

SHAREHOLDERS' VALUE CREATION IN THE SUN PHARMA-RANBAXY MERGER: AN EVENT STUDY

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ABSTRACT

Mergers and Acquisitions have been the area of strategic focus for many corporate houses since the last two decades. It is now a global inorganic growth strategy to serve a variety of firm specific objectives like accessing new markets, foreign strategic assets, trade and supporting infrastructure and shareholder's value creation. The pharmaceutical industry in India witnessed one of the biggest mergers in its history when Sun Pharma took over Ranbaxy Laboratories. The merger failed to create value for the shareholders of Sun Pharma and considerable amount of literature has corroborated the fact. The present study has attempted to gather statistical evidence to prove the fact of such failure to create value for the shareholders of Sun Pharma in an objective manner. Seven valuation ratios have been considered to measure the value creation by the merger. The results before and after the merger have been analysed for the purpose by way of an event study. The study has been based on secondary data collected for a ten-year window from the annual reports of both Sun Pharma and Ranbaxy laboratories as well as from Ace Equity © data product. This

study has objectively proved that the acquiring firm was not able to create enough wealth for shareholders post acquisition.

Keywords: Sun Pharma, Ranbaxy Laboratories, Value Creation, Valuation Ratio, Event Study

INTRODUCTIONS

The corporate sector in India has seen a considerable growth of mergers and acquisitions since the 1990's & it's a common business strategy today for Indian corporate houses. The two main objectives behind any Merger & Acquisition (M&A) transaction, for corporate houses have been to improve revenues & profitability and faster growth in scale and quicker time to market. M&A rank among the most important decisions about the allocation of corporate wealth.

Sun Pharmaceutical Industries Limited is an Indian multinational pharmaceutical company headquartered in Mumbai, Maharashtra that manufactures and sells pharmaceutical formulations and active pharmaceutical ingredients (APIs) primarily in India and the United States. The company offers formulations in various therapeutic areas, such as cardiology,

psychiatry, neurology, gastroenterology and diabetology. It was established in 1983 in Vapi, Gujarat with five products to treat psychiatry ailments. The 2014 acquisition of Ranbaxy has made the company the largest pharma company in India, the largest Indian pharma company in US, and the 5th largest specialty generic company globally. Over 72% of Sun Pharma sales are from markets outside India, primarily in States. US is the single largest market, accounting for about 50% turnover; in all, formulations or finished dosage forms, account for 93% of the turnover. Currently Sun Pharma is the second largest and the most profitable pharmaceutical company in India, as well as the largest pharmaceutical company by market capitalisation on the Indian exchanges. On 6 April 2014, Sun Pharma announced that it would acquire 100% of Ranbaxy Laboratories Ltd, in an all-stock transaction, valued at \$4 billion. Japan's Daiichi Sankyo held 63.4% stake in Ranbaxy. After this acquisition, Sun Pharma has become the largest pharmaceutical company in India, the largest Indian Pharma company in US, and the 5th largest generic company worldwide.

Both Ranbaxy and Sun Pharma are established names in the pharma industry worldwide and have operations in a number of countries. They also complement each other in their areas of expertise and efficiency, both functionally and geographically. While Sun Pharma is a major global specialty pharmaceutical company with expertise in complex and niche therapy areas and a proven record of turning around its acquisitions, Ranbaxy had a strong global footprint and presence in the generics segment. Shareholder value is the value delivered to shareholders because of management's ability

to grow sales, earnings and free cash flow over time. If this value is created over the long term, the share price increases and the company can pay larger cash dividends to shareholders. This study is an attempt to provide statistical evidence of the failure to create shareholder value to Sur Pharma.

OBJECTIVES AND SCOPE OF THE STUDY

The objective of this study is to have a statistical proof of the established fact that the merger under consideration was not able to create value for the shareholders.

The present study attempts to examine the short run as well as long run impact of Sun Pharma-Ranbaxy merger in India. This study has used only a few selected financial ratios for a 10-Year window to ascertain value creation or otherwise due to the merger and also to test the statistical significance thereof.

SURVEY OF LITERATURE

Many companies have grown as big empires through mergers and acquisitions programs. With growing size of M&A activity in India there is need to study whether growth achieved through merger and acquisition route is profitable or otherwise. In most of the previous studies the evidence show that target companies experience positive gains around merger announcement and there is negative impact of mergers on acquiring companies. The studies during recent times have more focus on long run performance of acquiring firms.

Hitt et al (2012) conducted a review of the extant empirical research on M&A performance over the last 25 years (1983–2008). The research suggests that acquiring firms create little or no value.

Reasons for these outcomes include an inability to create synergy, paying too high a premium, selecting inappropriate targets, and ineffective integration processes, among others. However, careful selection of targets and effectively implemented acquisitions can achieve synergy and create value.

Syalet al (2016) conducted a study which dealt with the objective of reviewing the empirical literature related to various motives behind domestic as well as cross border M&A's and also to investigate that whether these deals are resulted into value creation for the shareholder of acquirer or target firms with various M&A deal characteristics. The two set of hypothesis in the theories of value creation by Mergers & acquisitions were two pronged i.e. Value Maximizing Hypothesis and Non Value Maximizing Hypothesis. The former suggested that acquisitions were motivated by maximizing the value of firm and whereas latter proposed that managers of bidding firms embarked on acquisitions to maximize their own utility at the expense of stockholders.

Bild et al (2001) developed and empirically tested a new methodology for evaluating the financial performance of takeovers. The existing accounting and event study methodologies did not adequately address the key issue of whether takeovers are a positive net present value investment for the acquiring company. Their methodology attempted this by employing the residual income approach to valuation and comparing the present value of the acquirer's future earnings before the acquisition, with those that actually resulted following takeover. In contrast to existing methodologies, they had explicitly taken into account of the cost of the acquisition, the acquirers cost of capital, and

the earnings which were created beyond the sample period. The methodology was used for evaluating a comprehensive sample of U.K. acquisitions completed during 1985-96. Using the traditional accounting method, it was found that acquisitions resulted in a significant improvement in profitability. However, the residual income approach revealed that on average, acquisitions destroyed roughly 30 percent of the acquirer's pre-acquisition value. Brage et al (2007) had outlined that in 2007, M&A volume reached an unprecedented value of \$4,500 billion globally. Previous studies showed that approximately 60-80 percent of all M&As failed to create value. As a result, much effort had been put into investigating sources of value creation in M&A contexts. Many studies singled out firm relatedness as an important factor, i.e. the extent to which merging firms share similarities. This study aimed to extend previous research on firm relatedness by introducing the role of intellectual capital in value creation processes pertaining to M&A activity. The study theorized that through the ability to pool two sets of intellectual capital with divergent configurations, unrelated M&As should be expected to create greater value than related ones. This was tested by calculating pre- and post-consummation values of intellectual capital for a sample of 15 related and 15 unrelated M&As. Cumulative abnormal returns were also calculated as a measure of each deals' value creation potential according to market expectations. The findings of the study suggested that the unrelated M&As consistently seemed to outperform related ones in terms of gains to the value of intellectual capital and in terms of market expectations. However, the statistical significance of the findings was insufficient for

valid conclusions to be drawn. It was argued that further research should be made in order to investigate for statistical significance.

Vinogradova (2014) in her Ph.D. thesis paper identified the key factors that influenced announcement effects of M&As and evaluated the key value drivers that impacted performance of the acquiring companies and their value creation for the shareholders in the strategic acquisitions completed between 2000 and 2010. Using event-study method and comparative statistics with mean-difference tests, seven variables were identified and tested on their influence on transaction outcome. Besides purely empirical results, the paper took into consideration the pre-event operating performance of the acquirers and their strategic rationale for the acquisition, analysing how it impacted the outcome. The examples of value-creating and a value-destroying acquisitions helped to understand the strategies behind their success or failure. The companies having strong positive NOPAT performance focused on pursuing the strategic acquisitions for growth in order to be able to sustain their high profit margins and their competitive advantage over time. The companies with negative NOPAT performance focused on improving it. Their decision to pursue an acquisition in order to reduce costs or add additional assets was of purely short-term pecuniary interest. Therefore, these acquisitions were called financial acquisitions as their primary goal was resource re-allocation and they did not create additional sustainable value for the shareholders.

Sharma et al (2016) had outlined in the case study of Tata and Chorus merger that mergers and acquisitions were undertaken by companies to achieve certain strategic and financial objectives. They involved the bringing together of the two

organizations with often disparate corporate personalities, cultures and value systems. The analysis was done on the basis of primary and secondary data available and with the help of ratio analysis and paired t-test for comparison. 5 ratios have been used for this purpose. The ratios used are earning per Share, Profit after Tax, Current Ratio, Debtors Turnover ratio, Return on Net Worth. The results showed that there was no significant change in the short run but the merger had a long term effect on the company.

The survey of literature revealed that various ratios relating to liquidity, profitability and turnover activities had been considered for post merger corporate valuation. The said ratios have been used as indicators for value creation of companies. However different valuation ratios may be computed for companies which are better reflection of company value creation. Literature on using valuation ratios for assessing value creation by M&As were found to be scarce.

Hence the current study has used valuation ratios to have a direct assessment of the post-merger value creation in Sun Pharma – Ranbaxy merger and to check statistically the fact that no significant value has been created due to the merger.

METHODOLOGY OF THE STUDY

Seven valuation ratios have been considered in the current study to assess the value creation in post merger scenario. The ratios used are price to earnings ratio (P/E), price to book value ratio (P/B), enterprise value to net sales ratio (EV/NET SALES), enterprise value to earnings before interest and depreciation and amortisation ratio (EV/EBITDA), enterprise value to earnings before interest and taxes ratio (EV/EBIT), enterprise value to capital employed ratio (EV/CE), market capitalisation to sales

ratio (M CAP/SALES). The results before and after the merger have been analysed. Paired t-test has performed on these ratios. To check whether result as per mean and median is same, both t-test and Wilcoxon test have been performed. The following hypotheses have been framed for the t-test for each of the valuation ratios considered:

H0= There is no significant difference in the mean ratio, before and after the merger.

H1=There is a significant difference in the mean ratio, before and after the merger.

The following hypotheses have been framed for the Wilcoxon test for each of the valuation ratios considered:

H0= There is no significant difference in the median ratio, before and after the merger.

H1=There is a significant difference in the median ratio, before and after the merger.

All the hypotheses have tested at 5% level of significance.

Co-relation test has also been performed which is an indicative test to infer whether the pre and post merger company financials are related or otherwise.

The data used in this study have been collected from Ace Equity Data product and is thus entirely secondary in nature.

The statistical analysis were carried out on SPSS (version 23) platform.

The study considered a 10-year window i.e. from year ended 31st March 2010 to year ended 31st March 2014 as the pre-merger period and from year ended 31st March 2015 to year ended 31st March 2019 as the post merger period.

FINDINGS OF THE STUDY

The valuation ratios for the 10-year window are appended below:

Table 1: Valuation Ratios

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Adjusted PE	23.69	43.38	46.64	37.8	28.35	22.19	25.15	27.43	12.67	17.15
Price/Book Value	4.5	5.98	8.28	6.41	5.65	4.82	4.82	4.73	3.27	5.11
EV / NET SALES	5.1	6.85	7.66	7.07	7.16	6.97	7.68	9.17	5.04	7.27
EV/EBITDA	14.91	21.84	24.92	15.06	15.32	15.22	18.97	23.33	10.37	14.32
EV / EBIT	16.9	27.14	30.04	24.59	18.55	16.52	20.81	25.85	11.02	15.18
EV / CE	2.71	3.68	4.46	4.03	4.12	3.54	3.7	4.14	2.67	4.09
Market Cap/ Sales	5.27	7.02	7.73	7.38	7.5	7.35	7.99	9.25	5.39	7.6

Source: Annual reports of the selected companies obtained by Ace Equity © data product)

The results of the t-test and Wilcoxon test for each of the valuation ratios are appended below.

Adjusted Price to earnings ratio (P/E)

Situation	Mean
Pre Merger	35.9720
Post Merger	20.9180

Analysis of T – Test and WILCOXON test:-

	Based on t – test	Based on Wilcoxon median test	Decision
p-value	0.030	0.043	Reject Null hypothesis

The calculated p value of T test is .030 and Wilcoxon test is .043 (at 5% level of significance). Since the calculated p values are less than 0.05, the Null Hypothesis is rejected.

Price/Book Value

Situation	Mean
Pre – merger	6.1640
Post- merger	4.5500
Correlation coefficient	- 0.096

Analysis of T – Test and WILCOXON test:-

	Based on t – test	Based on Wilcoxon median test	Decision
p-value	0.090	0.080	Retain Null hypothesis

The calculated p value of T test is .090 and Wilcoxon test is .080 (at 5% level of significance). Since the calculated p values are more than 0.05, the Null Hypothesis is accepted.

EV/NET SALES

Situation	Mean
Pre – merger	6.7680
Post- merger	7.2260
Correlation coefficient	0.261

Analysis of T – Test and WILCOXON test:-

	Based on t – test	Based on Wilcoxon median test	Decision
p-value	0.545	0.500	Retain the Null hypothesis

The calculated p value of T test is .545 and Wilcoxon test is .500 (at 5% level of significance). Since the calculated p values are more than 0.05, the Null Hypothesis is accepted.

EV/EBITDA

Situation	Mean
Pre – merger	18.4100
Post- merger	16.4420
Correlation coefficient	0.291

Analysis of t – Test and WILCOXON test:-

	Based on t – test	Based on Wilcoxon median test	Decision
p-value	0.484	0.345	Retain the Null hypothesis

The calculated p value of T test is .484 and Wilcoxon test is .345 (at 5% level of significance). Since the calculated p values are more than 0.05, the Null Hypothesis is accepted.

EV/EBIT

Situation	MEAN
Pre – merger	23.4440
Post- merger	17.8760
Correlation coefficient	0.433

Analysis of t – Test and WILCOXON test:-

	Based on t – test	Based on Wilcoxon median test	Decision
p-value	0.106	0.043	Retain the Null Hypothesis for t-test but reject it for Wilcoxon test

The calculated p value of T test is .106 and Wilcoxon test is .043 (at 5% level of significance). Though the median test has confirmed the value less than .05 but due to marginally less value it is construed that it is almost equal to .05 .So, the Null Hypothesis is accepted

EV/CE

Situation	MEAN
Pre – merger	3.8000
Post- merger	3.6280
Correlation coefficient	- 0.039

Analysis of t – Test and WILCOXON test:-

	Based on t – test	Based on Wilcoxon median test	Decision
p-value	0.695	0.500	Retain the Null hypothesis

The calculated p value of t- test is .695 and Wilcoxon test is .500 (at 5% level of significance). Since the calculated p values are more than or equal to 0.05, the Null Hypothesis is accepted.

M CAP / SALES

Situation	MEAN
Pre – merger	6.9800
Post- merger	7.5160
Correlation coefficient	0.213

Analysis of t – Test and WILCOXON test:-

	Based on t – test	Based on Wilcoxon median test	Decision
p-value	0.477	0.500	Retain the Null hypothesis

The calculated p value of T test is .477 and Wilcoxon test is .500 (at 5% level of significance). Since the calculated p values are more than 0.05, the Null Hypothesis is accepted.

DISCUSSION

The comparison of pre-merger and post-merger performance ratios shows that in case of price to book value, EV/Net Sales ratio, EV/EBITDA ratio, EV/EBIT ratio, EV/CE ratio and Market Cap to Sales ratio there was no significant difference between the pre-merger and post-merger performance ratios. This

has been validated by the paired t- statistics at 5% level of significance. However, in case of adjusted price to earnings ratio, there is significant fall from the pre-merger to the post-merger ratios. Positive correlation testifies to the fact regarding the interlinkage between pre and post-merger results. While negative ratios denies such linkage.

One possible reason for the failure to reject the null hypotheses could be the low number of observations considered for the event study.

Sun Pharma had followed a strategy of acquiring poorly performing companies and turning them around. Hence, the success of the deal depended on how quickly Sun Pharma was able to resolve the regulatory issues of Ranbaxy, improve the operating margins of Ranbaxy and achieve the synergies. Given the large diversified operations of Ranbaxy and potential synergy benefits, the transaction seemed to be more value accretive for Sun Pharma shareholders.

The company bought distressed assets across the globe and turned them around to not only add to its books but also its product pipeline and regions. But as it turned out later, Sun Pharma underestimated problems in case of this latest acquisition both in terms of cost of compliance and time.

The deal had reaped the benefit in the market price as Sun Pharma stock price after the date of announcement of merger with Ranbaxy till the record the date of merger. However, subsequent fall therefrom resulted from the hit on profit for F Y 2015-16 which eroded the gains which were seen as being due to the merger for the shareholders of Sun Pharma. Post-merger, the stock was trading at the normal return of Sun Pharma which had been yielded in the last two previous years.

CONCLUSION

Mergers have been the prime reason by which companies around the world have been growing. The inorganic route has been adopted by companies forced by immense competition, need to enter new markets, saturation in domestic

markets, thrust to grow big and maximize profits for shareholders. In the changing market scenario it has become very important for firms to maximise wealth for shareholders.

This study shows that the acquiring firm was not able to create enough wealth for shareholders post acquisition.

One of the key objectives behind the merger was to expand Sun Pharma's presence in the US market through leveraging Ranbaxy's network. However, during the period, its contribution from the US market had come down by 33%. Intense competition in the US market leading to price war significantly reduced revenues for Sun Pharma. Post-merger, Sun Pharma got riddled into various legal and operational compliance defaults. Intense competition in the US market leading to price war significantly reduced revenues for Sun Pharma.

Sun Pharma's strategy of growth by becoming a global leader got hindered with many macro factors affecting the pharma sector with legal hurdles faced by the company leading to lacklustre performance. ROCE became considerably low which did not allow the company to repay debt. One of the key objectives behind this merger was to accelerate growth & create value for the stakeholders. However, Sun Pharma could not integrate Ranbaxy as it was busy in solving macro factors. Though the management claimed that the company had achieved the targeted synergy benefits amounting to \$ 300 million in FY 18, a huge cultural difference had resulted in an increase in the cost of operations, mainly employee costs, for Sun Pharma. In addition to this, corporate governance issues resulted in worsening the situation for Sun Pharma

SCOPE FOR FURTHER STUDIES

Mergers and acquisitions has been an emerging area for research in the field of finance. In India, the subject has not been well explored. Comparatively fewer studies relating to impact of mergers and acquisitions have been done in India. The relationship between pre-merger returns and post- merger returns may be examined further empirically. Earlier studies show that the

incidence of the Indian entrepreneurs acquiring the foreign company was not so common. But now the situation has changed and the acquisition of foreign companies by the Indian companies has been the latest trend. Studies may be carried out on identifying generic and sector-specific factors which have causal effect of value creation through M&As in India and the complex relation between them.

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