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Date : 21-06-2010

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The perils of betting on 'takeover' news

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Looking for a magic spell to revive market interest in a moribund stock or an out-of-favour business? Just breathe the two words — 'stake sale'. Many beaten-down stocks have made a remarkable recovery in recent months on takeover speculation — whether it is Bajaj Finserv in 'talks' with Berkshire Hathaway, Spicejet seeking suitors or the promoters of Pipavav Shipyard scouting for buyers.

To add to all this, the thaw in hostilities between the Ambani brothers has also unleashed a storm of speculation.

Reliance Communications is said to be 'contemplating' a stake sale to a foreign partner and Reliance Industries on the prowl for acquisition targets. Both brothers are said to be shopping for stakes in listed businesses ranging from shipyards to television serial-makers.

What are the odds?

Given that takeover news usually sets off a vertical climb in the target's stock price, investors may be tempted to buy into such news. However, doing so is fraught with risk. To start with, for every rumoured takeover that actually materialises, there are a good number that don't.

Sifting through the news flow in the past six months throws up scores of instances of stocks — Karuturi Global, EIH, Bajaj Finserv, Patni Computers — which hit new highs on 'stake sale' news, only to fizzle out when nothing concrete came through. In some cases, takeover rumours persist even after they have been hotly denied by the company.

Or they simply take on a new form! Take the recent case of Reliance Communications. The stock began its vertical climb on May 24, after the Ambani brothers announced plans to scrap their non-compete agreements.

First, it was talk of the Etisalat group 'eyeing' a stake in the company at a hefty premium to market prices; then the identity of the potential acquirer changed to AT&T.

The company's Board too helpfully passed a resolution authorising a 26 per cent stake sale, not mentioning any potential acquirer or price. Reports are now suggesting that the company plans to sell a stake in its

tower arm, after it demerges it into a separate company.

No doubt, Reliance Communications may have to eventually tap one of these options to raise the cash it needs to bankroll its plans. But there is still plenty of uncertainty attached to when and at what price this will happen. That may hold the key to whether the 40 per cent rise in the stock price in less than a month, is warranted.

What price

That brings us to the second big 'if' attached to betting on takeover news – the deal price. Even if reports about a company selling an equity stake do come good, what matters to investors is the price at which the deal is finally inked.

If stock prices soar too much in the run-up to a deal, the acquirer may balk at paying the stiff valuation for the company. That could result in the negotiations falling through or in the deal being clinched at prices well below the prevailing market price. Either event would mean significant downside risk to investors in the stock.

Thanks to a fragmented shareholding, the Spicejet stock has been dogged by takeover speculation for over two years now, with entities ranging from Kingfisher Airlines to the Anil Ambani group rumoured to be in talks with the airline. When a deal finally came through last week, it was with Kal Airways — associated with Mr Maran of Sun TV.

The market actually marked down the stock on the announcement, as Mr Maran picked up the stake at a sizeable 16 per cent discount to the prevailing market price. Not so long ago, Pipavav Shipyard, also the object of persistent rumours saw its cash-strapped stakeholder — Punj Lloyd exit at a sizeable discount to the market price. The lessons from such instances are clear. With India Inc still in a cautious mood, not all buyouts need to happen at a hefty premium to the market value for the business. So if you're looking to bet on a stock just because news reports mentioned a fancy deal 'price', best take them with a pinch of salt and stay away.

Pricing apart, the structure of the deal too will decide whether investors make a windfall gain or lose their shirt.

Shape of the deal

Given that takeover 'news' is usually based on unauthorised leaks from company or merchant banking sources even as negotiations are on, there can be a vast difference between the final contours of the deal and what was speculated. There can no better illustration of this than the recent case of Piramal Healthcare.

Speculation about the company selling a stake to a multinational company at a stiff premium with an open offer to follow, had pushed the stock price up by nearly 25 per cent in the five weeks leading up to May 20. However, the details of the deal when they were announced on May 21, came as a shocker to the markets. Instead of a stake sale, the company announced the sale of its formulations division and assets, contributing over half of its revenues, to Abbott Labs.

Though the sale fetched a handsome price, the stock was swiftly de-rated to adjust for the loss of a key money-spinner. After plunging 12 per cent on the day of the announcement, the stock has declined further to wipe out all the gains put on before the deal.

Not all the 'stake sale' stories circulated in the markets may end this way. However, the above instances do drive home the risks of adding a stock to your portfolio without paying attention to the prospects for the underlying business or the price you are paying.

Takeover news can be a trigger for an undervalued stock to get noticed on the bourses; but don't rely on it to prop up an undeserving business with lacklustre prospects for any length of time.