RESOURCE PAPER

Vedanta PLC's acquisition of Cairn India Ltd

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Vedanta PLC - Brief

Vedanta Resources is a FTSE 100, London Stock Exchange listed, globally diversified natural resources major with interests in Zinc, Lead, Silver, Copper, Iron Ore, Aluminium, Power and Oil & Gas.
Their exploration portfolio from all the four continents follows a history of consistent geological discovery. With a business model of growth, constant value creation and improved operations, the company's vision is focused towards building the wealth of the shareholders.

Cairn India Ltd - Brief

Cairn Energy, an unknown British oil company till 2003, got a golden opportunity to mint money, as Royal Dutch Shell, a British oil company probably made an injudicious decision to exit from the oil blocks in Rajasthan (India). Cairn Energy bought the oil blocks for a meager $7 million and is minting a return of about $7 billion in seven years, approximately a return of 1000 times.

Cairn India is amongst the world's fastest-growing independent oil and natural gas exploration and production companies, with 1.3 bn boe of gross proved and probable reserves and resources as of 31 March 2013 and 205,323 boepd of average operated production in FY2013 – which contributes 25% to India's domestic crude oil production. The company combines a world-class asset portfolio with proven expertise across exploration, development and production. It delivers best-in-class production growth with one of the lowest operating costs to create significant value for all stakeholders. To date, Cairn India has opened 3 frontier basins with over 40 discoveries, with 26 in Rajasthan alone. Cairn India has a portfolio of 9 blocks - one block in Rajasthan, which contains multiple assets, two on the west coast and four on the east coast of India and one each in Sri Lanka and South Africa. Oil and gas is currently being produced from Rajasthan, Ravva and Cambay.

Deal Rationale

"A move into oil would be a very strange shift away from Vedanta's core business of developing mines and smelters, with their primary commodity exposure being base metals and iron ore," Credit Suisse wrote in a note to investors. "We therefore struggle to see any strategic fit or synergies." No one was able to understand this move of Mr Agarwal to move into Oil & Gas..

"Now we feel like a complete organization providing end to end energy solutions across mineral and energy assets……." – Mr Agarwal. In the hindsight, it looks to be a perfect merger of two different verticals of business co-existing in a group to complete the identity of this group.

Due Diligence

There is no provision under the Takeover Code, or any other law in force in India, that require due diligence to be conducted on a target company. Accordingly, there is no obligation on the target company to comply with any requests for documents made by the acquirer, unless agreed under contract and subject to the restriction on disclosures of non-public, price sensitive information under the SEBI

(Prohibition of Insider Trading) Regulations 1992. However, in case of competitive bids, the target company must provide the competitive acquirer with all information and assistance provided to the original acquirer (*Takeover Code*).

Generally, an investor may want to inspect the following:

- ***Financial Due Diligence*** – done extensively by investment bankers on behalf of Vedanta for determining the financial strength and statements, especially for various geography statement of affairs
- ***Legal Due Diligence*** – done on continuing basis by Latham & Watkins Lawyers on behalf of Vedanta, especially for understanding transferability of Cairn, taking majority control and whether permissions needs to be sought from GOI and other owners
- ***Commercial Due Diligence*** - done on a regular basis incorporating operational efficiencies and how best it will fit worth Vedanta group, how best it will add to profitability of the multi-0dimensional group
- ***Environmental Due Diligence*** – was conducted by Investment bankers on behalf of Cairn Energy to seek required permissions from Environment Ministry and to see if there are any potential violations/ glitch
- ***Security Due Diligence*** – was conducted by Vedanta especially in view of various Litigations on Vedanta group for minor and serious defaults across geographies
- ***External Due Diligence*** - was conducted by both parties especially since Bilateral Treaty was involved and any unfavorable outcomes therein would have impacted relations of both Governments.

Valuation

The initial offer price was Rs.405 per share including the controlling premium or non-compete fee which is a 32% premium to Cairn India's average closing price over 90 days. This included Rs.50 per share non-compete premium for Cairn Energy not entering into the oil and gas business in India, Pakistan, Bhutan and Sri Lanka. it works out to EV/barrel of oil equivalent price of USD 11, which is a 15% discount in terms of what international majors traded at. All international companies are basically trading at an enterprise value per barrel of the equivalent (EV/BOE) of anywhere between USD 14 to USD 17.

However, post the SEBI's severe warning against non-compete fees in view of new SEBI Takeover Code Guidelines just on the anvil, the deal price was decided at Rs355 per share – which valued Cairn at over Rs67,355 crore, or $14.6 bn, EV/ BOE of USD 10

Regulatory Clearance

- Since it was Foreign Direct Investment, first and foremost clearance was sought from DIPP – it was satisfying the existing sectoral caps – however transferability of Cairn was an issue as it was a license holder in the assets and not the owner
- Next, Valuations were required by an independent CA or a SEBI registered Merchant Banker according to DCF methodology
- Since Cairn India Ltd was a listed company, next permission was required by SEBI and clearance from other shareholders like Cairn Energy, ONGC and other minority shareholders
- SEBI strongly denied Non – compete fees and Cairn had to tweak the valuation to incorporate the same. Also, SEBI denied its permissions for the Put – Call options that were incorporated in Share Purchase Agreement, which was also changed to incorporate SEBI's negative stand
- Oil Ministry permissions had to be sought for transferring of rights in Cairn India Ltd – which gave a conditional clearance that Cairn would withdraw the ongoing arbitration against paying of Cess and would accept to pay royalties from the Production of current fields
- Law Ministry permissions were sought to bring clarity that transfer of Cairn India Ltd did not tantamount to transfer of rights in licenses o the assets

- ONGC permissions were sought since it was decided that ONGC being partner in majority of Cairn's assets had a ROFR and it would not give clearance to the deal unless cess and royalty issues were sorted and accepted by Cairn
- Shareholders including Cairn Energy voted in favour so also minority shareholders of Cairn India Ltd for open offer and acquisition of Cairn India Ltd
- Home Ministry clearances especially not to jeopardize India assets in view of various litigations on Vedanta
- Environment Ministry clearance for continuation of CSR and minimizing environmental impact of its continued operations
- RBI permissions for transfer of monies and shares since it was all cash deal – also SPA included Break fees to be payable by Cairn India Ltd in the event of cancellation of the deal
- The Takeover Code does not draw any distinction between domestic and foreign acquirers. A foreign acquirer must comply with the pricing guidelines set out under the FDI Policy, in addition to the pricing guidelines under the Takeover Code.
- In addition, there are certain procedural and reporting requirements under the FDI Policy which must be complied with by the target company when it receives consideration from a foreign acquirer

Pre-conditions

- Break fees - Although Indian law does not provide for break fees or reverse break fees, the acquirer and the target company or the selling promoter group can contractually agree to such fees. Generally, break fees and reverse break fees are not common in India. An amount equal to 1% of the market capitalization of Vedanta at the close of business in London on the Business Day prior to the announcement of the terms of the transactions envisaged by this Agreement - £1 was included as Break Fees in this transaction
- Some other general clauses included right of exclusivity and no-shop clauses

Other pre-conditions imposed by Indian regulators subject to which the deal was given a green signal were:

- Arbitration, which is ongoing between Cairn India and the ministry of petroleum in UK (cess arbitration) is to be withdrawn by Cairn India, and Cairn India has to agree to pay the entire cess tax, which annually is around Rs250 crore
- Concede to ONGC's stand that the royalty to be paid for the Gujarat project should be equally borne by Cairn India (royalty argument). This may further increase the burden by Rs1,400 crore
- Guarantee that technical capability of Cairn India is kept undisturbed failing which the government of India is entitled to change the operatorship
- Vedanta will provide "the parent financial and performance guarantee besides ensuring adherence to approved field development plans" in respect of the 10 oil and gas blocks being transferred to it under the deal
- Clearance to the Cairn-Vedanta deal is subject to "necessary security clearance by the ministry of home affairs to Vedanta Resources to acquire the shareholding

Potential Deal Breakers

During through Due Diligence, acquirer side diligence pointed that cess and royalty issues could be the only threat and prove to be potential deal breakers – the financial impact of which was to be covered by reducing valuations effectively and also covered under break fees

Vendor due diligence was only the security issues due to litigations on Vedanta because of which the deal could not have got a clearance in India, however they could have sought redress under the Bilateral treaty BIPA between India and UK

Funding of the Deal

A) ***Under original purchase price consideration of Rs405 a piece:***

- Transaction consideration of US$8.5bn to US$9.6bn
- Payable on completion (expected by Q1 2011)

Funding

- Vedanta Resources: bank debt facilities of up to US$6.5bn, ≥ 2 year tenure
- Sesa Goa: c. US$3bn, primarily from cash resources Payable on completion (expected by Q1 2011)
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B) ***Final consideration at Rs355 a piece:***

Description	Date	Sesa Goa	Vedanta Plc	Total %
Purchase from Petronas	19.04.11	10.40%	-	10.40%
Open offer	30.04.11	8.10%	-	8.10%
Purchase from Cairn Energy	12.07.11	-	10.00%	10.00%
Purchase from Cairn Energy	07.12.11	1.50%	28.50%	30.00%

Consideration	**$ bn**
20% stake acquired by Sesa Goa	2.88
38.5% stake acquired by Vedanta	5.79
Total consideration	**8.67**

Funding	
Sesa Goa - own resources	2.88
Sr. Secured Bank Term Loan - Tranche A (18 months)	1.47
Sr. Secured Bank Term Loan - Tranche B (36 months)	1.31
Bonds (Maturing 2016 and 2021)	1.65
Own Cash	1.36
Bridge to Equity – never drawn, cancelled	0
Vedanta plc – Total	**8.67**

Post Deal Integration

Deal integration was a smooth transition, with few changes in Board representation and core activities of Cairn, DGH approvals followed for revised FDPs for its Rajasthan fields and cess and royalty payments smoothened out. However a few key management personnel exited post the deal integration like Sir Gammell, Mr. Rahul Dhir and Mr. Indrajeet Banerjee. However, this is more perceived as a passing transition towards new business opportunities rather than exits due to any post deal conflicts.

Left stake

Cairn Energy is left with 10.3% residual stake in Cairn India Ltd after this deal and had an intention to continue holding it as it had no reason for exiting this business completely. Also, it completely matched with their global oil and gas business holding stake in assets in India to their portfolio. However, off late due to large regulatory and compliance issues, it has been learnt that Cairn Energy is in a dialogue to exit the company totally.

Further synergies

Of course the congruence with its current portfolio of Zinc, Lead, Silver, Copper, Iron Ore, Aluminium and Power was completed by addition of this prestigious Oil asset. Apart from adding tremendous synergies of being a total energy solution provider – it gave Vedanta a clean chit to operate an existing and successful business in India – which it is not able to do with its other assets.
However, one more rather significant synergy that comes post the deal is metals group will be the owner of the Cairn brand both in India and abroad as and when the London-based Cairn Energy's holding in Cairn India slips below 10%.

When a foreign company sells its local business it usually retains the corporate name or leases out the name to the new entity for a limited period. However, Vedanta will get to keep the Cairn brand as the British oil explorer, founded by former international rugby player Bill Gammell, licensed the brand to Cairn India when the local unit was gearing up for its initial public offering in 2006. The complete ownership of the Cairn brand would, therefore, help Agarwal leverage the brand name not just in India but also for the oil explorer's international expansion – which is a significant leverage….!!!