Butter Chicken At Birla Maybe, But The Stockholders Are Stuck With A Lemon

A fascinating new book titled "Reimagining India: Unlocking the Potential of Asia's Next Superpower,"[1] by Clay Chandler and Adil Zainulbhai of McKinsey & Company has an essay titled "Butter Chicken at Birla" written by the chairman of the Aditya Birla Group of companies, Mr. Kumar Mangalam Birla.

Mr. Birla tells the story of how his group adapted with the times.

> When I took over the company in 1996 at age twenty-nine, after the sudden death of my father, no meat was cooked in Birla cafeterias; no wine or whiskey was served at company functions.
>
> Seven years later we bought a small copper mine in Australia. The deal wasn't a huge one, worth only about $12.5 million, but it presented me with a unique challenge of the sort I had not yet faced as chairman. Our newest employees were understandably worried about how life might change under Indian ownership. Would they have to give up their Foster's and barbecues at company events? Of course not, we assured them.
>
> But then several of my Indian managers asked why *they* should have to go meatless at parties, of employees abroad did not. At Marwari business houses, including Birla, the top ranks of executives traditionally have been filled with other Marwaris. I had introduced some managers from other firms and other communities, and they had a valid point. I was genuinely flustered. My lieutenants were relentless: I had never faced a situation where my own people felt so strongly about something. Yet at the same time I knew vegetarianism was a part of our values as a family and as a company. A core belief! I had broken a lot of family norms, but I thought this one was going to be multidimensionally disastrous for me.
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> Fortunately, my grandparents merely laughed when I approached them with my dilemma: They understood better than I did that our company had to change with the times…

He goes on to tell how his group has become one of India's "most globalized conglomerates with operations in thirty-six countries on five continents employing 136,000 people."

> Since I took over as chairman, we've made a dozen acquisitions overseas worth a total of more than $8 billion in sectors as varied as mining, pulp, aluminum, and insurance. We've branched out into Australia, America, Canada, and Europe…
>
> We have expanded internationally for many reasons— sometimes to spread our bets, sometimes because we found it impossible to open a plant in India as fast and as cheaply as we could abroad. *In each case, we've made our decision based on whether or not the deal would increase shareholder value.*" (Emphasis mine)

Let's look at the largest of those dozen acquisitions and see what impact it had on shareholder value. This was the February 2007 buyout of the aluminum giant Novelis which, Mr. Birla writes, "made us the biggest producer of rolled aluminum in the world."

Hindalco was indeed on a "roll" in early 2007. After all, the company would soon deliver its highest annual EBITDA of more than a billion dollars on its highest annual revenues of $4.5 billion. The company's superb profitability— pretax ROE would be 40% in FY07— was largely a function of the company's well-deserved reputation as one of the world's lowest cost producers of aluminum.

Nevertheless, the price tag of $6 billion was a very large sum of money for the acquisition, given that Hindalco's market cap just *before* it swallowed Novelis was $4.5 billion[2] spread over 1.2 billion shares.

And what is Hindalco's market cap now?

$4.4 billion[3] spread over 2.1 billion shares.

Price Is What You Pay; Value Is What You Get

We know Hindalco paid $6 billion for the acquisition (but I will qualify this later).

What did it get back in return?

I obtained the quarterly and annual filings made by Novelis with SEC, and the picture— you guessed it— does not look pretty.

The deal closed on 15 May 2007. From 16 May 2007 till 31 March 2013, Novelis reported pre-tax *losses* aggregating to $2.8 billion.[4] Revenues over the same period totaled to $53 billion.

Seems like Novelis turned out to be a lemon, no?

But, was it a lemon, *before* the acquisition too? Let's see.

SEC filings by the company show that from Jan 2004 till 15 May 2007 (just before the company was acquired), pre-tax earnings totaled to a *minuscule* $27 million on aggregate revenues of $30 billion.

Novelis *was* a lemon before the acquisition and it *remained* a lemon afterwards too.

It's not surprising that just when Mr. Birla was gushing all over the media about the wonderful acquisition he had just announced, Ed Blechschmidt, the then CEO of Novelis had this to say about the very same deal:

> After careful consideration, the Board has unanimously agreed that this transaction with Hindalco delivers outstanding value to Novelis shareholders.[5]

How can outstanding value for a seller be outstanding value for the buyer at the same time? Clearly, one of them was going to be wrong. And now, we know who *that* turned out to be.

That this acquisition turned out to be disaster for Hindalco's shareholders can also be understood in another way. That's by thinking about the *opportunity cost* of the *alternate* use of $6 billion that Hindalco blew up on the acquisition.

Imagine for a moment that Hindalco had $6 billion of it's *own* money on its balance sheet before the acquisition. Imagine further that the annual interest rate on fixed deposits were just 6%. How much money Hindalco would have earned by not buying Novelis and by putting the money at 6% a year in a fixed deposit instead?

That number— the opportunity cost of this acquisition— comes to a staggering $360 million a year!

In other words, the target company should have delivered pre-tax earnings of at least $360 million a year for *every* year post acquisition. That translates into $986,301 *every day* or an aggregate of $1.8 billion from the date of acquisition till 31 March 2013.

Even if Novelis had miraculously accomplished that feat, this would *still* have been labeled as a *mediocre* deal.

Instead, it lost $2.8 billion.

In reality, things actually got *worse* for two reasons.

First, Hindalco did not have $6 billion of its own money to buy Novelis. About $5.5 billion of the purchase price was financed with borrowed money.

What did this massive borrowing (and additional borrowing for other expansion projects) do to the consolidated financial condition of Hindalco?

You can gauge that by looking at the following numbers which portray the "before" and "after" pictures.

Hindalco *before* Novelis acquisition: FY07

Operating Cash Flow: $924 million
Interest Paid: $149 million

Hindalco *after* Novelis acquisition: FY13

Operating Cash Flow: $796 million
Interest Paid: $677 million

That brings me to the *second* reason why the deal is even worse than it appears, which is this: The above *horror* show is *after* considering the fact that post acquisition, Hindalco raised fresh equity capital primarily to de-leverage its balance sheet. Had that not happened, Hindalco would have been in a *precarious* condition today.

The dilution for existing stockholders from this new equity injection also increased the cost of the Novelis acquisition. Many analysts don't get this point, but it remains fundamentally important to understand the economics of this deal. Post acquisition, Hindalco raised $680 million of equity capital in FY08, $650 million in FY09 and $367 million in FY10.

A very large part of this $1.7 billion infusion of equity capital was to "restore" balance sheet strength after Hindalco acquired Novelis primarily with borrowed money. So, to correctly analyze the true cost of Hindalco's acquisition of Novelis, one must not just focus on what was paid, one must also add the amount of value given away to new shareholders for capital raised to effectively finance the acquisition. Warren Buffett explained this beautifully in his 1982 letter.

> In a trade, what you are giving is just as important as what you are getting. This remains true even when the final tally on what is being given is delayed. Subsequent sales of common stock or convertible issues, either to complete the financing for a deal or to restore balance sheet strength, must be fully counted in evaluating the fundamental mathematics of the original acquisition. (If corporate pregnancy is going to be the consequence of corporate mating, the time to face that fact is before the moment of ecstasy.)

While it's true that some of this money was raised through a rights issue and so the dilution factor is not relevant if everyone subscribed for his or her entitlement, the fact remains that the true cost of the Novelis acquisition to Hindalco's shareholders was *higher* that the $6 billion price tag. Investors poured new money to pay for an acquisition and have nothing to show for it in incremental market value.

So, no matter how one looks at it, my conclusion is that this deal was a lemon, and not butter chicken. (My apologies to vegetarian readers but I am just making a point here).

Birla Vs. Buffett

The funny thing is that if you go back to the time of the acquisition and look at the press releases, the media interviews, and the letters written by Mr. Birla to Hindalco's shareholders justifying the acquisition, there is little mention of concepts like *profitability*, *opportunity cost,* and *per-share intrinsic business value.* Instead, I found words like *big*, *expand*, *global*, and *vision*.

Here's a sample:

> The acquisition of Novelis is a landmark transaction for Hindalco and our Group. It is in line with our long-term strategies of expanding our global presence across our various businesses and is consistent with our vision of taking India to the world. The combination of Hindalco and Novelis will establish a global integrated aluminum producer with low-cost alumina and aluminum production facilities combined with high-end aluminum rolled product capabilities. The complementary expertise of both these companies will create and provide a strong platform for sustainable growth and ongoing success.[6]

> Hindalco is offering $44.93 a share, amounting to Rs26,400 crore once Novelis' debt of $2.4 billion is included in the transaction value. The per-share price is nearly a 17% premium to where Novelis' shares were trading on Friday. Novelis shares have more than doubled in the past year after touching a 12-month low of $17.89 a share last February. "When you are acquiring a world leader, you will have to pay a premium," said Kumar Mangalam Birla, chairman of the Aditya Birla Group, whose flagship company is Hindalco. "This is something reasonable."[7]

> I am indeed delighted to share with you that Hindalco today, with the acquisition of Novelis, has become a truly global corporation. It ranks among the top 5 of the world's aluminum major. With a combined

> turnover of US$ 14 billion, your Company is already in the League of the Fortune 500. Collectively, your Company and its subsidiary Novelis boast of over 33 plants spanning 13 countries and anchored by a 32,000 workforce belonging to over 15 nationalities.[8]
>
> Novelis with its value added products and a global leader, makes a perfect fit for Hindalco. The acquisition is also the key to fulfilling our global aspirations. It is in line with our long-term strategy of expanding our global presence across our various businesses.[9]
>
> I do realize that in the short-term it does cause a strain on your Company's Balance Sheet. However, if you look at the bigger picture, this is one of the most striking acquisitions and over the long-term will undeniably create enormous shareholder value. I look forward to your support and understanding on this acquisition.[10]
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> With Novelis we have added several Hindalcos in size at one go. The expansions at Hindalco means that we would add about 50% of the Hindalco - Novelis combine in the next 3-4 years.[11]
>
> I believe Hindalco has never had headier times than today.[12]

Now, contrast that with the words of Warren Buffett, who is regarded as one of the world's best acquirers of businesses.

> A managerial "wish list" will not be filled at shareholder expense. We will not purchase entire businesses at control prices that ignore long-term economic consequences to our shareholders.
>
> Leaders, business or otherwise, seldom are deficient in animal spirits and often relish increased activity and challenge. At Berkshire, the corporate pulse never beats faster than when an acquisition is in prospect.
>
> We use debt sparingly and, when we do borrow, we attempt to structure our loans on a long-term fixed-rate basis. We will reject interesting opportunities rather than over-leverage our balance sheet.

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Many years ago, I read a wonderful quote from an excellent book[13] which I wish Mr. Birla had read before he did the Novelis deal.

> The objective of our company is to increase the intrinsic value of our equity shares. We are not in business to grow bigger for the sake of size, nor to become more diversified, not to make the most or the best of anything, nor to provide jobs, have the most modern plants, the happiest customers, lead in new product development, or achieve any other status which has no relation to the economic use of capital. Any or all of these may be, from time to time, a means to our objective, but means and ends must never be confused. We are in the business solely to improve the inherent value of the equity shareholders' equity in the company.

Had Mr. Birla read, understood, internalized, and followed this advice, and that of Mr. Buffett, I doubt that Hindalco's minority shareholders would have been stuck with a lemon today (Tequila Not Included).

Note: I have no position in Hindalco's stock or any of its derivatives.

Ends

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[1] http://www.amazon.com/Reimagining-India-Unlocking-Potential-Superpower/dp/

1476735301
[2] Hindalco's market cap on 9 February 2007, one day before the Novelis acquisition was announced.
[3] Hindalco' market cap on 13 November, 2013.
[4] Including $1.3 billion of impairment of goodwill.
[5] http://web.archive.org/web/20070216033340/http://www.hindalco.com/media/press_releases/200702feb/hindalco_and_novelis.htm
[6] Mr. Birla quoted in Company Press Release http://web.archive.org/web/20070216033340/http://www.hindalco.com/media/press_releases/200702feb/hindalco_and_novelis.htm
[7] http://www.livemint.com/Home-Page/v8Nz0EASvQJUD7vYrLG9WL/Hindalco-to-acquire-Novelis-for-6-bn.html
[8] Chairman's letter to shareholders of Hindalco in FY07 Annual Report.
[9] Chairman's letter to shareholders of Hindalco in FY07 Annual Report.
[10] Chairman's letter to shareholders of Hindalco in FY07 Annual Report.
[11] Chairman's letter to shareholders of Hindalco in FY08 Annual Report.
[12] Chairman's letter to shareholders of Hindalco in FY07 Annual Report.
[13] http://www.amazon.com/Value-Imperative-Managing-Superior-Shareholder/dp/0029206707/