Chapter-II
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CONCEPTUAL FRAMEWORK

History of M&A:

In the ongoing scenario, when the stress is on globalisation, opening up of the economy, world wide competition, expanding markets, extending beyond the national frontiers, fast changing technologies, never ending need for finance, necessity for diversification and similar such situations, small is no longer beautiful in the fields of business, trade, commerce and developing economies of the nations. The stress now is on larger and bigger establishments/conglomerates to achieve more efficiency for standing up against global challenges and world in India and abroad, there is a ‘merger’ wave. Various establishments/banks, wide competition by availing of the economies of scale and one up man ship. Thus, all around multinationals and transnational are fast expanding by amalgamations, mergers and takeovers/acquisitions. In India there had been quite few mergers/takeovers like that of Hindustan Lever and tea companies, mergers of financial companies like SCICI Limited and ICICI Limited, buyout of Gujarat Gas by British Gas etc. There is thus greater need and enormous potential in India, particularly in the context of clear commitment to continue liberalizing the economy. There is increased focus on infrastructure development, which cannot be handled by small organisations commanding minor resources. So combinations, mergers, amalgamations, takeovers have become the order of the day.
In market-oriented economies, mergers and takeovers to be regarded as a major corporate preoccupation. M&A activity in the United States has long been described as occurring in waves. For example, the merger wave which began at the 19th century and an over into the beginning of the 20th created a large number of monopolies. The second merger wave which took place in the 1920s replaced monopolies with “oligopolies”. After the second merger wave in the 20s, the government intervened strongly to discourage mergers, which could increase “concentration” or “market power”. The third mergers wave of the 60s avoided this legislation by creating “conglomerates”. The fourth merger wave of the 80s saw the return to corporate specialization. Similar trends in mergers acquisitions have been witnessed in many other developed economies.

With the accent on **globalisation** round, the numbers of cross-border mergers have increased dramatically over the last few years. The large scale privatization programs that are on anvil in the East European countries and in many of the developing countries and the formation of common markets like the single European market are some of the other factors which are bound to stimulate a larger merger wave in the 90s.

Now, let us look at the Indian scenario. Has India remained insulated from the merger waves sweeping across the worlds? Well, it was so in the past. Given the regulatory framework with enactment's like the MRTP and the FERA which inhibited growth of large industrial houses and restricted the infusion of foreign capital in Indian industry, the tax policies which encouraged only some specific types of mergers, and the high entry and exit
barriers built into different industries, and the merger at a low ebb. Having said that, we must add this scenario is currently undergoing a sea change, thanks to the several far-reaching measures of liberalization and globalisation initiated by the government. With foreign companies being invited to invest in India; projectionist tariff walls being progressively demolished; fetters on the growth of large business houses being removed; the gateway to competition being opened up in almost every sector of the Indian economy; and infusion of private capital being encouraged in many industries hitherto reserved for the public sector, the government has made the domestic companies realize that there is going to be more competition than ever before in the Indian market. One of the consequences of such realization is the large scale corporate restructuring that has started through a spate of mergers, acquisitions, strategic alliances and divestitures.⁵
**HOW TO ACQUIRE A COMPANY?**

<table>
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<th>Ideal Target Companies Have The Following Characteristics</th>
<th>Attack Strategies for Predator Companies</th>
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<td>• Cash rich under performers</td>
<td>• Acquire shares of a target slowly</td>
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<td>• Potential turnarounds</td>
<td>• Buy shares via group companies</td>
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<td>• Low promoter holdings</td>
<td>• Price offer will mop up stake</td>
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<td>• Under valued assets</td>
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<td><strong>Warning Signals for Targeted Companies</strong></td>
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<td>• Abrupt changes in the share price</td>
<td>• Gradually consolidate holdings</td>
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<td>• Sudden rise in the share prices</td>
<td>• Sell and lease back assets</td>
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<tr>
<td>• Share transfer to same owner</td>
<td>• Refuse to register transfer</td>
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<tr>
<td>• Disclosure of 5% acquisition</td>
<td>• Invite help from white knight.*</td>
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White knights are companies to which the company can be offered for takeover. They are in general regarded as friendly to the company. White squires are those that help and even arrange for the sale of the company. Hostile companies attempting takeovers are referred to as black knights. Greenmailing is the process of buying back of shares to prevent hostile takeovers.\textsuperscript{14}

**GROWTH OF M&A**

The motives for mergers and acquisitions are complex and present problems of classification. Often there is not a single reason for a takeover, but rather a number of reasons.

1. **Synergy:** Synergy is a concept by which two firms combine and increase their value;

   in other words, \( V_{ab} = V_a + V_b + X \)

   \( V_{ab} \) = Value of combined firm
   \( V_a \) = Value of acquiring firm A before merger
   \( V_b \) = Value of target firm B
   \( X \) = Present value of cash benefits resulting from merger.

   If \( X \) is positive, the merger makes economic sense; if \( x \) is negative the merger makes no economic sense. Synergistic gains are possible from a number of sources, I can group under two main categories –
i) Operating on real synergies can arise from economies of scale, marketing of distribution efficiencies, reduced workforce possible through reorganization, bringing into operation unutilized patents, amalgamation of related specialist R&D personnel and etc.

ii) Financial synergies are possible largely from interest rate differentials, tax shelter, tax rate differentials etc.

2. **Growth:** A reason for acquiring another company is to sustain growth. The acquiree may be in a growth sector, which seems attractive to the acquirer. In addition it may well be cheaper to acquire growth rather than to develop into new areas.

3. **Acquisition of specific assets:** The acquisition of a specific asset or access to an asset is also often a reason for mergers e.g. a manufacturer may decide to integrate vertically in order to secure a source of raw materials. The acquiree may also have a specific asset such as good management team or good research and development facilities that may be utilised more efficiently and effectively.

4. **Acquiring assets at a discount:** The aim of acquiring assets at a discount is to obtain a going concern cheaply. The basis of this approach is that the acquirer knows better than the acquiree the real value of assets. The acquiree may posses valuable land or freehold property that might stand in the books
at depreciated historical cost, which underestimates its current replacement value. The acquirer might purchase the company and sell off its valuable assets. Another motive might be to acquire an unprofitable company, close down the loss making activities and sell off the profitable sectors in hope of making a gain. The basis of acquiring assets at a discount is that existing management is somehow inefficient in utilising its assets.

5. **Acquiring market share**: Increased market share leads to high profitability. This motive is closely aligned to the economies of scale argument, since increasing market share usually entails a higher level of production, economies will be achieved and learning effects will assist in decreasing unit costs.

6. **Taxation**: A high rate of taxation could be one of the motives for the merger of two companies. Tax benefits accruing from the mergers encourage a lot of mergers of viable companies with non-viable companies. Another tax motivation would exist for shareholders of selling company. Exchange of the share at high-level premium to the shares of the acquiring company will not attract the capital gains tax or the ordinary income tax.

7. **Diversification**: In conglomerate mergers, the acquiring company and the acquired company are unrelated in their business. It may lead to increased returns or lower financial risk. The reduction of risk is dependent on the correlation between the earnings of the two companies i.e. the acquiring
company and the target company. A negative or a low positive correlation is desirable.

8. **Managerial motives:** Management of some companies are ambitious to have more control, power and prestige. Managers sometimes wish to expand their enterprise, since their salaries, prerequisites and status often increase with size.\(^\text{17}\)

**THEORIES OF M&A**

Many theories have been advanced to explain why mergers and other forms of restructuring take place. Efficiency theories imply social gains from M&A activity in addition to the gains for participants.

1. **Differential efficiency Theory:** The differential efficiency theory says that more efficient firms will acquire less efficient firms and realize gains by improving their efficiency; this implies excess managerial capabilities in the acquiring firm. Differential efficiency would be most likely to be a factor in mergers between firms related industries where the need for improvement could be more easily identified.

2. **Inefficient Management Theory:** The related inefficient management theory suggest that target management is so inept that virtually any management could do better, and thus could be an explanation for mergers between firms in unrelated industries. The theory's main limitation is its implication that agency costs are so high that shareholders have no way to discipline managers short of costly merger.
3. **Operating Synergy Theory**: The operating synergy theories postulates economies of scale or of scope and those mergers help achieve levels of activities at which they can be obtained. It includes the concept of complementary of capabilities. For example, one firm might be strong in R&D but weak in marketing while another has a strong marketing department without the R&D capability. Merging the two firms would result in operating synergy.

4. **Financial Synergy Theory**: The financial synergy theory hypothesis complementarities between merging firms, not in management capabilities, but in the availability of investment opportunities an internal cash flow. A firm in a declining industry will produce large cash flows since there are few attractive investment opportunities. A growth industry has more investment opportunities than cash with which to finance the. The merged firm will have a lower cost of capital due to the lower cost of internal funds as well as possible risk reduction, savings in flotation costs, and improvements in capital allocation.

5. **Pure diversification Theory**: Pure diversification as a theory of mergers differs from shareholder portfolio diversification. Shareholders can efficiently spread their investment and risk among industries, so there is no need for firms to diversify for the sake of their shareholders. Managers and other employees, however, are at greater risk if the single industry in which their firm operates should fail their firm specific human capital is not transferable. Therefore, firms may diversify to encourage firm specific human capital investments which make their employees
more valuable and productive, and to increase the probability that the organization and reputation capital of the firm will be preserved by transfer to another line of business owned by the firm in the event its initial industry declines.

6. **Theory of Strategic Alignment:** The theory of strategic alignment to changing environments says that mergers take place in response to environmental changes. External acquisitions of needed capabilities allow firms to adapt more quickly and with less risk than developing capabilities internally.

7. **Undervaluation Theory:** The under valuation theory states that mergers occur when the market value of target firm stock for some reason does not reflect its true or potential value in the hands of an alternative management. The q-ratio is also related to the under valuation theory. Firms can acquire assets for expansion more cheaply by buying the stock of existing firms than by buying or building the assets when the target’s stock price is below the replacement cost of its assets.

8. **Signaling Theory:** Theories other than efficiency include information and signaling agency problems and managerialism, free cash flow, market power, taxes, and redistribution. The information or signaling theory attempts to explain why target shares seem to be permanently revalued upward in a tender offer whether or not it is successful. The information hypothesis says that the tender offer sends a signal to the market that the target shares are undervalued, or alternatively, the offer signals information to target management, which inspires them to implement a more efficient strategy on their own. Another school holds that the revaluation is not really permanent, but only
reflects the likelihood that another acquirer will materialize for a synergistic combination. Other aspects of takeovers may also be interpreted as signals value, including the means of payment and target management's response to the offer.

9. **Agency Theory:** Agency problems may result from a conflict of interest between managers and shareholders or between shareholders and debt holders. A number of organization and market mechanisms serve to discipline self-serving managers, and takeovers are viewed as the discipline of last resort. Managerialism, on the other hand, views takeovers as a manifestation of the agency problem rather than its solution. It suggests that self-serving managers make ill-conceived combinations solely to increase firm size and their own compensation.

10. **Hubris Theory:** The hubris theory is another variant on the agency cost theory; it implies acquiring firm managers commit errors of over optimism (winner's curse) in bidding for targets.

11. **Jensen's Free Cash Flow Theory:** Jensen's free cash flow hypothesis says that takeovers take place because of the conflicts between managers and shareholders over the payout of free cash flows. The hypothesis posits that free cash flows (that is, in excess of investment needs) should be paid out to shareholders, reducing the power of management and subjecting managers to the scrutiny of the public capital markets more frequently. Debts for stock exchange offers are viewed as a means of bonding the managers. Promise to pay out future cash flows to shareholders.
12. Market Power Theory: Market power advocates claim that merger gains are the result of increased concentration leading to collusion and monopoly effects. Empirical evidence on whether industry concentration causes reduced competition is not conclusive. There is much evidence that concentration is the result of vigorous and continuing competition which causes the composition of the leading firms to change over time.

13. Tax Effects Theory: Tax effects can be important in mergers, although they do not play a major role in explaining M&A activity overall. Carry over of net operating losses and tax credits, stepped up asset basis, and the substation of capital gains for ordinary income (less important after the Tax Reform Act of 1986) are among the tax motivations for mergers. Looming inheritance taxes may also motivate the sale of privately held firms with aging owners.

A final theory of the value increases to shareholders in takeovers is that the gains come at the expense of other stakeholders in the firm. Expropriated stakeholders under the redistribution hypotheses may include bondholders, the government (in the case of tax savings), and organized labour.

CULTURAL ISSUES OF THE MERGERS
Corporate culture is an important factor in a merger of two organizations. Culture includes the values, symbols, legend, myths, metaphors and accepted operation methods shared by a significant number of the organizations’ members. Behind the attempt to increase competitive advantage, to achieve...
efficiencies of scale, to boost stock price, and to cut costs, the human factor is very important. Mergers and acquisitions affect every employee. When a company merges there is always turmoil and confusion for the workforce as employees try to sort out pay, benefits, severance package, cultural issues and so on.

Corporate culture plays an important role in mergers as it has an impact on the motivation of the workforce and therefore on the efficiency of the whole company. Well managed mergers of different corporate cultures can even provide more opportunity for people to reach their highest potential and take added responsibility, but there are also some pitfalls that have to be avoided and which may result from the differences in the organizations. Compatibility of the respective organizational cultures has an influence on the success of the merger.

**Understanding the Environment**

This section seeks to look at the environment, which includes the regulations and the regulators, the shareholders and the stakeholders.

Bulk acquisitions of shares and takeovers are presently regulated by Clauses 40-A and 40-B and by SEBI (Substantial acquisition of shares and Takeovers) Regulation, 1997, promulgated on 20th February '1997(19)

**HOW TO GO ABOUT A MERGER**

This section focuses on what steps can the management of a company take to analyze a prospective acquisition with perspective ness and sound judgment, probing behind the seemingly attractive facade, which is often created by a deft
There is no simple answer. Each merger possibility is unique and should be considered on its own merits. But there are certain key considerations that apply to virtually every merger. They may not guarantee success. But taking full cognizance of them will help immeasurably. The ten factors listed below take into consideration both the hits and misses. The first four factors are of critical nature and apply to all mergers. If any one of them is violated; the chances of a successful wedding are virtually nil. Hence these have been named must factors.

There are numerous factors, which a management has to keep in view while going for a merger:

1. **Pinpoint the objectives:** Goal definition is an important factor that determines the success of a merger negotiation. Goals could be increased earnings for the stockholders of both companies, to improve further the market diversification of net income, to upgrade, while increasing total sales, the balance between government and commercial business etc. Goals should be continuously reassessed and kept up to date.

2. **Specify gains for owners:** Even where both companies are in black, the merger will stand small chance of coming off successfully unless definite values are exchanged to produce the desired synergistic effect. The top management would
analyse the two-way benefits in depth and describe them in detail in early stage of negotiation.

3. **Check management ability**: The most important corporate asset is good, skilled, experienced and loyal management. Also three characteristics of company's able executives are unusually high degree of motivation, energy and intelligence. Not all successful executives have all three, but few have less than two. Competence should be compatible with the needs of acquiring company's management.

4. **Seek a good fit**: Some top managements search for a non-existent perfect match that they miss out on prime opportunities along the way. In mergers the trick is to come up with the maximum number of fits you can, measure the potential gains against the risk involved and move decisively when the time is right.

5. **Involve the headman**: The biggest reason for failure of mergers is the failure of a company's chief executive to take an intense, direct and continuing interest in the company being acquired. The President's participation does not cease when the right company is located and the merger deal consummated. After agreement has been signed, it is the President's job to get the wheels moving and keep them moving to start the cross-pollination of ideas and to convert hopeful thinking to profitable action.
6. **Define your business:** Unnecessary and unrelated diversifications lead to failures. Company should know which business it is in and how deeply it wants to be involved.

7. **Analyse the performance factors:** Different variables predicting the performance of acquired company should be analysed. Certain parameters related to strategy and planning of the acquired company, finance, physical assets, management and personnel, marketing etc. should be defined in details.

8. **Face problems early:** The merging companies’ management should anticipate as many major problems as possible, to set them on the table for both parties to digest and jointly hammer out a practical and mutually acceptable plan for coping with each issue. The differences should be ironed out in the early stages.

9. **Make the right advances:** A strategy should be devised to time the merger. Also the price of the merger should be arrived at after telling the acquired company the advantages accruing to it from the merger. When approaching a company, the first essential talk is to pinpoint the right person to be contacted and then making the desired contact with him.

10. **Absorb people with care:** Any employee of the company, who is being effected in any way by the merger, should be disseminated information about the advantages of the merger by any medium possible. The most important asset of any company is its people. So they should be handled with care.
Their prestige should be kept intact, as it is the employees who keep the company aggressive, inspired and dynamic.²

CORPORATE RESTRUCTURING

The term 'Corporate Restructuring' is used to describe any significant change in the capital structure, in the operations or in the ownership of a firm, which is outside the ordinary course of its business. Examples include, transfer of controlling interest in a business, a transfer of the assets and liabilities of a company to another company and the transformation of a business entity into a limited partnership from of business organization. In each of these instances there has been a major change in one of the following:

- Pattern of Ownership
- Profile of Assets and Liabilities
- Legal Structure.

Of course, we can also think of a number of other transactions, which can be classified as a form of Corporate Restructuring. Forms of Corporate Restructuring are mergers, acquisitions, takeovers etc.

Merger is a combination of two or more companies into one company. It may involve either absorption or consolidation. A merger in which one of the companies loses its identity and the assets and liabilities of this company are taken over by the other (acquiring) company is referred to as Absorption. A merger in
which all the participating companies go out of existence to form a new company is referred to as Consolidation.

Acquisition (tender offers) involves the transfer of controlling interest in a company from one management group to another. Typically it involves the bidding company making a tender offer directly to the shareholders of the target company. The tender offer is an offer to purchase the shares of the target company at a fixed price per share from shareholders of the target to sell their shares, the tender price is usually set significantly above the current market price. Use of tender offer allows the acquiring company to bypass the management of the company it wishes to acquire. The term ‘takeover’ is also used to refer to this process.\textsuperscript{21}

Various form of Corporate Restructuring

M & A is a generic term used to mean many different types of corporate restructuring exercises. The various form of corporate restructuring can be summarised under three heads:

I. Expansion: -

• Merger or amalgamation

Two companies are independent. Within past 2 years one company cannot have owned 50% of another the acquisition should be a single step transaction. The consideration should be in shares. 90% of shareholders of the target company should remain. No disposal of significant part of business within 2 years.
• **Takeovers/Acquisitions**
  Gaining control of the utilisation of corporate assets and resources. This can be done either by taking control through share holding or by purchase of the asset itself. The accounting treatment differs depending upon the method of takeover.

**II. Sell off:** -

• **Spin offs**
  A Company distributes all the shares it owns in a subsidiary to its own shareholders implying creation of two separate public companies with same proportional equity ownership. Sometimes, a division is set up as a separate company.

• **Split ups**
  Parent company has many 100% or near 100% subsidiaries. Each of them is spun off as a public company.

**III. Changes in ownership:** -

• **Equity carve out**
  A parent has substantial holding in a subsidiary. It sells part of that holding to the public. "Public" does not necessarily mean shareholders of the parent company. Thus the asset item "Subsidiary Investment" in the balance sheet of the parent company is replaced with cash. Parent company keeps control of the subsidiary but gets
cash. This may be the first stage of a two-stage divestment transaction.

- **Leveraged buy out**

  A party is interested in buying out the stake in a company but lacks financial resources. It forms a team of banks who are willing to fund the idea. The team structures the deal after discussions with the company.

  The deal structure involves the following steps:

  - The sponsor of the idea forms a shell company.
  - The only asset is cash.
  - The debt-equity ratio is high.
  - It is not listed.
  - Shell Company purchases the shares from existing shareholders of the target mostly paying for in cash.
  - Target and shell company merge.
  - Target is thus de-listed.
  - The merged company is tightly managed for cash.
  - All debts are repaid in short period of, say, 1-5 years.
  - Sponsor takes the company public again, sells his stakes at a profit and exits.
FUNDING OF M&A ACTIVITY IN INDIA

Funding requirements could arise in the case of either an acquisition or a defence deal. Acquisitions could be negotiated or hostile. Negotiated takeovers could further be divided into those involving purchase of the equity stake of the shareholders and those, which involve purchase of an asset alone, without any acquisition of shares.

Defence mechanisms could be broadly divided into two categories -those prior to a bid having been made (preventive defence) and those, which are adopted by the company after a bid has been made for it (reactive defence). Preventive could take the form of raising the promoter’s stake through a creeping acquisition of shares by the promoter Reactive defence could take the form of the promoter making a counter offer, a white knight making a counter bid for a company, garnering the support of financial institutions for the existing management or a combination of these three.
A synopsis of the type of funding requirement is as follows;

**Figure: Categories of M & A funding transactions**

Source: www.mergers.net

**Conclusion:**

In this chapter mergers and acquisitions have been placed in the broader context of a company's corporate and business strategies.

An analytical framework for a strategic analysis of acquisitions has been provided. Using the models derived from this framework, acquirers can develop the acquisition criteria, which potential targets must satisfy.

The chapter has been concerned with the hard analysis of quantifiable economic and financial aspects of acquisitions.
M&A offers tremendous opportunities for companies to grow and add value to shareholders' wealth. M&A is a strategy for growth and expansion. M&A increase value and efficiency and thereby increase shareholder' value.

In the following chapter an attempt has been made to tax aspects of M&A through Legal framework.

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