

# Rising from the flames



## Peter Brudenall explains how 'Mahindra Satyam' was born and identifies key lessons the transaction holds for dealmakers, legal advisers and regulators

**O**n 7 January Ramalinga Raju, the chairman of Satyam Computer Services, stunned markets when he confessed that the company's financial statements had been manipulated for years. Raju sent a letter to Satyam's board, stating that the bulk of the assets reported in Satyam's second quarter earnings report – some 50.4 billion rupees (US\$1.04 billion) – was fictitious. Raju further admitted that Satyam had inflated its revenues, operating margin and accrued interest, and had understated its liabilities.

Founded in 1987, Satyam had been one of India's top IT performers, with over 45,000 employees and strategic technology and marketing alliances with no less than 50 companies.

The company plunged into crisis after what appears to have started as a small gap in the financials got out of hand. "It was like riding a tiger," Raju wrote, "not knowing how to get off without being eaten." What further shocked analysts was that the fraudulent balance sheets and accounts had been audited by respected international accountancy firm PricewaterhouseCoopers.

Raju's disclosure led to a short-term meltdown of Indian IT stocks. Satyam's stock tumbled by over 70% and sent the index of the Bombay Stock Exchange down by 7.3%. There were fears that Raju's confession might be only the

first in a series of nasty revelations of failures in Indian corporate governance.

CB Bhavé, the chairman of India's capital markets regulator, the Securities and Exchange Board of India (SEBI), described the financial wrongdoing in Satyam as an event of "horrifying magnitude". It remains the largest case of corporate fraud in Indian history.

### Defying expectations

In April another Indian-based technology company, Tech Mahindra, successfully bid for Satyam. Following the takeover, Satyam – rebranded "Mahindra Satyam" – defied all predictions of collapse. It had a resurgent share price after posting solid financial details for the first quarter of 2009.

While these are still early days for assessing the impact of the Satyam scandal, it is clear that initial fears of lasting damage to the Indian outsourcing sector have eased, and that Satyam as a company appears far more capable of continuing to serve its still-considerable client base than it did six months ago. For observers of India's outsourcing sector it is a valuable exercise to analyse the government's response to the Satyam crisis. There may well be important lessons for regulators, government bodies and prospective investors in dealing with similar events in the future.

## Government response

In the wake of Raju's confession, the National Association of Software and Services Companies (NASSCOM), the Indian government and SEBI immediately stepped in to stabilise the situation. The fraud had attracted worldwide interest and was quickly dubbed "India's Enron". Most observers believed that Satyam would collapse, with considerable implications for the reputation of the Indian technology and outsourcing sector.

The government recognized the imminent danger. Within days Satyam's entire board was removed and three new directors were appointed: Kiran Karnik, the former president of NASSCOM; Deepak Parekh, head of the Housing Development Finance Corporation; and C Achuthan, a former member of SEBI. The government also moved quickly to replace the firm's auditor, PricewaterhouseCoopers, appointing KPMG and Deloitte to the task.

By February 2009, only a few weeks after the initial revelations, the newly constituted Satyam board had already started reviewing the process for selling the company to a strategic investor. The sale required approval by SEBI, which facilitated and simplified the process by amending the takeover rules for companies having a government-appointed board, allowing them to seek exemption from certain provisions, such as for a mandatory open offer and 26-week average price. (The open offer allows existing shareholders to exit the company by selling equity to the acquirer at a predetermined price.)

In reviewing the process, SEBI consulted with other regulators, including the US Securities and Exchange Commission (SEC), in jurisdictions where Satyam's shareholders were based.

By early March SEBI gave its formal approval to a bidding process that would allow a strategic investor to acquire up to a 51% stake in the company. Bidding started shortly thereafter. The information pack sent to potential investors included details of Satyam's geographical revenue breakdown, the revenue attributable to each of its largest clients (although not their identities), the contract life of major clients and the likelihood of them staying with the company.

The minimum reserve price was understood to be based on Satyam's current gross block (the total value of all its assets) and linked to the previous two weeks' average share price. Significantly, the books were not open for due diligence. In addition, bidders were not allowed to revise their price after submitting their bid, and the new buyer would be required to have a three-year lock-in period.

By mid-March, the line-up of companies which appeared seriously interested in acquiring Satyam included engineering and construction firm Larsen & Toubro (which was already a 12% shareholder in Satyam), Spice Group, iGate and Tech Mahindra. International companies such as IBM were also reportedly eyeing the opportunity.

Not surprisingly, the most difficult issue for the potential buyers appeared to be how to value the company, given the limited information available and the uncertainty surrounding Satyam's financials (including actual revenues, operating margins and receivables), businesses (including the tenure of major contracts and the status of orders) and liabilities.

On 13 April Satyam announced Tech Mahindra as the

successful bidder with its offer of Rs58 per share, or Rs28.89 billion (US\$587 million) for a 51% stake in the company. 31% of the shares were acquired immediately and Tech Mahindra said it would acquire the remaining 20% by 1 July through the open-offer method mandated by the stock exchange. The bid was reportedly 20% higher than that of the next closest, and more than double the lowest.

Tech Mahindra was advised on the deal by Kotak Investment Banking, supported by UBS. P&A Law Offices acted as Indian counsel to Tech Mahindra, while Jones Day acted as US counsel.

Satyam was advised by Goldman Sachs and Aventus. Amarchand Mangaldas acted as Indian counsel to Satyam, while Latham & Watkins acted as US counsel.

## Rising markets spell danger

In early June, as a matter of "good corporate governance and in the interest of full disclosure", Satyam published the financial information it had previously shared only with the selected bidders in March – although it cautioned that the figures given were not audited. As a result, industry observers were given a better feel for the relative strengths of the company, which appeared to be greater than many previously realized.

Satyam announced robust earnings for the fourth quarter of 2008, and a profit of more than 500 million rupees (US\$10.5 million). It also disclosed liabilities of over US\$2.5 billion, including current, contingent and acquisition-related disputes.

The Indian stock market immediately rebounded, facing Tech Mahindra with two equally unappealing prospects: either to pay much more than originally budgeted for the additional 20% it needed to take full control of Satyam, or to maintain a minority stake and risk a hostile bid from a deep-pocketed buyer.

In the original deal announced on 13 April, Tech Mahindra had paid Rs58 (US\$1.23) per share for a 31% stake in Satyam (at a total cost of Rs17.56 billion or US\$354 million) and said it would buy another 20% at the same per share price by 1 July. But much had changed by that date: the benchmark Sensex had gained over 41%, and Satyam's share price had risen to around Rs81.

Few now expect Tech Mahindra's open offer to succeed, especially after its chief executive said the company would not raise the offer price. In early July, it announced that its open offer to the shareholders of Mahindra Satyam received less than 0.1% of the outstanding shares. If the open offer fails, Tech Mahindra is allowed the option of a preferential share issue. Alternatively, it could choose to do nothing and keep its stake at 31%, a risky choice because a healthier Satyam has become far more appealing to other investors than it was before. It would seem it will have little choice but to raise its stake in the company in the short term.

In the regulatory arena the open offer is proceeding more smoothly. It has already received anti-trust approval from the US regulator, Germany's competition regulator, the Federal Cartel Office and India's two leading exchanges, the Bombay Stock Exchange and the National Stock Exchange. (Anti-trust approval in the US was needed because both Satyam and Tech Mahindra have technology outsourcing work there, and because Satyam is listed on the NYSE.)

## Bidding process raises difficult questions

The Satyam bidding process – especially the alterations to SEBI's rules that facilitated it – raises questions that go beyond the company and the infamous fraud perpetrated by its promoter. Normally SEBI's takeover code ensures that investors in a target company receive an offer price that factors in market valuations. By contrast, the waivers that SEBI granted to expedite the sale of Satyam removed both the market linkage and the scope for a rival bid.

Investors have been left with an open offer price that is based only on the bid price – which, it can be argued, was a “distress price”. Not only did the sale involve a scandal-hit company, it occurred in the context of a severe liquidity crunch and at a time when the IT sector was at its most turbulent – factors likely to have reduced the number of serious bidders. Further limitations were placed on the successful bidder, such as a ban on the further sale of any assets owned by Satyam over the following two years, with the entire shareholding subject to a three-year lock-in.

Investors in Satyam may have received a better deal if the sale of the company had been finalized after its financial details, however provisional, were made public. Against this possibility stands the argument that the government should act quickly by loosening the regulatory conditions of sale in order to provide stability to Satyam as soon as possible.

## Unresolved disputes

A critical issue faced by the bidders undertaking due diligence on Satyam was the extent of its exposure to significant liabilities. Among these are class action lawsuits, still ongoing, that arose following Raju's resignation. Several people in the US, claiming to have invested in the company's securities in the previous five years, launched class actions against the company and others, including its directors and certain former officers.

Another concern was litigation involving a UK company called Upaid. Upaid is a privately held company registered in the British Virgin Islands for which Satyam Enterprise Solutions (a Satyam subsidiary) executed a software development project relating to mobile prepaid technology between 1997 and 2002. Satyam received payment of US\$10 million, which was partly made in shares due to Upaid's inability to pay cash.

Wishing to patent the technology for which the software coding had been performed by Satyam, Upaid needed to obtain the signatures of the 20 Satyam employees who worked on the project, in order to complete assignment of intellectual property rights in the software. Satyam helped Upaid achieve this, though some of those employees had by then moved out of the company.

Armed with the patent, Upaid filed suit against Qualcomm and Verizon Wireless in 2005, alleging that they were using the patented technology. However, one of the original Satyam project employees, who was by then working at Verizon, identified his supposed signature on the patent application as a forgery. This revelation forced Upaid to retreat, and in 2007 it filed a suit against Satyam accusing it of forgery and fraud, seeking over US\$1.1 billion in damages.

The Upaid case is likely to come up for hearing in a Texas court later this year, although it may also be put through mediation. It appears that all bidders were provided with complete information on the case, including the opinion of Satyam's US lawyers.

In addition to these liabilities, promoters of three companies that Satyam acquired in the past have served legal notices seeking termination of the asset purchase pacts or asking for guarantees on payments due under the buy-out agreements. In a disclosure to the stock exchanges, Satyam said it was involved in acquisition-related disputes pertaining to companies such as Caterpillar Inc (Satyam had announced its intention to buy the latter's market research and customer analytics business unit in April 2008 for a total consideration of US\$60 million), Bridge Strategy Group (a Chicago-based strategy and general management consulting firm that Satyam intended to acquire for US\$35 million) and S&V Management Consultants (a Belgium-based supply chain management consulting firm whose acquisition price tag was US\$31.4 million).

In at least two of these cases, Satyam has entered into negotiations to resolve outstanding issues.

## The road ahead

With the purchase of Satyam, Tech Mahindra is now set to figure among the top five players in information technology services in terms of revenue, market capitalization and size of workforce. Satyam should bring to Tech Mahindra new capabilities in enterprise resource planning, systems integration and vertical expertise in the embedded, manufacturing and insurance industries. While Tech Mahindra does face the twin risks of high dependence on BT (British Telecom), its part owner and major client, and excessive concentration on the telecoms sector generally, both BT and non-BT revenues have increased.

Retaining the services of Satyam's 50,000 employees will be of prime concern to the new owners. Up to 3,500



**MARKET FLUCTUATIONS:** Satyam's volatile share price has been a blessing and a curse for Tech Mahindra.

