

Mergers, Acquisitions & Restructuring

Learning Objective

After going through the chapter student shall be able to understand

- Introduction
- Reasons and Rationale for Mergers and Acquisitions
- Gains from Mergers or Synergy
- Accounting for Amalgamations
- Problems for M & A in India
- Mergers in specific sectors
- Acquisition and Takeover
- Takeover by Reverse Bid
- The Acquisition Process
- Defending a company in a takeover bid
- Legal Aspects of M & As
- Due Diligence
- Target Valuation for M & As
- Corporate Restructuring
- Financial Restructuring
- Merger Failures or Potential Adverse Competitive Effects
- Acquiring for shares
- Cross-Border M&A
- Decade of Corporate Churning and Change

1. Introduction

The most talked about subject of the day is Mergers & Acquisitions (M&A). In developed economies, corporate Mergers and Acquisition are a regular feature. In Japan, the US and

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Europe, hundreds of mergers and acquisition take place every year. In India, too, mergers and acquisition have become part of corporate strategy today.

Mergers, acquisitions and corporate restructuring business in India have grown by leaps and bounds in the last decade. This tremendous growth was attributed to the fact that the foreign investors were looking for an alternative destination, preferable a growing economy as their own country was reeling under the pressure of recession. This was caused by the tough macro economic climate created due to Euro Zone crisis and other domestic reasons such as inflation, fiscal deficit and currency depreciation.

The terms 'mergers; 'acquisitions' and 'takeovers' are often used interchangeably in common parlance. However, there are differences. While merger means unification of two entities into one, acquisition involves one entity buying out another and absorbing the same. In India, in legal sense merger is known as 'Amalgamation'.

The amalgamations can be by merger of companies within the provisions of the Companies Act, and acquisition through takeovers. While takeovers are regulated by SEBI.M & A deals fall under the Companies Act. In cross border transactions, international tax considerations also arise.

Halsbury's *Laws of England* defined amalgamation as a blending of two or more existing undertakings, the shareholders of each **amalgamating** company becoming substantially the shareholders in the **amalgamating** company. Accordingly, in a merger, two or more companies combine into a single unit.

The term "amalgamation" is used when two or more companies are amalgamated or where one is merged with another or taken over by another. In *Inland steam Navigation Workers Union vs. R.S. Navigation Company Ltd.*, it was observed that in case of amalgamation, the rights and liabilities of a company are amalgamated into another so that the transferee company becomes vested with all rights and liabilities of the transferor company.

An **acquisition** is when both the acquiring and acquired companies are still left standing as separate entities at the end of the transaction. A **merger** results in the legal dissolution of one of the companies, and a **consolidation** dissolves both of the parties and creates a new one, into which the previous entities are merged.

Corporate takeovers were started by Swaraj Paul when he tried to takeover Escorts. The other major takeovers are that of Ashok Leyland by the Hindujas Shaw Wallace, Dunlop, and Falcon Tyres by the Chabbria Group; Ceat Tyres by the Goenkas; and Consolidated Coffee by Tata Tea. The BIFR arranged for the takeover of companies by giants like ITC, McDowells, Lakshmi Machine Works, and the Somani Group.

Many new companies are being incorporated as a result of the fast growing industrialisation of the country which is mainly dependent on agriculture. With the new trends of globalisation, not only in this country but also worldwide, there has been increasing interaction of companies and persons of one country with those of other countries. Today, corporate restructuring has gained momentum and undertakings and companies are merging, demerging, divesting and taking in or taking over companies and undertakings, both unregistered and registered, in India and outside.

Against this corporate backdrop, mergers and acquisitions have to be encouraged in the interest of the general public and for the promotion of industry and trade. At the same time the government has to safeguard the interest of the citizens, the consumers and the investors on the one hand and the shareholders, creditors and employees/workers on the other.

Chapter XV (Section 230 to 240) of Companies Act, 2013 (the Act) contains provisions on 'Compromises, Arrangements and Amalgamations', that covers compromise or arrangements, mergers and amalgamations, Corporate Debt Restructuring, demergers, fast track mergers for small companies/holding subsidiary companies, cross border mergers, takeovers, amalgamation of companies in public interest etc.

Special restructuring processes such as 'Reconstruction' of sick industrial companies envisaged by the Sick Industries (Special Provisions) Act, 1985 and 'Revival' of financially unviable companies envisaged by sec 72A of the Income Tax Act, 1961. However, all such mergers and acquisitions are also governed or controlled through relevant provisions of the Foreign Exchange Management Act, 1999; Income Tax Act, 1961; Industries (Development and Regulation) Act, 1951, the Competition Act 2002; the restrictions imposed by other relevant Acts including SEBI Act, 1992, as the case may be.

Amalgamation signifies the transfer of all or some part of the assets and liabilities of one or more than one existing company to another existing company or of two or more existing companies or to a new company, of which transferee company or all the members of the transferor company or companies become, or have the right of becoming, members and generally, such amalgamation is accomplished by a voluntary winding-up of the transferor company or companies.

Under an amalgamation, merger or takeover, two (or more) companies are merged either *de jure* by a consolidation of their undertakings or *de facto* by the acquisition of a controlling interest in the share capital of one by the other or of the capital of both by a new company.

Amalgamation is a state of things under which either two companies are so joined to form a third entity or one is absorbed into or blended with another."

"Generally, where only one company is involved in a scheme and the rights of the shareholders and creditors are varied, it amounts to **reconstruction or reorganisation or scheme of arrangement**. In an amalgamation, two or more companies are fused into one by merger or by one taking over the other. Amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company become substantially the shareholders of the company which is to carry on the blended undertaking. There may be amalgamation either by the transfer of two or more undertakings to a new company, or by the transfer of one or more undertaking to an existing company. Strictly, 'amalgamation' does not cover the mere acquisition by a company of the share capital of the other company which remains in existence and continues its undertaking but the context in which the term is used may show that it is intended to include such an acquisition."

Types of Mergers

A merger is generally understood to be a fusion of two companies. The term "merger" means and signifies the dissolution of one or more companies or firms or proprietorships to form or

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get absorbed into another company. By concept, merger increases the size of the undertakings. Following are major types of mergers:

- (i) **Horizontal Merger:** The two companies which have merged are in the same industry, normally the market share of the new consolidated company would be larger and it is possible that it may move closer to being a monopoly or a near monopoly to avoid competition.
- (ii) **Vertical Merger:** This merger happens when two companies that have 'buyer-seller' relationship (or potential buyer-seller relationship) come together.
- (iii) **Conglomerate Mergers:** Such mergers involve firms engaged in unrelated type of business operations. In other words, the business activities of acquirer and the target are neither related to each other horizontally (i.e., producing the same or competing products) nor vertically (having relationship of buyer and supplier). In a pure conglomerate merger, there are no important common factors between the companies in production, marketing, research and development and technology. There may however be some degree of overlapping in one or more of these common factors. Such mergers are in fact, unification of different kinds of businesses under one flagship company. The purpose of merger remains utilization of financial resources, enlarged debt capacity and also synergy of managerial functions.
- (iv) **Congeneric Merger:** In these mergers, the acquirer and the target companies are related through basic technologies, production processes or markets. The acquired company represents an extension of product-line, market participants or technologies of the acquirer. These mergers represent an outward movement by the acquirer from its current business scenario to other related business activities within the overarching industry structure
- (v) **Reverse Merger:** Such mergers involve acquisition of a public (Shell Company) by a private company, as it helps private company to by-pass lengthy and complex process required to be followed in case it is interested in going public.

Sometimes, it might be possible that a public company continuously a public traded corporation but it has no or very little assets and what remains only its internal structure and shareholders. This type of merger is also known as 'back door listing'. This kind of merger has been started as an alternative to go for public issue without incurring huge expenses and passing through cumbersome process. Thus, it can be said that reverse merger leads to the following benefits for acquiring company:

- Easy access to capital market.
- Increase in visibility of the company in corporate world.
- Tax benefits on carry forward losses acquired (public) company.
- Cheaper and easier route to become a public company.

2. Reasons and Rationale for Mergers and Acquisitions

The most common reasons for Mergers and Acquisition (M&A) are:

- **Synergistic operating economics:** Synergy May be defined as follows:

$$V(AB) > V(A) + V(B).$$

In other words the combined value of two firms or companies shall be more than their individual value. Synergy is the increase in performance of the combined firm over what the two firms are already expected or required to accomplish as independent firms (Mark L Sirower of Boston Consulting Group, in his book "The Synergy Trap"). This may be result of complimentary services economics of scale or both.

A good example of complimentary activities can a company may have a good networking of branches and other company may have efficient production system. Thus, the merged companies will be more efficient than individual companies.

On similar lines, economies of large scale is also one of the reasons for synergy benefits. The main reason is that, the large-scale production results in lower average cost of production e.g. reduction in overhead costs on account of sharing of central services such as accounting and finances, office executives, top level management, legal, sales promotion and advertisement etc.

These economies can be "real" arising out of reduction in factor input per unit of output, whereas pecuniary economics are realized from paying lower prices for factor inputs for bulk transactions. Other factors for synergy are as follows:

- **Diversification:** In case of merger between two unrelated companies would lead to reduction in business risk, which in turn will increase the market value consequent upon the reduction in discount rate/ required rate of return. Normally, greater the combination of statistically independent or negatively correlated income streams of merged companies, there will be higher reduction in the business risk in comparison to companies having income streams which are positively correlated to each other.
- **Taxation:** The provisions of set off and carry forward of losses as per Income Tax Act may be another strong season for the merger and acquisition. Thus, there will be Tax saving or reduction in tax liability of the merged firm. Similarly, in the case of acquisition the losses of the target company will be allowed to be set off against the profits of the acquiring company.
- **Growth:** Merger and acquisition mode enables the firm to grow at a rate faster than the other mode viz., organic growth. The reason being the shortening of 'Time to Market'. The acquiring company avoids delays associated with purchasing of building, site, setting up of the plant and hiring personnel etc.
- **Consolidation of Production Capacities and increasing market power:** Due to reduced competition, marketing power increases. Further, production capacity is increased by combined of two or more plants. The following table shows the key rationale for some of the well known transactions which took place in India in the recent past.

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Rationale for M & A

Instantaneous growth, Snuffing out competition, Increased market share.	<ul style="list-style-type: none"> Airtel – Loop Mobile (2014) (Airtel bags top spot in Mumbai Telecom Circle)
Acquisition of a competence or a capability	<ul style="list-style-type: none"> Google – Motorola (2011) (Google got access to Motorola's 17,000 issued patents and 7500 applications)
Entry into new markets/product segments	<ul style="list-style-type: none"> Airtel – Zain Telecom (2010) (Airtel enters 15 nations of African Continent in one shot)
Access to funds	<ul style="list-style-type: none"> Ranbaxy – Sun Pharma (2014) (Daiichi Sankyo sold Ranbaxy to generate funds)
Tax benefits	<ul style="list-style-type: none"> Burger King (US) – Tim Hortons(Canada) (2014) (Burger King could save taxes in future)
Instantaneous growth, Snuffing out competition, Increased market share.	<ul style="list-style-type: none"> Facebook – Whatsapp (2014) (Facebook acquired its biggest threat in chat space)
Acquisition of a competence or a capability	<ul style="list-style-type: none"> Flipkart – Myntra (2014) (Flipkart poised to strengthen its competency in apparel e-commerce market)
Entry into new markets/product segments	<ul style="list-style-type: none"> Cargill – Wipro (2013) (Cargill acquired Sunflower Vanaspati oil business to enter Western India Market)
Access to funds	<ul style="list-style-type: none"> Jaypee – Ultratech (2014) (Jaypee sold its cement unit to raise funds for cutting off its debt)
Tax benefits	<ul style="list-style-type: none"> Durga Projects Limited (DPL) – WBPDC (2014) (DPL's loss could be carry forward and setoff)

Amalgamation is effected basically for growth and sometimes for image. Some of the objectives for which amalgamation may be resorted to are:

- Horizontal growth to achieve optimum size, to enlarge the market share, to curb competition or to use unutilised capacity;

- Vertical combination with a view to economising costs and eliminating avoidable sales-tax and/or excise duty;
- Diversification of business;
- Mobilising financial resources by utilising the idle funds lying with another company for the expansion of business. (For example, nationalisation of banks provided this opportunity and the erstwhile banking companies merged with industrial companies);
- Merger of an export, investment or trading company with an industrial company or *vice versa* with a view to increasing cash flow;
- Merging subsidiary company with the holding company with a view to improving cash flow;
- Taking over a 'shell' company which may have the necessary industrial licences etc., but whose promoters do not wish to proceed with the project.

An amalgamation may also be resorted to for the purpose of nourishing a sick unit in the group and this is normally a merger for keeping up the image of the group.

3. Gains from Mergers or Synergy

The first step in merger analysis is to identify the economic gains from the merger. There are gains, if the combined entity is more than the sum of its parts.

That is, Combined value > (Value of acquirer + Stand alone value of target)

The difference between the combined value and the sum of the values of individual companies is usually attributed to **synergy**.

$$\text{Value of acquirer} + \text{Stand alone value of target} + \text{Value of synergy} = \text{Combined value}$$

There is also a cost attached to an acquisition. The cost of acquisition is the price premium paid over the market value plus other costs of integration. Therefore, the net gain is the value of synergy minus premium paid.

$$V_A = ₹100$$

$$V_B = ₹ 50$$

$$V_{AB} = ₹ 175$$

$$\text{Synergy} = V_{AB} - (V_A + V_B) = 25$$

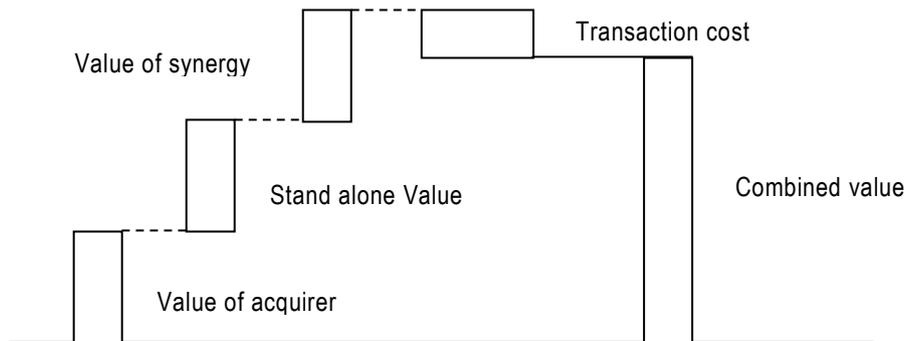
If premium is ₹ 10, Net gain = 25 – 10 = 15

The following depicts the synergy equation. Acquisition need not be made with synergy in mind. It is possible to make money from non-synergistic acquisitions as well. As can be seen from Exhibit, operating improvements are a big source of value creation. Better post-merger integration could lead to abnormal returns even when the acquired company is in unrelated business. Obviously, managerial talent is the single most important instrument in creating

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value by cutting down costs, improving revenues and operating profit margin, cash flow position, etc. Many a time, executive compensation is tied to the performance in the post-merger period. Providing equity stake in the company induces executives to think and behave like shareholders.

Exhibit : Merger gains



Source : Patricia L Anslinger and Thomas E Copeland, 'Growth Through Acquisitions : A Fresh Look', *Harvard Business Review*, Jan–Feb., 1996.

There are five principal steps in a successful M & A programme.

1. Manage the pre-acquisition phase.
2. Screen candidates.
3. Eliminate those who do not meet the criteria and value the rest.
4. Negotiate.
5. Post-merger integration.

During the pre-acquisition phase, the acquirer should maintain secrecy about its intentions. Otherwise, the resulting price increase due to rumours may kill the deal.

Scheme of Amalgamation or Merger

The scheme of any arrangement or proposal for a merger is the heart of the process and has to be drafted with care.

There is no prescribed form for a scheme and it is designed to suit the terms and conditions relevant to the proposal and should take care of any special feature peculiar to the arrangement.

An essential component of a scheme is the provision for vesting all the assets and liabilities of the transferor company in its transferee company. If the transferee company does not want to take over any asset or liability, the transferor company before finalising the draft scheme should dispose it off or settle. Otherwise, the scheme would be considered defective and incomplete and the court would not sanction it.

It is equally important to define the **effective date** from which the scheme is intended to come into operation. This would save time and labour in explaining to the court the intention behind using several descriptions in the scheme. According to an order of the Central Government under Section 396 of the Companies Act, the entire business and undertaking of a transferor company shall be transferred to and vest with the transferee company on the day when it is notified in the Official Gazette. For accounting purposes, the amalgamation shall be effected with reference to the audited accounts and balance sheets as on a particular date (which precedes the date of notification) of the two companies and the transactions thereafter shall be pooled into a common account.

Another aspect relates to the **valuation of shares** to decide the exchange ratio. Objections have been raised as to the method of valuation even in cases where the scheme had been approved by a large majority of shareholders and the financial institutions as lenders. The courts have declared their unwillingness to engage in a study of the fitness of the mode of valuation. A High Court stated: "There are bound to be differences of opinion as to what the correct value of the shares of the company is. Simply because it is possible to value the share in a manner different from the one adopted in a given case, it cannot be said that the valuation agreed upon has been unfair." Similarly, in the case of Hindustan Lever the Supreme Court held that it would not interfere with the valuation of shares when more than 99 per cent of the shareholders have approved the scheme and the valuations having been perused by the financial institutions.

The position of employees also has to be clearly set out. The employment contract is a contract of personal service which may not be transferred by an order of court and may not have an effect of making an employee of the transferor company as an employee of the transferee company. The scheme should provide for the transfer of all employees to the transferee company on the same terms and conditions of service without any break in service. In the event of the transferee company not willing to absorb any of the employees through the merger, the transferor company should settle those employees with applicable law before the scheme is put through.

4. Accounting for Amalgamations

Accounting Standard 14 on *Accounting for Amalgamations*, issued by the Institute of Chartered Accountants of India which came into effect in respect of accounting periods commencing on or after April 1, 1995 is mandatory.

This statement deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves.

The Standard prescribes two methods of accounting for amalgamations namely (a) the pooling of interests method and (b) the purchase method. The pooling of interests method is confined to circumstances which meet the criteria referred to in the definition of the amalgamation in the nature of merger. The object of the purchase method is to account for the amalgamation by applying the same principle as are applied in the normal purchase of assets. This method is used in accounting for amalgamations in the nature of purchase. Under the purchase method,

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the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair value at the date of amalgamation.

The Standard prescribes that if, at the time of amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform accounting policy must be adopted following the amalgamation. (Note: Students are advised to refer to AS-14).

5. Problems for M & A in India

- Indian corporates are largely promoter-controlled and managed. The ownership stake should, in the normal course, inhibit any rational judgment on this sensitive issue. It is difficult for either of the two promoters to voluntarily relinquish management control in favour of the other, as a merger between two companies implies. In some cases, the need for prior negotiations and concurrence of financial institutions and banks is an added rider, besides SEBI's rules and regulations.
- The reluctance of financial institutions and banks to fund acquisitions directly.
- The BIFR route, although tedious, is preferred for obtaining financial concessions.
- Lack of Exit Policy for restructuring/downsizing.
- Absence of efficient capital market system makes the Market capitalisation not fair in some cases.
- Valuation is still evolving in India.

6. Mergers in specific sectors

The Companies Act and the SEBI's Takeover Code are the general source of guidelines governing mergers. There are sector specific legislative provisions, which to a limited extent empower the regulator to promote competition. For example, the Electricity Regulatory Commission has been given powers under the Electricity Act, 2003 to promote competition. Also, in the telecom and broadcasting Regulatory Authority of India (TRAI) Regulate mergers in these sectors and any dispute regarding the same is adjudicated by the Telecom Dispute Settlement Appellate Tribunal (TDSAT). Guidelines for (intra-circle mergers intra-circle mergers means mergers, of telecom service providers within the same geographical area or zone of operation) are also formulated by the TRAI.

In addition to the above authorities, approval may also be required from other sector-specific authorities. Mergers in the banking sector require approval from the RBI.

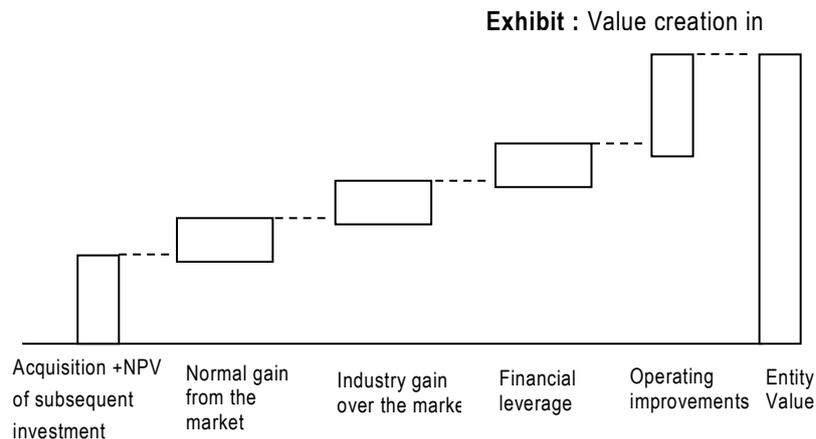
7. Acquisition and Takeover

7.1 Acquisition: This refers to the purchase of controlling interest by one company in the share capital of an existing company. This may be by:

- (i) an agreement with majority holder of Interest.
- (ii) Purchase of new shares by private agreement.

- (iii) Purchase of shares in open market (open offer)
- (iv) Acquisition of share capital of a company by means of cash, issuance of shares.
- (v) Making a buyout offer to general body of shareholders.

When a company is acquired by another company, the acquiring company has two choices either to merge both the companies into one and function as a single entity and the another is to operate the taken-over company as an independent entity with changed management and policies. ‘Merger’ is the fusion of two independent firms on co-equal terms. ‘Acquisition’ is buying out a company by another company and the acquired company usually loses its identity. Usually, this process is friendly.



Source: Patricia Anslinger and Thomas E Copeland, “Growth through Acquisitions : A Fresh look, *Harvard Business Review* Jan. – Feb -1996.

Acquisition of one of the business of a company, as a going concern by an agreement need not necessarily be routed through court, if the transfer of business is to be accomplished without allotting shares in the transferee company to the shareholders of the transferor company. This would tantamount to a simple acquisition. In this case the transferor company continues to exist and no change in shareholding is expected. If the sale takes place for a lumpsum consideration without attributing any individual values to any class of assets, such sales are called slump sales. The capital gains arising on slump sales were being exempt from income tax based on a decision of the Supreme Court of India.

7.2 Takeover: Normally acquisitions are made friendly, however when the process of acquisition is unfriendly (i.e., hostile) such acquisition is referred to as ‘takeover’. Hostile takeover arises when the Board of Directors of the acquiring company decide to approach the shareholders of the target company directly through a Public Announcement (Tender Offer) to buy their shares consequent to the rejection of the offer made to the Board of Directors of the target company.

Take Over Strategies: Other than Tender Offer the acquiring company can also use the following techniques:

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- *Street Sweep*: This refers to the technique where the acquiring company accumulates larger number of shares in a target before making an open offer. The advantage is that the target company is left with no choice but to agree to the proposal of acquirer for takeover.
- *Bear Hug*: When the acquirer threatens the target to make an open offer, the board of target company agrees to a settlement with the acquirer for change of control.
- *Strategic Alliance*: This involves disarming the acquirer by offering a partnership rather than a buyout. The acquirer should assert control from within and takeover the target company.
- *Brand Power*: This refers to entering into an alliance with powerful brands to displace the target's brands and as a result, buyout the weakened company.

8. Takeover by Reverse Bid

In ordinary case, the company taken over is the smaller company; in a 'reverse takeover', a smaller company gains control of a larger one. The concept of takeover by reverse bid, or of reverse merger, is thus not the usual case of amalgamation of a sick unit which is non-viable with a healthy or prosperous unit but is a case whereby the entire undertaking of the healthy and prosperous company is to be merged and vested in the sick company which is non-viable. A company becomes a sick industrial company when there is erosion in its net worth. This alternative is also known as taking over by reverse bid.

The three tests should be fulfilled before an arrangement can be termed as a reverse takeover are specified as follows:

- (i) the assets of the transferor company are greater than the transferee company,
- (ii) equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital, and
- (iii) the change of control in the transferee company through the introduction of a minority holder or group of holders.

9. The Acquisition Process

The acquisition process involves the following essential stages:

- (i) Defining the Acquisition Criteria
- (ii) Competitive analysis;
- (iii) Search and screen.
- (iv) Strategy development.
- (v) Financial evaluation.
- (vi) Target contact and negotiation.
- (vii) Due Diligence (in the case of a friendly acquisition)

- (viii) Arranging for finance for acquisition
- (ix) Putting through the acquisition and Post merger integration

(i) Defining the Acquisition Criteria

A company that has decided to go the inorganic growth route needs to fit in its acquisition criteria in conjunction with its acquisition strategy, which in turn should mesh with its business vision and mission. For example, acquisition criteria can be articulated as:-

- Annual Revenue of the target firm to be between ₹ xx million and ₹ yy million
- Annual EBITDA of the target firm to be between ₹ pp million and ₹ qq million
- Target firm should be aged between nn years to mm years
- Target firm should have established operations in Europe and Asia Pacific
- Target firm's number of customers with 5 million plus shall not less than 2 million
- Target firm has its products that are well entrenched in multiple markets

The following extract from the Annual Report of Berkshire Hathaway Inc., of 1998, talks about 'acquisition criteria'

We are eager to hear *from principals or their representatives* about businesses that meet all of the following criteria:

- (1) Large purchases (at least \$50 million of before-tax earnings),
- (2) Demonstrated consistent earning power (future projections are of no interest to us, nor are "turnaround" situations),
- (3) Businesses earning good returns on equity while employing little or no debt,
- (4) Management in place (we can't supply it),
- (5) Simple businesses (if there's lots of technology, we won't understand it),
- (6) An offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

The larger the company, the greater will be our interest: We would like to make an acquisition in the \$5-20 billion range. *We are not interested, however, in receiving suggestions about purchases we might make in the general stock market.*

We will not engage in unfriendly takeovers. We can promise complete confidentiality and a very fast answer -- customarily within five minutes -- as to whether we're interested. We prefer to buy for cash, but will consider issuing stock when we receive as much in intrinsic business value as we give.

(ii) Competitive Analysis.

The competitive analysis stage is to identify synergistic inter-relationship between the buyer and the target's business opportunities.

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In search and screen stage a list of good acquisition candidates is developed. The screening process involves identifying a few of the best candidates that meet the established criteria. Once best apparent candidates have been identified, more detailed analysis for each will be initiated.

(iii) Search and Screen

This phase comprises initial market evaluation, market study and research and initial screening. Parts of this initial data-gathering phase, which could take a few days at most in the developed countries, where reliable third-party information is readily available, could last as long as two to three months in developing countries, where it is a far more painstaking and labor-intensive task to unearth company information.

Robert F Bruner, an authority on Mergers and Acquisitions, says 'Target Search is non-linear and sometimes even unruly'. Proper knowledge, experience and skills with capital transactions of in-house experts or internationally seasoned investment bankers is critical to the M&A process. It is usual for a corporate that is doing a scenario planning, to engage a set of investment bankers to identify prospective candidates for acquisition/takeover

(iv) Strategy Development

The strategy development calls for the development of a blue print for execution of acquisition. In particular, the strategy for the exploitation of apparent operational synergies would be delineated. The more an acquisition depends upon synergistic interrelationship, the greater is the need to develop a post-merger integration blueprint beforehand. In particular, once you have figured out what drives the value of the target firm, the acquisition strategy should sure that it is still there after the acquiring firm has acquired the business.

(v) Financial Evaluation

Next there is financial evaluation stage of the acquisition process. The central issues addressed in this stage include:

- (i) What is the maximum price that should be for the target company?
- (ii) What are the principal areas of Risk?
- (iii) What are the cash flow and balance sheet implications of the acquisition? and
- (iv) What is the best way of structuring the acquisition?

(vi) Target Contact and Negotiation.

Once a target Co. is identified, the acquirer company initiates the process of contacting the target firm. It is now a reasonably agreed protocol for the CEO/Executive Chairman of the acquiring company to talk to his/her counterpart of the target company. This enables the acquirer to quickly assess the other side's interest. A direct formal letter containing a purchase offer is certain to be construed as notice of a hostile acquisition, and hence is very undesirable.

When an acquirer approaches the target for merger/acquisition, the bidder must assess the target's response. This will involve evaluation of:-

Personalities in the opposite camp

Motivations for sale

Relation to the target – e.g. Promoters/Prof. Managers

Desire for independence

Post-acquisition expectations from the merger

Preference for payment – cash or equity

Evaluation of the above will enable the acquirer to be proactively manage the deal rather than being reactive

If the target company is interested, then it will be usually result in an agreement for exchange of information. At this point, pricing is in the air but not finalised. This agreement results in Non-Disclosure Agreement (NDA). NDA does not result in a Yes or No to the proposal – but enables both parties to start evaluating the deal from close quarters.

It is quite possible that the Executive Board of the target company could reject the advance made by the acquiring company. In such a road block, the acquiring company will have to take a call – whether it will still proceed with the acquisition process through a hostile takeover strategy or it will make a strategic exit. If the second decision is taken, the acquiring company goes back to the drawing board to identify the next target.

Assuming that the target company Board of Directors are interested in pursuing the deal, the next stage would be signing the Term Sheet.

Subsequent to NDA, both sides exchange information – most information is sought intensively about the target, its operations, financial details and other details, especially pending litigation. Based on the information exchanged, general terms and conditions of a possible deal are crystallized, usually after protracted negotiations.

The Acquirer will now issue a Letter of Intent (LOI) (also known as Term Sheet). Most importantly, LOI will contain the business interest to be acquired, price and warranties. LOI is a non-binding summary of the primary terms of what will eventually become part of a purchase agreement.

Once the LOI is signed, the due diligence process will start. Due diligence will usually be carried out by Statutory Auditors or by an established audit firm.

(vii) Due Diligence

According to a 2006 survey by Eco. Intelligence Unit (EIU) and Accenture, due diligence is one of the two most critical elements in the success of an Mergers and Acquisitions (M&A) transaction (the other being the proper execution of the integration process). Due diligence is considered to be of greater importance than target selection, negotiation, pricing the deal, and the development of the company's overall M&A strategy. 23% of CEOs consider Due diligence as the most challenging in domestic acquisitions. This % rises to 41% in the case of cross border acquisitions.

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Areas to evaluate include finance, management, employees, IT, legal, risk management systems, culture, innovation, intangible assets (IPs, Patents, etc), corporate governance and ethics. There are different types of due diligence and the purpose of each will vary to assess different aspects of the target's business. The other additional purposes of 'Due Diligence' are:-

Identifying potential deal breakers – this will help the acquiring company in drafting the 'negotiating strategy'.

Identifying key points for 'post integration 30 days/90 days/180 days strategies' – the areas that require immediate management action

Due Diligence process could throw up previously unknown/undisclosed negatives and flaws in the target company's operations and finances. In such an eventuality, the acquiring firm may take a call either to abandon the deal or re-negotiate the terms and conditions built into the Term Sheet. Due Diligence process gives the last opportunity to the acquiring company Board of Directors to make a go or no-go decision. If the decision to 'go' is taken, 'Purchase Agreement' is signed. This is otherwise called 'Definitive Agreement'

(viii) Arranging Finance for Acquisition

Once the Definitive Agreement is signed, the Company Secretarial aspects relating to putting through the acquisition process will be taken up by the legal and secretarial department of both the companies. Side by side, the CFO of the acquiring company will move to the next stage which is 'Financing the Acquisition'.

One of the most important decisions is how to pay for the acquisition – cash or stock or part of each. And this would be part of the Definitive Agreement. If the acquisition is an 'all equity deal', the CFO's can breathe easy. However, if cash payout is significant, the acquirer has to plan for financing the deal. Sometimes acquirers do not pay all of the purchase consideration as, even though they could have sufficient funds. This is part of the acquisition strategy to keep the war chest ready for further acquisitions. Another reason to pay by shares would be when the acquirer considers that their company's shares are 'over priced' in the market.

Financing the acquisition can be quite challenging where the acquisition is a LBO. Many times strong companies plan to shore up their long term funds subsequent to the takeover. The immediate funding is accomplished with bridge financing.

(ix) Putting through the acquisition and Post-Acquisition Integration

It is in this stage that most M&As lose out – Companies do not realise that proof of the pudding is in the eating

Every acquirer must build an 'Integration Plan' document as soon as possible. The usual guiding principles that underpin an integration plan are:

- integrate the business quickly into one unit which is the right size for the future
- integrate and retain the best people from both organizations into one high performing team

- build support for the new organization with employees, customers and suppliers
- achieve valuation commitments.

It is usual for acquiring companies to make 30 days/90 days/ 180 days transition plan to ensure that immediate pressing needs of the acquisition are met. Whether it should be a 30 days/90 days/ 180 days will be determined after evaluation of the 'Due Diligence Report'.

A typical 90/100 days plan to cover the initial period of integration will have the following purposes:

- identify key events and activities that should take place in the first 100 days to achieve the above integration goals
- identify the required resources to integrate the new businesses
- develop a plan for each functional area including sales, marketing, finance, IT, HR and operations
- ensure open communication
- drive synergy realisation
- achieve transition from integration to business team.

Cultural differences have caused mergers to fail or prevented them from achieving their full potential. Cultural differences are certainly likely to surface when two different entities come together in a merger or acquisition, and become even more important as in a cross-border transaction.

10. Defending a Company in a Takeover Bid

The speed with which a hostile takeover is attempted puts the target Company at a disadvantage.

One of observations on the prevailing regulations pertaining to takeover is that, there is very little scope for a target company to defend itself in a takeover battle. Due to the prevailing guidelines, the target company without the approval of the shareholder cannot resort to any issuance of fresh capital or sale of assets etc., and also due to the necessity of getting approvals from various authorities. In the past most companies who wanted to resist a takeover, did so, either by getting a White Knight to support the Company or by refusing to transfer shares acquired by the Acquirer, followed by long protracted legal battle. Now under the guidelines, the target company cannot refuse transfer of shares without the consent of shareholders in a general meeting.

10.1 Defensive Tactics: A target company can adopt a number of tactics to defend itself from hostile takeover through a tender offer.

- **Divestiture** - In a *divestiture* the target company divests or spins off some of its businesses in the form of an independent, subsidiary company. Thus, reducing the attractiveness of the existing business to the acquirer.

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- **Crown jewels** - When a target company uses the tactic of divestiture it is said to sell the crown jewels. In some countries such as the UK, such tactic is not allowed once the deal becomes known and is unavoidable.
- **Poison pill** - Sometimes an acquiring company itself becomes a target when it is bidding for another company. The tactics used by the acquiring company to make itself unattractive to a potential bidder is called poison pills. For instance, the acquiring company may issue substantial amount of convertible debentures to its existing shareholders to be converted at a future date when it faces a takeover threat. The task of the bidder would become difficult since the number of shares to having voting control of the company increases substantially.
- **Poison Put** - In this case the target company issue bonds that encourage holder to cash in at higher prices. The resultant cash drainage would make the target unattractive.
- **Greenmail** - Greenmail refers to an incentive offered by management of the target company to the potential bidder for not pursuing the takeover. The management of the target company may offer the acquirer for its shares a price higher than the market price.
- **White knight** - In this a target company offers to be acquired by a friendly company to escape from a hostile takeover. The possible motive for the management of the target company to do so is not to lose the management of the company. The hostile acquirer may change the management.
- **White squire** - This strategy is essentially the same as white knight and involves sell out of shares to a company that is not interested in the takeover. As a consequence, the management of the target company retains its control over the company.
- **Golden parachutes** - When a company offers hefty compensations to its managers if they get ousted due to takeover, the company is said to offer *golden parachutes*. This reduces their resistance to takeover.
- **Pac-man defence** - This strategy aims at the target company making a counter bid for the acquirer company. This would force the acquirer to defend itself and consequently may call off its proposal for takeover.

It is needless to mention that hostile takeovers, as far as possible, should be avoided as they are more difficult to consummate. In other words, friendly takeover are better course of action to follow.

11. Legal Aspects of M & As

Merger control requirements in India are currently governed by the provisions of the Companies Act and the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("the takeover code"). The provisions of the Takeover Code apply only to acquisition of shares in listed public companies. Although there is no definition of amalgamation or mergers in the Indian Companies Act, it is understood to mean an arrangement by which transfer of undertakings is affected. Other statues which governs merger proposals are the Industries (Development and Regulation) Act, 1951; the

Foreign Exchange Management Act, 1999, the Income Tax Act, 1961, SEBI Act, 1992, SEBI Takeover Code and Competition Act 2002.

12. Due Diligence

In the past, various authors have emphasized the importance of due diligence in M&A. The concept of due diligence has many dimensions such as:

- Due diligence is research, its purpose in M&A is to support the valuation process, arm negotiators, test the accuracy of representations and warranties contained in the merger agreement, fulfill disclosure requirements to investors, and inform the planners of post-merger integration.
- Due diligence is conducted in a wide variety of corporate finance settings, and is usually connected with the performance of a professional or fiduciary duty.
- It is the opposite of negligence.
- Weaknesses in the due diligence process may cause an M&A to fail.
- In addition, buyers in M&A may find “ignorance of knowledge risks to be a weak basis for a lawsuit seeking damages from sellers”.

A due diligence process should focus at least on the following issues:

- Legal issues: These include examining documents of asset ownership and associated liabilities; and whether the target company is in compliance with government regulations.
- Financial and tax issues: These include examining accounting records and reports to determine whether the target companies are in compliance with generally accepted accounting principles. In addition, the target company’s compliance with tax laws and regulations should be examined.
- Marketing issues: These include strengths and weaknesses of products and services provided by the target company and their domestic and foreign competition.
- Cross-border issues: These include foreign currency exchange risks, foreign laws and regulations, investment promotional agency and investment incentives, foreign banking and credit agencies, accounting principles, and local tax rules.
- Cultural and ethical issues: These cover cultural differences between the acquirer and target companies and how to deal with these differences; the degree of compliance with the acquirer’s ethical guidelines; and the exposure to liabilities and legal proceedings on unethical conduct such as patent and copyright violations, price fixing and others.

13. Target Valuation for M & As

The value of a business is a function of the business logic driving the M&As and is based on bargaining powers of buyers and sellers. Since business is based on expectations which are

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dynamic, valuation also tends to be dynamic and not static which means that the same transaction would be valued by the same players at different values at two different times.

Thorough **due diligence** has to be exercised in deciding the valuation parameters since these parameters would differ from sector to sector and company to company.

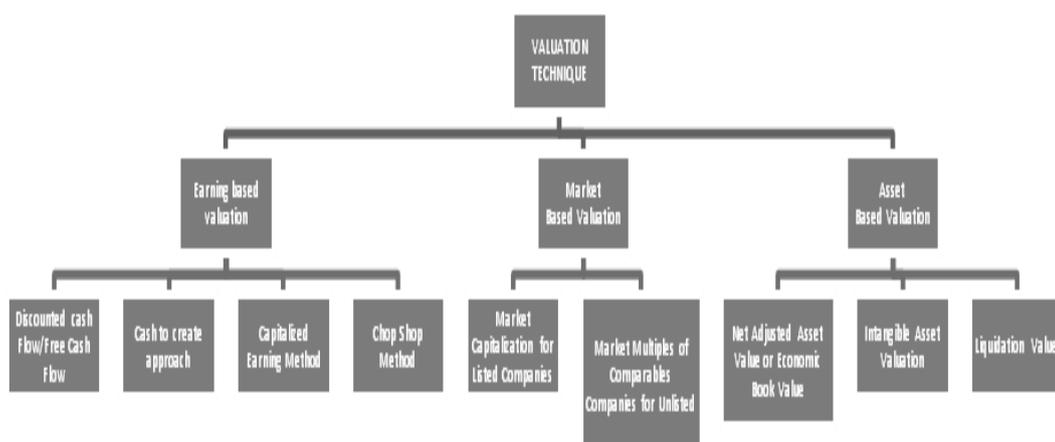
Because of the competitive nature of the acquisition market, companies not only need to respond wisely but often must respond quickly as well. The growing independence of corporate boards and their demand for better information to support strategic decisions such as acquisitions have raised the general standard for acquisition analysis. Sound analysis, convincingly, communicated also yields substantial benefits in negotiations with the target company's management or, in the case of tender offers, its shareholders.

After all, shareholders value creation depends not on pre-merger market valuation of the target company but on the actual acquisition price the acquiring company pays compared with the setting company's cash flow contribution to the combined company. Only a limited supply of acquisition, candidates is available at the price that enables the acquirer to earn an acceptable economic return on investment. A well conceived valuation programme that minimizes the risk of buying an economically unattractive company or paying too much for an attractive one is particularly important in today's market. The premium that must be paid by a successful bidder requires a more careful analysis by buyer than ever before.

There are also social and cultural issues post merger. There are primarily related to work culture, management style and human resources. Synergies fructify only when these issues could be sorted out very early in the merger.

We have studied valuation of stocks and bonds. You understand terms like BVPS (book value per share), Price to Book and P/E (price / earnings per share). Now question arises how do you value a firm?

There are several techniques to value a business as shown below:



13.1 Earnings Based Valuation

13.1.1 Discounted Cash Flow/Free Cash Flow valuation

This discounted cash-flow technique being the most common technique takes into consideration the future earnings of the business and hence the appropriate value depends on projected revenues and costs in future, expected capital outflows, number of years of projection, discounting rate and terminal value of business. This methodology is used to value companies since firms are essentially collection of projects. There are six steps involved in the valuation.

Step 1: Determine Free Cash Flow

Free cash flow to the Firm (FCFF) is the cash flow available to all investors in the company — both shareholders and bondholders after consideration for taxes, capital expenditure and working capital investment. Free cash flow to Equity (FCFE) is the cash flow available to only the equity shareholders after bondholders are paid their interest and the committed principal repayment for the year.

Free Cash Flow to Firm (FCFF) = NOPAT + Depreciation and Amortization – (Capital expenditure + Working capital investment)

Estimate the most likely incremental cash flows to be generated by the target company with the acquirer as owner (and not on as-is basis). Note that financing is not incorporated in the cash flows. Suitable adjustments for the specific financing of the acquisition will be made in the discount rate.

Step 2 : Estimate a suitable Discount Rate for the Acquisition

The acquiring company can use its weighted average cost of capital based on its target capital structure only if the acquisition will not affect the riskiness of the acquirer. If the acquirer intends to change the capital structure of the target company, suitable adjustments for the discount rate should be made. The discount rate should reflect the capital structure of the company after the acquisition. The appropriate discount rate for discounting FCFF is the Weighted Average Cost of Capital (WACC) and the discount rate for discounting FCFE is the Cost of Equity.

Step 3 : Calculate the Present Value of Cash Flows

Since the life of a going concern, by definition, is infinite, the value of the company is,

$$= \text{PV of cash flows during the forecast period} + \text{Terminal value}$$

We can set the forecast period in such a way that the company reaches a stable phase after that. In other words, we are assuming that the company will grow at a constant rate after the forecast period.

Step 4 : Estimate the Terminal Value

Generally it is quite difficult to estimate Terminal Value (TV) of a company because the end of explicit period represents a date when forecasted projections have no more meaning.

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Generally analysts assumes that after explicit period the company enters in its maturity phase of business cycle. TV can be determined by using following methods:

(i) *On the basis of Capital Employed:* Usually this basis is used in some specific type of industries e.g. mining etc. Where we estimate liquidation value by adding up realizable value of various assets. Thus, under this method it is assumed that the company has a finite life, therefore scrap or realizable value of all assets is computed.

(ii) *On the basis of Multiple of Earnings:* Under this approach TV is determined by multiplying the forecasted terminal year profits by an available/appropriate price earning multiple. Normally, the current P/E multiple can also be used as proxy for future P/E multiple and can be calculated as follows:

$$TV = \text{Current market value of company} / \text{Current profit after tax}$$

Suppose, if the current market value of company is ₹ 576.20 crore and profit after tax is ₹ 82.30 crore,

$$\text{Then P/E} = 576.20 / 82.30 = 7$$

Further if last year's profit are ₹ 201.20 crore, then TV shall be

$$\begin{aligned} &= \text{Last year's profit} \times \text{P/E multiple} \\ &= ₹ 201.20 \text{ crore} \times 7 = ₹ 1408.40 \text{ crore} \end{aligned}$$

(iii) *On the basis of Free Cash Flow:* This is one of the popular method of estimating TV because future expected cash flows are discounted at a rate that reflects the riskiness of the projected cash flows.

It should however be noted that following two approaches can be employed to compute the TV.

(a) Growing Perpetuity: Under this approach we assume that cash flow grows at a constant rate after forecasted period and it is calculated as follows:

$$TV = [CF_t (1 + g)] / (k - g)$$

where,

CF_t = Cash flow in the last year

g = Constant Growth Rate

k = Discount rate or Cost of Capital

(b) Stable Perpetuity: This approach is followed when there is no Capital Expenditure or if it is there then it is equal to depreciation charged. In other words capital does not grow any more. In such situations cash flows becomes equal to Profit After Tax (PAT). Therefore, we can assume that the company earns a rate of return on capital employed is equal to Cost of Capital irrespective of Sales Growth.

The TV in such case shall be calculated as follows:

$$\begin{aligned} \text{TV} &= \text{Free Cash Flow} / \text{Discount Rate (Cost of Capital)} \\ &= \text{FCF}/k \end{aligned}$$

(iv) *On the basis of Multiple Book Value:* Under this method TV is estimated by multiplying an appropriate or available market-to-book ratio to forecasted book value of capital.

Generally, current Market Value/ Book Value (M/B) ratio is taken as proxy for the futures.

Example

The following information is related to A Ltd.

	Market Value (₹ Crore)	Book Value (₹ Crore)	M/B
Debt	792	792	1.00
Equity	1500	1000	1.50
Total	2292	1792	1.28

Now if book value of capital at the end of forecast period is ₹ 300 Crore, then TV shall be:

$$= ₹ 300 \text{ Crore} \times 1.28 = ₹ 3840 \text{ Crore}$$

It is very important to note that, since in case of Growing Perpetuity much of value comes from TV, which is quite sensitive assumption, the other methods can also be used to determine the TV.

Step 5 : Add Present Value of Terminal Value = TV x PVIF_{k,n}

Step 6 : Deduct the Value of Debt and Other Obligations Assumed by the Acquirer.

Thus, the method adopted by the analyst affects the final value placed on the company's equity. These four methods might give four different answers. However, the DCF approach can capture the value of assets in place. Some components of the acquisition are hard to quantify. Consequently, the final price paid by the acquirer might be much higher than the DCF value obtained. But the premium paid for the so-called synergy should not be out of proportion. We could think of the target company's value as:

Value of buyer = Value of seller + Value added by buyer + Change in value to buyer if target firm is acquired by competitor.

The first component is the DCF value of the target firm in its current form with the current growth rate, current financial plan, etc.

The second component, value added by acquirer comprises of synergy to acquirer, cost savings, value of new strategy after the acquisition, proceeds from sale of redundant assets adjusted for taxes benefits from improvement in credit-rating and other financing side-effects.

The third component is the gain or loss to the acquirer if the competitor manages to acquire the target. The sum total of these three components gives the maximum value of the target.

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A sensitivity analysis may be conducted for pessimistic and optimistic values of key financial variables like sales growth rate, profit margin, working capital investment, capital expenditure, period of high growth, etc. The end product of such an analysis is a range of prices within the acquisition price may lie. Obviously, the acquirer would want to lower the price as much as possible and the opposite is true for the target. The important message is that the acquirer should consider not only what the target may be worth to the buyer but also what the target's next best alternative is likely to be. For example, suppose that when valued as a stand alone, a target is worth ₹ 100, whereas, due to synergies, the target is worth ₹ 150 as part of the buying firm. A key element in the negotiation process is the value of the target to another bidder. If the synergy is unique to the buyer, the buyer may purchase the company for one rupee more than the stand-alone value (₹ 101). On the other hand, if the synergy is available to other bidders as well, the buyer may have to raise the bid closer to ₹ 150. In other words, the valuation must take into account the uniqueness of synergy and the likely range of prices affordable by other bidders. To sum up, valuation has three elements — estimation of cash flows, estimation of discount rate, and sensitivity analysis.

Illustration 1

XYZ Ltd. is a paints manufacturer. The analyst's forecast of free cash flow is shown below:

Free cash flow forecast for XYZ Ltd.

(₹ in crore)

	Years							
	2013	2014	2015	2016	2017	2018	2019	2020
Sales	178.13	204.85	235.58	270.92	311.56	358.29	412.03	473.83
EBIT	16.33	17.25	17.19	19.58	22.17	24.95	27.89	30.95
NOPAT	10.61	11.21	11.17	12.73	14.41	16.22	18.13	20.12
+ Depreciation	3.14	2.13	2.68	2.82	2.96	3.11	3.26	3.42
Less :								
Capital exp.	0	0.63	2.36	1.79	1.88	1.97	2.07	2.17
Increase in working capital	0	6.44	4.12	6.10	9.45	11.67	12.97	14.32
Free cash flow	13.75	6.27	7.37	7.66	6.04	5.69	6.35	7.05

The cost of capital of the company is 15 per cent and value of debt is ₹7.92 crore. Assuming that the company acquiring XYZ Ltd. will not make any operating improvements or change the capital structure and analyst expects the cash flows to grow at 10 per cent forever after 2020, determine the value of Firm and Equity.

Solution

Present Value of Free Cash Flows

(₹ in crore)

	Years							
	2013	2014	2015	2016	2017	2018	2019	2020
Free Cash Flow	13.75	6.27	7.37	7.66	6.04	5.69	6.35	7.05
PVF@15%	0.870	0.756	0.658	0.572	0.497	0.432	0.376	0.327
Present Value	11.96	4.74	4.85	4.38	3.00	2.46	2.39	2.31
Total								36.09

Approach I: Terminal Value is a Growing Perpetuity

$$\begin{aligned} \text{Terminal value} &= \text{FCFF} \times (1 + g) / (k - g) \\ &= \frac{7.05(1.10)}{0.15 - 0.10} = \frac{7.755}{0.05} \\ &= ₹ 155.1 \text{ crore} \end{aligned}$$

$$\begin{aligned} \text{Present value of terminal value} &= 155.1 \times \text{PVIF} (15\%, 8) \\ &= 155.1 \times 0.327 = 50.72 \text{ crore} \end{aligned}$$

$$\text{Total value} = ₹ (36.09 + 50.72) = ₹ 86.81 \text{ crore}$$

$$\text{Value of Equity} = ₹ 86.81 \text{ crore} - ₹ 7.92 \text{ crore} = ₹ 78.89 \text{ crore}$$

Approach 2: Terminal Value is a Stable Perpetuity

$$\begin{aligned} \text{Terminal value} &= \left[\frac{\text{Free cash flow}}{\text{Discount rate}} \right] = \text{FCF} / k \\ &= \left[\frac{7.05}{0.15} \right] = ₹ 47 \text{ crores} \end{aligned}$$

$$\text{Value of the firm} = ₹ 36.09 \text{ crore} + ₹ 47.00 \text{ crore} \times 0.327 = ₹ 51.46 \text{ crore}$$

13.1.2 Cost to Create: In this approach, the cost for building up the business from scratch is taken into consideration and the purchase price is typically the cost plus a margin. This is suitable in cases like build-operate-transfer deals. The value of a business is estimated in the capitalized earnings method by capitalizing the net profits of the business of the current year or average of three years or projected years at required rate of return.

13.1.3 Capitalised Earning Method: A common method of valuing a business is also called the Capitalization of Earnings (or Capitalized Earnings) method. Capitalization refers to the return on investment that is expected by an investor. The value of a business is estimated in the capitalized earnings method by capitalizing the net profits of the business of the current year or average of three years or a projected year at required rate of return. There are many variations in how this method is applied. However, the basic logic is the same. Suppose you

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had ₹ 1,00,000 to invest. You might look at different investment options available e.g. shares, bonds, or savings accounts etc. You would compare the potential return against the risk of each and make a judgment as to which is the best deal in your particular situation.

The same return on investment logic holds for buying a business. Capitalization methods (and other methods) for valuing a business are based upon return on the new entity's investment.

13.1.4 Chop-Shop Method: This approach attempts to identify multi-industry companies that are undervalued and would have more value if separated from each other. In other words as per this approach an attempt is made to buy assets below their replacement value. This approach involves following three steps:

Step 1: Identify the firm's various business segments and calculate the average capitalization ratios for firms in those industries.

Step 2: Calculate a "theoretical" market value based upon each of the average capitalization ratios.

Step 3: Average the "theoretical" market values to determine the "chop-shop" value of the firm.

Illustration 2

Using the chop-shop approach (or Break-up value approach), assign a value for Cornett GMBH. whose stock is currently trading at a total market price of €4 million. For Cornett, the accounting data set forth in three business segments: consumer wholesaling, specialty services, and assorted centers. Data for the firm's three segments are as follows:

Business segment	Segment sales	Segment assets	Segment income
Consumer wholesaling	€1,500,000	€ 750,000	€100,000
Specialty services	€800,000	€700,000	€150,000
Assorted centers	€2,000,000	€3,000,000	€600,000

Industry data for "pure-play" firms have been compiled and are summarized as follows:

Business segment	Capitalization/sales	Capitalization/assets	Capitalization/operating income
Consumer wholesaling	0.75	0.60	10.00
Specialty services	1.10	0.90	7.00
Assorted centers	1.00	0.60	6.00

Solution

Cornett, GMBH. – Break-up valuation

Business Segment	Capital-to-Sales	Segment Sales	Theoretical Values
Consumer wholesale	0.75	€1,500,000	€1,125,000
Specialty services	1.10	€800,000	€880,000
Assorted centers	1.00	€2,000,000	€2,000,000
Total value			€4,005,000

Business Segment	Capital-to-Sales	Segment Sales	Theoretical Values
Specialty services	0.60	€750,000	€450,000
Specialty services	0.90	€700,000	€630,000
Assorted centers	0.60	€3,000,000	<u>€1,800,000</u>
Total value			<u>€2,880,000</u>

Business Segment	Capital-to-Sales	Segment Sales	Theoretical Values
Consumer wholesale	10.00	€100,000	€1,000,000
Specialty services	7.00	€150,000	€1,050,000
Assorted centers	6.00	€600,000	<u>€3,600,000</u>
Total value			<u>€5,650,000</u>

$$\text{Average theoretical value} = \frac{4,005,000 + 2,880,000 + 5,650,000}{3} = 4,178,333.33 \text{ say } 4,178,000$$

Average theoretical value of Cornett GMBH. = €4,178,000

13.2 Market Based Valuation: While using the market based valuation for unlisted companies, comparable listed companies have to be identified and their market multiples (such as market capitalizations to sales or stock price to earnings per share) are used as surrogates to arrive at a value.

13.2.1 Market capitalization for listed companies: Method of evaluating the market capitalization for listed companies is same as Capitalized Earning Method except that here the basis is taken earning of similar type of companies.

13.2.2 Market multiples of comparable companies for unlisted company: This method is mainly concerned with the valuation of unlisted companies. In this method various Market multiples i.e. market value of a company's equity (resulting in Market Value of Equity Multiple) or invested capital (resulting in Market Value of Invested Capital) are divided by a company measure (or company fundamental financial variable) – earnings, book value or revenue of comparable listed companies are computed. These computed multiples are then adjusted in light of differences in under consideration company's growth, size or any company specific risk vis-à-vis as those of guideline company. Thereafter these adjusted market multiples are applied to the appropriate fundamental financial variable of the company under consideration to derive its value.

The basics of valuation for listed and unlisted company stay the same. Only thing that is limited with a unlisted company is the ready-made price market perceives for its equity etc. In such cases we need to carry out an exhaustive/ disciplined "Benchmarking Analysis" and identify the most applicable "normalised" median multiples for company under consideration. It is very necessary to ensure the proximity of the business model, size, profitability, geographical spread, risk patterns etc. of the comparable companies with the subject

company. Once this is done, it is as good as valuing any listed entity (of course you would need to make subject company specific adjustments say growth, competition etc.).

13.3 Asset Based Valuation : The asset based value considers either the book value (assets net liabilities) or the net adjusted value (revalued net assets). If the company has intangible assets like brands, copyrights, intellectual property etc., these are valued independently and added to the net asset value to arrive at the business value. Sometimes, if the business were not to be acquired on a going concern basis, the liquidation value (or the realization from sale of assets) is considered for the purpose of valuation.

13.3.1 Net Adjusted Asset Value or Economic Book Value: Valuation of a 'going concern' business by computed by adjusting the value of its all assets and liabilities to the fair market value. This method allows for valuation of goodwill, inventories, real estate, and other assets at their current market value. In other words this method includes valuation of intangible assets and also allows assets to be adjusted to their current market value.

13.3.2 Intangible Asset Valuation: Acceptable methods for the valuation of identifiable intangible assets and intellectual property fall into three broad categories. They are market based, cost based, or based on estimates of past and future economic benefits.

Cost-based methodologies, such as the "cost to create" or the "cost to replace" a given asset, assume that there is some relationship between cost and value and the approach has very little to commend itself other than ease of use. The method ignores changes in the time value of money and ignores maintenance.

The methods of valuation flowing from an estimate of past and future economic benefits (also referred to as the income methods) can be broken down in to four limbs as follows:

1. *The capitalization of historic profits* arrives at the value of intangible assets by multiplying the maintainable historic profitability of the asset by a multiple that has been assessed after scoring the relative strength of the intangible assets. For example, a multiple is arrived at after assessing a brand in the light of factors such as leadership, stability, market share, internationality, trend of profitability, marketing and advertising support and protection. While this capitalization process recognizes some of the factors which should be considered, it has major shortcomings, mostly associated with historic earning capability. The method pays little regard to the future.
2. *Gross profit differential methods* are often associated with trade mark and brand valuation. These methods look at the differences in sale prices, adjusted for differences in marketing costs. That is the difference between the margin of the branded and/or patented product and an unbranded or generic product. This formula is used to drive out cash-flows and calculate value. Finding generic equivalents for a patent and identifiable price differences is far more difficult than for a retail brand.
3. *The excess profits method* looks at the current value of the net tangible assets employed as the benchmark for an estimated rate of return. This is used to calculate the profits that are required in order to induce investors to invest into those net tangible assets. Any return over

and above those profits required in order to induce investment is considered to be the excess return attributable to the intangible assets. While theoretically relying upon future economic benefits from the use of the asset, the method has difficulty in adjusting to alternative uses of the asset.

4. *Relief from royalty* considers what the purchaser could afford, or would be willing to pay, for a licence of similar intangible assets. The royalty stream is then capitalized reflecting the risk and return relationship of investing in the asset.

13.3.3 Liquidation Value: This approach is similar to the book valuation method, except that the value of assets at liquidation is used instead of the book or market value of the assets. Using this approach, the liabilities of the business are deducted from the liquidation value of the assets to determine the liquidation value of the business. The overall value of a business using this method should be lower than a valuation reached using the standard book or adjusted book methods.

The liquidation value of a company is equal to what remains after all assets have been sold and all liabilities have been paid. It differs from book value in that assets would be sold at market prices, whereas book value uses the historical costs of assets. This is considered to be a better floor price than book value for a company, because if a company drops significantly below this price, then someone, such as a corporate raider, can buy enough stock to take control of it, and then liquidate it for a riskless profit. Of course, the company's stock price would have to be low enough to cover the costs of liquidating it and the uncertainty in what the assets would actually sell for in the marketplace.

Student may please note that the topic of 'Valuation' has also been covered in the paper 'Financial Reporting' wherein other different type of techniques of valuation has been discussed from reporting point of view. Students may refer to Chapter 9 in Study Material Vol. I on Financial Reporting. Students are expected to have a complete understanding of these techniques also.

14. Case Studies

Premiums and discounts are typically attached to a business valuation, based on the situation. These could be market share premium, controlling stake premium, brand value premium, small player discount or unlisted company discount. In addition, it may be required to work out various potential scenarios in each methodology and arrive at the likely probabilities of each while deriving the values.

Timing is very critical while divesting a business since valuation depends on the timing. Timing of sale is crucial keeping in mind economic cycles (deal valuation takes into consideration GDP growth rates), stock market situations (which would decide market multiples), global situations (*like a war or terrorist attacks*).

In times like the above, the price expectations between the buyer and the seller would widely vary. For example, during a stock market lull, there could be a situation where there are more buyers but not sellers due to the low valuation.

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The basis for M&A is the expectation of several future benefits arising out of **synergies** between businesses. There is a risk involved in realizing this synergy value. This could be due to corporate, market, economic reasons or wrong estimation of the benefits/synergies. A key case in point here is the high valuations at which internet companies were acquired in the year 2000 (*such as Satyam Infoway acquisition of India World*).

It is also important to try and work out valuations from as many of the above methods as possible and then try and see which methodology is to be taken in and which are to be rejected and derive a range of values for the transaction in different situations in case one is called upon to assist in advising the transaction valuation. Some methods like Net Asset Value or past earnings based methods may prove inadequate in case of growing businesses or those with intangible assets.

Some case studies are listed below based on actual Indian situations and an analysis based on published data is given below.

14.1 Case Study – Rationale for M & A and Valuation

Bharti Airtel to buy Loop Mobile for ₹ 700 crores

In February 2014, Bharti Airtel (“Airtel”), a leading global telecommunications services provider with operations in 20 countries across Asia and Africa has announced to buy Mumbai based Loop Mobile. Although the price was not stated it is understood to be in the region of around ₹ 700 crores. The proposed association will undergo seamless integration once definitive agreements are signed and are subject to regulatory and statutory approvals. Under the agreement, Loop Mobile’s 3 million subscribers in Mumbai will join Airtel’s over 4 million subscribers, creating an unmatched mobile network in Mumbai. The merged network will be the largest by customer base in the Mumbai circle. The proposed transaction will bring together Loop Mobile’s 2G/EDGE enabled network supported by 2,500 plus cell sites, and Airtel’s 2G and 3G network supported by over 4000 cell sites across Mumbai. It will also offer subscribers the widest exclusive retail reach with 220 outlets that will enable best in class customer service. The agreement will ensure continuity of quality services to Loop Mobile’s subscribers, while offering them the added benefits of Airtel’s innovative product portfolio and access to superior services, innovative products like 3G, 4G, Airtel Money, VAS and domestic/international roaming facilities. Loop Mobile subscribers will become part of Airtel’s global network that serves over 289 million customers in 20 countries. Globally, Airtel is ranked as the fourth largest mobile services provider in terms of subscribers.

(Based on Press release hosted on Bharti Airtel’s website)

14.2 Case Study – Valuation Analysis

Listed software company X to merge with unlisted company Y

Company X and company Y were in the software services business. X was a listed company and Y was an unlisted entity. X and Y decided to merge in order to benefit from marketing. Operational synergies and economies of scale. With both companies being mid-sized, the merger would make them a larger player, open new market avenues, bring in expertise in

more verticals and wider management expertise. For company X, the benefit lies in merging with a newer company with high growth potential and for company Y, the advantage was in merging with a business with track record, that too a listed entity.

The stock swap ratio considered after valuation of the two businesses was 1:1.

Several key factors were considered to arrive at this valuation. Some of them were very unique to the businesses and the deal:

- Valuation based on book value net asset value would not be appropriate for X and Y since they are in the knowledge business, unless other intangibles assets like human capital, customer relationships etc. could be identified and valued.
- X and Y were valued on the basis of
(a) expected earnings (b) market multiple.
- While arriving at a valuation based on expected earnings, a higher growth rate was considered for Y, it being on the growth stage of the business life cycle while a lower rate was considered for X, it being in the mature stage and considering past growth.
- Different discount factors were considered for X and Y, based on their cost of capital, fund raising capabilities and debt-equity ratios.
- While arriving at a market based valuation, the market capitalization was used as the starting point for X which was a listed company. Since X had a significant stake in Z, another listed company, the market capitalization of X reflected the value of Z as well. Hence the market capitalization of Z had to be removed to the extent of X's stake from X's value as on the valuation date.
- Since Y was unlisted, several comparable companies had to be identified, based on size, nature of business etc. and a composite of their market multiples had to be estimated as a surrogate measure to arrive at Y's likely market capitalization, as if it were listed. This value had to be discounted to remove the listing or liquidity premium since the surrogate measure was estimated from listed companies.
- After arriving at two sets of values for X and Y, a weighted average value was calculated after allotting a higher weight for market based method for X (being a listed company) and a higher weight for earnings based method for Y (being an unlisted but growing company). The final values for X and Y were almost equal and hence the 1:1 ratio was decided.

14.3 Case Study – Rationale for M&A and Valuation

(1) Ranbaxy To Bring In Daiichi Sankyo Company Limited As Majority Partner– June 2008

Ranbaxy Laboratories Limited, among the top 10 generic companies in the world and India's largest pharmaceutical company, and Daiichi Sankyo Company Limited, one of the largest pharmaceutical companies in Japan, announced that a binding Share Purchase and Share

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Subscription Agreement was entered into between Daiichi Sankyo, Ranbaxy and the Singh family, the largest and controlling shareholders of Ranbaxy (the "Sellers"), pursuant to which Daiichi Sankyo will acquire the entire shareholding of the Sellers in Ranbaxy and further seek to acquire the majority of the voting capital of Ranbaxy at a price of Rs737 per share with the total transaction value expected to be between US\$3.4 to US\$4.6 billion (currency exchange rate: US\$1=Rs43). On the post closing basis, the transaction would value Ranbaxy at US\$8.5 billion.

The Share Purchase and Share Subscription Agreement has been unanimously approved by the Boards of Directors of both companies. Daiichi Sankyo is expected to acquire the majority equity stake in Ranbaxy by a combination of (i) purchase of shares held by the Sellers, (ii) preferential allotment of equity shares, (iii) an open offer to the public shareholders for 20% of Ranbaxy's shares, as per Indian regulations, and (iv) Daiichi Sankyo's exercise of a portion or all of the share warrants to be issued on a preferential basis. All the shares/warrants will be acquired at a price of Rs737 per share. This purchase price represents a premium of 53.5% to Ranbaxy's average daily closing price on the National Stock Exchange for the three months ending on June 10, 2008 and 31.4% to such closing price on June 10, 2008.

The deal will be financed through a mix of bank debt facilities and existing cash resources of Daiichi Sankyo. It is anticipated that the transaction will be accretive to Daiichi Sankyo's EPS and Operating income before amortization of goodwill in the fiscal year ending March 31, 2010 (FY2009). EPS and Operating income after amortization of goodwill are expected to see an accretive effect in FY2010 and FY2009, respectively.

Why would Daiichi Sankyo wanted to acquire majority stake in Ranbaxy, that too at a premium?

Ranbaxy's drive to become a research-based drug developer and major manufacturer has led it straight into the welcoming arms of Japan's Daiichi Sankyo, that's why it announced to buy a majority stake in the Indian pharma company. After Sankyo completes a buyout of the founding Singh family's stake in the company, Ranbaxy will become a subsidiary operation. The deal is valued at \$4.6 billion and will create a combined company worth about \$30 billion. That move positions Daiichi Sankyo to become a major supplier of low-priced generics to Japan's aging population and accelerates a trend by Japanese pharma companies to enter emerging Asian markets, where they see much of their future growth. The acquisition stunned investors and analysts alike, who were caught off guard by a bold move from a conservative player in the industry. (Source: Fiercebiotech.com)

Also, from a financial and business perspective Ranbaxy's revenues and bottom lines were continuously on the rise since 2001; the R&D expenses were stable around 6%. In FY 2007 the company had revenues of 69,822 million INR (\$1.5billion) excluding other income. The earnings of the company were well diversified across the globe; however the emerging world contributed heavily to the revenues (Emerging 54%, Developed 40%, others 6%). However the Japan market, with low generics penetration contributed just \$25 million to the top line. The company had just begun to re-orient its strategy in favour of the emerging markets. The product, patent and API portfolio of the company was strong. The company made 526 product

filings and received 457 approvals globally. The Company then served customers in over 125 countries and had an expanding international portfolio of affiliates, joint ventures and alliances, operations in 56 countries. (Source: ukessays.com)

(2) Sun Pharma to acquire Ranbaxy in US\$4 billion – April 2014

Sun Pharmaceutical Industries Ltd. and Ranbaxy Laboratories Ltd today announced that they have entered into definitive agreements pursuant to which Sun Pharma will acquire 100% of Ranbaxy in an all-stock transaction. Under these agreements, Ranbaxy shareholders will receive 0.8 share of Sun Pharma for each share of Ranbaxy. This exchange ratio represents an implied value of ₹457 for each Ranbaxy share, a premium of 18% to Ranbaxy's 30-day volume-weighted average share price and a premium of 24.3% to Ranbaxy's 60-day volume-weighted average share price, in each case, as of the close of business on April 4, 2014. The transaction is expected to represent a tax-free exchange to Ranbaxy shareholders, who are expected to own approximately 14% of the combined company on a pro forma basis. Upon closing, Daiichi Sankyo will become a significant shareholder of Sun Pharma and will have the right to nominate one director to Sun Pharma's Board of Directors.

What prompted Daiichi Sankyo to decide on divestiture of the Indian Pharma company which it had barely acquired just about six years ago?

It has been a rocky path for Japanese pharma major Daiichi Sankyo ever since it acquired a 63.5 per cent stake in Indian drug maker Ranbaxy in June 2008. The Japanese drug-maker was expected to improve manufacturing process at Ranbaxy, which has a long history of run-ins with drug regulators in the US, its largest market, going back to 2002. Instead, serious issues persisted, resulting in a ban by the US Food & Drug Administration on most drugs and pharmaceutical ingredients made in Ranbaxy's four Indian manufacturing plants. Soon after the deal was inked, in September 2008, the US drug regulator - Food and Drug Administration - accused Ranbaxy of misrepresenting data and manufacturing deficiencies. It issued an import ban on Ranbaxy, prohibiting the export of 30 drugs to the US, within three months after Daiichi announced the acquisition. Following this, Ranbaxy's sales in the US shrank almost by a fourth, and its stock price slumped to over a fifth of the acquisition price. It has since taken Ranbaxy four years to reach a settlement with the US regulatory authorities. In 2013, The Company agreed to pay a fine of \$500 million after admitting to false representation of data and quality issues at its three Indian plants supplying to the US market. The company's problems in the US are far from done with. It continues to face challenges in securing timely approval for its exclusive products in the US markets. (Source: thehindubusinessline.com)

Why Sun Pharma take interest in acquiring Ranbaxy?

The combination of Sun Pharma and Ranbaxy creates the fifth-largest specialty generics company in the world and the largest pharmaceutical company in India. The combined entity will have 47 manufacturing facilities across 5 continents. The transaction will combine Sun Pharma's proven complex product capabilities with Ranbaxy's strong global footprint, leading to significant value creation opportunities. Additionally, the combined entity will have increased exposure to emerging economies while also bolstering Sun Pharma's commercial and

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manufacturing presence in the United States and India. It will have an established presence in key high-growth emerging markets. In India, it will be ranked No. 1 by prescriptions amongst 13 different classes of specialist doctors.

Also, from a financial and business perspective on a pro forma basis, the combined entity's revenues are estimated at US\$ 4.2 billion with EBITDA of US\$ 1.2 billion for the twelve month period ended December 31, 2013. The transaction value implies a revenue multiple of 2.2 based on 12 months ended December 31, 2013. Sun Pharma expects to realize revenue and operating synergies of US\$ 250 million by third year post closing of the transaction. These synergies are expected to result primarily from topline growth, efficient procurement and supply chain efficiencies.

(Major contents are derived from press releases hosted on website of Ranbaxy)

In summary, the challenge to valuing for M&As is to obtain a thorough understanding of the business dynamics of both the parties, the rationale for the merger, the industry dynamics, the resulting synergies as well as the likely risks of the transaction are required in order to ensure that the valuation is such that it is a 'win-win' for both the parties and is financially viable. It is also important to understand that there are no hard and fast rules since one is projecting the future which is 'unknown' based on current understanding. Therefore, experience, good judgment and diligence are important in working out values.

15. Corporate Restructuring

Restructuring of business is an integral part of modern business enterprises. The globalization and liberalization of Control and Restrictions has generated new waves of competition and free trade. This requires Restructuring and Re-organisation of business organization to create new synergies to face the competitive environment and changed market conditions.

Restructuring usually involves major organizational changes such as shift in corporate strategies. Restructuring can be internally in the form of new investments in plant and machinery, Research and Development of products and processes, hiving off of non-core businesses, divestment, sell-offs, de-merger etc. Restructuring can also take place externally through mergers and acquisition (M&A) and by forming joint-ventures and having strategic alliances with other firms.

The topic of Mergers and Acquisition has already been discussed in previous section. It is now proposed to focus on Corporate Restructuring.

The aspects relating to expansion or contraction of a firm's operations or changes in its assets or financial or ownership structure are known as corporate re-structuring. While there are many forms of corporate re-structuring, mergers, acquisitions and takeovers, financial restructuring and re-organisation, divestitures de-mergers and spin-offs, leveraged buyouts and management buyouts are some of the most common forms of corporate restructuring. These forms are discussed herein as follows:

15.1 Demergers or Divestment: There are various reasons for divestment or demerger viz.,

- (i) To pay attention on core areas of business;
- (ii) The Division's/business may not be sufficiently contributing to the revenues;
- (iii) The size of the firm may be too big to handle;
- (iv) The firm may be requiring cash urgently in view of other investment opportunities.

Different ways of divestment or demerger are as follows:

Sell off: A sell off is the sale of an asset, factory, division, product line or subsidiary by one entity to another for a purchase consideration payable either in cash or in the form of securities.

Example: DLF Ltd completed the sale of its Luxury Hotel Unit Aman Resorts to a joint venture of Peak Hotels & Resorts Group and Zecha for \$360 million in 2014.

Spin-off: In this case, a part of the business is separated and created as a separate firm. The existing shareholders of the firm get proportionate ownership. So there is no change in ownership and the same shareholders continue to own the newly created entity in the same proportion as previously in the original firm. The management of spun-off division is however, parted with. Spin-off does not bring fresh cash. The reasons for spin off may be:

- (i) Separate identity to a part/division.
- (ii) To avoid the takeover attempt by a predator by making the firm unattractive to him since a valuable division is spun-off.
- (iii) To create separate Regulated and unregulated lines of business.

Example: Kishore Biyani led Future Group spin off its consumer durables business, Ezone, into a separate entity in order to maximise value from it.

Split-up: This involves breaking up of the entire firm into a series of spin off (by creating separate legal entities). The parent firm no longer legally exists and only the newly created entities survive. For instance, a corporate firm has 4 divisions namely A, B, C, D. All these 4 division shall be split-up to create 4 new corporate firms with full autonomy and legal status. The original corporate firm is to be wound up. Since de-merged units are relatively smaller in size, they are logistically more convenient and manageable. Therefore, it is understood that spin-off and split-up are likely to enhance shareholders value and bring efficiency and effectiveness.

Example: Philips, the Dutch conglomerate that started life making light bulbs 123 years ago, is splitting off its lighting business in a bold step to expand its higher-margin healthcare and consumer divisions. The new structure should save 100 million euros (\$128.5 million) next year and 200 million euros in 2016. It expects restructuring charges of 50 million euros from 2014 to 2016.

Carve outs: This is like spin off however; some shares of the new company are sold in the market by making a public offer, so this brings cash. In carve out, the existing company may sell either majority stake or minority stake, depending upon whether the existing management wants to continue to control it or not.

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Example – Encana Corp., North America's second-largest producer of natural gas, split itself into two, jettisoning most of its oil assets by carving out oil sands producer Cenovus Energy Inc in 2009.

Sale of a Division: In the case of sale of a division, the seller company is demerging its business whereas the buyer company is acquiring a business. For the first time the tax laws in India propose to recognise demergers.

15.2 Demerger or Division of Family-Managed Business: Around 80 per cent of private sector companies in India are family-managed companies. The family-owned companies are, under extraordinary pressure to yield control to professional managements, as, in the emerging scenario of a liberalised economy the capital markets are broadening, with attendant incentives for growth. So, many of these companies are arranging to hive off their unprofitable businesses or divisions with a view to meeting a variety of succession problems. Even otherwise, a group of such family-managed companies may undertake restructuring of its operations with a view also to consolidating its core businesses. For this, the first step that may need to be taken is to identify core and non-core operations within the group. The second step may involve reducing interest burden through debt restructuring along with sale of surplus assets. The proceeds from the sale of assets may be employed for expanding by acquisitions and rejuvenation of its existing operations. The bottom line is that an acquisition must improve economies of scale, lower the cost of production, and generate and promote synergies. Besides acquisitions, therefore, the group may necessarily have to take steps to improve productivity of its existing operations.

15.3 Corporate Controls

Going Private: This refers to the situation wherein a listed company is converted into a private company by buying back all the outstanding shares from the markets.

Example: The Essar group successfully completed Essar Energy Plc delisting process from London Stock Exchange in 2014.

Equity buyback: This refers to the situation wherein a company buys back its own shares back from the market. This results in reduction in the equity capital of the company. This strengthen the promoter's position by increasing his stake in the equity of the company.

Example Cairn India bought back 3.67 crores shares and spent nearly ₹ 1230 crores by May 2014.

Restructuring of an existing business: An existing business in the face of impending onslaught of international competition or even otherwise, may require restructuring. Such restructuring may involve, for instance, downsizing and closing down of some unprofitable departments. So also, trimming the number of personnel. There may also arise a case of restructuring of a company where for instance, there has been a failure of management, or for the matter of that, to overcome a wrong business or financial decision. In such a situation, the company may sell or close certain divisions, pay off debt, focus on more promising lines of business and focus hard to enhance shareholder value. Restructuring may also involve a long-drawn process. The interesting part is that the process of change has affected stock prices of

these companies. And the same can be expected of their domestic subsidiaries after a while unless business dynamics or holding structure widely differ.

Buy-outs: This has two versions. The classical version where the current management of a company or business division 'buys out' the company/division from the owners/promoters (i.e., shareholders or the company). This happens due to the owners/promoters losing interest in the line of business or due to the accumulating losses. The takeover of Escorts Auto Components Ltd. by its CEO (Bharat Caprihan) and six other CXOs in 2004 was probably the first such reported transaction. There's another example where Liquid Comics has completed the management buyout of the Virgin Comics (a Virgin Group company) in 2008 led by the founding management team of Gotham Chopra, Sharad Devarajan and Suresh Seetharaman. Usually there will be a banker/financier/PE who will bankroll the transaction. This MBO was followed up by the PE Firm Actis helping out the CEO team in Phoenix Lamps. In 2008, Intelnet Global Services Private Limited was bought out by its CXO Team led by Susit Kumar with the support of Blackstone Group from the original promoters of the Company viz., Tata Consultancy Services and HDFC.

The newer version of MBO relates to an active PE who goes after weak managements and buys out the stake and the brings in their CXOs to Manage the Business – the PE gets actively involved in the Management and turns over the company into a profitable opportunity and exits at the right time. The Management Team that comes in takes stake in the equity capital of the company while coming on board and hence the term Management Buy-in.

In recessionary periods buy-outs can play a big part in restructuring of failed or failing businesses and in an environment of generally weakened corporate performance often represent the only viable purchasers when parents wish to dispose of subsidiaries.

Buy-outs are one of the most common forms of privatisation, offering opportunities for enhancing the performances of parts of the public sector, widening employee ownership and giving managers and employees incentives to make best use of their expertise in particular sectors.

Buy-outs will typically be financed by a mixture of senior secured debt and a range of equity and quasi-equity instruments. For larger buy-outs, especially when auctions and buoyant conditions mean that prices well in excess of the security value of assets have to be paid, subordinated (mezzanine debt) may be used. Quasi-equity instruments, such as cumulative convertible participating preferred ordinary shares, are important both in ensuring the venture capitalist obtains a regular dividend and in putting pressure on managers to perform and/or seek to realise an investment in a timely fashion.

Seller's Perspective: It is necessary to remember that for every buyer there must be a seller. Although the methods of analysis for selling are the same as for buying, the selling process is termed **divestiture**. The decision to sell a company is at least as important as buying one. But selling generally lacks the kind of planning that goes into buying. Quite often, the decision and the choice of the buyer is arbitrary, resulting in a raw deal for the selling company's shareholders. It is important to understand that selling needs the same set of skills required for buying. At some point of time the executives of a company may have to take the decision to divest a division There is nothing wrong in selling a division if it is worth more to someone

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else. The decision to sell may be prompted by poor growth prospects for a division or consolidation in the industry. Given the fact that the need to sell may arise any time, it makes sense for executives to be prepared. More specifically, executives need to know their company's worth. Consideration may be given to strengths and weakness in production, marketing, general management, value of synergy to potential buyers, value of brand equity, skill base of the organisation, etc.

To summarise, the following are some of the 'sell-side' imperatives

- Competitor's pressure is increasing.
- Sale of company seems to be inevitable because company is facing serious problems like:
 - No access to new technologies and developments
 - Strong market entry barriers. Geographical presence could not be enhanced
 - Badly positioned on the supply and/or demand side
 - Critical mass could not be realised
 - No efficient utilisation of distribution capabilities
 - New strategic business units for future growth could not be developed
 - Not enough capital to complete the project
- Window of opportunity: Possibility to sell the business at an attractive price
- Focus on core competencies
- In the best interest of the shareholders – where a large well known firm brings-up the proposal, the target firm may be more than willing to give-up

16. Financial Restructuring

Financial restructuring refers to a kind of internal changes made by the management in Assets and Liabilities of a company with the consent of its various stakeholders. This is a suitable mode of restructuring for corporate entities who have suffered from sizeable losses over a period of time. Consequent upon losses the share capital or net worth of such companies get substantially eroded. In fact, in some cases, the accumulated losses are even more than the share capital and thus leading to negative net worth, putting the firm on the verge of liquidation. In order to revive such firms, financial restructuring is one of the technique to bring into health such firms which are having potential and promise for better financial performance in the years to come. To achieve this desired objective, such firms need to re-start with a fresh balance sheet free from losses and fictitious assets and show share capital at its true worth.

To nurse back such firms a plan of restructuring need to be formulated involving a number of legal formalities (which includes consent of court, and other stake-holders viz., creditors, lenders and shareholders etc.). An attempt is made to do refinancing and rescue financing while Restructuring. Normally equity shareholders make maximum sacrifice by foregoing

certain accrued benefits, followed by preference shareholders and debenture holders, lenders and creditors etc. The sacrifice may be in the form of waving a part of the sum payable to various liability holders. The foregone benefits may be in the form of new securities with lower coupon rates so as to reduce future liabilities. The sacrifice may also lead to the conversion of debt into equity. Sometime, creditors, apart from reducing their claim, may also agree to convert their dues into securities to avert pressure of payment. These measures will lead to better financial liquidity. The financial restructuring leads to significant changes in the financial obligations and capital structure of corporate firm, leading to a change in the financing pattern, ownership and control and payment of various financial charges.

In nutshell it may be said that financial restructuring (also known as internal re-construction) is aimed at reducing the debt/payment burden of the corporate firm. This results into

- (i) Reduction/Waiver in the claims from various stakeholders;
- (ii) Real worth of various properties/assets by revaluing them timely;
- (iii) utilizing profit accruing on account of appreciation of assets to write off accumulated losses and fictitious assets (such as preliminary expenses and cost of issue of shares and debentures) and creating provision for bad and doubtful debts. In practice, the financial restructuring scheme is drawn in such a way so that all the above requirements of write off are duly met. The following illustration is a good example of financial restructuring.

Illustration 3

The following is the Balance-sheet of XYZ Company Ltd as on March 31st, 2013.

(₹ in lakh)

Liabilities	Amount	Assets	Amount
6 lakh equity shares of ₹100/- each	600	Land & Building	200
2 lakh 14% Preference shares of ₹100/- each	200	Plant & Machinery	300
13% Debentures	200	Furniture & Fixtures	50
Debenture Interest accrued and Payable	26	Inventory	150
Loan from Bank	74	Sundry debtors	70
Trade Creditors	300	Cash at Bank	130
		Preliminary Expenses	10
		Cost of Issue of debentures	5
		Profit & Loss A/c	485
	1,400		1,400

The XYZ Company did not perform well and has suffered sizable losses during the last few years. However, it is now felt that the company can be nursed back to health by proper financial restructuring and consequently the following scheme of reconstruction has been devised:

- (i) Equity shares are to be reduced to ₹ 25/- per share, fully paid up;

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- (ii) Preference shares are to be reduced (with coupon rate of 10%) to equal number of shares of ₹50 each, fully paid up.
- (iii) Debenture holders have agreed to forego interest accrued to them. Beside this, they have agreed to accept new debentures carrying a coupon rate of 9%.
- (iv) Trade creditors have agreed to forgo 25 per cent of their existing claim; for the balance sum they have agreed to convert their claims into equity shares of ₹ 25/- each.
- (v) In order to make payment for bank loan and augment the working capital, the company issues 6 lakh equity shares at ₹ 25/- each; the entire sum is required to be paid on application. The existing shareholders have agreed to subscribe to the new issue.
- (vi) While Land and Building is to be revalued at ₹ 250 lakh, Plant & Machinery is to be written down to ₹ 104 lakh. A provision amounting to ₹ 5 lakh is to be made for bad and doubtful debts.

You are required to show the impact of financial restructuring/re-construction. Also, prepare the new balance sheet assuming the scheme of re-construction is implemented in letter and spirit.

Solution

Impact of Financial Restructuring

- (i) Benefits to XYZ Ltd.

		₹ in lakhs
(a)	<i>Reduction of liabilities payable</i>	
	Reduction in equity share capital (6 lakh shares × ₹75 per share)	450
	Reduction in preference share capital (2 lakh shares × ₹50 per share)	100
	Waiver of outstanding debenture Interest	26
	Waiver from trade creditors (₹300 lakhs × 0.25)	<u>75</u>
		<u>651</u>
(b)	<i>Revaluation of Assets</i>	
	Appreciation of Land and Building (₹250 lakhs - ₹200 lakhs)	<u>50</u>
		<u>701</u>

- (ii) Amount of ₹701 lakhs utilized to write off losses, fictitious assets and over-valued assets.

	₹ in lakhs
Writing off profit and loss account	485
Cost of issue of debentures	5
Preliminary expenses	10
Provision for bad and doubtful debts	5
Revaluation of Plant and Machinery (₹300 lakhs – ₹104 lakhs)	<u>196</u>
	<u>701</u>

Balance sheet of XYZ Ltd as at _____ (after re-construction)

(₹ in lakhs)

Liabilities	Amount	Assets	Amount
21 lakhs equity shares of ₹25/- each	525	Land & Building	250
2 lakhs 10% Preference shares of ₹50/- each	100	Plant & Machinery	104
9% Debentures	200	Furnitures & Fixtures	50
		Inventory	150
		Sundry debtors	70
			<u>-5</u>
		Cash-at-Bank	206
		(Balancing figure)*	
	825		825

*Opening Balance of ₹130/- lakhs + Sale proceeds from issue of new equity shares ₹150/- lakhs – Payment of bank loan of ₹74/- lakhs = ₹206 lakhs.

It is worth mentioning that financial restructuring is unique in nature and is company specific. It is carried out, in practice when all shareholders sacrifice and understand that the restructured firm (reflecting its true value of assets, capital and other significant financial parameters) can now be nursed back to health. This type of corporate restructuring helps in the revival of firms that otherwise would have faced closure/liquidation.

17. Merger Failures or Potential Adverse Competitive Effects

Academic studies indicate that success in creating value through acquisitions in a competitive market is extremely difficult. Jensen and Ruback (1983) highlighted this point by summarising results from mergers and acquisitions over a period of 11 years. They found that in case of a merger, the average return, around the date of announcement, to shareholders of the acquired company is 20 per cent, whereas the average return to the acquiring company is 0 per cent. Another study by McKinsey indicates that 61 per cent of the 116 acquisitions studied were failures, 23 per cent were successes. Despite such statistics why do companies acquire? Why do mergers fail? The reasons for merger failures can be numerous. Some of the key reasons are :

- Acquirers generally overpay;
- The value of synergy is over-estimated;
- Poor post-merger integration; and
- Psychological barriers.

Companies often merge in the fear that the bigger competitors have economies of scale and may destroy them by exercising a stranglehold on raw material supply, distribution etc. What they do not realise is the drawbacks of being big. The acquiring company's executives would

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have drawn up elaborate plans for the target without consulting its executives which leads to resentment and managerial attrition. This can be avoided by honest discussions with the target company's executives.

Most companies merge with the hope that the benefits of synergy will be realised. Synergy will be there only if the merged entity is managed better after the acquisition than it was managed before. It is the quality of the top management that determines the success of the merger. Quite often the executives of the acquiring company lose interest in the target company due to its smallness. The small company executives get bogged down repairing vision and mission statements, budgets, forecasts, profit plans which were hitherto unheard of. The elaborateness of the control system depends on the size and culture of the company. To make a merger successful:

- Decide what tasks need to be accomplished in the post-merger period;
- Choose managers from both the companies (and from outside);
- Establish performance yardstick and evaluate the managers on that yardstick; and
- Motivate them.

18. Acquiring for Shares

The acquirer can pay the target company in cash or exchange shares in consideration. The analysis of acquisition for shares is slightly different. The steps involved in the analysis are:

- Estimate the value of acquirer's (self) equity;
- Estimate the value of target company's equity;
- Calculate the maximum number of shares that can be exchanged with the target company's shares; and
- Conduct the analysis for pessimistic and optimistic scenarios.

Exchange ratio is the number of acquiring firm's shares exchanged for each share of the selling firm's stock. Suppose company A is trying to acquire company B's 100,000 shares at ₹230. So the cost of acquisition is ₹230,00,000. Company A has estimated its value at ₹200 per share. To get one share of company B, A has to exchange $(230/200)$ 1.15 share, or 115,000 shares for 100,000 shares of B. The relative merits of acquisition for cash or shares should be analysed after giving due consideration to the impact on EPS, capital structure, etc.

Normally when shares are issued in payment to the selling company's shareholders, stockholders will find the merger desirable only if the value of their shares is higher with the merger than without the merger. The number of shares that the buying company will issue in acquiring the selling company is determined as follows:

- (1) The acquiring company will compare its value per share with and without the merger.
- (2) The selling company will compare its value with the value of shares that they would receive from acquiring company under the merger.

- (3) The managements of acquiring company and selling company will negotiate the final terms of the merger in the light of (1) and (2); the ultimate terms of the merger will reflect the relative bargaining position of the two companies.

The fewer of acquiring company's shares that acquiring company must pay to selling company, the better off are the shareholders of acquiring company and worse off are the shareholders of selling company. However, for the merger to be effected, the shareholders of both the buying and selling company will have to anticipate some benefits from the merger.

Impact of Price Earning Ratio: The reciprocal of cost of equity is price-earning (P/E) ratio. The cost of equity, and consequently the P/E ratio reflects risk as perceived by the shareholders. The risk of merging entities and the combined business can be different. In other words, the combined P/E ratio can very well be different from those of the merging entities. Since market value of a business can be expressed as product of earning and P/E ratio ($P/E \times E = P$), the value of combined business is a function of combined earning and combined P/E ratio. A lower combined P/E ratio can offset the gains of synergy or a higher P/E ratio can lead to higher value of business, even if there is no synergy. In ascertaining the exchange ratio of shares due care should be exercised to take the possible combined P/E ratio into account.

Illustration 4

Company X is contemplating the purchase of Company Y, Company X has 3,00,000 shares having a market price of ₹ 30 per share, while Company Y has 2,00,000 shares selling at ₹ 20 per share. The EPS are ₹ 4.00 and ₹ 2.25 for Company X and Y respectively. Managements of both companies are discussing two alternative proposals for exchange of shares as indicated below:

- (i) *in proportion to the relative earnings per share of two companies.*
- (ii) *0.5 share of Company X for one share of Company Y (0.5:1).*

You are required:

- (i) *to calculate the Earnings Per share (EPS) after merger under two alternatives; and*
- (ii) *to show the impact of EPS for the shareholders of two companies under both the alternatives.*

Solution

Working Notes: Calculation of total earnings after merger

Particulars	Company X	Company Y	Total
Outstanding shares	3,00,000	2,00,000	
EPS (₹)	4	2.25	
Total earnings (₹)	12,00,000	4,50,000	16,50,000

- (i) (a) Calculation of EPS when exchange ratio is in proportion to relative EPS of two companies

Company X		3,00,000
Company Y	$2,00,000 \times 2.25/4$	1,12,500
Total number of shares after merger		4,12,500

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Company X

EPS before merger	=	₹ 4
EPS after merger = ₹ 16,50,000/4,12,500 shares	=	₹ 4

Company Y

EPS before merger	=	₹ 2.25
EPS after merger		
= EPS of Merged Entity after merger x Share Exchange ratio on EPS basis	=	₹ 2.25
= ₹ $4 \times \frac{2.25}{4}$		

(b) Calculation of EPS when share exchange ratio is 0.5 : 1

Total earnings after merger	=	₹ 16,50,000
Total number of shares after merger	=	3,00,000 + (2,00,000 x 0.5)
	=	4,00,000 shares
EPS after merger = ₹ 16,50,000/4,00,000	=	₹ 4.125

(ii) Impact of merger on EPS for shareholders of Company X and Company Y

(a) Impact on Shareholders of Company X

	(₹)
EPS before merger	4.000
EPS after merger	4.125
Increase in EPS	0.125

(b) Impact on Shareholders of Company Y

	(₹)
Equivalent EPS before merger	2.2500
Equivalent EPS after merger	2.0625
Decrease in EPS	0.1875

Illustration 5

A Ltd. is studying the possible acquisition of B Ltd. by way of merger. The following data are available:

Firm	After-tax earnings	No. of equity shares	Market price per share
A Ltd.	₹ 10,00,000	2,00,000	₹ 75
B Ltd.	₹ 3,00,000	50,000	₹ 60

(i) If the merger goes through by exchange of equity shares and the exchange ratio is set according to the current market prices, what is the new earnings per share for A Ltd.?

- (ii) B Ltd. wants to be sure that its earning per share is not diminished by the merger. What exchange ratio is relevant to achieve the objective?

Solution

- (i) The current market price is the basis of exchange of equity shares, in the proposed merger, shareholders of B Ltd. will get only 40,000 shares in all or 4 shares of A Ltd. for every 5 shares held by them, i.e.,

$$\frac{50,000 \times 60}{75} = 40,000$$

The total number of shares in A Ltd. will then be 2,40,000 and, ignoring any synergistic effect, the profit will be ₹ 13,00,000. The new earning per share (EPS) of A Ltd. will be ₹ 5.42, i.e., ₹ 13,00,000/2,40,000.

- (ii) The present earnings per share of B Ltd. is ₹6/- (₹ 3,00,000 ÷ 50,000) and that of A Ltd. is ₹5/-, i.e., ₹ 10,00,000 ÷ 2,00,000. If B Ltd. wants to ensure that, even after merger, the earning per share of its shareholders should remain unaffected, then the exchange ratio will be 6 shares for every 5 shares.

The total number of shares of A Ltd. that will produce ₹ 3,00,000 profit is 60,000, (3,00,000 ÷ 5), to be distributed among, shareholders of B Ltd., giving a ratio of 6 shares in A for 5 shares in B.

Proof:

The shareholders of B Ltd. will get in all 60,000 share for 50,000 shares. It means after merger, their earning per share will be ₹ 5/-, i.e. $\frac{₹13,00,000}{2,60,000}$.

In all they will get ₹3,00,000, i.e., 60,000 x 5, as before.

Illustration 6

Simpson Ltd. is considering a merger with Wilson Ltd. The data below are in the hands of both Board of Directors. The issue at hand is how many shares of Simpson should be exchanged for Wilson Ltd. Both boards are considering three possibilities 20,000, 25,000 and 30,000 shares. You are required to construct a table demonstrating the potential impact of each scheme on each set of shareholders:

		Simpson Ltd.	Wilson Ltd.	Combined Post merger Firm 'A'
1.	Current earnings per year	2,00,000	1,00,000	3,50,000
2.	Shares outstanding	50,000	10,000	?
3.	Earnings per share (₹) (1 ÷ 2)	4	10	?
4.	Price per share (₹)	40	100	?
5.	Price-earning ratio [4 ÷ 3]	10	10	10
6.	Value of firm (₹)	20,00,000	10,00,000	35,00,000
7.	Expected Annual growth rate in earnings in foreseeable future	0	0	0

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Solution

The following table demonstrates the potential impact of the three possible schemes, on each set of shareholders: -

<i>Number of Simpson Ltd.'s shares issued to shareholders of Wilson Ltd.</i>	<i>Exchange ratio [(1)/10,000 shares of Wilson Ltd.]</i>	<i>Number of Simpson Ltd.'s shares outstanding after merger [50,000+(1)]</i>	<i>Fraction of Simpson Ltd. (Post merger) owned by Wilson Ltd.'s shareholders [(1)/(3)]</i>	<i>Value of shares owned by Wilson Ltd.'s shareholders [(4)x 35,00,000]</i>	<i>Fraction of Simpson Ltd. (combined Post-merger owned by Simpson Ltd.'s shareholders [50,000/(3)]</i>	<i>Value of shares owned by Simpson Ltd.'s shareholders [(6) x 35,00,000]</i>
(1)	(2)	(3)	(4)	(5)	(6)	(7)
20,000	2	70,000	2/7	10,00,000	5/7	25,00,000
25,000	2.5	75,000	1/3	11,66,667	2/3	23,33,333
30,000	3	80,000	3/8	13,12,500	5/8	21,87,500

19. Cross-Border M&A

Cross-border M&A is a popular route for global growth and overseas expansion. Cross-border M&A is also playing an important role in global M&A. This is especially true for developing countries such as India. Kaushik Chatterjee, CFO, of Tata Steel in an interview with McKenzie Quarterly in September 2009 articulates this point very clearly. To the following question

The Quarterly: Last year was the first in which Asian and Indian companies acquired more businesses outside of Asia than European or US multinationals acquired within it. What's behind the Tata Group's move to go global?

His response is as follows:-

"India is clearly a very large country with a significant population and a big market, and the Tata Group's companies in a number of sectors have a pretty significant market share. India remains the main base for future growth for Tata Steel Group, and we have substantial investment plans in India, which are currently being pursued. But meeting our growth goals through organic means in India, unfortunately, is not the fastest approach, especially for large capital projects, due to significant delays on various fronts. Nor are there many opportunities for growth through acquisitions in India, particularly in sectors like steel, where the value to be captured is limited—for example, in terms of technology, product profiles, the product mix, and good management."

Other major factors that motivate multinational companies to engage in cross-border M&A in Asia include the following:

- Globalization of production and distribution of products and services.

- Integration of global economies.
- Expansion of trade and investment relationships on International level.
- Many countries are reforming their economic and legal systems, and providing generous investment and tax incentives to attract foreign investment.
- Privatisation of state-owned enterprises and consolidation of the banking industry.

20. Decade of Corporate Churning and Change

Despite the churning and change that has taken place over the past decade, the corporate sector has still to go a long way in improving its image and become globally competitive. The successes and failures have not been industry-specific but company-specific. But at the macro-level, the overall efficiency of industry has not shown much improvement.

The internal and external liberalisation measures introduced over the last two decades and the dramatic changes that have taken place in the international business environment have had a far-reaching impact on Indian business. The face of Corporate India has changed during the last two decades than in the preceding four decades thanks to the U-turn in the Government's economic policy in 1991.

Major policy changes: The major policy changes introduced since July, 1991 include:

- (a) abolition of industrial licensing;
- (b) lifting of restrictions on the size of firms;
- (c) a drastic reduction in the areas reserved for the public sector;
- (d) disinvestments of Government equity in public sector undertakings (PSUs) aimed at eventual privatisation of most of them;
- (e) liberalisation of foreign investment regulations;
- (f) substantial liberalisation of import tariffs;
- (g) removal of all quantitative restrictions on imports;
- (h) abolition of the office of the Controller of Capital Issues (CCI) and freedom to companies to set premia on their share issues;
- (i) freedom to companies to raise capital abroad;
- (j) rationalisation and lowering of excise and Customs duties
- (k) replacing the draconian FERA with FEMA
- (l) a substantial reduction in corporate and personal income tax rates and introduction of total current account convertibility and partial capital account convertibility

In large measure, these reforms met the longstanding demands of the Indian industry to free it from the plethora of controls and regulations, exorbitantly high rates of direct and indirect taxes and severe restrictions on foreign exchange transactions. All the internal liberalisation

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measures provided greater freedom and opportunities to the Indian companies and entrepreneurs to expand their existing businesses and enter new areas hitherto reserved exclusively for the public sector.

However, the corporate sector was not quite prepared for the other side of reforms, namely, the external liberalisation and the movement towards globalisation, which opened the Indian economy to competition from abroad. Although India was not strictly a closed economy even before the launch of the reforms process, Indian industry was generally insulated from external competition thanks to a variety of import restrictions and high tariff walls, the peak level import duty being some 300 per cent.

Companies are now obliged to offer better quality products at increasingly competitive prices, and their profit margins are constantly under pressure. Under the earlier regime of protection, 'cost-plus' pricing was the norm in most cases. In the majority of cases, it was possible to pass on the burden of higher costs and inefficiencies to the customer by charging a higher price for the product. Today there is a paradigm shift in this equation. No more is the formula "Cost + Profit = Revenue". Presently, the commodity markets (real markets) define the maximum revenue potential and the capital markets (equity, in particular) define the minimum profit requirements. Therefore, the Corporate Managers are not given any leeway other than managing the Costs. This has resulted in yet another paradigm shift from focus on 'Cost Reduction' to 'Cost Management'.

To succeed in the new environment, companies are required to bring:

- New insights into understanding the customer who is becoming increasingly demanding;
- the ability to design, develop and produce new and more customer-friendly products of better quality;
- skills to develop exclusive positions in the minds of the consumer;
- new processes, techniques and technologies to ensure that costs are being continuously reduced,
- ways to restructure organisations so that trained and talented people stay to give their best efforts; and
- considerable funds to invest in marketing and building brand franchises.

Churning and restructuring: It is not surprising, therefore, that the Indian corporate sector is undergoing a process of churning and restructuring. The fortunes of the once renowned family business houses such as the Dalmia-Jain group, Sriram group, Walchands, Thapars, Singhania, Somanis, Wadias, Mafatlals, Khaitans and Modis have witnessed an unprecedented decline. With much erosion in their wealth, they lie scattered because of family splits and mismanagement. However, Mr. Dhirubhai Ambani's Reliance Group has been an exception. It managed to prosper and grow despite all odds by seizing the opportunities provided by liberalisation and globalisation. Reliance Industries is now among the top five companies in the country in terms of market capitalisation.

The decade also witnessed the phenomenal growth of the so-called New Economy companies such as Infosys, Wipro and Bharti Airtel which started creating more wealth than the Tatas and Birlas. Mr. Azim Premji of Wipro and Mr. Narayan Murthy of Infosys are the new breed of entrepreneurs known for very high standards of corporate governance and global outlook.

It must be said to the credit of at least some of the family business houses and leading individual companies that they have not been silent spectators allowing the events to overtake them. For instance, Mr. Ratan Tata has initiated measures since 1998 to restructure the Tata empire with the help of management consultants McKinsey & Co. with a view to eventually reduce the number of companies in the group from the existing 80 to 30 and cut down the portfolio from 25 to just a dozen core businesses.

The restructuring exercises also include financial restructuring— restructuring of debt and equity. Many companies have been retiring the earlier high cost debt with the new low interest bearing loans. The threat of hostile takeovers following the big slump in share values of Old Economy companies has prompted managements to hike their equity stake. Gone are the days when business families could exercise control on the management of companies with a small equity stake, often less than 10 per cent.

Consolidation of market power: While the first wave of mergers and joint ventures was driven primarily by competitive compulsions and as an outcome of business restructuring, of late, the larger and more aggressive companies have been buying out the smaller ones to assume market leadership. Till 1999, the biggest mergers and acquisitions deals were in the FMCG industries that are traditionally intensely competitive and have become more so with the entry of well-known international brands. A classic example of the extensions and consolidation of market power is the Hindustan Lever's acquisition and restructuring spree over the last few years. By 1998, it wrapped up five acquisitions (Tomco, Dollop's, Kwality, Milkfood and Kissan) and effected a host of mergers — Doom Dooma with Brooke Bond, Brooke Bond with Lipton, Pond's with Quest International, and finally Brooke Bond Lipton India Ltd (BBLIL) with Hindustan Lever Ltd (HLL). It acquired a 74 percent stake in Modern Foods and turned it into a profitable venture.

M&As also took place in cement, aluminium, steel, chemicals and pharmaceuticals. Incidentally, one of the biggest mergers in India Inc took place in the telecom sector with BPL Communications and the Birla-Tata-AT&T combine, two of the nation's biggest cellular players, announcing an agreement to merge operations.

Where mergers were not convenient, companies tried to form strategic alliances. Pharmaceutical companies such as Dr. Reddys, Ranbaxy and Lupin Laboratories entered into strategic alliances with some MNCs. Incidentally Ranbaxy itself was acquired by Daiichi-Sankyo of Japan in 2008. Another strategy was to form joint ventures with foreign majors, notably in automobile and consumer durable sectors. Unfortunately, most of these joint ventures did not last long. Some of the prominent joint ventures between Indian and foreign partners, particularly in the high-tech and high capital intensity automobile sectors, failed to mature and the foreign partners assumed full control.

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Despite the churning and change that has taken place over the last two decades, the Indian corporate sector has still to go a long way in improving its image and become globally competitive. True, there have been notable winners across industries such as HLL, Reliance Industries, Hindalco, Tata Group, Hero Motocorp Asian Paints, Sundram Fasteners, Dr. Reddy's Laboratories, Larsen & Toubro, and the public sector companies BHEL and Punjab Tractors. The successes and failures have not been industry specific but company specific. But at the macro level, the overall efficiency of Indian industry has not shown much improvement.

While there has been some increase in expenditure on R&D and brand building, the Indian companies are still lagging far behind their foreign counterparts. Here again, there are a few exceptions. Naushad Forbes finds two major changes in corporate R&D. One is the emergence of new companies, particularly in the pharma sector, as substantial spenders in R&D.

With India recognising the foreign product patents, companies have begun acquiring innovation capacity. Dr. Reddy's have licensed out their discoveries to MNCs earning fat royalties. Nicholas Piramal bought the R&D laboratory of Hoechst Marion Roussel. Second, and more important, is the change in the character of R&D. While earlier the R&D expenditure was mostly on import substitution and diversification, today a part of it is on reaching the international technological frontier.

Unfortunately, the large public sector and the small-scale industries sector still lagging behind in reforms. Unless the Government is able to push ahead vigorously with reforming these sectors, along with a viable exit policy and labour reforms, they will continue to act as major impediments to competitiveness.