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EDITOR: DR. PRASANNA CHANDRA

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CFM Quarterly in Finance, a publication of the Centre for Financial Management, Bangalore is primarily a practitioner-oriented journal. It seeks to discuss contemporary developments, analytical concepts and techniques, research insights, perspectives, and state-of-the art practices.

By and large, the CFM Quarterly in Finance seeks to convey important developments in the theory and practice of finance in a rigorous, but relatively non-technical, manner.

SECTION A: ARTICLES/CASES

MERGER OF SUN PHARMACEUTICALS AND RANBAXY LABORATORIES

DR. PRASANNA CHANDRA

On Monday, April 7, 2014, Sun Pharmaceuticals announced that it will acquire Ranbaxy Laboratories in an all stock merger in which Ranbaxy shareholders will be get 0.8 shares of Sun Pharmaceuticals for every share in Ranbaxy. Based on the prevailing market price of Sun Pharmaceuticals this implied a valuation of Rs.457 per share, which was a tad more than the prevailing price of Ranbaxy. Incidentally, there was a surge of 24 percent in Ranbaxy share in six trading sessions before the deal was announced. This suggests that Sun Pharmaceuticals may have offered an acquisition premium of about 25 percent.

Unusually for a deal of this size, it was stitched up abroad in just two weeks. As a source involved in the deal said, “Till the last one week, what transpired behind the closed doors stayed there until the stock market speculated and the Ranbaxy stock shot up with very high volumes.”

Transaction Highlights

The highlights of the transaction are as follows:

- Ranbaxy shareholders will get 0.8 shares of Sun Pharma stock for every share of Ranbaxy.
- The deal size is approximately US $ 4 billion.
- Revenue and operating synergies of US $ 250 million are expected by the third year after closure. The deal is expected to be cash EPS accretive within the first 12 months of closure.
- Daichi Sankyo will become the second largest shareholder in Sun Pharma and will continue its strategic business relationship with Sun Pharma.
- Daichi sankyo (with nearly 63.5 percent ownership in Ranbaxy) and Sun Pharma promotes (with nearly 63.7 percent ownership in Sun Pharma) will vote in favour of the transaction.
- Daichi Sankyo has agreed to indemnify Sun Pharma and Ranbaxy for, among other things, certain costs and expenses that may arise from the recent subpoena which Ranbaxy has received from the Toansa facility.

- The conditions to close the transaction are (a) the requisite approval of Sun Pharma and Ranbaxy shareholders and (b) the approval of Indian central government and other regulatory bodies.

Profile of the Combined Entity

The combined entity will be:

- The 5th largest global specialty generic pharma company with a pro forma CV 2013 sales US $ 4.2 billion (Sun Pharma was already the 5th largest global specialty generic pharma company, but the combined entity will move much closer to the 4th largest company) and a pro forma CV 2013 EBITDA of $ 1.2 billion.
- No 1 pharma company in India with the top position in 13 specialty segments and strong OTC business with trusted brands.
- No 1 Indian pharma company in the US market with over US $ 2 billion in sales, a pipeline of 184 ANDAS including hig-value FTFs (First to file), and No 1 in generic dermatology.
- Approaching US $ 1 billion sales in high- growth emerging markets
- Expanding presence in Western Europe.

Sun Pharma's Track Record of Acquisitions

Sun Pharma has an outstanding track record of successfully turning around 16 acquisitions from 1996-97 onwards. It made 8 early acquisitions from 1996-97 to 2000-01, which included Tamil Nadu Dadha Pharmaceuticals Limited, Caraco Pharmaceuticals , US, Milmet Labs, Gujarat Lyka Organics, and Pradeep Drug Company. Between 2005-06 and 2008-09 it made 4 acquisitions including Able Labs, Chattem Chemicals, and plants from Valeant Pharma. Continuing on this path, it made 4 recent acquisitions including Taro, DUSA, and URL, during the period 2010-11 to 2013-14.

When Sun Pharma acquired Taro in 2010, Taro's EBITDA was $ 100 million. In three year's Taro's EBITDA increased to $ 400 million. Likewise, Sun Pharma acquired URL for less than $ 50 million, an amount that its recovered in one year.

Valuation Gap

In March 2014, Sun Pharma's share was trading at 11.5 times its sales while Ranbaxy's share traded at 1.7 times. The primary reason for such a huge valuation gap is that Sun Pharma's operating margin of about 40 percent is one of the highest in the world, while Ranbaxy's operating margin is a

meagre 10 percent and the company is in the red.

Industry Reactions on the Mega Deal

Industry leaders have hailed the transaction. Here are some reactions

- *G.V. Prasad, Chairman Dr Reddy's*: "Great move by Sun. Consistent with their strategy of acquiring distressed assets and turning them around."
- *Malvinder Singh, Former Promoter, Ranbaxy*: "This is definitely a positive development for Ranbaxy, Sun and the entire generics industry. Ranbaxy is a great company and Sun with its understanding of the generics space should be able to unlock the true potential and value in Ranbaxy. This, unfortunately, did not happen under Daichi which failed to harness the strong generics business."
- *Ajay Pirmal, Chairman Piramal Enterprises*: "I feel Sun is in a better position to manage Ranbaxy. They have handled overseas acquisitions successfully. Look at the way they have turned around Taro. Taro, too, had its own issues. Sun Pharma will be able to navigate the Indian environment better."
- *D.S. Brar, Ex- CEO, Ranbaxy*: "It is a very good development. Great for Indian companies and also for this market where consolidation is needed."

Next Steps

Announcement: April 7, 2014		Post Closing	
Regulatory Shareholder Votes	• Indian Central Government, State Governments	Integration Transaction Synergies Remediation Planning	• Integration planning leadership teams appointed
	• High Courts of Gujarat, Punjab and Haryana		
	• Competition Commission of India		• -US$ 250 million in synergies 3rd year
	• Hart-Scott- Radio approval		• Remediation of manufacturing facilities

			utilizing combined expertise
	• Approval of 75% of the shares voted by both Sun Pharma and Ranbaxy shareholders		• Third- Party consultants to develop plans
	• Both Daiichi Sankyo and Sun Pharma promoters have agreed to vote in favour of transaction		

Closing : Anticipated by end of 2014

SECOND-LEVEL THINKING

DR. PRASANNA CHANDRA

What is second-level thinking?

- First-level thinking says, “It’s a good company; let’s buy the stock.” Second-level thinking says, “It’s a good company, but everyone thinks it’s a great company, and it’s not. So the stock’s overrated and overpriced; let’s sell.”
- First-level thinking says, “The outlook calls for low growth and rising inflation. Let’s dump our stocks.” Second-level thinking says, “The outlook stinks, but everyone else is selling in panic. Buy!”
- First-level thinking says, “I think the company’s earnings will fall; sell.” Second-level thinking says, “I think the company’s earnings will fall less than people expect, and the pleasant surprise will lift the stock; buy.”

First-level thinking is simplistic and superficial, and just about everyone can do it. All the First-level thinker needs is an opinion about the future, as in “The outlook for the company is favorable, meaning the stock will go up.”

The second-level thinking is deep, complex, and convoluted. The second-level thinker takes a great many things into account:

- What is the range of likely future outcomes?
- Which outcome do I think will occur?
- What’s the probability I’m right?
- What does the consensus think?

- How does my expectation differ from the consensus view of the future, and with mine?
- Is the consensus psychology that's incorporated in the price too bullish or bearish?
- What will happen to the asset's price if the consensus turns out to be right, and what if I'm right?

FINANCIAL CRISIS AND LIMBIC SYSTEM

DR. PRASANNA CHANDRA

A survey of financial history reveals that the world is convulsed by periodic credit booms and busts. Charles Kindleberger, an eminent economic historian, counted 46 such booms and busts from 1618 to 2000. The regularity of financial crises suggests that there is some defect in the hardwiring of our brains. This seems to be the case.

To understand why rational, self-interested participants engage in such destructive behaviour, we must understand a little bit of neuroanatomy. According to the triune model of the brain, the brain has three parts, viz., the *brain stem* which controls basic bodily functions such as breathing and heartbeat, the *limbic system* which is the seat of emotions, instincts, and social behaviour, and the *neocortex* which is the seat of complex and abstract thinking where logical reasoning, language , learning, and so on reside.

Our ability to compute consciously resides largely in the neocortex on the left side, in the so called association areas. However, these association areas can perform only relatively simple mathematical operations. When asked to form more complex quantitative judgments, which are not amenable to discrete mental computation, the brain unconsciously relies on the limbic system, which roughly speaking processes emotions and instinctual responses.

In the front part of the limbic system is a pair of structures called the *nuclei accumbens,* located roughly behind each eye. It responds very intensely to the *anticipation* of reward (culinary, sexual, social, monetary, or whatever) rather than the reward itself. The nuclei accumbens may loosely be called the "greed centre." It is activated when an investor watches CNBC television during a bull run. and it also fuels the bull run. While Kindleberger did not know at the time, he must have had the nuclei accumbens in mind when he wrote this memorable sentence: "There's nothing so disturbing to one's well being and judgment as to see a friend get rich."

When the financial cycle reverses, another pair of limbic system nuclei kicks in the *amygdalae*. Located deep inside our temples, the *amygdalae* activate in response to revulsion, fear, and financial loss. Loosely called the brain's "fear centre," the amygdalae are, as William Berstein put it, "the financial market's horsemen of the apocalypse, triggering financial panic and discredit wherever they gallop."

It is true that over the past 100,000 years or so- a blink of an eye in the evolutionary scale- the size of the neocortex region (the seat of reflective thinking and calculation) has expanded greatly. But unfortunately, in the battle between our older, irrational limbie system and the newer, rational neocortex, the former wins all too often. This results in the familiar boom- bust cycle.

When the nuclei accumbens is stimulated by dopamine, it is very hard or impossible to pull back. This is what addiction is all about. It appears that making money has the same physiological effect as taking cocaine or having sex.

Need for Regulation

Economists have long argued for regulation because we have public goods, externalities, and incomplete markets. But economists have overlooked the most obvious rationale for regulation: the need for society to prevent itself from doing things that it is predisposed to do but knows that it should not be doing. This can be done for problems like leverage.

SECTION B: SNIPPETS

Institutional Investors and Market Volatility

Ralph Wanger, a distinguished professional money manager, believes that the presence of institutional players in the stock market is likely to make it *more* rather than *less* volatile.

"Herd instincts are as prevalent as ever. We're all supposed to be more sophisticated now, but human psychology doesn't change. In fact, in this day of high speed communications, money managers quickly react – and overreact – to recent events with frightening unanimity. Long – term thinking has practically disappeared. Institutions stampede into energy or biotechnology or emerging – market stocks and then stampede out again. Charged up by analysts' optimistic earnings projections, they drive a stock to silly heights, only to rush for the exits when earnings come in even a penny or two below the forecast. With this kind of skittish institutional activity accounting for such a large percentage of the trading, markets have a potential for greater volatility."

Reflections on IPOs

There are four characteristics of the IPO market which tilt it in favour of sellers, not buyers.

1. The sellers, being insiders, have an informational advantage over buyers.

2. The sellers decide the timing of sale. So they are likely to sell when they can get higher prices.

3. There are only a handful of sellers, but many buyers.

4. The quantity of shares offered being flexible, the merchant bankers (who are paid by the sellers) would try to optimise the price from the point of view of sellers.

IPOs thrive in bull markets and as the time goes by, the investment quality of issues deteriorates. As Ben Graham put it:

"Somewhere in the middle of a bull market the first few issues make their appearance. These are priced, not unattractively, and some large profits are made by the buyers of the early issues. As the market continues to rise, this brand of financing grows more frequent; the quality of the companies becomes steadily poorer; the prices asked verge on the exorbitant. One fairly dependable sign of the approaching end of a bull swing is the fact that new issues of small and nondescript companies are offered at prices somewhat higher than the current level for many medium-sized companies with a long market history."

Risk Estimation a la Warren Buffett

In the 1993 annual report of Berkshire Hathaway, Warren Buffett suggested that investors should focus on the following five factors to estimate the risk inherent in any business

- *Factor1: The certainty with which the long-term economic characteristics of the business can be evaluated. Other things remaining unchanged, the more predictable a business the less risky it is. You don't need a computer model to tell you that, when other factors are constant, a stable business such as that of a gas supply company is less risky than the fast moving fashion business.*

- *Factor 2 : The certainty with which management can be evaluated, both as to its ability to realise the full potential of the business and to wisely employ its cash flows. A business lodged in the hands of a competent manager, is far less risky than an otherwise identical business, lodged in the hands of an incompetent* *manager. You have already figured this out already, but it will take a few more years for the academics, wedded to beat, to realise it.*

- *Factor 3: The certainty with which management can be counted on to channel the rewards from business to the shareholders rather than to itself.*

- *Factor 4: The purchase price of the business*

- *Factor 5 : The levels of taxation and inflation that will be experienced and that will determine the degree by which an investors' purchasing power return is reduced from his gross return.*

SECTION C: WIT AND WISDOM

Humour

- Dr. Hans Selye, the famous Canadian medical scientist, needed a urine specimen of a patient located in California for his research. When the urine specimen reached Toronto it was not cleared for few days because the customs authorities did not know how to classify it. Later it was cleared under the category "used personal effects." Much later, they sent a mail to Dr. Hans Selye saying, "Unless the item is not collected within 5 days after the receipt of this mail, the shipment will be opened and its contents sold at public auction." Of course, by that time the urine sample had no use for D. Hans Selye's research.
- An indignant dowager (an elderly society woman) once demanded of Dr. Gallup, the famous sampler of public opinion, why she had never been questioned on any subject whatsoever. "Madam, soothed Dr Gallup, "Don't you realize that your mathematical chances of being interviewed are about equal to your chances of being struck by lightning?" The lady replied, "But I have been struck by lightning."

Wise Saws

- It is not only the most difficult thing to know oneself, but also most inconvenient one, too *Henry W. Shaw*
- The only thing which cannot be misquoted is silence.