M&A Hotline

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TIME TO RECONSIDER MERGERS AND ACQUISITIONS PRICING NORMS?

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It is almost universally accepted that valuation is an art and not a science and the value determined by one expert can vary significantly from that of the other expert especially for large and complex M&A (mergers and acquisitions) transactions even if both the experts are independent and reputed. Rather ironically, the Indian M&A rules rely heavily on valuation reports and fairness opinions prepared by experts based on historical market prices.

For example, the Indian takeover code prescribes the minimum offer price to be the higher of — the price paid to the controlling shareholders or the historical market price calculated as per a prescribed formula. Curiously, courts have applied the traditional business judgment rule to examine the fiduciary duties of directors in the context of M&As and consequently adopted a hands off approach to valuation (or other business decisions) unless mala fides are established.

This approach may not be the most optimum and certainly requires a closer re-look. To elaborate, consider the example of the recent Delaware Chancery Court ruling in the Dell buyout case. To provide some context first — In 2012, Michael Dell, the founder of Dell Inc. (Dell) communicated to its board his intention to partner with Silver Lake, a financial sponsor and take Dell private after the stock had underperformed for almost half a decade.

The board hired at least three financial advisors to set in motion a sale process to ascertain the fair value of the shares of Dell. The board and its team of advisors approached several financial sponsors prior to the signing of the deal. Curiously, the board had not approached any strategic buyer prior to signing the deal with Michael Dell and Silver Lake but had engaged with one such strategic buyer, Hewlett Packard only after the deal with Michael Dell and Silver Lake was inked.

After almost 15 months of hectic negotiations and after evaluation of several offers including one from the legendary activist shareholder Carl Icahn, the shareholders by a very narrow margin approved Michael Dell and Silver Lake's merger offer. The merger offer, which was recommended by the board, touted as fair by the financial advisors, and approved by the shareholders was at a significant premium to the current and historical market prices. Significant number of shareholders dissented to the merger price and invoked the appraisal jurisdiction of the Delaware courts to determine the fair value of the shares.

The Delaware court found the merger price to be unfair. At the heart of the Delaware court's findings were three factors — first, the market price cannot be considered as a benchmark as the value of each share does not represent the intrinsic value of the entire company, especially, when the company is undergoing a transformation and the market has undervalued such a stock. Second, the financial sponsors valued the company in a way that would enable them to achieve a certain IRR (internal rate of return) after 4-5 years and therefore, such a self-serving process of valuation could not be used as a benchmark to determine the fair value of a company. Third, the sale process was not competitive enough to achieve a fair price as the board of Dell had not actively engaged with strategic buyers and other noteworthy financial sponsors prior to signing the deal with the Michael Dell and Silver Lake. The court finally based on its own analysis of the discounted cash flow valuation presented by two expert witnesses arrived at the revised merger price which was significantly higher than the original merger price.

A similar fact pattern in the Indian context would have resulted in divergent outcomes and the intent of this piece is not to undertake a prognosis of that. However, the ruling has a larger philosophical undertone which policymakers and all M&A stakeholders in India must take note of. The ruling re-enforces a couple of points — one, market or deal price is not necessarily reflective of the fair price in a M&A scenario and two, fair value cannot be achieved by only commissioning an independent valuation but a competitive and robust sale process is imperative in achieving a fair outcome. The Indian takeover code does not endeavour to achieve a "fair" value for the minority shareholders but instead endeavours to assure a price which is not "inferior" to the one paid to the controlling shareholders. This pricing policy while persuasive may be suboptimal in the Indian context.

First, due to the concentrated shareholding pattern of Indian companies, an acquirer can achieve a controlling stake merely by negotiating a deal with the controlling shareholder and therefore, there is no incentive to pay a premium to the minority shareholders to acquire their shares. Second, the controlling shareholders, especially, in the case of India where still a significant number of listed entities are family owned, may have various reasons of exiting a company including to deleverage group debt, explore a new line of business etc. and in such cases the controlling shareholder may not necessarily strike a deal at a "fair" price. Third, while any additional disguised payment such as non-compete fees, etc. is required to be added to the offer price per the existing Indian takeover rules, there are still instances of camouflaged payments being made to controlling shareholder in the form of guarantees, board seats and fees in lieu thereof, future business arrangements, etc. These disguised payments render a body blow to the

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entire philosophy of assuring a “non-inferior” price for the minority shareholders.

The question is where does all this leave the minority shareholders today? To be fair, all is not gloomy for the minority shareholders. There is enough in the Indian M&A rules which can be relied upon to force boards to get a fair outcome. For example, the Indian takeover rules require independent directors to provide a “reasoned” recommendation on an open offer.

Similarly, in the case of mergers, the listing rules require the audit committee to approve the valuation. Can these be construed to mean that the boards are required to achieve a fair price or undertake a sale process to obtain the best price? Are boards required to ensure that there are no disguised payments and therefore actively engage in the deal negotiations? Will the courts question the fairness of the business decisions and abandon the blanket reliance on the business decisions made by the board (traditional business judgement rule) in suitable cases? An ambitious and activist shareholder will certainly test these propositions, especially, in an environment where the stakes are high. Board of Indian companies on their part would do well to take a more nuanced position of their role in M&As as given the global trend their actions would be under microscopic scrutiny.

– Ankit Mishra & Nishchal Joshipura
You can direct your queries or comments to the authors

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