Chapter One

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Mergers and acquisitions are increasingly becoming strategic choice for organizational growth and achievement of business goals including profit, empire building, market dominance and long term survival. The ultimate goal of this strategic choice of inorganic growth is, however, maximization of shareholder value. The phenomenon of rising M&A activity is observed world over across various continents, although, it has commenced much earlier in developed countries (as early as 1895 in US and 1920s in Europe), and is relatively recent in developing countries. In India, the real impetus for growth in M&A activity had been the ushering of economic reforms introduced in the year 1991, following the financial crisis and subsequent implementation of structural adjustment programme under the aegis of International Monetary Fund (IMF). In recent times, though the pace of M&As has increased significantly in India too and varied forms of this inorganic growth strategy are visible across various economic sectors.

The term mergers and acquisitions encompasses varied activities of stake acquisition and control of assets of different firms. Besides, there are several motives for different types of mergers and acquisitions seen in corporate world. This chapter provides an understanding of the concept of mergers and acquisitions from industry and regulatory point of view and motives for mergers and acquisitions.
INTRODUCTION TO MERGERS AND ACQUISITIONS

1.1 Meaning of Mergers and Acquisitions:

The term mergers and acquisitions are often interchangeably used although together they include more than one form of transaction of acquiring ownership in other companies. Specific meaning of these different forms of transactions is discussed below.

Mergers:

Sherman and Hart (2006) define Merger as "a combination of two or more companies in which the assets and liabilities of the selling firm(s) are absorbed by the buying firm. Although the buying firm may be a considerably different organization after the merger, it retains its original identity." In other words, in a merger one of the two existing companies merges its identity into another existing company or one or more existing companies may form a new company and merge their identities into a new company by transferring their businesses and undertakings including all other assets and liabilities to the new company (hereinafter referred to as the merged company). The shareholders of the company (or companies, as the case may be) will have substantial shareholding in the merged company. They will be allotted shares in the merged company in exchange for the shares held by them in the merging company or companies, as the case may be, according to the share exchange ratio incorporated in the scheme of merger as approved by all or the prescribed majority of the shareholders of the merging company or companies and the merged company in their separate general meetings and sanctioned by the court.
Acquisitions and Takeovers

"An acquisition", according to Krishnamurti and Vishwanath (2008) "is the purchase of by one company (the acquirer) of a substantial part of the assets or the securities of another (target company). The purchase may be a division of the target company or a large part (or all) of the target company's voting shares."

Acquisitions are often made as part of a company's growth strategy whereby it is more beneficial to take over an existing firm's operations and niche compared to expanding on its own. Acquisitions are often paid in cash, the acquiring company's shares or a combination of both. Further, an acquisition may be friendly or hostile. In the former case, the companies cooperate in negotiations; in the latter case, the takeover target is unwilling to be bought or the target's board has no prior knowledge of the offer. Acquisition usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger or longer established company and keep its name for the combined entity. This is known as a reverse takeover.

Amalgamation

The term "amalgamation" contemplates two or more companies deciding to pool their resources to function either in the name of one of the existing companies or to form a new company to take over the businesses and undertakings including all other assets and liabilities of both the existing companies. The shareholders of the existing companies (known as the amalgamating companies) hold substantial shares in the new company (referred to as the amalgamated company). They are allotted shares in the new company.
in lieu of the shares held by them in the amalgamating companies according to share exchange ratio incorporated in the scheme of amalgamation as approved by all or the statutory majority of the shareholders of the companies in their separate general meetings and sanctioned by the court. In other words, in amalgamation, the undertaking comprising property, assets and liabilities of one or more companies are taken over by another or are absorbed by and transferred to an existing company or a new company. The transferor company merges into or integrates with the transfeeree company. The transferor company losses its legal identity and is dissolved (without winding up). Both the existing companies may form a new company and amalgamate themselves with the new company. The shareholders of each amalgamating company become the shareholders in the amalgamated company. To give a simple example of amalgamation, we may say A Ltd. and B Ltd. and merge their legal identities into C Ltd. It may be said in another way that A Ltd. + B Ltd. = C Ltd. Therefore, the essence of amalgamation is to make an arrangement thereby uniting the undertakings of two or more companies so that they become vested in, or under the control of one company which may or may not be original of the two or more of such uniting companies.

1.2 Types of Mergers and Acquisitions

Mergers appear in three forms, based on the competitive relationships between the merging parties.
(a) **Horizontal Merger**

Horizontal mergers occur when two companies sell similar products to the same markets. The goal of a horizontal merger is to create a new, larger organization with more market share. Because the merging companies' business operations may be very similar, there may be opportunities to join certain operations, such as manufacturing, and reduce costs. However, an interesting observation by Weston (1990) is that not all small firms merge horizontally to achieve such economies of scale. Horizontal mergers raise three basic competitive problems. The first is the elimination of competition between the merging firms, which, depending on their size, could be significant. The second is that the unification of the merging firms' operations might create substantial market power and might enable the merged entity to raise prices by reducing output unilaterally. The third problem is that, by increasing concentration in the relevant market, the transaction might strengthen the ability of the market's remaining participants to coordinate their pricing and output decisions. The fear is not that the entities will engage in secret collaboration but that the reduction in the number of industry members will enhance tacit coordination of behaviour.

(b) **Vertical Merger**

A vertical merger joins two companies that may not compete with each other, but exist in the same supply chain. Vertical mergers take two basic forms: forward integration, by which a firm buys a customer, and backward integration, by which a firm acquires a supplier. Replacing market exchanges with internal transfers can offer at least two major benefits. First, the vertical merger
internalizes all transactions between a manufacturer and its supplier or dealer, thus converting a potentially adversarial relationship into something more like a partnership. Second, internalization can give management more effective ways to monitor and improve performance.

Vertical integration by merger does not reduce the total number of economic entities operating at one level of the market, but it might change patterns of industry behavior. Whether a forward or backward integration, the newly acquired firm may decide to deal only with the acquiring firm, thereby altering competition among the acquiring firm's suppliers, customers, or competitors. Suppliers may lose a market for their goods; retail outlets may be deprived of supplies; or competitors may find that both supplies and outlets are blocked. These possibilities raise the concern that vertical integration will foreclose competitors by limiting their access to sources of supply or to customers. Vertical mergers also may be anticompetitive because their entrenched market power may impede new businesses from entering the market.

(c) **Conglomerate Mergers**

Conglomerate mergers occur when two organizations sell products in completely different markets. There may be little or no synergy between their product lines or areas of business. The benefit of a conglomerate merger is that the new, parent organization gains diversity in its business portfolio. Conglomerate transactions take many forms, ranging from short-term joint
ventures to complete mergers. Whether a conglomerate merger is pure, geographical, or a product-line extension, it involves firms that operate in separate markets. Therefore, a conglomerate transaction ordinarily has no direct effect on competition. There is no reduction or other change in the number of firms in either the acquiring or acquired firm's market.

Conglomerate mergers can supply a market or "demand" for firms, thus giving entrepreneurs liquidity at an open market price and with a key inducement to form new enterprises. The threat of takeover might force existing managers to increase efficiency in competitive markets. Conglomerate mergers also provide opportunities for firms to reduce capital costs and overhead and to achieve other efficiencies.

Additionally Soubeniotis, Mylonakis and Fotiadis (2006) include the following new form of mergers that have emerged during the last decade and are known as "going private transactions". These mergers are facilitated with high bank lending and appear in the following forms:

*Lending buyouts (LBOs):*

It is the buyout of all shares or the assets of a company which is already introduced to the Stock Exchange by a group of investors through a transaction that is mainly financed via lending. Investors usually are financially supported by enterprise specializing in buyouts or by Investment Banks that arrange such transactions. Following the buyout, the bought out company operates as a
company with few shareholders which outside the framework of the stock market.

Management buyouts (MBOs):

It is the buyout that starts with the initiative of a group of management executive who buy out part of the company's shares. The remaining money is deposited by investment banks either as share capital or loans.

Unit MBOs:

It is a special form of a company buyout where buyers, usually guided by a manager of the mother company, buy a subsidiary company. Buyers pay part of the capital while the remaining capitals are drawn by investment banks in the form of share and loan capital.

Reverse LBOs:

according to this form, the shareholder of a company which is not introduced to the stock exchange participate in the issuance of rights concerning a company already introduced to the stock exchange, and uses the drawn capitals in order to buy out the first and secure its introduction to the Stock Exchange.

1.3 Motives for Mergers and Acquisitions

Mergers and acquisitions are resorted to by the corporate entities due to more than one reason. Some of the significant motives for mergers include the following:
(a) Growth

Broadly there are two alternatives available for growth of a corporate entity as long as investment opportunities exist. The first is through the internal growth where the firm invests its own resources in creating facilities for expansion. This can be slow and ineffective if a firm is seeking to take advantage of a window of opportunity in which it has short term advantage over competitors (Gaughan, P., 2002). The faster way to achieve growth in such case would be to merger and acquire necessary resources to achieve competitive goals. In this process, the acquirer will pay premium for acquisition of other company or assets, but ideally, the strategy would not be as expensive as that of internal growth.

(b) Operating Synergy

Synergy is one of the most commonly cited reasons to go for mergers. Synergy is simply defined as 2+2=5 phenomenon. The value of the company formed through merger will be more than the sum of the value of the individual companies just merged. Symbolically,

\[ V(A) + V(B) < V(AB) \]

\[ V(A) = \text{value of A Ltd.} \]

\[ V(B) = \text{value of B Ltd.} \]

\[ V(AB) = \text{value of merged company.} \]

This maximization of firm's value is based on premises that combined company can often reduce its fixed costs by avoiding duplication of operations, lowering the costs of the company relative to the same revenue stream, thus
increasing profit margins. Operating synergy assumes that economies of scale exist in an industry and that prior to their M&A, firms are operating at levels of activity that fall short of achieving the potential for economies of scale (Weston et al., 2001). Expansion through a merger or acquisition increases the size of the company and hence may lower per-unit costs. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from reduced staff costs, economies of scale, acquisition of new technology to maintain or develop competitive edge and improved market reach and industry visibility.

Synergy cannot be automatically realized once two companies merge. In many cases, synergy opportunities may exist only in the minds of the corporate leaders and the deal makers. Where there is no value to be created, the CEO and investment bankers - who have much to gain from a successful M&A deal - will try to create an image of enhanced value. The market, however, eventually sees through this and penalizes the company by assigning it a discounted share price.

(c) Financial synergy

The following are the financial synergy available in the case of mergers:

**Better credit worthiness:** This helps the company to purchase the goods on credit, obtain bank loan and raise capital in the market easily.

**Reduces the cost of capital:** The investors consider big firms as safe and hence they expect lower rate of return for the capital supplied by them. So the cost of capital reduces after the merger.
Increases the debt capacity: After the merger the earnings and cash flows become more stable than before. This increases the capacity of the company to borrow more funds.

Increases the P/E ratio and value per share: The liquidity and marketability of the security increases after the merger. The growth rate as well as earnings of the firm will also increase due to various economies after the merged company. All these factors help the company to enjoy higher P/E in the market.

Low floatation cost: Small companies have to spend higher percentage of the issued capital as floatation cost when compared to a big firm.

Raising of capital: After the merger due to increase in the size of the company and better credit worthiness and reputation, the company can easily raise the capital at any time.

(d) Diversification of risk

When a company produce single product then the company's profits and cash flows fluctuate widely. This increases the risk of a firm. Diversification reduces the risk of the firm. The merger of companies whose earnings are negatively correlated will bring stability in the earnings of the combined firm. So diversification reduces the risk of the firm.

(e) Empire building:

Managers have larger companies to manage and hence more power. Manager's compensation: In the past, certain executive management teams had their payout based on the total amount of profit of the company, instead of the
profit per share, which would give the team a perverse incentive to buy companies to increase the total profit while decreasing the profit per share (which hurts the owners of the company, the shareholders); although some empirical studies show that compensation is linked to profitability rather than mere profits of the company.

1.4 Growth of Mergers and Acquisitions

Mergers and Acquisitions (M&A) have been a popular strategy of business expansion worldwide. Literature on the subject accounts for growth of M&A by way of several waves that are caused by some favourable business climate and end on account of economic or regulatory reasons. Lipton, M (2006) reports such merger waves for US that has seen multiple waves of mergers over a long period in its corporate history. The first period – 1893-1904 was the time for horizontal mergers and created the principal steel, telephone, oil, mining, railroad, and other giants of the basic manufacturing and transportation industries in the US. The Panics of 1904 and 1907, anti-trust laws, and then the First World War are pointed to as the causes of the end of the first wave. The second wave from 1919 to 1929 significantly increased vertical integrations in US but ended with the Great Depression and the 1929 Crash. The third wave of 1955 to 1969 gave birth to conglomerates with companies diversifying into new industries and areas. The wave ended with the crash of conglomerate stocks in 1969-70. While the fourth wave, 1980-89 was the period of takeovers and hostile bids that ended with collapse of junk bond market, the fifth wave 1993-2000 was the era of mega deals for US. During this time, companies of unprecedented size
and global sweep were created on the assumption that size matters. This period also, however, ended with slowdown in important sectors such as telecommunication and media and technology and bursting of IT bubble. Similarly, Europe also has witnessed a wave of takeovers since middle 1950s and subsequently in 1980s. In recent times, such merger wave phenomenon is observed in emerging markets with Asian economies experiencing a large growth in M&A transactions. Deals by companies in emerging markets now account for 30% of global M&A activity.¹

Mergers and acquisitions deals worldwide reached an all time high in 2006, with a total value of $3.7 trillion, surpassing the 2000 high of $3.4 trillion [Dobbs, Goedhart and Suonio (2006)]. The analysis of authors indicate that US was the most targeted country for acquisition representing over 40% of global M&A activity, while UK was the most targeted European country for acquisition with $339 bn of cross-border and domestic transactions. During the year 2010, the global M&A activity increased 33% over 2009.² Fig.1.1 clearly depicts the growing interest of corporate firms around the world in mergers and acquisitions. It can be observed that the number of M&As have announced during the period 1988 to 2006, have increased from 2,856 in 1988 to 23,708 in the year 2006 with maximum number of deals announced reported at 40,141 in the year 2000. Nearly half (44%) of privately held businesses in the BRIC (Brazil, Russia, India and China) economies are planning to grow by acquisition in 2011.³

1.5 Mergers and Acquisitions and Corporate Performance

The subject of impact of mergers and acquisitions on corporate performance has been immensely researched. Globally, several researchers have provided evidence that acquirers actually have not realized significant gains from M&A strategy. A study conducted by Boston Consulting Group (BCG) on 302 major mergers from July 1, 1995 to August 31, 2001 showed that merger deals are not necessarily beneficial to shareholders. Moeller, Sara B., Schlingemann, F. and Stulz, R. (2005) also report a massive destruction in shareholder value for acquirers during post merger period (Fig. 1.2). A number of reasons have been cited for failure of mergers and acquisitions in improving corporate performance and accomplishing the intended objectives of the transactions. A mismatch in the size between acquirer and target firms, where
buying too big targets or not giving sufficient time and attention for smaller acquisitions is one such reason (Hubbard, 1999). Besides, unfamiliarity with businesses, particularly in case of diversified mergers (Sudarsanam, 2004; Dash, 2004), lack of previous acquisition experience (Hubbard, 1999; Sudarsanam, 2004), poor organization fit (Jemison and Sitkin, 1986), poor strategic fit (Maitra, 1996), lack of proper communication (Schweiger, 2003) and failure of leadership role (Prayag, 2005) are some other reasons for failure of mergers and acquisitions in creating shareholder value.

Fig.1.2 : Yearly Aggregate Dollar Returns of Acquiring-Firms Shareholders (1980-2001)


Mergers and acquisitions are growing even in Indian economy. Particularly, with implementation of economic reforms in 1991, a favourable
economic and regulatory environment has encouraged businesses to resort to consolidation route to establish big size business firms, improve efficiency and develop competitiveness. However, with global evidence of value destruction by mergers and acquisitions it becomes imperative to study if shareholders in Indian companies are able to make any significant long term gains.