Due Diligence in Mergers and Acquisitions with Dr. Sheeba Kapil

Dr. Sheeba Kapil with the faculty, Prof S N Sinha and the student managers of IMT, Nagpur

The student managers of Institute of Management Technology, Nagpur had the opportunity to interact with Dr. Sheeba Kapil, professor at Indian Institute of Foreign Trade, New Delhi, on the topic Mergers and Acquisitions. Dr. Sheeba Kapil has over 12 years of experience in teaching and she has given her contribution in national and international journals. Apart from teaching, she is involved in consulting activities and training and management development programs for different organizations. Here is the excerpt from the interview:

Q1. How to value intangibles like goodwill, patents, knowhow, etc. in takeovers?

Ans. From the viewpoint of Mergers and Acquisitions, Goodwill is the extra premium that a company is being paid while being acquired. The moment we have acquired a company, we have gained that amount of intangible assets. So, goodwill calculation is a very distinct and personal value that a company calculates in house to determine the current perceived value it has. During Mergers and Acquisitions, the current valuation of goodwill is not taken into consideration unless it arises from the acquisition or it is purchased goodwill.

Q2. How different is valuation methods for different industries?

Ans. When we talk of valuation, the first thing that strikes our mind is asset valuation. And when we talk of asset valuation, the next thing we think of is Discounted Cash Flow (DCF). The moment, we do valuation, the first thing we are taught is understanding the industry - one directly cannot come to DCF. DCF comes to picture only when we look at the quality of an asset.

In short, DCF means the cash flow generating capacity of the assets as well. For an auto company say Ford, the market cap will be quiet different and very less from the asset value as per the balance sheet of the company. Now suppose I want to buy Ford, the shareholders will sell me at the market price per share; but at the same price I am getting a higher priced asset which is involved with that equity. But then there will be a dispute where company will say that market is undervalued and they are worth much more – the company might demand the price for the entire value of the asset. So for this, assets needs to create cash flows that it is supposed to, else the market will give thumbs down. To solve this, intrinsic value of asset comes to picture i.e., the maximum and the minimum cash flow generating capacity of the assets. So, one is DCF standalone. It means valuing the DCF of any company or institution with whatever data is available at any given time. This is also known as traditional way of calculating DCF. Second thing to keep in mind is to know whether there is any scope for generating more cash flows from the same assets or not. Whether there can be any optional values assigned to hidden cash flows? So basically, it has to depend on the quality of the assets. Quality and different profile of assets of same industry will be the same. So if we are applying DCF to auto companies whether in India or US, the forecast drivers are hardly going to differ and the valuation model will be the same. I would categorize industry in two domains. One is hard assets and the other is soft assets. Quality of assets is different in hard assets. The company needs to recover the fixed cost. Kingfisher was into trouble because contribution margin was less. Soft assets can be categorized as Flipkart and other ecommerce firms or any new start ups for that matter. So, the better you understand the industry, the better you understand the asset quality. Before valuation what is important is to know what are we valuing and that depends from industry to industry and therefore there is no standardized model for DCF.

Q3. Despite due diligence being done, mergers fail. Is it an issue of HR integration or are other issues also involved?

Ans. There are many examples of failures. One of them being that of Daimler Chrysler. Now, diligence is of four type: Strategic, legal, finance and technological. Target burst when the acquirer could not manage and fight for bankruptcy, like Microsoft did when they acquired Nokia and subsequently problems arose. The way Motorola and Google played – Google bought Motorola, stripped off all the assets and patents, bought at a high price and sold for very less. Or even the case when Ranbaxy was sold to Sun Pharma. The type of failures that you see now, they show problems in due diligence. Another example is of the joint venture between Coke and P&G which failed within four months from the date it announced the merger because the share of Coke went down while of P&G went up. Coca Cola wanted research and development in soft beverage so they wanted to use P&G’s expertise. However, finding answers to such failures are very rare. Now increasingly we have investment bankers who not only advice us to sell or buy a company but also advice us on integration. Integration is a very complex process. The more capital intensive firm you are, the more difficult it is to acquire and successfully integrate. If you ask the acquirers to integrate, the only synergy gain they see is reducing the costs. Integration

requires target and acquirer to disrupt the existing activity. Also when we go to a new country, language is major barrier. So there are certain aspects but they cannot override integration. And mistakes can happen from anyone, including big brands.

Q4. US is the cradle of Mergers and Acquisitions. But Asia Pacific as a region is growing tremendously. Why?

Ans. A company seeks to buy growth in mergers and acquisitions. All the reasons have to point towards valuation. That means there has to be some operating efficiency. The firm should get some profits and cash flows. Where the markets are already stagnant, where auto industry is globally not growing, Indian auto industry is showing progress. Now how will you counter argue this? That globally auto industry is in recession, Ford is having problem selling but why is it that all Indian companies are doing great? Even China will stagnate because of age, demographic and other factors but India has no such barriers. Even Africa has enormous growth opportunities with there being higher penetration by mobile based banking like m-Pesa rather than growth of traditional banking network. So people do not store money in a bank anymore and this has given stiff competition to the banking sector. The two types of trends that Mergers and Acquisitions are having is DVA and POP. DVA captures how much value has been created and POP captures how much over valuation has been made. If DVA is not high, it means that value creation is there but people are not making huge payments. And POP shows over payment and over indulgence by companies.

Q5. How was your experience at IMT, Nagpur?

Ans. I am delighted you all asked me such good questions. I wish all the students very best for their future endeavors.