Chapter 1

Introduction

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INTRODUCTION

The main objective of any company is sustainable growth of business to maximize the wealth of its stakeholders. Due to liberalization, privatization and globalization the competition in Indian business market becomes very tough. This leads the necessity for small and medium size companies to reduce competition, expansion of business, modern technologies with less investment. This is possible by way of corporate restructuring in the form of merger, acquisition, takeover, consolidation, reverse merger, demerger etc. One of the significant objectives of any sovereign is to achieve high rate of economic growth. For achieving this, it keeps reviewing and improving its policies from time to time and introduces various measures, both at micro and macro levels. It also requires various regulatory measures to channelise all economic efforts to achieve its social and economic objectives and to prevent unhealthy practices entering in to its economic system which is detrimental to public welfare.

In pursuance of these objectives, restrictions in India were placed on the corporate sector as per the provisions of various laws and regulations like Monopolistic and Restrictive Trade Practices, Industrial licensing policy etc. The MRTP Act 1969, placed restrictions on the expansion of an enterprise, establishment of new enterprise, division of undertakings, consolidation of undertakings and acquisition and transfer of shares of undertakings in order to check concentration of economic
power, control the growth of monopolies and prevent various restrictive trade practices likely to result from operation of economic system. The provision of FERA, 1973 placed restrictions on foreign investments in the country. These restrictions remained in vogue for over two decades and proved incompatible in keeping pace with the global economic developments to achieve the objective of faster economic growth. So, the government had to review its entire policy framework and initiate economic liberalization measures.

Though government began initiating steps towards liberalization in the post 1985 period, the real opening up of the economy started with the statement on industrial policy made in June 1991. This statement indicated continuity with change, the main thrust being on relaxation in industrial licensing, foreign investments, transfer of foreign technology and monopolies and restrictive trade practices laws. Since 1991, there have been many industrial and economic reforms which have striven to clear the obstacles to faster the industrial development. MRTP Act has been amended and most of the sections restricting the expansion of company’s have been deleted. Changes have also been made in FERA to permit foreign direct investment. The new Act, Foreign Exchange Management Act, 1999 (FEMA) has been introduced. Industrial licensing has been abolished in almost all industries.
Table 1.1

<table>
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<th>YEAR</th>
<th>Number of M &amp; As</th>
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<td>21.80</td>
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<tr>
<td>2003</td>
<td>1905</td>
<td>22.46</td>
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<tr>
<td>2004</td>
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SIGNIFICANCE OF THE STUDY

Indian economy is currently witnessing a sea change from the controlled to the market driven environment. Increasing shareholder values is the golden rule which Indian corporate are increasingly focusing on, as a means and end to survive and grow under the fast changing economic scenario. Merger and acquisition activity has become a part and parcel of the corporate and professional life. M&A is a sporadic event and there is very little scope for companies to learn from their past experience. Therefore, to determine the success of a merger, it has to be ascertained if there will be any economic gain from mergers. Post-merger economic gain will be generated only if the two companies are worth more together than apart. The basic motive of M&A can be understood as an attempt to create value. There are many
reasons that appear to apply to each merger. Among the explanations offered at various times has been exploitation of economies, synergy, acquisition of market share, growth, diversification, tax advantage etc. Most mergers are controlled by multiple motives rather than single one. However, many motives are characterized as having a hidden agenda (not expressed) or fake motive (intending to mask real ones). Many motives may not be consistent over time but shift, change character, emphasis and priority in the course of time.

An acquisition involves acquiring ownership in the tangible and intangible assets of the business. An acquisition is the purchase, by the company of the controlling interest in the share capital of an existing company. When a company is acquired by another company, the acquiring company has two options: The first is to merge both the companies into one and operate as single entity and the second is two operate the takeover company as an independent entity, may be with changed management and changed policies. The first option is known as merger and second option is known as takeover.

The merger has been defined as arrangement whereby the assets of two or more companies become vested in, or under the control of one company (which mayor may not be one of the original two companies), which has its shareholders, all or substantially all the shareholders of the two companies. It may also include fusion of two or more companies in to another.
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 the new companies by transferring their businesses and undertakings all other assets and liabilities to the new companies (i.e. merged company). The shareholders of companies whose identities have been merged (referred here as merging company) get substantial shareholding in the merged company based on the share exchange ratio incorporated in the scheme of merger as approved by majority of shareholders of both merged and merging companies.

The situation may be illustrated as under:

Assume there are two companies X and Y which decide to merge:

Option one: Where X company merges into Y Company
Combined merged company emerged as Y Ltd.

Option Two: Where Y company merges into X Company
Combined merged company emerges as X Ltd.

Option Three: X Company and Y Company both merged to form a new Company Z. Combined merged company emerges as Z Ltd.

Amalgamations the legal process by which two or more companies join together to form a new entity, or one or more companies are blended with another and as a consequence, amalgamating company loses its existence and its shareholders become shareholders of new company or amalgamated company.
As per Companies Act, 1956 (legislation that facilitates amalgamation), the terms merger and amalgamation are synonymous and not defined anywhere in the Act. Sections 390-396A of Companies Act define statutory provisions relating to these terms. As per the mandatory Accounting Standards AS-14 issued by the institute of Chartered Accountants of India (ICAI), amalgamation pursuant to the provisions of Companies Act or any other statute, which may be applicable to the companies. Two methods of amalgamation are contemplated in AS-14:

(a) Amalgamation in the nature of merger

(b) Amalgamation in the nature of purchase

Amalgamation in the nature of merger is an organic unification of two or more entities or undertakings or fusion of one with another. Amalgamation in the nature of purchase is where one company’s assets and liabilities are taken over by another and lump-sum is paid to the former by the latter. Both these amalgamations are within the purview of Sections 390-396A of Companies Act.

As per Income Tax Act, 1961, merger is defined as amalgamation under Section 2(1B) with the following 3 conditions to be satisfied:

(1) All the properties of amalgamating company should vest with the amalgamated company after amalgamation.

(2) All the liabilities of Amalgamation Company should vest with the amalgamated company after amalgamation.
(3) Shareholders holding not less than 75% in value or voting power in amalgamating company should become shareholders of amalgamated company after amalgamation.

Takeover is a general term used to defined acquisitions only and terms, acquisition and takeover, can be used interchangeably. A takeover may be defined as series of transactions, whereby, a person, individual, group of individuals or a company acquires control over the assets of a company, either directly by becoming the owner of those assets or indirectly by obtaining control of the management of the company.

Takeover may be of the different types depending upon the purpose of management for acquiring a company as follows:

(1) A takeover may be straight takeover which is accomplished by the management of the company by acquiring shares of another company with the intention of operating ‘taken over company’ as an independent legal entity.

(2) The second type of takeover is where ownership of company is captured to merge both companies into one and operate as single legal entity.

(3) A third type of takeover of a sick company for its revival. This is accomplished by an order of Board for Industrial and Financial Reconstruction (BIFR) under the provisions of Sick Industrial Companies (Special Provisions) Act, 1985.
(4) The forth kind is the bail-out-takeover, which is substantial acquisition of shares in a financially weak company, not being a sick industrial company, in pursuance to a scheme of rehabilitation approved by public financial institution which is responsible for ensuring compliance with provisions of Substantial Acquisition of Shares and Takeovers Regulations, 1997 issued by SEBI which regulate the bail-out-takeovers.

The regulatory framework for controlling takeover activities of a company consists of Companies Act, 1956, Listing Agreement and SEBI Takeover Code. Section 372A of Companies Act is applicable to acquisition of shares through a company. The takeover of listed companies is also regulated by Section 40A and 40B of Listing Agreement which seek to regulate takeover activities by imposing certain requirements of disclosures and transparency. The Securities and Exchange Board of India had earlier issued SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 which was repealed by SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 issued on 20th February, 1997 and further amended on 28th October, 1998.

Therefore, there is a need to study motives for mergers and acquisitions which can be helpful in assessing the scope and degree of their financial success. Many researches have been conducted in US and U.K. in this regard. However, a comprehensive empirical study is
lacking in India. This study attempts to fill this void in the Indian context.

OBJECTIVES OF THE STUDY

In the context of the above stated need the following objectives have been formulated in the study:

(i) To evaluate the pre and post-merger performance of the merged companies using the value added metrics of corporate performance such as Economic Value Added, Market Value Added and Return on Net Worth.

(ii) To examine the motives of corporate mergers in India as avowed in their merger schemes and to assess if, motives as avowed in the schemes have been fulfilled or not.

(iii) To evaluate the pre-and post-merger financial performance of merged companies and examine the influence of motives variables on mergers on mergers such as

(a) Profit maximization
(b) Growth
(c) Tax Consideration
(d) Diversification
(e) Leverage

(iv) To suggest appropriate strategy for merger and acquisition of Indian industry.
HYPOTHESIS OF THE STUDY

To accomplish the objectives of the study, the following null hypotheses have been developed for empirical testing:

H.1 Mergers and acquisitions do not result in value addition to existing shareholders.

H.2 Merger in India is not predominantly horizontal.

H.3 There is no difference between pre- and post-merger performance of merged companies under the study period.

H.4 Synergy in profits, acquisition of market share, tax consideration and diversification, all do not result in value addition to existing shareholders.

H.5 There is no significant difference in the value addition to the existing shareholders due to Growth and Leverage.

H.6 Motives as avowed in the merger schemes have not been effected after mergers.

THE SAMPLE AND DATA COLLECTION

This study includes companies which have undergone merger during the period 1st April, 1999 - 31st March, 2000. The empirical analysis of all individual merger events has been carried out pre-merger and post-merger to give a somewhat clear picture of their success or failure. There are about 196 merged companies in India during about
period. Out of which the sample has been consist of selected merged manufacturing companies for which data available for the entire period of the study.

Table 1.2
Industry-wise Classification

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Industry</th>
<th>No. of Companies M&amp;A</th>
<th>No. of Companies Selected</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Chemicals, Petrochemicals</td>
<td>13</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>Electric, Electronics,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Hardware</td>
<td>17</td>
<td>9</td>
</tr>
<tr>
<td>3</td>
<td>Fertilizers, Pesticides</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>4</td>
<td>Miscellaneous</td>
<td>52</td>
<td>13</td>
</tr>
<tr>
<td>5</td>
<td>Packaging</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>6</td>
<td>Paper &amp; Pulp</td>
<td>4</td>
<td>1</td>
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<td>7</td>
<td>Pharmaceuticals</td>
<td>15</td>
<td>6</td>
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<tr>
<td>8</td>
<td>Steel, Engineering</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>9</td>
<td>Tea-Coffee</td>
<td>6</td>
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<td>10</td>
<td>Textiles</td>
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<td>11</td>
<td>Treading</td>
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<td>Cement</td>
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<td>Entertainment</td>
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<td>14</td>
<td>Finance &amp; Investments</td>
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<td>15</td>
<td>Food Products</td>
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<td>-</td>
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<tr>
<td>16</td>
<td>Transport</td>
<td>11</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>196</strong></td>
<td><strong>56</strong></td>
</tr>
</tbody>
</table>

The financial and non-financial data used in the study has been mainly drawn from Centre for Monitoring Indian Economy (CMIE) “PROWESS” and Capitalize Database of Capital Market, which is also considered as. the most reliable Indian corporate database. Prowess contains a highly normalized database for over 13000 companies in India. This database is supplemented with powerful analytical software tools to enable extensive research.
TOOLS AND TECHNIQUES FOR ANALYSIS

This study has made the following analysis in terms of the objectives:

Post-Merger EVA Analysis

The onset of liberalization in the last ten years has shifted the focus of corporate goals to enhancing shareholder value. So, post-merger analysis of merged companies has been carried out in terms of value addition to shareholders. For this purpose, two methods of measuring shareholder value have been employed. Firstly, broad measures comprising the value added twins namely, Economic Value Added (EVA) and Market Value Added (MVA) and secondly, the traditional measures of Return on Net worth (RONW) have been applied.

EVA, a new performance metric popularized by Stern Stewart of U.S. has started gaining popularity as a superior tool for measuring corporate performance. EVA indicates the amount of economic value created in any single accounting period and is simply stated as the amount a company earns in excess of its capital.

\[
\text{EVA} = \text{Net operating profits after taxes} - \text{Cost of capital employed}
\]

\[= \text{NOPAT-COCE} \]

Where,

NOPAT- Profit after tax after subtracting tax adjusted interest

COCE- Weighted average cost of debt and equity capital X capital employed
While EVA measures shareholder value addition in terms of operating performance, its twin measure, MVA measures the markets’ assessment of firm’s value.

\[
\text{MVA} = \text{Market value} - \text{Capital employed of company}
\]

The relatively narrower measure of shareholder value creation is Return on Net worth (RONW) which is profit after tax divided by shareholders wealth in the company i.e. paid up capital + free reserves. This measure nets out the recommitted payment obligations to all classes of creditors and focuses only on wealth created for residual claimants.

Broadly,

\[
\text{RONW} = \frac{\text{Profit after tax}}{\text{Net Worth}} \times 100
\]

\[
= \frac{\text{PAT}}{\text{NW}} \times 100
\]

Pre-and Post-Merger Analysis

Last but not the least, pre and post-merger analysis has been carried out (for the sample merged companies whose schemes have been procured) in terms of motives of mergers with the objective to financially assess if, motives, as avowed in the merger schemes have been achieved or not. Six variables have been selected as motives of mergers namely,
(a) Profitability

(b) Growth

(c) Tax Advantage

(d) Leverage

I. Profitability Ratios

- Return on capital employed (profit before interest after tax /total capital employed)
- Gross profit margin (Gross profit /Net sales)
- Return on Net Worth (Profit after tax /Net worth)
- Dividend payout ratio (Dividend per share /Earning per share)
- Expense ratio (Operating expense /Net sales)
- Earning per share (Profit after tax /No. of equity shares)

II Growth

Growth in net assets = \frac{\text{Net assets in the beginning} - 1}{\text{Net assets at the end}}

III Tax Advantage

Effective rate of tax = \frac{\text{Tax paid}}{\text{Profit before tax}} \times 100
IV Leverage Ratio

Total Debt /Total Equity

\[
\text{Interest Coverage} = \frac{\text{Profit before interest and tax}}{\text{Interest}}
\]

Apart from the variables explained above, some more financial variables have been included for in-depth motives analysis. These are determined with the help of following ratios:

1. Price earning ratio (P/E ratio)
2. Liquidity ratio
3. Gearing ratio
4. Current ratio

Method of Analysis

Using value added metrics following analysis has been carried out for selected companies for four post merger years.

(1) Intra-company comparison is carried out over post merger period to see if shareholder value has improved over the post merger period.

(2) Inter company comparison is carried out- for average post merger period to know who are the gainers in this detritus of shareholder value after merger.
(3) Intra-industry comparison is carried out over post merger period to see if shareholder value has improved over the post merger period.

(4) Inter industry comparison is carried out for average post merger period to know who are the gainers in this detritus of shareholder value after merger.

For this purpose, absolute EVA and MVA data have been converted in to relative figures using following formula:

\[
EVACE = \frac{EVA}{CE} \times 100
\]

Where,

EVACE : Economic Value Added as a percentage of capital employed.
EVA : Economic Value Added
CE : Capital Employed

Regression Analysis

To study the impact of merger on firm’s performance, the regression analysis is also carried out for pre merger and post merger performance of sample companies.
Study Plan

Chapter I
INTRODUCTION

This chapter includes the brief evolution of M&A’s in India, significance of the study, the objectives of the study, the hypothesis, the samples and date collection, tools and techniques for analysis and limitation of the study.

Chapter II
CONCEPTUAL FRAMEWORK: MERGERS AND ACQUISITIONS

In this chapter, conceptual aspects of merger, acquisition, takeover, consolidation, reverse merger, demergers etc. are discussed. Various Indian and global laws and statues having a bearing on merger process have been outlined and trends traced. The procedure for merger, determination of share exchange ratio, the relevance of appointed date and effective date and other related issues have also been covered.

Chapter III
REVIEW OF LITERATURE

This chapter contains a comprehensive review of various research studies conducted in and out of India. Research literature, out of India, especially in US and UK covers almost every aspect of mergers and acquisitions such theories of firm conceptualized into motives of mergers, their empirical investigation, performance measures using share price and accounting data, empirical examination of financial
characteristics of acquired and acquiring firms and determinants of aggregate merge activity.

Chapter IV
AN ANALYSIS OF ECONOMIC VALUE ADDED BASED ON MERGERS & ACQUISITIONS

This chapter includes the historical evolution of corporate performance metric popularized by Stem Stewart of US, namely Economic value added (EVA) and its twin, Market value added (MVA). After giving the rationale of its use and its superiority over other performance metrics like Earning Per Share (EPS) and Return On Net Worth (RONW), the detailed theoretical methodology regarding its computation has been discussed.

Chapter V
AN ANALYSIS OF FINANCIAL PERFORMANCE

This chapter specifies the process of sample selection, data collection and the financial variables included along with the methodology adopted for their computation. The second section gives the empirical results and last section discusses their interpretation and conclusions.

Chapter VI
SUMMARY, FINDINGS AND SUGGESTIONS

This chapter highlights general criteria, summary, findings and suggestions of the study. Also, suggested path for the improvement and future areas for research.
LIMITATIONS OF THE STUDY

- Impact of mergers on financial performance of companies due to certain other factors such as change in industry, economy, and stock market have not been covered by this study.

- This study is based on secondary data and secondary data has its own limitations.

- This study is limited to the merger of the selected companies and the findings can not be generalized to whole industry.

- There are many approaches to measure the impact of merger on financial performance of the company. There is no unanimous opinion among the experts. So the researcher has taken the approaches, which might be appropriate for the study.

REFERENCES


- Bhattacharya, H.K. 1988: Amalgamation and Takeovers; Company news and notes.


