of all integration issues lie below the surface. Accounting, tax, IPR and HR issues – and in Europe and America, pension liabilities – often become visible only after the purchase. When CG was calculating its potential synergies in Europe, it assumed a much higher material-cost ratio for the target company, as well as reductions on the people-cost side. What it miscalculated was the quality expectations that French power utilities have compared to SEBs in India, and the technical issues (oil leakages etc.) that can arise when shipping large pieces of equipment overseas. Consequently, it saw a spike in rejections, and was nearly black-listed by the European utilities. All of this goes to say that due diligence needs to be far more than skin-deep.

Culture

Research indicates that 75 per cent of M&A deals go off-track because of cultural issues – such as a failure to engage the new employees, or the inability to integrate the culture of the merging organisation. For firms making overseas acquisitions, the challenges can be severe. Europeans, for example, tend to be more protective of their off-duty hours and weekends than Indians, who are more used to a 24x7 culture. There are also myriad local nuances that must be handled with care and sensitivity. (Sometimes, it is a good to bring one's local embassy into the picture, not just to understand the domestic policy environment, but also to help push the deal through.) It may not work, for instance, to try and micro-manage people who are used to functioning with a fair degree of autonomy, or to expect them to look up to their new managers for every decision that needs to be made. Not recognising these issues can mean the difference between success and failure. Even within a country, acquirers and acquirees can be very differently built – entrepreneurial vs process/systems-driven; young and upcoming vs old and established; vigorous vs slow and stately. Making such marriages work, ultimately, are about give and take.

In the final analysis, cultural issues make or break the vast majority of mergers – and the issues are no less tricky in a domestic deal than in a foreign one

AN ENDLESS CYCLE...

Companies that play the M&A game must be prepared to be on both sides of the negotiating table, because what goes around, comes around. Crompton Greaves and Future Group have both acquired several firms, including some that were looking to buy them at one point. They have also, at times, had to sell crucial parts of their business. Future Group funded its growth spree, in part, by selling off its 'crown jewel', Pantaloon Retail. CG, meanwhile, went from near-bankruptcy in 2001 to an acquisitions-driven market-cap surge that eventually fizzled out – mainly because the infrastructure-spending boom it had forecast failed to materialise – and which forced it to sell its consumer business, which had long been its cash cow. All throughout, both companies have not shied away from taking tough decisions, and in the final analysis, they have managed to create considerable shareholder value. ■

Sanjay Jain is Group CFO, Future Capital. This article is based on his presentation at the 22nd Annual CFO Roundtable in Guwahati in February 2018