

ABC Group¹: The Saga of Expansion

Varsha Gupta*, Sanjeev Chaddha**

Abstract

ABC Private Limited², a manufacturer of auto parts was supplying majority of its products to well-known Indian original equipment manufacturers (OEMs) including Ashok Leyland, Swaraj Mazda, Escorts, Bharat Gears, and Mahindra and Mahindra. In FY 2012-13, ABC Private Limited intended to acquire majority state in Devki Enterprises Limited³ (DEL). The management of the company scouted for alternative sources of funds for clinching the deal as bank financing was not permissible for takeover in accordance with Reserve Bank of India (RBI) norms and the equity market not easily accessible. The company already had private equity investment, therefore decided to raise further resources from short term & long term borrowings and by selling some fixed assets for this acquisition. After the successful takeover of DEL, the higher increase in the current liabilities as compared to the current assets caused liquidity issues for ABC Ltd. The problem was aggravated further by reduced profits by the end of FY 2014-15. Now the company wanted to offer exit route to private equity fund and was looking for various alternative sources of finance for resolving the impending liquidity issues and further technical up-gradation of the plant.

Keywords: Acquisition, Equity Market, Expansion, Liquidity, Private Equity

About the Group

ABC Private Limited, a company incorporated under the Indian Companies Act, 1956, was set up in Greater Noida⁴ (Uttar Pradesh, India) in 1981 for manufacturing auto parts and components. It supplied majority of its products to well-known Indian original equipment manufacturers (OEMs) including Ashok Leyland, Swaraj Mazda, Escorts, Bharat Gears, and Mahindra and Mahindra. It was the first company to set up its production facility in Greater Noida. The company excelled in its domain in terms of quality, timeliness and so was awarded the appreciation and recognition as the best supplier by the OEMs several times. Meanwhile in the year 1999, the company got certification for quality standards by acquiring ISO 9001: 2000. The same year, it also ventured into manufacturing for the Ministry of Defence, Government of India, successfully getting the license for supplying various automobile spares and components - the only supplier of different components used in defence vehicles. In order to meet its expansion plans, the company raised funds from banks in the form of loans which it was unable to repay on time so the banks initiated recovery action against the company. To avoid takeover of the unit by the lending banks the company approached Board for Industrial Financial Reconstruction (BIFR) for relief in 2004. In accordance with the request of the company

¹Disguised name of the group

²Disguised name of acquirer company

³Disguised name of target company

⁴Disguised location of acquirer company

* Assistant Professor, School of Management Studies, Baddi University of Emerging Sciences and Technology, Baddi, Himachal Pradesh, India. Email: varshagarg2083@yahoo.co.in

** Professor & Head, MDC, MGSIPA, Govt. of Punjab, Chandigarh, India. Email: drsanjeevchaddha@gmail.com

and after detailed deliberations, the BIFR declared the company sick under the Sick Industrial Corporations Act (SICA), in the year 2006 and awarded certain reliefs to the company for repayment of its outstanding liabilities to the lenders. However, with the passage of time, the company was able to clear its outstanding liabilities to the lenders and regain its position in the market on the strength of its established presence in the forging industry and long-standing relationship with clients.

Till this time, the company was basically catering to the demands of domestic market through its four manufacturing units two each located at Greater Noida and south India respectively and seriously wanted to explore the overseas market for faster growth. Eyeing growth, the company acquired a new gear manufacturing facility after 2010 and also set up a new forging plant to increase its capacity in order to cater to the demand arising from the local and overseas market. The company was in look out for new investment opportunities for inorganic growth so that it can tap the ever-growing market. To improve its liquidity position the company acquired INR 150 million (\$2.23 million) in 2012-13 from one of the private equity fund against performance linked fully convertible debentures which were later converted into equity shares thus transferring around 27 per cent equity stake in the company to the investor. In the year 2013-14, further consolidating its position, the company acquired another unit namely M/S Devki Enterprises Limited (DEL) having its manufacturing base in western India at an estimated price of INR 218 million (\$3.6 million). After this successful takeover, the net working capital of ABC Private Limited turned negative indicating weak liquidity position. To revive itself from this situation company was badly in need of additional funds. Although funds amounting to INR 90 million and INR 80 million were raised in two tranches in the form of inter corporate deposits from DEL during FY 2013-14 and 2014-15 respectively, but the problem still persisted.

About Strategic Acquisition

DEL, which was established in the year 1973, was a fast growing auto and tractor components export oriented manufacturing company. This company was basically serving 'aftermarkets and original equipment manufacturers', emphasising on export markets generating bulk of its sales (97.63 per cent) from exports of its products in the year 2013-14. It had marked presence

in countries like Germany, Italy, United Kingdom, Sri Lanka, Singapore, Malaysia, Thailand, Belgium, Dubai, United States of America, etc.

As on 1st April, 2013, the total number of shares of DEL were 0.35 million of INR 10 each thus having total paid up capital of INR 3.5 million. In July 2013, ABC Private Limited entered into a definitive agreement with the promoters of DEL to acquire its 55 per cent stake for INR 218 million (\$3.6 million) thus reducing the stake of the promoters to 15.21 per cent post acquisition which was gradually reduced to zero by the end of March 2015.

As per a stock market disclosure in July 2013, the ABC group also made an open offer to acquire another 26 per cent stake in the public-listed firm, DEL for INR 1137/- per share aggregating to a consideration of INR 103.5 million, assuming full acceptance in the open offer. Issue was closed after paying INR 33.2 million consideration contributing 8.34 per cent additional stakes in DEL. Finally till the end of FY 13-14, ABC group of companies had acquired 67.11 per cent stake in the target company where in ABC Private Limited had 41.47 per cent holding and 32.89 per cent was available as free float.

Reaction of the Stock Market to Takeover

Tracking the price movement of DEL in the BSE/ NSE stock market, it was observed that the market value of share at the end of the September 2013 was INR 1089.9 while the average of monthly closing price of the share for the last one year was INR 1015.50. The price of said scrip fell down to INR 818 in December 2013 but rose to INR 1263.3 by the end of February 2014 owing to the announcement of stock split by the company in the ratio of 1:5 by March 2014. As per the decision, each shareholder having one equity share of DEL of face value of INR 10 was allotted five shares of DEL of face value INR 2. Subsequently, the market price of DEL scrip dropped to INR 203 at the end of March 2014 thus reducing the net worth of the shareholders to INR 1015 (=203 *5) for one equity share held prior to stock split. In the month of September 2014, the shares were being traded at INR 307 indicating a profit of 35 per cent over and above the offered price for shareholders ((307*5- 1137)/ 1137). Although the share price further came down to INR 196.8 in March 2015 (Table 2), the shareholders still got sufficient opportunities to gain after this takeover.

Financial Analysis of DEL

As ABC Private Limited had been exempted from consolidation of accounts due to its minority stake in its associate company DEL, the net worth of DEL as per their standalone balance sheet was INR 231.2 million in March 2015. The net worth of DEL has steadily increased from INR 85.2 million in FY 2010-11 to INR 140.4 million (64.79 per cent increase) in FY 2012-13 and subsequently to INR 231.2 million in the FY 2014-15 (171.4 per cent increase from 2010-11). The company also showed tremendous restraint in borrowings by reducing the secured loans from 2.9 million in the FY 2011-12 to nil in the FY 2013-14. However, the company borrowed INR 54.6 million in FY 14-15 to address its investment needs. Similarly, the sales revenue of the company also showed steady increase from INR 178.6 (FY 2010-11) to INR 241 million (FY 2012-13) and to INR 304.9 million (FY 2014-15) thus showing an increase of 70.7 per cent compared to the base year 2010-11. However, the same continuity was not evident in the case of Profit after tax (PAT) which showed a declining trend from a high of INR 59 million in FY 2010-11 to INR 40.8 million in FY 2012-13. But, the PAT raised to INR 47.5 million in FY 14-15 after the takeover of the company by ABC Private Ltd. It may be observed that the profit margins of the company have steadily declined which should be a cause of concern for the management. Post-acquisition, the net current assets of DEL increased by 146 per cent (from 105.7 million in 2012-13 to 259.8 million in 2014-15) because of loans and advances made in form of inter corporate deposits amounting INR 170 Millions in ABC Private Ltd. So, the company's current asset ratio also grew to 4.67 per cent in March 2015 from 2.10 per cent in March 2010 (Table 3).

Financial Analysis of ABC Private Limited

The net worth of ABC Private Ltd has steadily increased from INR 425.6 million in FY 2010-11 to INR 721.8 million (70 per cent increase) in FY 2012-13 and subsequently to INR 790.6 million in the FY 2014-15 (85.8 per cent increase from 2010-11). Total non-current assets including fixed assets and long term investments have also increased from INR 576 million to 1314 million (128 per cent) in FY 10-11 to FY 14-15 while non-current liabilities followed the identical trend and increased from INR 258.8 million in FY10-11 to INR 504.1 million in

FY14-15 indicating 95 per cent increase. Sales of the company were showing a steady growth as it increased from INR 1180 million in FY 10-11 to INR1350 million in FY12-13 and INR 1600 million in FY 14-15 for forging and INR 490 million to 780 million from FY10-11 to FY 14-15 for finished components. Total exports of the company were one per cent of the sales. Net revenues of the company increased from INR 1340 million in FY 10-11 to INR 1710 million (28per cent) in FY 12-13 which further rose to INR 1905 million in FY 14-15.

Fixed asset turnover ratio has shown a steady fall from 2.58 in March 2011 to 1.81 in March 2015 indicating weak managerial efficiency to utilise their fixed assets. The basic reason was less proportionate increase in sales (42.2 per cent) than in fixed asset (103.1 per cent) during this time. PAT of the company decreased to INR 26 million (49 per cent) in FY 14-15 from 50.7 million in FY 12-13 resulting into fall in company's Earnings per share (EPS) and Return on Equity (ROE) to 1.12 and 3.29 in FY 14-15, from 3.08 and 11.73 respectively in FY 2014-15.

Company's debt equity composition indicates high reliance on outside borrowings than equity financing. Also, fixed asset to net worth ratio had reflected increasing momentum (9.3per cent) in last five years. It had increased from 1.22 times in March 2011 to 1.33 times in March 2015 indicating that the firm is vulnerable to solvency problems (Table 5).

Since FY 2012-13 net working capital of the company was falling. It was INR 108 million in FY 10-11 which rose to INR 145 million in FY 11-12 but then it fell down to INR 96 million in FY 2012-13 and became negative thereafter. The basic reason seems to be greater increase in current liabilities (35 per cent) vis a vis the current assets (21 per cent) during FY 2012-13 to FY 2014-15. There was total increase of 77 per cent in short term borrowings and 32 per cent trade payables during FY 2011-15. Moreover company increased its average payment period from 83 days in FY 2012-13 to 120 days (4 months) in FY 2014-15 while average collection period remained constant at two and half month (Table 5).

Liquidity Position of ABC Private Limited

Major determinant like current assets (CA), current liabilities (CL), working capital (WC), quick assets (QA),

current ratio (CR), and quick ratio etc. indicating liquidity position of the company have been taken in Table 1. Mean,

standard deviation (SD), and coefficient of variance (CV) tools have been used to draw inferences.

Table 1: Liquidity Position of ABC Private Limited (Value in millions)

Year	CA	CL	WC	QA (CA- Inventory)	CR	Quick Ratio	WC/CA Ratio (%)	Inventory/ CA Ratio (%)	QA/CA (%)
2011	6.939	878.654	108.285	388.908	1.12	0.44	10.97	60.59	39.41
2012	1071.960	926.805	145.155	416.523	1.16	0.45	13.54	61.14	38.86
2013	1102.830	1007.190	95.640	406.917	1.09	0.40	8.67	63.10	36.90
2014	1247.740	1301.820	(54.080)	441.940	0.96	0.34	(4.33)	64.58	35.42
2015	1342.754	1361.500	(18.746)	454.754	0.99	0.33	(1.40)	66.13	33.87
Mean	1150.445	1095.194	55.251	421.808	1.06	0.39	5.49	63.11	36.89
Growth	355.815	482.846	(127.031)	65.846	(0.14)	(0.11)	(12.37)	5.54	(5.54)
Growth Rate	36.05	54.95	(117.31)	16.93	(12.20)	(24.5)	(112.7)	9.14	(14.05)
SD	142.8376	221.6993	86.538184	26.5653	0.0869	0.055	7.88877	2.318	2.31805
CV (%)	12.42	20.24	156.63	6.30	8.17	13.97	143.67	3.67	6.28

It may be observed from Table 1 that during the FY 2010-11 and FY 2014-15, the current assets of the company have grown by 36.05 per cent whereas the current liabilities have grown by 54.95 per cent showing one and half times more growth vis a vis the current assets. The standard deviation of the current assets was INR 142.837 million and the coefficient of variation (CV) was 12.42 per cent, which shows slow growth of current assets during the period of study. As evident from the table, the current liabilities, working capital and quick assets also changed in the similar fashion as that of current assets. The growth rate of current liabilities was 54.95 per cent with a standard deviation of INR 221.69 million and a CV of 20.24 per cent.

The growth rate of working capital was negative to the extent of -117.31 per cent with a SD of INR 86.538 million and a CV of 156.63 per cent. A negative growth in working capital has indicated a faster growth of current liabilities as compared to current assets. The quick asset has registered a positive growth rate of 16.93 per cent with a SD of INR 26.565 million and a CV of 6.3 per cent. All these have indicated a liquidity crunch in the company which was not good as the rate of growth of quick assets was quite less compared to current assets and the variability in working capital as well as quick assets were much more than the expected, which indicated a constant instability in the liquidity position of the company.

When the liquidity ratios of the company were analysed, we found that both current ratio and quick ratio have registered a negative growth rate i.e. -12.2 and -24.5 per cent respectively. The negative growth rates of both the ratios indicate that the liquidity position of the company has degraded over the years. The average current ratio of the company (1.06) and average quick ratio (0.39) compares very poorly to the ideal ratios of 2:1 and 1:1 respectively indicating an unsatisfactory liquidity position of the company during the years of study.

Although considering poor profitability and solvency ratio of ABC Ltd in FY2013, the company was not in position to raise further funds from private investors for acquiring DEL as it already had private equity investment equivalent to 26.911 per cent stake in company as on March 31, 2013. The management of the company continuously scouted for alternative sources of funds for clinching the deal. Even bank financing was also not permissible for takeover in accordance with Reserve Bank of India (RBI) norms and the equity market not easily accessible due to weak sentiments and non-availability of market maker for small companies. So, the company somehow managed to arrange funds through short term & long term borrowings and selling some fixed assets for this acquisition but the problem was aggravated over years. Now (FY 2015-16) the company wanted to offer exit route to private equity fund and was looking for various alternative sources of finance for resolving the impending liquidity issues.

Questions

1. What is the core issue/problem to be solved in the case?
2. What are the associated issues/ problems are depicted in this case?
3. What was the prime purpose behind this takeover?
4. Taking the perspective of managing director of the company ABC Private Limited, would you support the above said decision of management i.e. taking over the DEL? Justify your opinion
5. What are the options available with ABC Private Limited to dilute the investment of private equity fund?

Table 2: Pre and Post Takeover Movement in Share Price of DEL

Month	Pre-takeover Market price	Month	Post Takeover Market Price	Shareholder's Net-worth
Jan-12	643.7	Sep-13	1089.9	1089.9
Feb-12	780.1	Oct-13	950.0	950.0
Mar-12	820.5	Nov-13	931.0	931.0
Apr-12	1127.9	Dec-13	818.0	818.0
May-12	804.2	Jan-14	1119.3	1119.3
Jun-12	767.0	Feb-14	1263.3	1263.3
Jul-12	964.4	Mar-14	203.0	1015.0
Aug-12	892.6	Apr-14	201.0	1005.0
Sep-12	909.2	May-14	194.6	973.0
Oct-12	968.0	Jun-14	256.9	1284.5
Nov-12	953.5	Jul-14	302.1	1510.5
Dec-12	1053.1	Aug-14	306.1	1530.5
Jan-13	1141.3	Sep-14	307.0	1535.0
Feb-13	1065.2	Oct-14	309.7	1548.5
Mar-13	964.9	Nov-14	285.0	1425.0
Apr-13	949.9	Dec-14	278.4	1392.0
May-13	1020.0	Jan-15	288.4	1442.0
Jun-13	1050.0	Feb-15	255.9	1279.5
Jul-13	1081.0	Mar-15	196.8	984.0
Aug-13	1030.0	Apr-15	210.9	1054.5

Source: www.bseindia.com

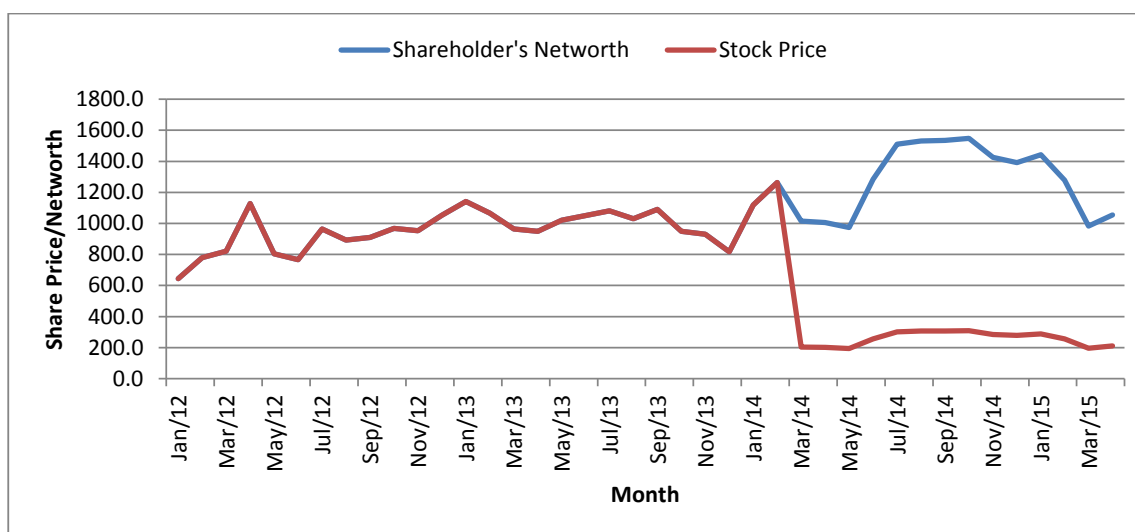


Table 3: Financial Data of DEL

(INR in millions)

Particulars	Mar '11	Mar '12	Mar '13	Mar '14	Mar '15
Net worth	85.2	100.8	140.4	185.6	231.2
Secured loans	1.1	2.9	1.3	0	54.6
Net current assets	61.6	74.3	105.7	155.3	259.8
Net block	24.9	28.3	36	30.3	26.1
Book value (INR)	2435.6	2880.5	4010.8	1060.6	1321.3
Net sales	178.6	224	241	286.3	304.9
Reported net profit	59	35.9	40.8	46.5	47.5
Earning per share (INR)	168.49	102.6	116.54	26.55	27.15

Source: Published sources of the company (Also available at www.moneycontrol.com)

Table 4: Financial Data of ABC Private Limited (Amount in millions)

Particulars	Mar '11	Mar '12	Mar '13	Mar '14	Mar '15
Total non-current assets	576.2	842.3	1002.7	1282	1313.5
Total non-current liabilities	258.8	369.3	376.5	462.3	504.1
Total current assets	986.9	1072.0	1102.8	1247.7	1342.8
Total current liabilities	878.7	926.8	1007.2	1301.8	1361.5
Net working capital	108.3	145.2	95.6	(54.1)	(18.8)
Total outside liabilities	1137.5	1296.153	1383.72	1764.103	1865.5
Total shareholder's funds	425.6	618.1	721.8	765.7	790.6
Revenue from operations (net)	1339.6	1827.7	1710.9	1815.3	1904.9
PAT	49.9	95.9	50.7	42.4	26
Net purchases	1233.07	1574.707	1523.671	1516.379	1553.35
Fixed assets	518.437	757.92	927.33	1018.12	1053.12
Debtors	329.52	345.81	354.52	384.09	385.67
Creditors	381.59	334.71	369.73	515.71	505.50

Source: Annual Reports of the Company

Table 5: Ratio Analysis of ABC Private Limited

Particulars	Mar '11	Mar '12	Mar '13	Mar '14	Mar '15	
Profitability ratio	Earnings per share (INR)	3.08	4.44	2.18	1.82	1.12
	Return on equity (%)	11.73	15.52	7.03	5.53	3.29
Solvency ratio	Debt/ equity ratio (times)	2.67	2.10	1.92	2.30	2.36
	Fixed asset to net worth ratio (times)	1.22	1.23	1.28	1.33	1.33
Managerial efficiency	Fixed asset turnover ratio (times)	2.58	2.41	1.84	1.78	1.81
	Average collection period (days)		67	75	74	74
	Average payment period (days)		83	84	107	120

Appendix-1

Report Excerpts: Indian Forging Industry Report (2015)

The Indian forging industry has emerged as a major contributor to the manufacturing sector of the Indian Economy.

The forging industry of India provides direct employment to about 95,000 people. Current share of auto sector is about 61per cent of total forging production while the rest is with the non-auto sector. The Indian forgings industry

has made rapid strides and currently, not only meets almost all the domestic demand, but has also emerged as a large exporter of forgings. Approx. 20-25per cent of the size of the forging industry is attributed to exports presently

The estimated turnover of the entities based on survey conducted by Association of Indian Forging Industry in FY 2012-13 was INR 195,000 million, with an overall capacity utilisation of at around 57per cent. The capacity utilisation of these entities increased from the earlier 57per cent in FY 2012-13 to 64.9 per cent in FY 2015-16 due to the rise in demand from the automotive industry which accounts for 2.45 million tones of production.