Chapter-1

INTRODUCTION

1.1 Performance of Mergers & Acquisitions

Mergers are important corporate strategic actions that, among other things, help the firm in external growth and provide it competitive advantage. This area has spawned a vast amount of literature over the past half a century, especially in the developed economies of the world. India too has been seeing a growth in the number of mergers over the past one-and-a-half decade. Studies on the post-merger long-term performance of firms in both the developed and the developing markets have not been able to come to a definite and convincing conclusion about whether mergers have helped or hindered firm performance, Ramakrishnan (2008).

This study is an attempt towards analyzing the long term performance of domestic mergers and acquisitions in India by using accounting parameters, cash flows and EVA as a measure of performance. Two main research approaches explain Mergers and Acquisition profitability. The event studies examine the abnormal returns to shareholders in the period surrounding the announcement of a merger or acquisition. The accounting studies examine the reported financial results of acquirers before and after the acquisitions to see how the financial performance changes, Kumar and Prabina Rajib (2007).

Mergers and Acquisition research results signify that target shareholders benefit from mergers. Researchers have attributed increases in equity value to some unmeasured source of real economic gains such as synergy. The key question in the context of corporate control issues is whether takeovers are value-creating activities. It can be stated that a given merger is successful if other things equal, it increases the total current wealth of the owners of the acquiring firm. The efficient market hypothesis assumes that investor's anticipation of future benefits will be reflected in the merging firm's stock prices at the time of acquisition announcement. The post takeover accounting performance measures represent actual economic benefits generated by
takeovers, whereas the takeover announcement returns represent the investor's expectation of takeover benefits. Kumar and Prabina Rajib (2007).

There is near unanimous agreement that target stockholders benefit from mergers, as evidenced by the premium they receive for selling their shares. The stock price studies of takeovers also indicate that bidders generally break-even, and that the combined equity value of the bidding and target firms increase as a result of takeovers. These increases in equity values are typically attributed to some unmeasured source of real economic gains, such as synergy. But the equity value gains could also be due to capital market inefficiencies. For example, the equity value gains may simply arise from the creation of an over-valued security Healy et al. (1992).

An increasing number of studies are now attempting to understand the long-term performance of the firm over a few years post-merger, as such studies with longer horizons may provide us with better insights on whether mergers are serving the intended purpose. The rationale behind studying a longer time horizon post-merger, and not just the immediate period surrounding merger announcement, is that stock price movements around the latter period are only indicative of the capital market's expectations of the merger's performance. They are speculative in character and by no means stand for the actual performance of the merger. This 'real' or actual performance is reflected in, among other things, the financial reports of the combination for a few years after the merger. A careful analysis of these financial statements is indicative of the true level of post-merger performance. The term 'post-merger' here means subsequent to the consummation of the merger that has been previously announced, Ramakrishnan (2008).

Operating performance studies using accounting measures also do not reveal a consensual view on the effect of acquisitions. While some studies report gains (e.g. Healy et al., 1992; Cornett and Tehranian, 1992; Manson, Stark and Thomas, 1994; and Ramaswamy and Salatka, 1996), some report losses (e.g. Hogarty, 1978; Philippatos, Choi and Dowling, 1985; and Ravenscraft and Scherer, 1987), and others show mixed results (e.g. Neely and Rochester, 1987; and Herman and Lowenstein, 1988). Generally, studies showing losses employ earnings based measures while studies showing gains use cash flow based performance measures. Very few studies
like Ravenscraft and Scherer (1987) and Sharma & Ho (2002) have employed cash and earnings based performance measures together. It is possible that the results observed in the past studies are an artifact of the measurement of operating performance. This may be so because the accounting method adopted for merger related transactions could influence earnings. Major accounting choices relate to immediate write-off versus capitalization for goodwill and restructuring costs, and revisions to the value of assets acquired (asset revaluations), Sharma and Ho (2002).

1.2 Conceptual Understanding & Findings of Key Reports on M&A

Organizations can grow by using the strategy of internal growth or external growth or a combination of these two strategies. Firstly they can adopt the strategy of organic growth that is they establish their plant & machinery or expand their capacities etc. The benefit of such an approach is that the owner has complete control on the operations and expansion process. There are no problems of cultural fit, post merger integration, over payment etc. which are commonly found when organizations adopt the route of external growth through mergers & acquisitions. However, the disadvantage of such an approach is that, it will be a time consuming process and in the meantime competitor may capture the market or the fast growth period of the industry/economy may be lost in capacity building.

Another approach to grow or expand at a faster pace is through inorganic growth that is to merge with or acquire another firm. M&A benefits the organizations in several ways. Few of the benefits of mergers and acquisitions are Expansion of capacity at a faster pace, Fast and easy entry in the new industry, Fast and easy entry in the new geographical market, To reduce the competition and increase market power, To achieve the consolidation in the industry. To acquire the key source of raw material/components. For taxation purpose etc.

Synergies are by far the most common reason to motivate acquisitions and premium paid. Synergies fall into two categories Cost reductions and Revenue enhancement. Synergies arise as a result of increase of size or scale of operations; this gives rise to economies of scale/scope; vertical integration leads to complementary benefits; monopoly gains are resulted out of the increase in market share in a horizontal
merger; efficiency gains are realized out of superior managerial performance and effectiveness.

1.2.1 Corporate Reports on M&A: There are reports of three companies which give us an understanding of mergers & acquisitions in present Indian scenario. They are detailed below:

Accenture Report 2008:

High Performance through Mergers & Acquisitions - India’s New Dynamics:
Mergers and Acquisitions have been one of the primary strategies of corporate sector for faster growth or entry to a new market or industry. Indian companies have significantly increased their M&A activity over recent years, particularly in terms of cross-border acquisitions. The value of deals conducted by Indian companies grew at a compound annual growth rate of 28.3 percent over 2000-2007 to reach US$ 30.4
billion in 2007, of which US$ 22.8 billion represented cross-border transactions. Many Indian companies are conducting multiple M&A deals, building a series of stakes in different businesses and often a variety of industries. This "string of pearls" approach allows them to rapidly expand their growth opportunities and extend their geographical footprint.

According to Accenture's analysis of data from Thomson Financial, as many as 643 M&A deals were completed by Indian companies both at home and abroad in 2007, with a total value of US$ 30.4 billion. This represents a compound annual growth rate (CAGR) of 28.3 percent in deal value over the period 2000-2007. Figure 1 illustrates the increase in both the number and size of deals over this period (Accenture-CII Report, 2007- High Performance through Mergers & Acquisitions: India's New Dynamics, India).

Figure 1: M&A transactions by Indian companies 2000-2007

![Graph showing M&A transactions by Indian companies 2000-2007]

Source: Accenture analysis of Thomson Financial data

KPMG 2010 Report: The Determinants of M&A Success

Key Findings of this report are as follows:

1. Cash-only deals had higher returns than stock-and-cash deals, and stock-only deals Acquirers with lower P/E ratios completed more successful deals
2. The number of prior deals pursued by an acquirer was relevant; those who closed three to five deals were the most successful
3. Transactions that were motivated by increasing "financial strength" were most successful.
4. Deals that were motivated by a desire to purchase IP or technology and those motivated by a desire to increase revenues were least successful.
5. The size of the acquirer (based on market capitalization) was not statistically significant.

**Accenture Report 2012: Who Says M&A Doesn’t Create Value**

Whether or not an industry is poised for growth turns out to be very germane to its ability to create value from M&A.

This research shows a wide range of value-creation potential across industries, from a median total return to shareholders of 25 percent for deals in banking and capital markets to a discouraging negative 23 percent in retail and services (as given in chart).

While the competitive dynamics in the two sectors may seem superficially similar - both have bricks-and-mortar branches, both are moving to Web-based interactions with their customers - the pertinent factor that may explain why banks succeeded in creating value while retailers didn’t could be their outlook toward growth. Bankers relentlessly acquired and consolidated from 2002 to 2009, generating more M&A volume than any other industry as consumers across the globe valued established banking brands (the financial crisis that broke out in 2008 does not appear to have significantly accelerated consolidation in the industry).

Retailers, on the other hand, thought small and looked inward. Leading players have suffered well-documented challenges in trying to move into new markets to capture growth. As a result, from 2002 to 2009, there were no acquisitions in the emerging markets retail sector by developed economy acquirers among the 500 largest deals.

Industry is also important in the sense that less concentrated industries tend to create more value from M&A than more heavily concentrated industries, as measured by the Herfindahl–Hirschman Index.
Their findings show this relationship is fairly loose—after all, banking and retail are both relatively fragmented. Report states that “But it’s possible that we would have found more evidence of this trend if we hadn’t confined our research to the 500 largest deals.”

As earlier researchers have reported, less concentrated industries offer prospective acquirers a target-rich environment where they can find and acquire smaller best-fit companies that meet their exact screening criteria—an advantage that’s somewhat blunted if the acquirer is determined to do a very large deal.

Further, earlier researchers have reported that less-concentrated industries tend to be less mature and less regulated than more concentrated industries, making change easier to enact during a deal’s critical merger integration phase.

**Is there an industry advantage?**

While deals in some industries create more value than those in other sectors, top-quartile performers in every industry create value from M&A.

Acquirer total return to shareholders versus industry index, by industry Top 500 deals from June 2002 to September 2009

(TRS measured 24 months after deal announced)
1.3 Theories of M&A

There are several theories explaining the possible sources of gains following corporate acquisitions. Three of the common theories are the synergy or efficiency theory, the market for corporate control theory and the free cash flow theory. All three theories predict enhanced operating performance through some sort of efficiency.

1.3.1 The Synergy Theory

A popular explanation for acquisition is improved efficiency that somehow a combination of firms will result in improved operations and a better financial and operational profile.

According to Chatterjee (1992) proponents of free markets have long maintained that acquisitions are value-increasing events. This improved performance is most often referred to as 'synergy'. Synergy occurs when two firms can be run more efficiently (i.e., with lower cost) and/or more effectively (i.e., with a more appropriate allocation of scarce resources, given environmental constraints) together than apart (Lubatkin, 1983). The common element is improved resource allocation, whereby an improvement in allocative efficiency is expected to promote overall economic gains. As briefly explained below, synergies can be created through economies of scale, economies of scope and market power (Seth, 1990).

(a) Economies of Scale

The economy of scale argument posits that corporate combinations generate efficiencies through size. There are several potential sources of this efficiency. The new combined firm may have a much higher debt capacity and thus be able to borrow at a lower cost (Leewllen, 1971) through better access to capital markets (Levy and Sarnat, 1970). These economies may be exploited by both conglomerate and non-conglomerate acquisitions. A combined firm may also be able to achieve greater efficiency in transportation, production or management (Severiens, 1991). For instance, production linked economies may be achieved in the areas of purchasing or inventory management in the case of acquisitions involving firms using common raw materials or components. Consequently, these economies of scale should manifest in lower operating and financing expenses thereby improving operating performance.
(b) Economies of Scope

Economies of scope exist when managers are able to produce multiple products jointly at lower cost than if production were spread across multiple firms (Severiens, 1991). Most commonly, both partners in an acquisition bring some complementary skills to the combination such that value is created as a result of the acquisition (Seth, 1990). For instance, managers who acquire skills of firm A may find those skills very useful in lowering costs and increasing profits in firm B. Economies of scope may also arise from reuse of an input, such as sharing of production knowhow or other intangible assets by more than one product (Teece, 1980). Efficiencies from economies of scope are typical of non-conglomerate acquisitions and tend to improve operating performance through lower costs.

(c) Market Power

Market power or pecuniary economies represent another source of synergies (Lubatkin, 1983). These economies are achieved by the firm's ability to dictate prices by exerting market power achieved primarily through size. Two types of pecuniary economies are monopoly and monopsony (Porter, 1980). The first refers to the ability of a firm to force buyers to accept higher prices. The second refers to the firm's ability to force suppliers to accept lower prices. However, the existence of these economies has never been proven because of measurement problems (Shepherd, 1970). Regardless, market power supposedly enhances profit margins and therefore profitability of the new economic entity.

1.3.2 The Market for Corporate Control Theory

There is an established recognition that corporate acquisitions provide a mechanism for more effective management of the acquiree's assets (Manne, 1965). The corporate control market is one in which several teams of management compete to acquire the right to manage the firm. Competition among these management teams ensures, at least theoretically, that the most efficient team manages the firm. The market therefore expects the new management to be more effective than the incumbent management. This increased effectiveness and efficiency should subsequently manifest in improved operating performance.

1.3.3 Free Cash Flow Theory

Jensen's (1986) theory of Free Cash Flow posits that managers have a tendency to invest 'free cash flow' in negative net present value projects, which is contrary to shareholders' wealth maximisation policy. According to Jensen (1986) this agency problem is particularly severe for firms with substantial free cash flow and limited growth potential, and where consideration for the acquisition is equity rather than debt or cash. Servaes (1991) found that more value is created when the consideration for the acquisition is cash or debt rather than equity. This is so because the acquisition event and the debt-load created in the process, limits management's freedom to use future cash flows, thereby reducing the possibility of misuse of free cash flows. The increased fixed interest charges of debt also compel management to be more efficient. Thus, according to Jensen's (1986) free cash flow theory, post-acquisition performance should also improve relative to the pre-acquisition period particularly for non-equity purchased acquisitions.

The three theories described above have a common underpinning that corporate acquisition ought to generate gains in operating performance.

1.3.4 Some other theories on Mergers & Acquisitions

However there are several other theories related to M&A which attempts to explain the motives/causes behind the M&A.

Value increasing theories

(a) Size and returns to scale

Benefits of size are usual source of "synergies". The bigger scale of operations leads to economies of scale. The average costs decline with larger size and large firms more able to implement specialization. Economies of scope enable a firm to produce related additional products due to experience with existing products.
(b) Transaction costs and information efficiency

According to Coase (1937) a firm must decide between internal or external production. Transaction costs within and outside firm determines the decision on firm size and merger. Williamson (1985) goes a step further by defining the transaction cost as a function of "transaction frequency" and "asset specificity". Vertical integration is only optimal when "asset specificity" and "transaction frequency" are high. Market structure is the best alternative when "asset specificity" is low.

(c) Monopoly gains

Buying a rival firm might reduce competition and increase industry profits. Only the merging firm pays the associated cost (i.e., the cost of managing a larger corporation). Monopoly power from horizontal mergers is limited due to the existence of competition law. Limited evidence is available in the literature on monopoly gains as a reason to acquire.

(d) Disciplinary motives (efficiency gains)

Manne (1965) introduces the concept of "market for corporate control" i.e., a market in which different management teams are competing with each other. The M&A market is viewed as an alternative control mechanism to internal control. Poorly managed companies are taken over by well performing companies. The M&A market exerts external control on incumbent managements. According to Manne (1965, p. 113), "greater capital losses are prevented by the existence of a competitive market for corporate control.

Value reducing theories

(a) Agency costs of free cash flow (Jensen, 1986)

As per this theory, free cash flow is a source of value reducing mergers. Firms with FCF are those where internal funds exceed investment required for positive NPV projects.

(b) Managerial entrenchment (Shleifer and Vishny, 1989)

Managers are reluctant to distribute cash to shareholders. Investments may be in form of acquisitions where managers over pay but reduce likelihood of their own
replacement. “Disciplinary mergers” are solutions to these “agency-problem driven mergers”

Jensen, 1986, p. 328 “Free cash flow theory predicts which mergers and takeovers are more likely to destroy, rather than to create, value; it shows how takeover are both evidence of the conflicts of interest between shareholders and managers, and a solution to the problem”

Mitchell & Lehn (1990) provide empirical evidence that “bad bidders become good targets”

Value neutral theory

(a) The hubris hypothesis of “corporate takeovers”

Merger bids results from managerial hubris – managers are prone to excessive self- or over-confidence. Competitive bidding has a distribution of value estimates. As per Winner’s curse theory, manager with most optimistic forecast wins bidding process, cursed by fact that the winning bid more likely overvalues target. Mergers can occur even when no value effects are there. Target sells when bid is higher than target value. No value effects takes place under the hubris hypothesis wealth is transferred from the bidding firm’s owners to target shareholders.

Roll (1986, p. 212) “the hubris hypothesis can serve as the null hypothesis of corporate takeovers”

As stated in these divergent theories on M&A it can be contemplated that mergers and acquisitions as a strategy to growth may result in the significant improvement in performance or they may also result in the destruction of value of the merged entity. Therefore it is important to empirically examine the performance of the merged company to examine the success/failure of M&A as a strategy for growth.

1.4 Research Objectives

It has always been a matter to investigate whether M&A are fruitful exercises or they are the waste of capital and human effort and do not lead to value enhancement. Therefore this study aims to examine long-term financial performance of domestic
acquisitions. This study examines the combined post-merger performance of acquiring and target firms vis a vis combined pre-merger performance. This research is motivated by the inquisitiveness to know, whether takeovers create real economic gains and can be considered as the rewarding strategy for corporate growth.

Here the approach is to use post-merger accounting data to directly test for changes in operating performance that result from mergers. The tests use accounting data collected from CMIE-Prowess data base. It is recognized that accounting data are imperfect measures of economic performance and that these data can be affected by managerial decisions. Therefore this study also uses cash flow measures of economic performance to mitigate the impact of the financing of the acquisition and the method of accounting for the transaction. It is also recognized that these cash flow variables measure period-by-period performance which is affected by firm-specific and industry factors. Therefore industry performance is used as a benchmark to evaluate post-merger performance following Healy et al. (1992).

1.5 Methodology

The evaluation will be done by comparing post-merger performance vis-à-vis pre-merger performance after adjusting for industry related factors. The performance measures which are applied for this purpose includes profitability ratios, operating cash flows and economic value added. For this purpose annual financial results of sample companies are used and paired t-test is applied to see whether there is significant difference in pre and post-merger performance of sample companies. The application of many measures will help to check the robustness of the results.

Further, past studies related to performance evaluation have depicted the mixed results. Therefore it is important to analyse, why some mergers are successful while others not. Therefore this study also aims to probe several merger characteristics which may have a bearing on the performance of M&A. The characteristics which will be studied include size, mode of payment, relatedness, capital structure, promoter's stake etc.

For this purpose multiple regression technique is applied to assess the impact of these characteristics on post merger performance. In addition to it, entire sample is divided
into two sub-samples for each of these factors. After that post-merger performance of such sub-samples is evaluated separately.

This work has also attempted to analyse the impact of M&A on firm performance for select industries. For this purpose entire sample is divided into nine subsamples each representing a specific industry. The pre and post-merger performance for these select industries is then compared.

Thus with the help of this study we have made an attempt to find out the performance of M&A and underlying factors which may influence their performance.