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‘Do’ Diligence Case Study: January 2013

Caveat Emptor: Caterpillar’s Acquisition of ERA in China

SUMMARY

- **November 2011:** Global mining and construction equipment company Caterpillar launched tender offer for Hong Kong-listed ERA Mining Machinery (‘ERA’) and subsidiary Zhengzhou Siwei (‘Siwei’) in China.
- **June 2012:** Caterpillar closed purchase of ERA and Siwei for HK$5.06bn (US$653m).
- **November 2012:** During integration process, Caterpillar uncovered discrepancy between Siwei’s physical inventory and inventory recorded in accounting records, prompting deeper look into Siwei.
- **January 2013:** Caterpillar took impairment charge of US$580m (89% of purchase price) on investment completed <8 months earlier because of accounting misconduct. Well known advisors and auditors on both sides missed (or ignored) many obvious red flags. Caterpillar defended due diligence as, “We believe our process is rigorous and robust...Siwei was a publicly traded company with audited financial statements.”
- For several years prior to the acquisition, Siwei managers overstated ERA’s profitability. Improper cost allocation overstated profits. Improper (early and unsupported) revenue recognition.

RED FLAGS MISSED

- **Public Listing via Reverse Takeover:** ERA obtained Hong Kong listing in 2010 using reverse takeover, which bypasses more stringent IPO regulatory hurdles.
- **Board of Directors Distracted:** A member of Caterpillar’s Board during the Siwei deal told Reuters the Board was distracted at the time by a larger transaction and paid relatively little attention to the ERA/Siwei acquisition. "It was presented as a pretty straightforward transaction. It should have been investigated further."
- **Unusual Transactions:** Directors lent ERA money at high interest rates and asset-shuffling between Siwei and related parties.
  - Why did ERA need to borrow >US$9.5m from 4 directors, who earned ≈US$500k in interest, at loan rates among the most expensive on ERA’s balance sheet?
  - Siwei disposed of business valued at ≈US$5m at "nil consideration" to a company in which a Siwei director and former substantial shareholder had taken majority stake 4 months earlier. ERA stated assets were loss-making, yet according to regulatory filings, continued to purchase millions of dollars worth of equipment and services from the same firm between 2007 and 2009, paying an average of 2% - 4% above the market rate for the "better quality services provided"..
  - Siwei transferred 7.5% stake in mining equipment firm to one of its partners to offset "trade payables".
- **Working Capital Crisis - Account Receivables Grew Much Faster Than Sales:** Siwei’s ARs grew 58% a year since 2008, and 37% between 2010 and 2011, overtaking total sales in 2011 - i.e. customers owed more than a year's worth of revenue. Sales growth was just 10% in 2011. ≈90% of these debts were overdue when Caterpillar launched its bid. ERA’s impressive revenue growth rested on rapidly increasing credit to buyers. At the same time, ERA was quickly burning cash.
- **Collecting Account Receivables 2x Industry Average:** ERA often took 180 days to collect payment, 2x the industry average. Sales were boosted only by extending credit and better terms to customers to compete with state-owned rivals. ERA stated in filings some debts were collected once its products were installed, but customers often did not inform it when this happened.
- **Unsold Goods Grew At Alarming Rate:** Bespoke machinery normally remains on the books longer than mass-produced products. However, Siwei’s stocks were rapidly increasing. At end of 2010, products/materials were in storage for average of 414 days, 2x as long as during China’s slowdown in 2009. Value of inventory increased 234% from 2010 to 2011.
- **Low Profits or Losses and High Debt:** ERA was losing money at time of the acquisition and had debt of >US$200m. In 2007, pre-tax profit was HK$14.4m (US$1.9m). In 2009, pre-tax profit rose >10x to HK$157m (US$20m). Shortly after Caterpillar launched offer, ERA issued profit warning in March 2012. In April 2012, ERA reported full-year loss of HK$10.3m (US$1.3m).
- **Valuation Priced To Perfection:** Caterpillar’s acquisition was bet on China’s infrastructure boom. End of 2011 marked beginning of slide in China’s machinery market with slowing construction activity and lower coal prices led to lower equipment. Caterpillar paid 33% premium above ERA’s stock price before acquisition was announced.

Sources: CKB Solutions research & analysis, Caterpillar, Financial Times, Forbes, Reuters, Wall Street Journal

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