ABNL – Grasim Merger - Case of Divided Opinion

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PRELIMINARY

The proposed merger once again has divided analysts into two camps, one who favor the transaction and other who are against it. And of course, there is third group as well who prefer to wait and watch, digest information and finally form a view. Last time such a divided opinion and strong reaction was seen from analyst's side in case of Maruti Suzuki.

SES is of the view that such divided opinion reflects maturity of analysts and is healthy trend. Each analyst is examining and viewing the issue from his own set of parameters rather than applying fixed formula. It also enables investor to see both view points and enables investors to take a considered view. Which opinion finally prevails is in the hands of investors and not in hands of analysts, certainly not in hands of SES.

Summary (SES View)

- The Scheme was not on expected lines of investors, and probably caused a setback, which led to a knee jerk reaction and for both the scrips and both shares fell sharply, however as the market digested the news, the share prices have gained a portion of lost ground although still trading at some discount to price prevailing on announcement day.
- The Scheme is fair in terms of swap ratio of shares. The swap ratio is fair for shareholders of both the companies if gains and losses are taken into account.
- SES believes that as both the companies are listed and liquid, market price is the best measure for determining swap ratio as it takes away the subjectivity inherent in Valuation Reports. However **for purpose of comparison only** SES has considered other parameters in this report.
- The proposed swap ratio may appear to be slightly favouring ABNL shareholder if 12-month average swap ratio is calculated, however it may be considered as premium for the ABNL shareholders by GRASIM as ABNL is sharing their financial services business, which appears to be a sunrise industry. It also can be treated as an investment for the Grasim shareholders in the long-term growth of the merged entity.
- SES has not observed any transparency concerns as of now, however it will depend on the information provided during the CCMs and PBs to be conducted by the Company for shareholders' approval
- There is an increase in promoter shareholding in GRASIM by 7.53% but in SES' opinion it is not too high, which may have detrimental effect on the decision making per se. As the promoters, cannot even pass an ordinary resolution without the favourable shareholders' approval. And this increase is coming by shedding around 19%+ stake in ABFSL, which in opinion of SES is sunrise industry provided promoter is strong with credibility.
- Grasim and ABNL are diversified Companies and will be a bigger diversified merged entity
- GRASIM as promoter will provide credit rating enhancement of ABFSL, thereby contributing to increased valuation of ABFSL even without support in form of funding, which may or may not be required.
- The holding Company discount existed in the case of both Grasim and ABNL and will continue to exist in the merged entity, however with listing of ABFSL on stock exchange, the holding Company discount will partially decrease.
- Listing of ABFSL will unlock value, giving choice to investor to remain invested in either or all of the businesses.
- It may appear that telecom business which is underperforming due to near term challenges is being palmed off to GRASIM shareholders. On face of it without deeper analysis it appears to be correct. However, one must look at larger picture. SES is of the view that strategically it makes **sense as discussed in detail in the Report**.
- Future sales of non-leadership businesses, will not only unlock value but provide liquidity.

Aditya Birla Nuvo – Grasim Merger: Who Loses Who Gains?

	Aditya Birla Nuvo Shareholders	Grasim Shareholders
GAINS	- Exposure to cash rich and strong balance sheet of 'Grasim' - Strong Parentage for 'ABFSL' - Direct ownership in ABFSL with liquidity and option to exit the business altogether - Exposure to more diversified business like Cement, VSF - Share in leadership business of VSF and Cement	- Exposure to well established Financial Services business, with lot of future potential-sunrise industry - Addition of a vertical in its already diversified portfolio - Direct ownership in ABFSL with liquidity and option to exit the business altogether
LOSSES	- Sharing 'ABFSL' and Telecom business with Grasim shareholders and Decrease in shareholding of ABFSL	- Sharing of cement business with ABNL shareholders - Near Term challenges in Telecom business

Gain and Loss in terms of Equity and Voting power for the shareholders of Grasim and ABNL can be read here.

BACKGROUND

At a joint press conference held on 11th August 2016, the companies viz. Aditya Birla Nuvo Limited ('ABNL') and Grasim ('Grasim') announced a scheme of arrangement between the two Companies. The scheme is primarily in two parts:

1. Merger of Aditya Birla Nuvo Limited (after internal restructuring in ABNL) into Grasim
    - Upon merger the shareholders of ABNL will receive 15 shares of Grasim of face value ₹ 2 each for every 10 shares of face value ₹ 10 each held in ABNL (GRASIM has sub divided the shares post the announcement of the merger in a ratio that 1 share of ₹ 10 each divided into 5 shares of ₹ 2 each)
2. Upon merger of ABNL with Grasim; **partial demerger** of ABFSL and subsequent listing of ABFSL
    - Upon this partial demerger the shareholders of Grasim (post-merger) will receive 7 shares of ABFSL for 5 shares (subdivided) held in Grasim. ABFSL on listing will be held by - GRASIM, GRASIM shareholders including erstwhile shareholders of AB Nuvo.

At the outset SES would like to draw attention of the readers of the report to Disclosures and Disclaimer on Page '16' of the report.

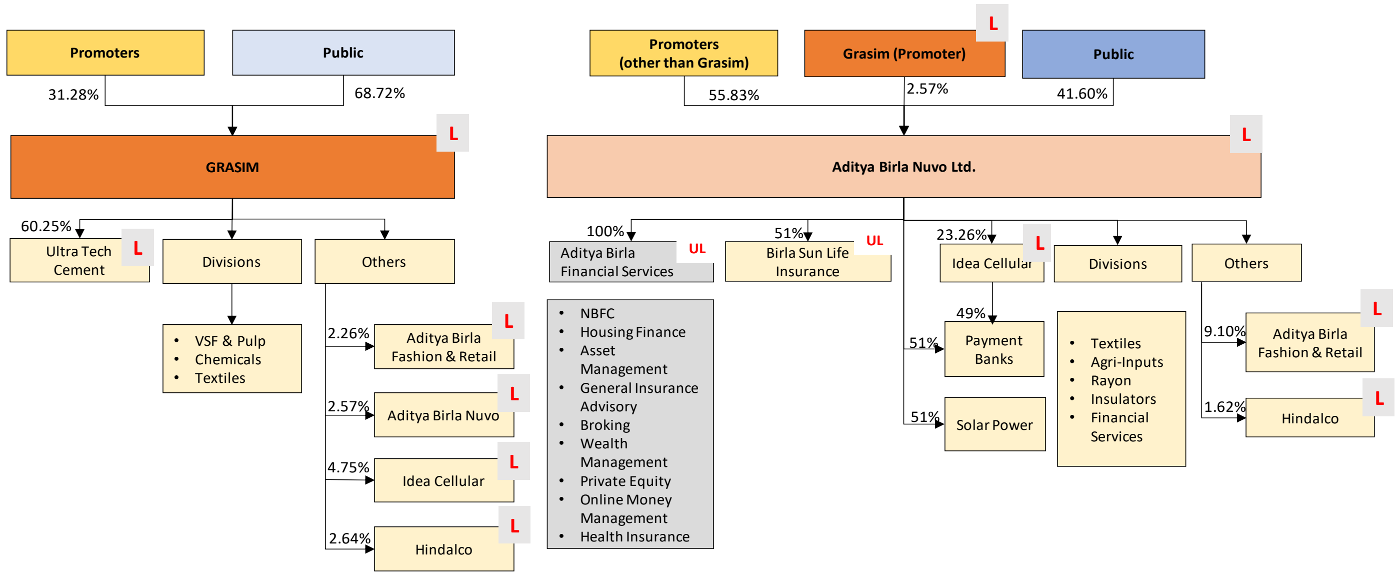
RATIONALE OF THE SCHEME

The rationale for the Scheme given by the Company(ies) are:

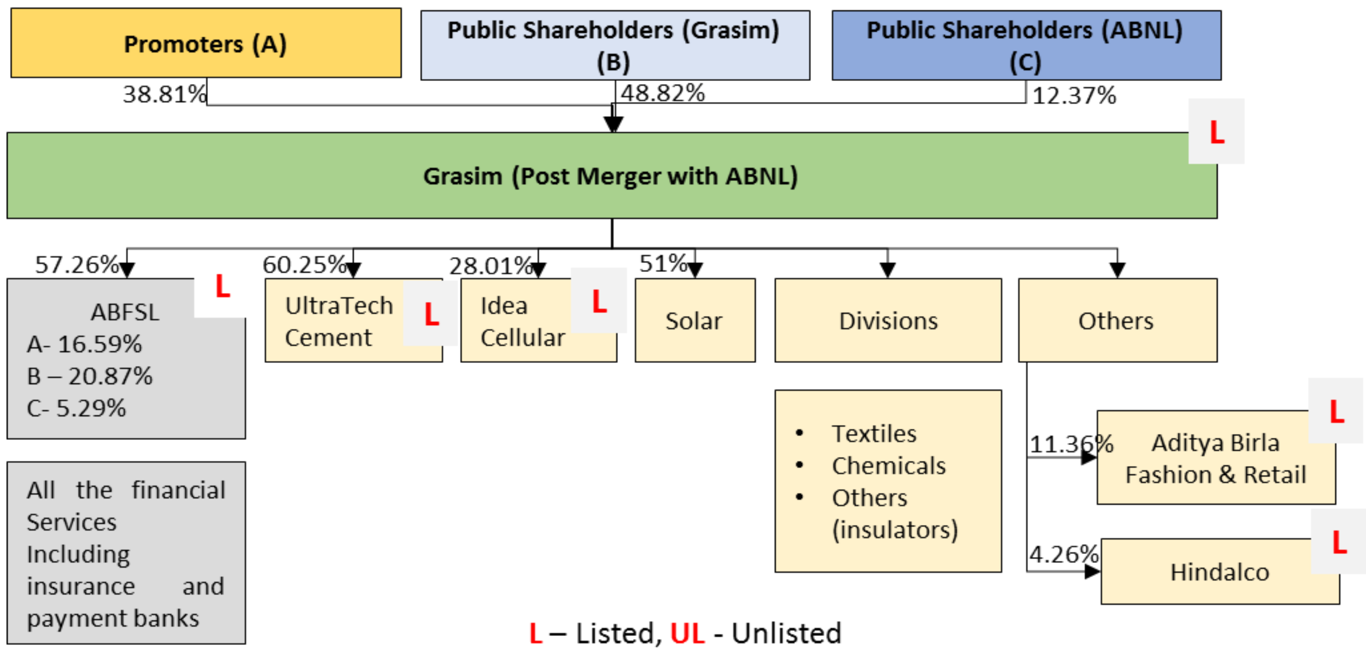
- The Amalgamation will create one of the India's largest and well diversified Company;
- The Amalgamation will create a portfolio of manufacturing and services business;
- The Amalgamation will achieve consolidation of common business;
- The Amalgamation will be followed by a demerger of the Demerged undertaking and Listing of ABFSL, providing value unlocking for shareholders

A snapshot of the proposed Scheme of Arrangement is provided below for the reference:

Pre-Merger

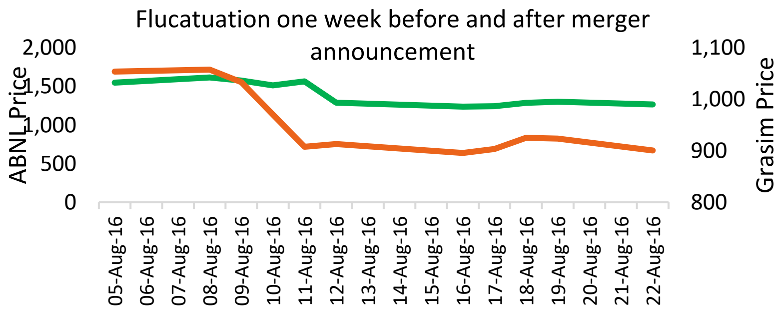


Post-Merger



Market Reaction and SES view:

The announcement regarding the scheme of arrangement was followed by sharp movement in the share prices of both the companies and wide spread criticism by a section of investors and analysts. Analysts raised questions about the objective and suggested various alternatives for demerger. As it is common in cases of scheme of arrangements, analysts were looking for hidden motives, using the crystal ball to look into future and doing their own calculations to suggest impact on share price in short term and long term.



It can be clearly observed that there was a sharp decrease in share prices of both the Companies and the decline continued for about 3-4 days. ABNL dipped 27%, Grasim share took a hit of nearly 15% from a weekly high price before the merger announcement. After the initial loss, the prices showed an uptrend. SES is of the view that the sudden decline in price was due a knee-jerk reaction of the investors as the scheme was different from what the market had expected. However, as the news got digested, the share prices recovered partially, from low of 913 to 1,015.25 for Grasim and from 1,238.10 to 1,430.75 for ABNL as on 11th October 2016. However, as on 11th October 2016, the prices were still down by 1.75% for Grasim and 9.27% for ABNL. It appears that the present prices reflect the proposed exchange ratio adjusted for tax etc.

Prediction of future is very difficult and if any analyst (including SES) had the capability to predict future correctly, the analyst would end up holding all the wealth in the world. Fortunately, SES does not make predictions of prices or give a buy/sell recommendation. SES limits its analysis of any scheme of arrangements to the issues related to the scheme. **Each scheme is examined on the touchstone of transparency, fairness and adverse impact on minority rights**. As a policy in normal course, SES does not suggest options or examine alternatives available for restructuring, unless that option makes the scheme fair to minority shareholders. The options/alternatives are suggested only to remove unfair component of the scheme. **This is because SES believes that Management not only has the expertise but the right to manage the business of the Company under the guidance of the Board, which is elected by the shareholders**. They are the ones, who fully understand the existing business, its potential and the Competition in the market. In fact, the Board does SWOT analysis of business on regular basis. Any Board or management which does not do proactive planning loses out in the market and the same is reflected in its performance over time. The Boards have holistic view of the business and if there is anyone whose crystal ball can at all be given credibility, it is the competent Management. **Based on this theory SES raises its first question:**

DO THE TWO BOARDS UNDERSTAND THEIR BUSINESSES WELL AND ARE THEY COMPETENT?

SES is of the opinion that the Boards and Management of both the Companies understand their business very well else both the Companies would not be having following credentials:

- **Grasim**
  - World's largest producer of Viscose Staple Fibre (VSF) with over 16% of global market share
  - India's largest player in Chlor Alkali/Caustic Soda
  - India's largest producer of Cement
- **Aditya Birla Nuvo Ltd.**:
  - Third Largest Cellular Operator in India with market share of 18.9% (Prior to Reliance JIO)

- One of the Largest non-bank financial services player with a portfolio of 12 business segments; among top 5 fund manager in India (excluding LIC)
- #1 Linen Player in India
- Largest manufacturer of Viscose Filament Yarn (VFY)
- #1 manufacturer of insulators in India and 4th largest globally
- 8th **Largest manufacturer of Urea**

The two companies have leadership positions in major businesses. Further as far as SES can recall, the two companies have not made operating loss in their history and weathered all business cycles, this indicates the robustness of their business model, understanding of business and their structure. Therefore, on this account SES does not find any negative issue with the Boards/ Companies.

IS THE SCHEME TRANSPARENT?

The Management of the Company has disclosed the presentation on scheme of arrangement on stock exchange(s), its website and other media platforms.

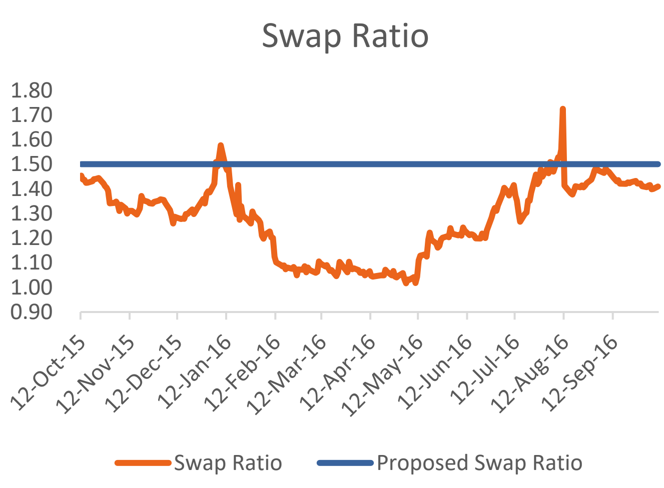
SES has not found anything which may lead one to believe that there are any transparency issues. However, the answer to the question can be given only after the Company(ies) approach shareholders with the Scheme for approval. Level of disclosures therein would finally decide SES view on transparency.

IS THE SCHEME UNFAIR TO ANY CLASS OF SHAREHOLDERS?

The swap ratio proposed by the Company is as follows:

- 3 shares of Grasim of ₹ 10 each for every 10 shares held in ABNL(after sub-division of GRASIM shares - 15 shares of GRASIM of ₹ 2 each for every 10 shares held in ABNL)
- 7 shares of ABFSL for each share held in Grasim (after sub-division of GRASIM shares - 7 shares in ABFSL for 5 shares of ₹ 2 each of Grasim)

The swap ratio proposed by the Company is same for all the shareholders including promoters of the Company.



SES has analysed the historical swap ratio for the two Companies, ABNL and Grasim. SES observed that the proposed swap ratio slightly favours the ABNL shareholders; Primarily whatever may be the difference in current price based on Swap Ratio, it is due to arbitrage and tax differential. However, such a premium may be provided to ABNL shareholders as they are losing a part of their sunrise business of ABFSL to Grasim shareholders. Further, the Grasim shareholders may appear to be at a loss in short term, however since they will get access to Financial services business, this may be considered as an investment for future growth.

SES is of the view that the proposed scheme is fair to all the shareholders and no particular investor is benefitting on the expense of the other investor. The scheme is structured in a way that when a particular investor loses part exposure to a particular business/Company then he is gaining partial exposure in another Business/entity. Further, with all the entities being listed/ proposed to be listed, the scheme also provides the investor an exit option from a particular business if one wishes not to be an investor in that business. Therefore, the scheme meets the SES benchmark that no investor should be saddled with any illiquid instruments, forcing investors to exit at a price which may not be true value or having no exit option. SES has analysed the actual gain and loss for Promoters and public shareholders in various group Companies especially the effect of the scheme on the gain/loss of the Promoters in terms of monetary rights and voting rights.

SES has worked out Swap Ratio based on market price and other factors as per following tables

Market Cap Basis

As on 8th August 2016	Price (₹)	Mcap. (₹ Crore)	Share of Combined Mkt Cap Pre merger %	Existing shares	Future Grasim Shares	share of Combined Grasim Mkt Cap Rs Crore	share of Combined Grasim Mkt Cap %	Difference in MCap.
ABNL	1,615	**21,015**	29.87%	13,02,22,858	19,53,34,287	**20,758**	29.50%	**- 257**
GRASIM	1,057	**49,343**	70.13%	46,67,37,645	46,67,37,645	**49,600**	70.50%	**257**
Combined Grasim	1,063	70,358			66,20,71,932	70,358		

From the above table it can be seen that based on price as on 8th August 2016, if one creates a picture of merged entity and by ignoring all complications computes market cap of joint entity as arithmetical sum of two market cap, one finds that based on swap ratio, the ABNL shareholders would have shared 29.50% of Market cap of merged entity based on swap ratio. By this swap ratio it appears ABNL shareholders share of market cap in the combined entity is slightly lower by Rs 257 Crore as compared to stand alone market cap before merger. The difference is insignificant in comparison to overall figure. Therefore, based on price alone the ratio appears to be fair. However, there at first glance it appears that there could be valid criticism of this swap ratio if one looks at past one year prices**. The swap ratio based on daily price of last 12 month has fluctuated between a low of 1.02 to a high of 1.72, with an average of 1.28 against recommended ratio of 1.50.** Due to such variation in the swap ratio based on prices of the two Companies, one can question the timing of the announcement of the merger. However, the argument could be cut in both ways, while one can say the ratio should be 1.02 the other argument could be why not 1.72 or 1.28. SES has no answer to these questions, as one can never time the market, Swap ratio is likely to be different than yearly average or high low. Question can be raised on timing only if there is price manipulation issue. However, SES understands that for valuers' market price is just one of the factor for calculating swap ratio. While maintaining its view that Market price, of a liquid share which is fairly traded, is best guide for calculating swap ratio, **only for academic objective** SES has carried out similar analysis based on EBITDA/Revenue and PAT (as per data in Presentation made by the Company) and arrived at different ratios.

Swap Ratio based on EBITDA

	EBITDA ₹ Crore	% of Joint Company before merger	existing shares Number	future Grasim Shares based on EBITDA	Proposed shares	share of Combined Grasim EBITDA %	SWAP Ratio Based on EBITDA	Proposed Swap Ratio
ABNL	4,935	41.26%	13,02,22,858	32,78,79,043	19,53,34,287	29.50%	**2.52**	1.50
GRASIM	7,025	58.74%	46,67,37,645	46,67,37,645	46,67,37,645	70.50%		
Combined Grasim	11,960			79,46,16,688	66,20,71,932			

Swap Ratio based on PAT

	PAT ₹ Crore	% of Joint Company	existing shares Number	future Grasim Shares based on PAT	Proposed shares	share of Combined Grasim PAT %	SWAP Ratio Based PAT	Proposed Swap Ratio
ABNL	1,886	44.42%	13,02,22,858	37,29,94,576	19,53,34,287	29.50%	**2.86**	1.50
GRASIM	2,360	55.58%	46,67,37,645	46,67,37,645	46,67,37,645	70.50%		
Combined Grasim	4,246			83,97,32,221	66,20,71,932			

Swap Ratio based on Revenue

	Revenue ₹ Crore	% of Joint Company	existing shares Number	future Grasim Shares based on Revenue	Proposed shares	share of Combined Grasim Revenue %	SWAP Ratio Based on Revenue	Proposed Swap Ratio
ABNL	23,129	38.70%	13,02,22,858	29,46,52,264	19,53,34,287	29.50%	**2.26**	1.50
GRASIM	36,637	61.30%	46,67,37,645	46,67,37,645	46,67,37,645	70.50%		
Combined Grasim	59,766			76,13,89,909	66,20,71,932			

From the above it appears that swap ratio based on average of EBITDA, PAT and Revenue, comes out to be 2.53, which is equal to EBITDA ratio. EBITDA ratio swap ratio is much higher as compared to swap ratio on Market Price or Market Cap basis.

In the absence of valuation Report and other parameters, SES is not aware how the Company has calculated SWAP RATIO. SES has observed that valuers' assign different weightages to different factors. From the above it is seen that if market price is assigned twice the weight swap ratio comes to be 1.69, which is nearer to recommended swap ratio. However, SES believes that market forces are best in valuation and impact of financial numbers including future expectation gets ultimately reflected in market price and market price is best barometer of swap, and to remove time bias, average over a period of time is best measure, while accounting for exceptional events. As stated above yearly average is 1.28 and recommended ratio is 1.5:, indicating premium for AB Nuvo shareholders.

How the Board has valued the companies would be known only till such time valuation report is in public domain. SES's experience as regards to valuation reports has not been very good as these reports do not ever reveal any substantive information.

IS THE OBJECTIVE OF SCHEME CLEARLY STATED AND UNDERSTOOD?

The objective of the Scheme given by the Company is as follows:

- The Amalgamation will create one of the India's largest and well diversified Company;
- The Amalgamation will create a portfolio of manufacturing and services business;
- The Amalgamation will achieve consolidation of common business;
- The Amalgamation will be followed by a demerger of the Demerged undertaking and Listing of ABFSL, providing value unlocking for shareholders

Although, different analysts have analysed it differently. SES has analysed the various concerns raised by the analysts & investors later in its report. SES is of the view that the main objective of the scheme is to get best valuation for all its businesses and use strength of one company for other and vice versa. Idea is to complement to add value for all shareholders. One way to look at it is that Grasim may provide financial support to the fast-growing business of 'ABFSL' from the cash rich Grasim and parentage of GRASIM will improve its credit rating, increase NIM and subsequently reduce NPAs. SES feels that the two boards have stated the objective straight forward without cloaking the same. The questions raised are why GRASIM shall use its cash for supporting ABFSL? Why it shall not use the same cash for its own business or give dividend to shareholders. While these questions are best answered by management, SES believes GRASIM has leadership position in both its main Businesses - Cement and VSF. In cement, further expansion although possible has to clear CCI hurdle and VSF it is already a world leader. Further, its debt equity ratio is low. In case it requires funds for expansion it can certainly borrow more funds. The issue is whether business being acquired makes sense or not. SES is of the view that Financial Service business is a sunrise industry in India and could be a future money spinner. While GRASIM is acquiring it and may have to support financially, but gains will accrue to it. On the other hand, ABNL is sharing the sunrise business but will reap benefit of cash rich promoter. In nut shell, it is a give and take transaction.

However, some analysts have indicated that objective is to increase promoters holding in Grasim. Thus, SES raises its next question - Is increase in holding of promoters in GRASIM an objective or result of the proposed scheme? And what impact does this make for public or promoters.

INCREASE IN PROMOTERS SHAREHOLDING – OBJECTIVE OR RESULT?

After entire scheme is consummated as prescribed, promoters will end up holding 38.81% share in Grasim up from 31.28%, an increase of 7.53%. This has been talked about as negative of the scheme. SES has examined the increase in promoters holding from various perspectives whether such an increase is really material? And whether this increase is coming to promoters free of cost?

- Will this in any way impact control or adversely impact public shareholders? SES is of the view that level **of shareholding** between 25% - 50% is immaterial as far as political (voting) rights are concerned. As any equity beyond 25% enables promoters to block any special resolution and any equity less than 50%+ cannot block ordinary resolutions. **Therefore,** politically speaking the increased equity does not give any additional rights. On the contrary increased promoter holding becomes double edged sword mostly in case of RPT as the chances of a defeat in such a case will increase - 'A thin minority can disturb an Apple cart'. From RPT **transactions** angle a Company having low promoters' equity is better off than a Company with higher promoters' equity due to majority of minority rule as threshold for defeat of any resolution gets reduced.
- Even if one assumes that objective was to increase the promoters' stake, the question would remain what for? Has any of these Companies faced any defeat of resolution in the past? The answer is 'NONE'. Therefore, for continuing control while equity increase is one option, the better option is performance. Against consistent good performance no investor would like any change of control.
- Continuing the assumption that, increasing stake was one of the objective, the question comes was this the only method for increasing stake? Preferential offer to promoters is the most abused **method of increasing the stake** and like other promoters these promoters in past have resorted to increasing stake through preferential offer route. While investors are raising concerns on increase in promoters' stake in this cases, the same investors have in past supported issue on preferential basis to promoters and enabled promoters to increase stake. SES does not recall that any of the preferential offer proposal by any company including these has ever been defeated. Like many other promoters, ABNL promoters are also guilty of using the preferential offer route to shore up their stake in past. As against preferential offer route this method is far superior as while they are gaining stake at one place but losing stake at another place.
- Cross holding is being cancelled and not being transferred into trust (like ESCORTS Ltd.). If the objective was to increase equity the cross holding would have been retained giving promoters additional voting power. Not doing this indicates that increasing voting power is not the objective.
- As per SES analysis, the gain of 7.53% in Grasim is at the cost of losing about 19+% economic interest in ABFSL. One can still argue that Promoters have more faith in GRASIM hence increasing their stake and are wary of ABFSL hence, reducing stake. If that is to be believed, the best course for promoters would be to divest entire holding in ABFSL. Since, they are not doing so, SES is of the view that increase in equity is consequential and not the underlying objective.

ARE THERE ANY GOVERNANCE RELATED ISSUE IN THESE COMPANIES?

SES, since 2012 has been publishing its recommendation through its Proxy Advisory Reports of various shareholders meeting of AV Birla Group. These Reports contain our analysis of corporate governance practices of almost all the listed Companies of AV Birla Group which majorly incudes Grasim, AB Nuvo, Hindalco, UltraTech, Idea Cellular and of B K Birla group like Century Textiles & Century Enka. Links to such reports has been provided under disclosures on page '16' of the report. While neither a clean chit be given to the Companies nor the Companies can be said to be defaulting. SES has not observed any major governance concern in any of these Companies except for:

- The skewed remuneration paid to the Non-Executive Promoter Directors, Mr. Kumar Mangalam Birla and his mother Mrs. Rajashree Birla. SES has observed that the mother-son duo has received very high commission compared to other Non-Executive Directors in almost all the group Companies. The remuneration of Mr. K M Birla has been even higher than the Executive Directors in few of these Companies. SES has raised its concern in all its previous reports and recommended the Company to provide adequate justification and disclose reason/logic for such high remuneration paid to the Birlas.

- Long association of the Independent Directors in Group Companies
- Age of directors being more than 70 years and they holding Directorships in more than 5 Listed Companies
- Attendance Record of Mrs. Rajashree Birla in Board meetings and AGMs and her subsequent reappointment proposal

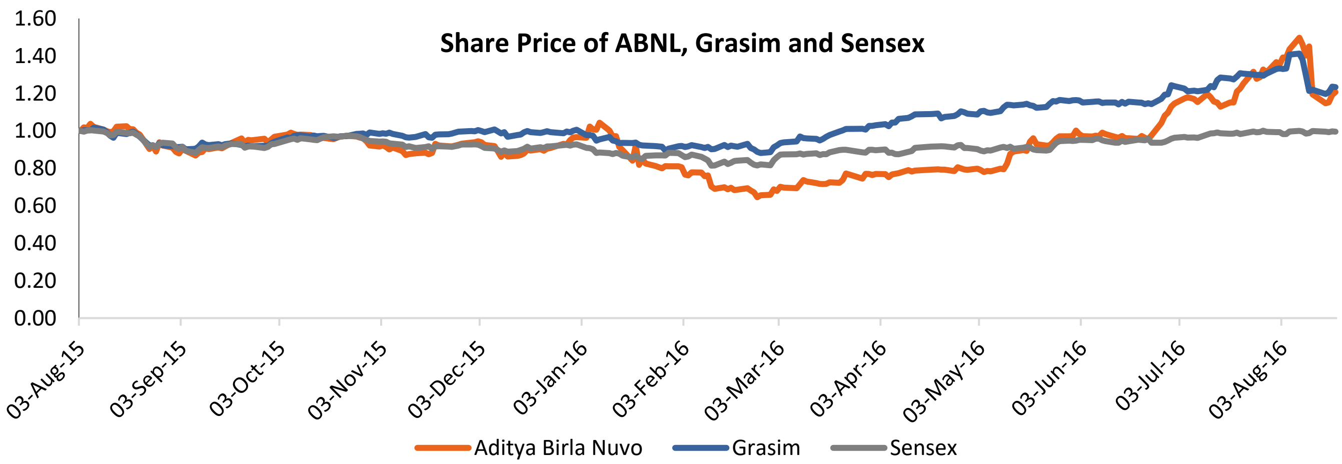
WHAT ARE THE NEGATIVES OF THE SCHEME?

SES has not found any negatives in the scheme which has potential to cause loss to the shareholders of either Company. However, SES has listed out the issues raised by investors in conference call with the Company (source: Call Transcripts) and in various media reports. SES has analysed the same applying its gold standard of transparency, fairness, independence and conflict free relationship.

SCHEME AGAINST EXPECTATIONS OF INVESTORS:

The biggest criticism of the scheme emanates from the investors and the analysts who had expected that AB Nuvo will demerge ABFSL directly and list the same on stock exchange(s). **Hence, the Scheme fails to meet their expectations**. The question that arises is, should the managements and the Boards **play to gallery and meet expectations of few investors**, whose investment **objective could be vastly different** from that of promoters or other investors or objective could be only **short term or even sectoral exposure**? **or follow advise of analysts like us who do not have any stake**? Or should they take a decision which is **in the long term interest of business and with an objective to deliver shareholder value**? The situation is like a batsman batting in a match, hearing the demand of viewers to hit six. Should he hit a six or play keeping in mind interest of team and to win the game? SES agrees that there could be various options of restructuring, but who decides which is the best option for the business and shareholders - We the analysts who can have various different opinion or shareholders who having different objectives, different horizon of investments and different stake **or the Management/Board of the Company?** As each stakeholder can have different opinion,It is for this reason a corporation is managed by the Board, which is expected to take a holistic long term view in the interest of all stakeholders.

The concern must not be that the Board/management has decided the scheme, however the concern should be - Are they capable to take such a decision? And whether the decision is fair to all shareholders or benefits a class of shareholders. SES is of the view that the stock market is the best barometer of evaluating the performance of the Management of the Company. Looking at the market performance of the stocks of both the Companies (at least till the announcement) SES is of the view that market trusts the capability of management and the Board, as stocks of both the Companies have outperformed the market index for major part of the year. While Grasim has been consistent outperformer, ABNL has been a little less consistent.



Share prices/sensex has been indexed to the value as on 1st August, 2015

The second deciding parameter is the past history of M&A, investments and divestments. This could be analysed from the instances of failed acquisitions, wrong divestments, mergers and demergers? Before SES examines the same a word of caution is warranted that the business is dynamic and the situations keep on changing, therefore at different points of time for the same situation/business decision, the results may be totally different. As far as the memory goes AV Birla group in past has given up following business:

1. Divestment of MRPL (JV with HPCL)
2. Hive off of Sponge Iron Business
3. Hive off of part of Textile Business
4. Restructuring of Carbon Black business
5. Acquisition of cement Companies/units
6. Acquisition of pantaloons and restructuring of apparel business
7. Acquisition of share broking Company (Apollo)

In retrospect one can say few of the decisions were not prudent. However, the same looked extremely prudent when the same were taken. On one hand, **SES would say that hiving of Carbon Black Business was unfair** from the point of view not sharing the future growth with shareholder on the other hand if one looks for simplifying business structure and concentrate on few businesses such decisions looks inevitable. **However, SES would maintain that it could have been hived off to a separate listed entity, and be fair to all shareholders allowing them to get fair value of their investment and liquidity, so that they could choose to remain or exit at market price.**

At least on this count one cannot fault the current scheme.

HOLDING COMPANY DISCOUNT:

Presently AB Nuvo itself is a diversified Company, operating in a diverse business and having both listed and unlisted subsidiaries/associate Companies. On the same lines Grasim is also a well-diversified Company with both listed and unlisted subsidiaries/ associate Companies. Both the companies being partly holding Company and partly operating Company have been historically trading at a discount to arithmetic sum of parts of their subsidiary/associate Companies. Such discounts are natural and are widespread in Market.

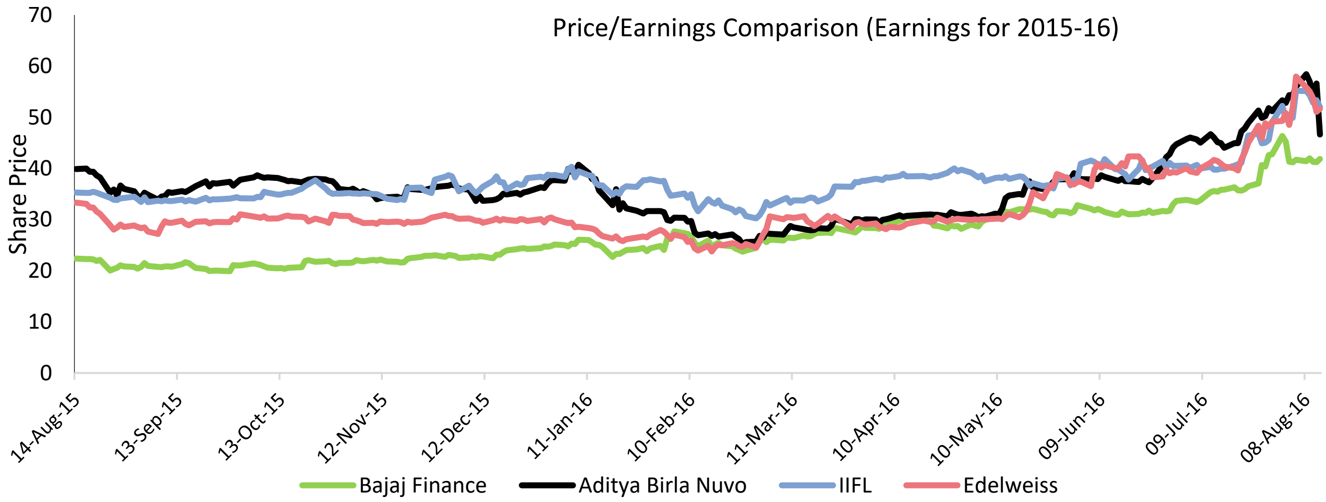
Although, SES is not an expert in management decisions however, from governance perspective, SES believes that the decision is supportive of ABFSL business. Since, Grasim has a stronger balance sheet than ABNL, it would be easier to fund the finserv business which may require funds at urgent basis in future. Further, the management of the Company has mentioned that a stronger parentage like Grasim will provide a better credit rating which will reduce the cost of borrowing and will help the Company to increase NIM and reduce NPAs.

SES has analysed the P/E ratios of Grasim, ABNL and their subsidiaries and Associate Companies:

Company	P/E
Grasim	16.99
ABNL	12.54
UltraTech Cement (Subsidiary of Grasim)	41.03
Idea Cellular (Assosciate of Grasim and ABNL)	14.73
Hindalco (Standalone)	39.45

**Source Moneycontrol.com*

ABNL has been trading at a lower P/E than its associate Companies. As major earnings of ABNL are from its Financial Services division, SES compared the share price data of ABNL with Companies which are NBFCs or other related financial services business viz. Bajaj Finance, IIFL and Edelweiss:



From the above trend in share prices of the Companies, SES has observed that the price of all the NBFC Companies have increased over 1 year and the share price of ABNL has shown similar trend.

SES has analysed the different restructuring proposed in the media and by other analysts:

1. Partial Demerger of ABNFSL from ABNL and listing it as a separate entity:

Although, this would not dilute the shareholding of the existing shareholders of ABNL in ABFSL. However, ABFSL then may have to suffer in terms of funds for future needs. It may have to dilute equity resulting in dilution for existing shareholders and Grasim or promoters could increase equity by preferential offer. In such structure if needed Grasim could still provide funds to ABFSL both being same group Companies, however it will need approval of related party transactions for both Grasim and ABFSL. However, in such structure benefit of credit rating improvement due to strong balance sheet of promoters will not be available and the same may result in decrease in NIM and increase in cost of funding, even the quality of assets may go down due to higher cost of funds thus eventually increasing NPA. Therefore, it is more to do with strong parentage of GRASIM rather than support in form of funds.

In past SES has opposed partial demerger (Crompton Greaves / CG) as partial demerger gives disproportionate voting rights to promoters. However, SES analyses every case based on its merits and objective stated. In the present case if ADFSL was demerged from ABNL fully and listed promoters would have got direct voting of 58.4% (which is >50%), with partial demerger their control on voting would be 73.84% (still less than 75%). This indirect voting power in no way would enable passing of Special Resolution, therefore they would not gain any special rights. In case of CG the voting power was crossing 50% due to partial demerger. In CG there was no rationale for partial demerger, in the present case it is very clearly stated that partial demerger is to continue strong parentage of GRASIM for ABFSL, which will increase value of ABFSL benefitting all stakeholders. Without this logic SES would not support partial demerger.

2. Initial Public Offering of shares of ABFSL and listing on stock exchanges:

This would have been the worst case for the shareholders because:

a) they would not get liquidity for their investment as ABFSL will be held as a subsidiary of ABNL

b) dilution of their shareholding

c) issue of strong parentage required for Finserv business will not be solved

3. Hiving of ABFSL and listing on stock exchanges: By scheme of arrangement and listing as mirror image of ABNL. While this is what was expected by shareholders and market. It was simplest and would have pleased the market. The issue is whether it is best option or not. SES believes that management decisions are in best interest of all, unless we can find any mala-fide. SES is of the view that in such restructuring ABFSL would have ABNL as parent and may not enjoy same credit rating and financial muscle as it would have in case GRASIM is promoter of ABFSL. Therefore, SES is of the view that proposed restructuring is aimed at protecting shareholder value post listing.

INCREASE OF PROMOTER SHAREHOLDING IN GRASIM

The shareholding of promoters will increase from 31.28% to 39% in Grasim. Although, SES is against the increased promoter shareholding by indirect method(s), however in this case the shareholding of promoters is increasing in Grasim, however it should be taken into account that there shareholding in ABNL as of now is 58.40% will decrease to 39% and they would hold only 17% of ABFSL directly and 57% through Grasim, as presently 100% held through ABNL. SES has looked at the holistic picture in this particular transaction and observed that the Promoters are losing some part of its holding in ABNL to gain some part in Grasim. Further, the similar is happening with the Public shareholders of Grasim and ABNL. If they are losing shares in one entity they are receiving shares of another entity. Hence, as per SES the said transaction is fair and does not have a preferential treatment to promoter/promoter group. SES has found the change in Equity stake and controlling stake of the Promoters in Grasim, ABNL, ABFSL and other group Companies:

	Equity stake (in %)			Voting Power (in %)		
	Pre-Merger	Post-Merger	Gain/Loss	Pre-Merger	Post-Merger	Gain/Loss
Grasim	31.28	38.81	7.53	31.28	38.81	7.53
ABNL	56.63	-	-	58.40	-	-
UltraTech Cement	20.87	25.40	4.54	62.27	62.27	-
Idea Cellular	29.29	25.09	-4.20	42.23	42.23	-
Aditya Birla Fashion and Retail	54.12	52.51	-1.61	59.46	59.46	-
Hindalco	35.20	35.08	-0.12	37.69	37.69	-
ABFSL	58.40	38.81	-19.59	100.00	73.85	-26.15

**Considered proportionate shareholding of promoters in Subsidiary and Associate Companies. However, neglected the crossholding between the Associate Companies as they will continue to exist (eg. Holding of Hindalco in UltraTech Ltd.) and will not affect the Gain/Loss.*

SES has analysed the gain/loss for Public Shareholders in terms of equity stake and voting power:

	Equity stake (in %)			Voting Power (in %)		
	Pre-Merger	Post-Merger	Gain/Loss	Pre-Merger	Post-Merger	Gain/Loss
Grasim	68.72	61.19	-7.53	68.72	61.19	-7.53
ABNL	43.37	-	-	41.60	-	-
UltraTech Cement	79.13	74.60	-4.54	37.73	37.73	-
Idea Cellular	70.71	74.91	4.20	57.77	57.77	-
Aditya Birla Fashion and Retail	45.88	47.49	1.61	40.54	40.54	-
Hindalco	64.80	64.92	0.12	62.31	62.31	-
ABFSL	41.60	51.63	10.03	-	26.15	26.15

Risk of Investment in Other Businesses

Shareholders of ABNL fear that they would get into the risk of Cement and VSF business and shareholders of Grasim fear that they would get into the risk of financial services business, interalia, with other ABNL businesses. SES is of the opinion that ABNL is not only a financial Company and Grasim is not only a cement. Both have a diversified business of chemicals, textiles, VSF, Telecom etc. SES is of the view that from two diversified Companies, the merger is creating a bigger diversified Company. Further, since the Company is listing 'ABFSL' it is providing liquidity to the investors. Thus, the shareholders if they feel they can exit the business of any Company which they don't want to be invested in. Shareholders of ABNL who invested in ABNL only due to its financial services will not only get a chance to exit the business but also have an opportunity to grow the business with the cash rich Grasim which has a strong balance sheet than ABNL. Further, SES is of the view that the shareholders of ABNL did not only invest in its Financial Services. ABNL was always a diversified business with Telecom, Textiles, Insulators, solar powers in its kitty and investments into Aditya Birla Fashion and Retail and Hindalco. Further, Grasim is similarly diversified entity with business like Cement, Textiles, VSF and investments in other group companies including idea Cellular. SES is of the view this is a merger of two diversified Companies into a bigger diversified Company which may or may not synergise the businesses but at least nullify the cross shareholding in group Companies like Idea Cellular, Hindalco, Aditya Birla Fashion and Retail and ABNL itself.

Grasim as per Audited Financial Statements as on 31st march, 2016 has a current ratio of 1.43 and debt-equity ratio of 0.13. Grasim shareholders may have to share the cash with ABNL shareholders which they have grown over the years from its profitable Companies like Ultratech Cement, however the will get in return a well-established financial services business. Grasim will directly hold 57% of the ABFSL after its demerger from the merged Grasim.

While SES does not have crystal ball to predict anything, still it does not stop SES from doing logical analysis. The promoters off late have been following a policy that if they are not leaders in the business (Top Three-Four) they quit the business, unless they can scale it up. ABNL has following business which are either small or they are not top 3:

- Fertilisers
- Telecom (presently in top 3, however with Reliance Jio on horizon, risk of losing the position)
- Insulators
- Rayon etc.

Textile and Retail is the main business of ABNL apart from ABFSL. Rayon is part of the same. Recent sale by TATA Chemicals of its Fertiliser business confirms the philosophy of big business houses to retain businesses where they have leadership positions. Telecom shake up is imminent due to war chest of Reliance and Vodafone. Insulator business is not big and doesn't fit into core businesses. Therefore, going forward rationalisation of business is more likely. SES would assume that unless any of these businesses are sold - lock stock and barrel, in any hiving off shareholders would have option to remain part of the same.

Creeping Acquisition

The promoters of both ABNL and Grasim have made creeping acquisition of shares i.e. acquired shares from secondary market. The promoter holding of GRASIM increased from 30.73% as on Dec'15 to 31.28% as on June'16. Similarly, promoter holding of ABNL increased from 57.18% as on Dec'15 to 58.40% as on Jun'16. SES is of the view that till the creeping acquisition is as per the law, there is no concern regarding the merger of the Companies. Further, as on face; the shares acquired by the promoters are miniscule as their holding increased by 0.55% in ABNL and 1.22% in Grasim, hence, there seems no concern to the merger even if the promoters have made creeping acquisitions in last six months.

Merger to Provide Support to Idea Cellular

Some media reports have mentioned that the Company has proposed the restructuring to fund the business of Idea Cellular from the cash of Grasim due to the increase competition from the proposed launch of Reliance – Jio. Although, the Company has denied any such plans and mentioned that Idea Cellular is an Independent Company and can raise funds on its own. SES has analysed the following financial ratios of Idea Cellular from the Balance Sheet and P&L for year ended 31st March, 2016.

	Mar' 16	Mar' 15	Shift	Company's Discussion
Interest Coverage Ratio	6.81	11.40	-40.26%	Interest and Finance Charges for the current year increased from ₹ 931 crore to ₹ 1,798 crore, largely due to higher interest cost on deferred payment obligation towards Spectrum
Current Ratio	0.30	0.89	-66.29%	Majorly due to decrease in Investment in Units of Liquid Mutual Funds and Bank Deposits
Debt Equity Ratio	1.56	0.74	110.81%	Total loans outstanding as at 31st March, 2016 were ₹ 40,852 crore, an increase of ₹ 14,977 crore, mainly due to the deferred payment liability on spectrum acquired in March 2015 auctions and partially offset by the repayment of borrowings during the year

Source: Company's Annual Reports

The debt-equity of the Company increased from 0.74 to 1.56. Further, the debt equity of its peer Companies is comparatively low:

Bharti Airtel	0.50
Reliance Communication	0.87
TATA Communication	0.08

Although, the borrowings of the Company has increased, however, the intangible assets of the Company increased by more than 200% from ₹ 14,215 crore to ₹ 29,718 crores majorly due to Entry/License Fees and Spectrum.

SES understands that presently Telecom business of not only the Company ABNL is under pressure but all other players in the industry are facing pressure. The current market price of ABNL reflects this reality. The question is, where does the industry go from here? Has it already hit the seabed or will it go down further? When will the Industry revive?

SES has no answer to all these questions. However, following factors must be kept in mind.

- GRASIM is becoming part owner of IDEA (about 28%) at current market price, which is at a multi-year low and swap ratio takes the same into account.
- Telecom is an important infrastructure and almost half the population is affected by it.
- The industry cannot be allowed to go bust
- Predatory and aggressive pricing cannot be sustained indefinitely-both financial pressure and regulatory pressures will come into play.
- SES is of the opinion that consolidation is imminent in the industry as there cannot be room for 5-6 players in the business.
- SES has no clue on when and how the consolidation will happen. However, SES is clear that in case of consolidation, without merger of ABNL – Grasim, ABNL alone would be negotiating from a very weak position as IDEA is treated as a separate entity surviving on its own. However, once it becomes a part of GRASIM, the position changes. Therefore, for ABNL it is positive due to financial strength of GRASIM, for GRASIM it is positive that after acquiring at current multi year low, chances of reaping benefits become brighter. SES is of the view there is potential of unlocking value in future. The value at present is not known but will be realised when business will be sold. While these businesses are presently embedded and suffers from holding company discount. When sold the same will be sold at intrinsic value or market value which in all probability will be higher than the discounted value embedded in the deal. However, SES understands that it is all futuristic.

DISCLOSURES:

- Mr. J N Gupta, Founder & Managing Director of SES and former Executive Director of SEBI, was in employment of AV Birla Group (1991-1994 & 1998-2001). He holds 1,200 shares in AB Nuvo & 1,492 shares in Hindalco
- Mr. Devendra Bhandari, Executive Director of SES was in employment of AV Birla Group (1983-2013). He along with his spouse holds 1,221 shares in AB Nuvo, 30 shares in GRASIM, 5,001 shares in Idea Cellular, 17 shares in Ultratech cement, 1,235 in Hindalco Industries and 6,351 in Aditya Birla Fashion and Retail.

Both declare that they have no pecuniary relationship with the AV Birla group. SES has released many reports on AV Birla group. Independence and freedom from conflict of SES can be seen from observations of SES in these Reports.

- Proxy Advisory report for Aditya Birla Nuvo AGM dated 27th August, 2016
- Proxy Advisory report for Aditya Birla Nuvo AGM dated 15th September, 2015
- Proxy Advisory report for Grasim AGM dated 19th September, 2015
- Proxy Advisory report for UltraTech Cement AGM dated 19th July, 2016
- Proxy Advisory report for UltraTech Cement AGM dated 28th June, 2015
- Proxy Advisory report for Hindalco Industries AGM dated 16th September, 2015
- Proxy Advisory report for Idea Cellular AGM dated 28th September, 2015

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