The significance of mergers and acquisition in india

The term mergers and acquisition refers to the facet of corporate finance, strategy and management dealing with buying and selling or amalgamating different companies that can help in financial aid or help in increasing the market share and growth without creating another business entity.

Important terms used in the world of mergers & acquisition, & their brief explanation:

Merger: is defined as the combination of two or more companies into a single company where one survives and the other loses its corporate existence. The survivor acquires the assets as well as liabilities of the merged company or companies.

Amalgamation: Halsbury's Laws of England describe amalgamation as a blending of two or more existing undertakings onto one undertaking, the shareholders of each blending company becoming substantially the share holders in the company which is to carry on the blended undertaking. Section 2 (a) of Income Tax Act defines: Amalgamation in relation to companies means the merger of two or more companies to form one company in such a manner that:

All the properties of the amalgamating company or companies just before the amalgamated company by virtue of amalgamation become the properties of amalgamation.

All the liabilities of the amalgamating company or companies just before the amalgamation become the liabilities of the amalgamation; become the liabilities of the amalgamated company by virtue of amalgamation.

Shareholders holding not less than three-fourth in value of shares in the amalgamating company or companies becomes the shareholders of the amalgamated company by virtue of amalgamation.

Consolidation: is the fusion of two existing companies into a new company in which both the existing companies extinguish. The small difference between consolidation and merger is that in merger one of the two or more merging companies retains its identity while in consolidation all the consolidating companies extinguish and an entirely new company is born.

Acquisitions/Takeovers: This refers to purchase of majority stake (controlling interest) in the share capital of an existing company by another company. It may be noted that in the case of takeover although there is change in management, both the companies retain their separate legal identity.

Leveraged Buyouts: It means any takeover which is routed through a high degree of borrowings. In simple words a takeover with the help of debt.

Management Buyouts: It refers to the purchase of the corporation part or whole of shareholding of the controlling / dominant group of shareholders by the existing mangers of the company.

Sell Off: General Term for divestiture of part or whole of the firm by any one or number of means: i. e. sale, spin off, split up etc.

Spin Off: A transaction in which a company distributes all the shares it owns in a subsidiary to its own shareholders on pro-rata basis & then creates a new company with the same proportional shareholding pattern as in the parent company.

Split Off: A transaction in which some, but not all, shareholders of the parent company receive shares in a subsidiary, for relinquishing their parent company shares.

Split Up: A transaction in which a company spins off, all of its subsidiaries to it shareholders and ceases to exist.

Equity Carve Out: A transaction in which a parent company offers some common stock of one of its subsidiaries to the general public, so as to bring in a cash infusion to the parent company without losing the control.

TYPES OF MERGERS AND ACQUISITIONS

Mergers can be classified into three categories:

On the basis of movement in the industries

Horizontal Mergers

These involves merger of two firms operating and competing in the same line of business activity. It is performed with a view to form a larger firm, which may have economies of scale in production by eliminating duplication of competitions, increase in market segments and exercise of better control over the market. It also helps firms in industries like pharmaceuticals, automobiles where huge amount is spent on R&D to achieve a critical mass and reduce unit development costs.

Example: India cements acquiring Raasi Cement.

Vertical Mergers

These take place between two or more firms engaged in different stages of production. The main reason for vertical merger is to ensure ready take off of the materials, gain control over scarce raw materials, gain control over product specifications, increase in profitability by eliminating the margins of the previous supplier/ distributor and in some cases to avoid sales tax.

Example: Tea Estate Ltd merging with Brooke Bond Ltd.

Conglomerate Mergers

Conglomerate merger refers to the merger of two or more firms engaged in unrelated line of business activity.

Example: GNFC acquiring Gujarat Scooters.

Two important characteristics of conglomerate mergers are:

A conglomerate firm controls a range of activities in various industries that require different skills in the specific managerial functions of research, applied engineering, production and marketing.

The diversification is achieved mainly by external acquisitions and mergers and not by internal development.

Consolidation Mergers

This involves a merger of a subsidiary company with parent company. The reasons behind such mergers are to stabilize cash flows and to make funds available for the subsidiary. In consolidation mergers, economic gains are not readily apparent as merging firms are under the same management.

Still, Flow of funds between parent and the subsidiary is obstructed by other consideration of laws such as taxation laws, Companies Act etc. Therefore, consolidation can make it easier for to infuse funds for revival of subsidiaries.

One the basis of method or approach

Leveraged buyouts

Management buyouts

Takeover by workers

On the basis of response/relation

Friendly Takeovers

Hostile Takeovers

Acquisition is buying of Target Company by another. It may be friendly or aggressive. In friendly acquisitions the companies cooperate and negotiate with each other whereas in aggressive the target company is not willing to be sold but it is with no prior knowledge. The word acquisition is used when a large company overtakes small but when the small overtakes large it is called reverse takeover or merger.

MERGER MOTIVES

The merger motives are as follows:

Growth Advantage / Combination Benefits:

The companies would always like to grow and best way to grow without much loss of time and resources is too inorganically by acquisition and mergers.

Example: Merger of

SCICI with ICICI

ITC Classic with ICICI

Acquisition of

Raasi cement by India cement

Dharani Cement and Digvijay cement by Grasim

Modi cement by Gujarat Ambuja.

Diversification:

The companies could diversify into different product lines by acquiring companies with diverse products. The purpose is to diversify business risk by avoiding putting all eggs into one basket.

Example: All Multi-product companies

Synergy:

When the companies combine their operations and realize results greater in value than mere additions of their assets, the synergy is said to have been resulted.

Example: Merger of Ranbaxy and Crossland Laboratories.

Market Dominance / Market Share/ Beat Competition:

The predominant market share or market dominance has always driven the executives to look for acquiring competitive companies and create a huge market empire.

Example:

Acquisition of Tomco by Hindustan Lever

Computer Associates International – Acquired around twenty software companies.

Consolidation in cement industry

Nicholas Piramal Ltd. has merged into itself.

Technological Considerations:

It refers to enhancing production capacities to derive economies of scale.

Example: Acquisition of Corus by Tata.

Taxation Benefits / Revival Of Sick Units:

Section 72 A provides for revival of sick units by allowing accumulated losses of the sick unit to be absorbed by the healthy units subject to compliances to the conditions of the provisions.

Acquiring Platform:

When a company would like to expand beyond geographical limits and acquire platform in the new place the best way would be to acquire the companies.

Example: Acquisition of Parle by Coke.

METHODOLOGY

ANALYSIS

Objective:

To inspect and analyze the trends and progress of M&A in Indian market and corporation.

To analyze year-wise trends with the variance.

Hypotheses: With the above objective in mind certain hypotheses are:

No major difference in the amount and number of deals in M&A between the industries and between the years

No major changes between service and manufacturing sector in M&A growth

The table 1 shows the trends of M&A's in India from the year 2000 to 2007.

Food & Beverages

India is the second largest producer of food & Beverages, first being China. The food market is expected to be USD 182 billion and it is two thirds of the total retail market in India. The carbonated drinks market is worth USD 1. 5 billion whereas the market for juice is worth USD 0. 25 billion. The market for

fruit drinks is growing at 25%. The major reasons for M&A concept commenced in this industry are deregulation, restructuring of parent companies, disinvestments and existing foreign players.

Textile Industry

The Indian textile industry was unorganized until liberalization of economy of India. After that there was an astounding growth in this industry and it is one of the largest in the world. 27% of foreign exchange is from textile exports. This industry is 3% of GDP and it involves 21% of the total employment in the country. The major reasons for growth of M&A are the growth of handlooms, closure of mills etc.

Chemicals, Drugs and Pharmaceuticals

This sector accounts for 70% of the demands for drugs, formulations, tablets, chemicals etc. There are almost 250 large and 8000 small manufacturers and suppliers in Pharma sector. The growth rate of this industry is almost 14%. The reason for the growth of M&A in this sector is due to the fundamental changes in this sector and the emergence of WTO

Non-Metallic Mineral Products

The major reasons for the growth of M&A in this sector are mainly because the Indian economy has slowed down, SME are finding difficult to raise the funds and are not able to handle the pressure from global market.

Information Technology and Telecom

The factors for the growth of M&A are up-gradation and expansion of the telecom industry, services and networks.

Automobiles and Ancillaries

Globalization is approaching and pushing foreign players merge and upgrade the technology and infrastructure, increase the product range and cut costs. Also there is huge competitive pressure due to the existing foreign players leading to growth in M&A.

The pie chart (Figure 2) gives the sector-wise division in 2007

Figure 2: Sector-wise division

Analysis of M&A in manufacturing and service sectors

Table1 shows the Trends and progress in terms of number of deals and Table 2 in terms of value of deals.

Table1: Industry-wise Trends & Growth of M&A’s in India (Number of deals)

Table2: Progress and Trends in M&A in number of deals (as calculated from Table1)

Table 3: Industry-wise Trends & Growth of M&A’s in India (in Rs. Cr.)

Table 4: Progress and Trends in M&A in value of deals (as calculated form Table 2)

Number of Deals & Value of deals: The progress and trends of M&A considered in number and value of deals in manufacturing and services

sectors have been calculated by using t-test and ANOVA analysis. On the basis of Table 2 and Table 4 the number of deals in service sector is lower in the first 4 years but reverses in the last 3 years. So there is no major association between these two sectors

Table5: Two-way ANOVA- Sector-wise Number of Deals (as calculated from Table 1)

Table6: Two-way ANOVA-Sector-wise Value of Deals (as calculated from Table 3)

ANALYSIS OF THE SURVEY DATA

RESEARCH AND FINDINGS

From the calculations done above, it is observed that the number of deals has decreased from 1300 to 1007 i. e. almost 18%. There can be various reasons for this decrease, some are as follows:

The slowdown of the economy

With no prior knowledge management makes a choice of M&A leading to decrease in profits

Economic crisis in the period of 2004-2007

Dropping market capitalizations and uncertainty in the economy

From the above analysis it is concluded that:

Total amount of deals increased by 613%

In manufacturing sector the value of deals increased by 273% whereas it increased by 1217% in service sector

Total number of deals decreased by 18. 5% i. e. from 1322 to 1075

In manufacturing sector the number of deals decreased by 844 to 440 i. e. 47. 2% decrease whereas in service sector deals increased from 480 to 636 i. e. 33% increase.

THEORIES OF MERGER

The phenomenon of merger and acquisitions has been explained by different theories as under:

Efficiency Theories

Differential Efficiency:

If the management of firm A is more efficient than the management of firm B and if after firm A acquires firm B, the efficiency of firm B is brought up to the level of efficiency of firm A, efficiency is increased by merger.

Features:

There would be social gain as well as private gain.

This may also be called managerial synergy hypothesis.

Limitations:

If carried to its logical extreme, it would result in only one firm in the economy, the firm with greatest managerial efficiency.

– Inefficient / underperforming firms could improve performance by employing additional managerial input through direct employment / contracting.

Inefficient Management:

Inefficient Management refers to non performance up to its potential level. It may be managed by another group more efficiently.

Features:

Inefficient Management represents management which is inept in absolute sense.

Differential management theory is more likely to be basis for horizontal merger; inefficient management theory could be basis for mergers between firms of unrelated business.

Limitations:

Difficult to differentiate differential management theory from inefficient theory.

The theory suggests replacement of inefficient management. However empirical evidence does not support this.

Operating Synergy:

Operating synergy or operating economies may be achieved in horizontal, vertical and even conglomerate mergers.

Features:

Theory is based on the assumption that economies of scale do exist in this industry and prior to merger, firms are operating at the levels of activity that fall short of achieving the potential for economies of scale.

Economies of scale arise because of indivisibilities such as people, equipment overhead which provide increasing returns if spread over a large number of units of output.

Pure Diversification:

Diversification of the firm can provide the managers and employees with job security and opportunity for promotion and other things being equal, results in lower costs. Even for owner manager diversification is valuable as risk premium for undiversified firm is higher.

Diversification has value for many reasons:

Demand for diversification by managers, other employees

Preservation of organizational and reputation capital

Financial and tax advantages

Diversification helps preserving reputational capital of the firm, which will be lost if firm is liquidated.

Strategic Realignment to Changing Environment:

Strategic planning is concerned with firm’s environment and constituencies, not just operating decisions. The speed of adjustment through merger would be quicker than internal development.

Features:

Strategic planning approach to mergers implies either the possibilities of economies of scale or tapping an underused capacity in the firms present managerial capabilities.

By external diversification the firm acquires management skills for augmentation of its present capabilities.

A competitive market for acquisitions implies that the net present value from merger and acquisition investment is likely to be small. Nonetheless if synergy can be used as a base for still additional investments with positive net present values, the strategy may succeed.

Agency problems

Agency problem arises when a manager owns a fraction of ownership shares of the firm. This partial ownership may cause managers to work less vigorously than other wise and / or consume more perquisites, (luxurious offices, company cars, membership of clubs) because majority owners bear most of the cost.

Agency costs include:

Cost of structuring a set of contracts

Cost of monitoring and controlling the behavior of agents by principals.

Cost of bonding to guarantee that agents will make optimal decisions or principles will be compensated for consequences of sub-optimal decisions.

Residual loss: i. e. welfare loss experienced, by the principals arising from the divergence between agent’s decisions and decisions to maximize principal’s warfare. This residual loss can arise because the cost of full enforcement of contracts exceeds the benefits.

Takeover as solution to Agency Problems:

Agency problems can be controlled by organizational or market mechanism:

A number of compensation arrangements and market for managers may mitigate agency problems.

Stock market gives rise to external monitoring device, because stock prices summaries the implications of decisions made by managers. Low stock prices exert pressure on managers to change their behavior and to stay in line with interest of shareholders.

When these mechanisms are not sufficient, market for takeover provides an external control device of last resort.

A takeover through a tender offer or proxy fight enables outside managers to gain control of decision process of Target Company, while circumventing the existing managers and Board of Directors.

Free Cash flow hypothesis

Pay out of free cash flow can play an important role in dealing with conflict between managers and shareholders. Payout of free cash flow reduces the amount under control of managers and reduces their power. Further they are subject to monitoring in capital market when they seek to finance additional investment with new capital. A free cash flow must be paid out to shareholders if firm is to be efficient and to maximize share price.

Further they are subject to monitoring in capital market when they seek to finance additional investment with new capital. Managers arrange cash flows also by issuing debts / leveraging. In leveraged buyouts, increased debt increases risk of bankruptcy cost in addition and agency costs. Optimum debt / Equity Ratio will be where the marginal cost of debt equals marginal benefit of debt.

Market Power

Mergers increase a firm’s market share. It is argued that larger volume of operations through Mergers and Acquisitions result in economies of scale. But it is not clear whether this price required by the selling firm will really make acquisition route more economical method of expanding a firm’s capacity either horizontally or vertically.

An objection often raised against permitting a firm to increase its market share by merger is that it will result into “ undue concentration” in the industry.

Value increase by Redistribution

Value increases under merger on account of redistribution among the stake holders of the firm. Shifts are from the Bond holders to stock holders and from labor to stock holders and / or consumers.

DE-MERGER AND REVERSE MERGER

DE-MERGER

De-merger essentially means bonafide separation of the key business assets and reorganizing the business in such a manner that though there is separation in favor of another company, atleast 50% of the equity stake in two companies continues to be common. Section 2 (19AA) was introduced by Finance Act of 1999 defining De-Merger

Examples:

Sterlite Industries and Sterlite Optical

Sterlite which was a diversified company with presence both in non-ferrous metal as well as Telecom cables decided to de-merge both the business into separate companies. The spin off was done in the ratio of 1: 1.

Raymonds Ltd:

Raymonds sold of Cement and Steel business to become one again, a purely fabric and garment company. The whole exercise fetched Raymonds Rs. 1140 crores. This enabled it to reduce high cost debts as well as buyback its own shares. Thus financially as well as in terms of shareholder value it was a correct step.

REVERSE MERGER

Reverse merger takes place when a healthy company merges into a financially weak company. Under the Companies Act there is no difference between regular merger and reverse merger. It is like any other amalgamation.

On Amalgamation merger automatically makes the transferee company entitled to the benefits of carry forward and set off of loss and unabsorbed depreciation of the transferor company. There is no need to comply with Section 72 of Income Tax Act.

On amalgamation being effective, the weak company's name may be changed into that of a healthy company.

Example:

Case Study- Kirloskar Oil Engines merging into Prashant Khosla Pneumatics Ltd

In April, 1994, Kirloskar Oil Engines Ltd. (KOEL) took over the management control of Prashant Khosla Pneumatics Ltd. (PKPL) a Delhi Based Company having its works at Nasik.

PKPL became a sick unit as on 31st March, 1994 and went into BIFR in June 1994. ICICI was appointed as Operating Agency who invited bids for PKPL for revival. KOEL made a bid although PKPL was already under its control. KOEL's bid was accepted and confirmed by BIFR.

Main objective in the takeover was to make use of PKPL's engine plant for KOEL's large engine activity.

PKPL take over added to KOEL's assets, two plants located at MIDC, Nasik on MIDC leased land of 80, 000 sq. mtrs.

A scheme for revival of PKPL through reverse merger of KOEL with PKPL was submitted to BIFR and was sanctioned in February 1996.

Accordingly, KOEL merged in PKPL, and name of PKPL stood changed KOEL on 1st March, 1996 which was the effective date of amalgamation.

Again of merged company for 1994-95 was held in April 1996 and consolidated accounts for the year ended 31st March, 1995 were adopted. Delay of 7 months for holding AGM was condoned by BIFR.

This merger did not affect in any way KOEL shareholders.

PKPL capital of Rs. 218 lakhs was reduced by 95% to 11 lakhs and KOEL shares were exchanged for PKPL shares in the merged company in the ratio of 1 for 20.

PKPL shareholders were paid 5% dividend for 1994-95 and full dividend for 1995-96.

56% of PKPL's capital held by its holding company was transferred at agreed price of Rs. 75 lakhs to KOEL associate company which subsequently got shares in the merged company.

The scheme provided for certain matters without going through the formalities under company’s Act, under powers of BIFR such as

Change of name of Transferee Company from PKPL to KOEL.

Memorandum of association (MOA), articles of association (AOA) of Transferor Company becomes MOA and AOA of Transferee Company.

Auditors of Transferee Company to automatically cease to hold office and auditors of the transferor company to become auditors of the transferee company.

MD and ED of Transferor Company to continue as such in Transferee Company without reappointment and without break.

Authorized capital of Transferee Company to stand increased from Rs. 5 crores to Rs. 27 crores.

Transferee Company to allot to shareholders of Transferor Company, shares in Transferee Company.

Share certificates of Transferor Company not to be called back and replaced by new certificates.

ICICI to be issued 4, 75, 000 equity shares in transferee company without complying with Section 81 (1A) and SEBI guidelines on preferential issue.

Stamp duty on transfer of property and share certificates was saved.

Premium payable to MIDC saved only loans for fee paid.

PKPL revival resulted into both the plants being operative- Direct employment to more than 300 people working.

POST MERGER SCENARIO

Key steps to successful Post Acquisition Management (Figure 3)

Figure 3: Steps for Successful Acquisition

Success constitutes two important factors:

Meeting the objectives

Enhanced shareholder value

Short lived mergers: Some Examples

Merger of ICICI and Anagram:

When employees of Anagram Finance heard that ailing firm was to be merged with ICICI there was a sigh of relief. But two months later, reality was bitter. Out of 450 staff only 140 were repaired and all others were given pink slips with 3 months' severance pay.

Takeover of Merind by Wockhardt:

There was exodus of top management team of Merind.

CIBA and Sandoz merged to form Novartis:

115 out of 120 managers of new corporate office were Sandoz people with Sandoz India's erstwhile MD John Simon ailing the shareholders.

POST MERGER INTEGRATION

SEVEN RULES BY MAX HABECK- FRITZ & MICHAEL TRAM

Vision

Guide post merger Integration with a clear and realistic vision derived from through business due diligence.

Research Findings:

78% of mergers are mistakenly driven by fit, and not vision.

Around 58% of mergers fail.

Examples: M & A Cases That Have Failed On Account Of Lack of Vision or Unrealistic Vision

AT & T and NCR:

In the late 1980s American Telephone and Telegraph still had assets such as Bell Labs to go with long distance telephone services it kept after the 1984 anti-trust break up. The company had a grand vision of a technological synergy between its expertise in telecommunications and NCR’s expertise in computer technology.

After years of intense searching, hampered by management changes as well as cultural frictions, no synergies were found. The presumed fit between telecommunication equipment and computer hardware failed to turn up. AT &T spun off the remains of NCR around five years later at a loss of around $ 3. 5 billion, nearly half of what it initially paid.

Sony Pictures:

Sony acquired Columbia Pictures in 1989 for $ 5 billion. However, Columbia had difficulties in generating the successful software to begin with. Rapidly rising salaries of stars and lack of success at box office culminated in Sony making operating loss of around $ 500 million. The company wrote off $ 2. 7 billion. The losses were attributed to abandonment of large number of projects and settlement of outstanding lawsuits.

However, instead of divesting the unit, Sony made management changes and imposed stricter controls. Columbia is now a part of Sony Pictures Entertainment, which represented just fewer than 10% of Sony Group’s Worldwide Sales of around $ 50 billion.

Examples of Successful cases of M& A driven by Vision:

Acquisition of Salomon Inc. by Citigroup

Ford Motor Acquisition of AB Volvo.

Leadership- Its Critical Establish It Quickly

Research Findings:

Leadership’s urgency is often neglected. Some 39% of all companies faced a leadership vacuum because they failed to make the establishment of leadership a priority.

A merger without strong leadership in place from its early days will drift quickly and drift is deadly.

Growth- Merge to Grow, Focus On added Value & not on Efficiency Synergies

Research Findings:

76% of the companies surveyed focused too heavily on “ efficiency” synergies. 30% of the companies virtually ignored attractive growth opportunities such as cross selling possibilities or knowledge sharing in research and development.

Most Successful Growth through Mergers:

Cisco Systems:

This fortune 500 company has grown since its founding in 1984, thanks to a combination of organic growth and successful integration of 25 acquisitions. Cisco has almost quadrupled its revenue since 1995 to $ 8. 5 billion and its net income tripled to $ 1. 3 billion. It holds a market share of around 80% routers and switches which form the internet infra structure.

Making mergers is and will continue to be absolutely essential for Cisco to maintain its rapid growth and enhance its competitive advantages.

CONCLUSION

The practice of Mergers and Acquisitions and restructuring of business entities has achieved a lot of importance and significance in today’s corporate world. Due to the cut-throat competition in the global market pushed Indian companies to opt for this strategic option in order to sustain in the marketplace.

There are various factors for making M&A deals constructive in India such as Government policies are dynamic, stability in the economy, ready-to-experiment approach of the firms etc.

Some additional and recent facts about M&A:

The value of M&A is increasing every year in India; it almost increased seven fold to USD 4. 2 billion in August 2010 from USD 629 billion in 2009

The number of deals (outbound) increased to USD 3. 35 billion in 2010 from USD 60 million

The number of domestic deals increased from 20 to 27 but the value of deals decreased from USD 521 million to USD 364 million in2010.

From the study it is observed that companies get involved in M&As to increase the shareholders earnings by increasing the revenue or decreasing the cost. It also increases the market share provided if management is careful about the M&A and has a prior knowledge of it.

Synergy should be achieved with M&A but at times it does not happens so the companies need to work to control the synergy and allow new company to go ahead and look for new business growth possibilities.