CHAPTER VI

CORPORATE MERGERS AND ACQUISITIONS: MOTIVES AND BENEFITS

6.1 INTRODUCTION:

The key determinants for success in the global market are ability to achieve sized, scale, integration and greater financial strength and flexibility. It is believed that corporate merger and acquisition are strategic decisions leading to the maximization of a company’s growth by enhancing its production and marketing operations. Corporate merger and acquisition become most popular in the recent times because of the enhanced competition, breaking of trade barriers, free flow of capital across countries and globalization of business as a number of economies are being deregulated and integrated with other economies.¹

A number of reasons are attributed for the occurrence of corporate merger and acquisition. For example, it is suggested that corporate merger and acquisition are intended to:²

1. Limit compensation,
2. Utilize under-utilized market power,
3. Overcome the problem of slow growth and profitability in one’s own industry,
4. Achiever diversification,
5. Gain economies of scale and increase income with proportionately less investment,
6. Establish a transnational bridgehead without excessive start-up costs to gain access to foreign market,
7. Utilize under-utilised resources-human and physical and managerial skills,

² Ibid.
8. Displace existing management,
9. Circumvent government regulations,
10. Reap speculative gains attendant upon new security issue,
11. Create an image of aggressiveness and strategies opportunism, empire building and to amass vast economic powers of the company.

6.2 MOTIVES FOR CORPORATE MERGERS & ACQUISITIONS:

Corporate mergers and acquisitions are caused with the support of shareholders, managers and promoters of the combining companies. The factors, which motivate the shareholders and managers to lend support to these combinations and the resultant consequences, are given as under: ³

6.2.1 From the Standpoint of Shareholders⁴:

Investment made by shareholders in the companies subject to merger should enhance in value. The sale of shares from one company’s shareholders to another and holding investment in shares should give rise to greater value i.e. the opportunity gains in alternative investments. Shareholders may gain from merger in different ways viz. from the gains and achievements of the company i.e. through

(a) Realisation of monopoly profits;
(b) Economies of scale;
(c) Diversification of product line;
(d) Acquisition of human assets and other resources not available otherwise;
(e) Better investment opportunity in combinations.

Realisation of gains from the corporate mergers and acquisitions to shareholders in the above form might not be generalised but one or more features would generally be available in each merger where shareholders may have attraction and favour merger.

³ Dr. J. C. Verma, Corporate Mergers Amalgamations & Takeovers, P.79, (Bharat Law House, New Delhi, 5th Ed. 2008).
⁴ Ibid.
6.2.2 From the Standpoint of Managers⁵:
Managers are concerned with improving operations of the company, managing affairs of the company effectively for all round gains and growth of the company which will provide them better deals in raising their status, perks and fringe benefits. Mergers where all these things are the guaranteed outcome get support from managers. At the same time, where managers have fear of displacement at the hands of new management in amalgamated company and also resultant depreciation from the merger then support from them becomes difficult.

6.2.3 Promoter’s Gains⁶:
Mergers do offer to company promoters the advantage of increasing the size of their company and the financial structure and strength. They can convert a closely-held and private limited company into a public company without contributing much wealth and without losing control.

For example, Merger of Hindustan Computers, Hindustan Reprographics, Hindustan Telecommunications and Indian Computer Software Company into HCL Limited. In this merger process with HCL, only Hindustan Reprographics Ltd was public company whereas the other three merging entities were private limited companies.

The promoters of Hindustan Computers were allotted shares worth Rs. 1.27 Crores on merger in a new company called HCL Limited. This gave them an 86% stake in HCL’s equity of Rs. 1.48 Crores shares. This gain was against their original investment of meagre Rs. 40 lakhs in Hindustan Computers and they did not invest any extra money in getting shares worth Rs. 1.48 Crores.

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⁶ Ibid.
6.3 OBJECTIVES OF CORPORATE MERGERS AND ACQUISITIONS:

Corporate mergers and acquisitions, in practice, depend upon the motives of the person behind such move. They adopt according to their convenience the route which leads to attaining their goal of acquiring the controlling interest in the voting rights or assets in part or in whole of the target company.

Generally, the following types of decisions limit their choice for a particular company in which corporate mergers and acquisitions activity could be organised:

1. Acquisition of shares in the target company;
2. Acquisition of the assets of the target company’s undertaking;
3. Acquisition for full or part ownership of the target undertaking;
4. Acquisition for cash or for shares or other securities of the offeror company or combination of cash and variety of securities;
5. Possibilities of friendly acquisition and the percentage of shareholding in target company available through persons agreeable to corporate merger and acquisition;
6. Legal formalities to be complied with under various corporate laws the provisions of which are attracted in effecting corporate merger and acquisition of the two or more companies;
7. Means of finance available with Offeror Company to pay off for the acquisition of shares, loan, stocks or assets of the target company;
8. The type of securities available with target company for acquisition and their possible adjustment in the capital structure of the combined company particularly of the loan stock, convertible securities, warrants, options or subscriptions rights outstanding which require appropriate arrangements to be made by the offeror.

7 Supra Note 3, PP.76-77.
9. Involvement of financial institutions and banks as lenders of long-term finance stake in the equity capital of the target company, the chances of obtaining their approval and also availing of further finance from them for the combined company;

10. Favourable features in the Memorandum and Articles of Association of the two companies with the power of Board to go for acquisition for Offeror Company and to go for sale of undertaking for the offered company through corporate merger and acquisition, etc.

6.4 ADVANTAGE OF CORPORATE MERGER AND ACQUISITION:

The general advantage behind mergers and acquisitions is that it provides a productive platform for the companies to grow, though much of it depends on the way the deal is implemented. It is a way to increase market penetration in a particular area with the help of an established base. There are few reasons for mergers and acquisitions, which are:

1. Accessing new markets;
2. Maintain growth momentum;
3. Acquiring visibility and international brands;
4. Buying cutting edge technology rather than importing it;
5. Taking on global competition;
6. Improving operating margins and efficiencies;
7. Developing new product mixes.

Are there any real benefits of merger? A number of corporate mergers and acquisitions benefits are claimed. But all of them are not real benefits. Based on experience of certain companies, the most common benefits of corporate mergers and acquisitions are as follow:\footnote{Supra Note 1, PP 15-17.}
6.4.1 Accelerated Growth:

Growth is essential for sustaining the viability, dynamism and value-enhancing capability of a company. A growth-oriented company is not only able to attract the most talented executives but it would also be able to retain them. Growing operations provide challenges and excitement to the executives as well as opportunities for their job enrichment and rapid career development. This helps to increase managerial efficiency. Other things being the same, growth lead to higher profits and increase in the shareholders’ value. A company can achieve its growth objective by:

1. Expanding its existing markets;
2. Entering in new markets.

A company may expand and diversify its markets internally or externally. If the company cannot grow internally due to lack of physical and managerial resources, it can grow externally by combining its operations with other companies through corporate mergers and acquisitions.

Internal growth requires that the company should develop its operating facilities – manufacturing, research, marketing etc. internal development of facilities for growth also requires time. Thus, lack or inadequacy of resources and time needed for internal development constrains a company’s pace of growth. The company can acquire production facilities as well as other resources from outside through mergers and acquisitions. Specially, for entering in new products/markets, the company may lack technical skills and may require special marketing skills and/or a wide distribution network to access different segments of markets. The company can acquire existing company or companies with requisite infrastructure and skills and grow quickly.

Corporate mergers and acquisitions, however, involve cost. External growth could be expensive if the company pays an excessive price of merger benefits should exceed the cost of acquisition for realizing a growth which adds

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9 http://acceleratedgrowth.com/ (Visited on June 27, 2012)
value to shareholders. In practice, it has been found that the management of a number of acquiring companies paid an excessive price for acquisition to satisfy their urge for high growth and larger size of their companies. It is necessary that price may be carefully determined and negotiated so that merger enhances the value of shareholders.

6.4.2 Enhanced Profitability\(^\text{10}\):

The combination of two or more companies may result in more than the average profitability due to cost reduction and efficient utilization of resources. This may happen because of the following reasons:

1. Economies of scale.
2. Operating economies.

1. Economies of Scale:

   Economies of scale arise when increase in the volume of productions leads to a reduction in the cost of production per unit. Merger may help to expand volume of production without a corresponding increase in fixed costs. Thus, fixed costs are distributed over a large volume of production causing the unit cost of production to decline. Economies of scale may also rise from other indivisibilities such as production facilities, management functions and management resources and systems. This happens because a given function, facility or resource is utilized for a larger scale of operation.

   For example, a given mix of plant and machinery can produce scale economies when its capacity utilization increases. Economies will be maximized when it is optimally utilized. Similarly, economies in the use of the marketing function can be achieved by covering wider markets and customers using a given sales force and promotion and advertising efforts. Economies of scale may also be obtained from the optimum utilization of management resource and systems of planning, budgeting, reporting and control. A company established management systems by employing enough qualified professionals.

irrespective of its size. A combined company with a larger size can make the optimum use of the management resource and systems resulting in economies of scale.¹¹

2. Operating Economies:

In addition to economies of scale, a combination of two or more companies may result into cost reduction due to operating economies. A combined company may avoid or reduce overlapping functions and facilities. It can consolidate its management functions such as manufacturing, marketing, R&D and reduce operating costs. For example, a combined company may eliminate duplicate channels of distribution, or create a centralized training centre, or introduce an integrated planning and control system.

In a vertical merger, a company may either combine with its suppliers of input (backward integration) and/or with its customers (forward integration). Such merger facilitates better co-ordination and administration of the different stages of business operations – purchasing, manufacturing, and marketing – eliminate the need for bargaining (with suppliers and/or customers), and minimizing uncertainty of supply of inputs and demand for product and saves costs of communication.

An example of a merger resulting in operating economies is the merger of Sundaram Clayton Ltd. (SCL) with TVS – Suzuki Ltd. (TSL). By this merger, TSL became the second largest producer of two-wheelers after Bajaj. The main motivation for the takeover was TSL’s need to tide over its different market situation through increased volume of production. It needed a large manufacturing base to reduce its production costs. Large amount of funds would have been required for creating additional production capacity. SCL also needed to upgrade its technology and increase its production. SCL’s and TSL’s plants were closely located which added to their advantage. The combined company has also been enabled to share the common R&D facilities. Yet

¹¹ Ibid.
another example, of a horizontal merger motivated by the desire for rationalization of operation is the takeover of Universal Luggage by Blow Plast. The intended objectives were elimination of fierce price war and reduction of marketing staff.  

6.4.3 Diversification of Risk:\footnote{Supra Note 1, PP 19-20.}:

Diversification implies growth through the combination of companies in unrelated businesses. Such mergers are called conglomerate mergers. It is difficult to justify conglomerate merger on the ground of economies as it does not help to strengthen horizontal or vertical linkage. It is argued that it can result into reduction of total risk through substantial reduction of cyclicality of operations. Total risk will be reduced if the operations of the combining companies are negatively correlated.

In practice, investors can reduce non-systematic risk (the company related risk) by diversifying their investment in shares of a large number of companies. Systematic risk (the market related risk) is not diversifiable. Therefore, investors do not pay any premium for diversifying total risk via reduction in non-systematic risk that they can do on their own, cheaply and quickly.

For example, an investor who holds one per cent of shares of company X and one per cent share of company Y could achieve the same share of earnings and assets if companies X and Y are merged and he holds one per cent of shares of the merged company. The risk from his point of view has been diversified by his acquiring shares of the two companies. Of course, the merger of two companies may reduce the variability of earnings vis-à-vis the market-related variables. What advantage can result from conglomerate mergers for shareholders who can diversify their portfolio to reduce non-systematic risk?

The reduction of total risk, however, is advantageous from the combined company’s point of view, since the combination of management and other systems strengthen the capacity of the combined companies to withstand the

\footnote{Ibid.}
severity of the unforeseen economies factors which could otherwise the survival of individual companies. Conglomerate mergers can also prove to be beneficial in the case of shareholders of unquoted companies since they do not have opportunity for trading in their company’s shares.

An example of diversification through mergers to reduce total risk improve profitability is that of RPG Enterprises (Goenka Group). The group started its takeover activity in 1979. It compromises a large number of companies, most of which have been takeover. The strategy has been to look out for any foreign disinvestment, or any cases of sick companies which could prove right target at low takeover prices. In 1988, RPG took over ICIM and Harrisons Malayalam Limited. In the case of ICIM, the parent company, ICL, continued to hold 40 per cent the equity stake with the Goenkas acquiring 10 per cent of the equity by private placement of shares. For the Goenkas, this has provided an easy access to electronics industry.

6.4.4 Reduction in Tax Liability14:

In a number of countries, a company is allowed to carry forward its accumulated loss to set-off against its future earnings for calculating its tax liability. A loss-making or sick company may not be in a position to earn sufficient profits in future to take advantage of the carry forward provision. If the company is allowed to merge with a sick company to set-off against its profit the accumulated loss and unutilised depreciation of that company. A number of companies in India have merged to take advantage of this provision.

An example of merger to reduce tax liability is the absorption of Ahmedabad Cotton Mills Limited (ACML) by Arvind Mills in 1979. AMCL was closed in August 1979; ACML had an accumulated loss of Rs. 3.34 crore. Arvind Mills saved about Rs. 2 crore in tax liability for the next two years because it could be set-off ACML’s accumulated loss against its profits.

Another example of merger induced tax saving is the takeover of Sidhpur Mills by Reliance in 1979. The carry forward losses and unabsorbed

14 Supra Note1, PP. 20-21.
depreciation of Sidhpur amounted to Rs. 2.47 crore. In addition to tax savings, the merger provided Reliance with an opportunity for vertical integration (Sidhpur would supply grey cloth to Reliance) and capacity expansion (Sidhpur had 490 looms and 50,000 spindles and 40 acres of land). ICICI taking new bank of Madurai in another case is point where tax benefits have been gained.

When two companies merge through an exchange of shares, the shareholders of selling company can save tax. The profits arising from the exchange of shares are not taxable until the shares are actually sold. When the shares are sold, they are subject to capital gains tax which is much lower than the ordinary income tax rate. For example, in India capital gains tax rate is 20 per cent while for the corporate tax rate is 35 per cent.

A strong urge to reduce tax liability, particularly when the marginal tax rate is high (as has been the case in India), is a strong motivation for the combination of companies. For example, the high tax rate was the main reason for the post-war merger activity in the USA. Also, tax benefits are responsible for one-third of mergers in the USA.

6.5 FINANCIAL BENEFITS15:

There are many ways in which a merger can result into financial synergy and benefits. A merger may help in:

1. Eliminating the financial constraint;
2. Deploying surplus cash;
3. Enhancing debt capacity;
4. Lowering the financing costs.

1. Financial Constraint:

A company may be constrained to grow through internal development due to shortage of funds. The company can grow externally by acquiring another company by the exchange of shares and thus, release the financial constraint.

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2. Surplus Cash:

A different situation may be faced by a cash-rich company. It may not have enough internal opportunities to invest its surplus cash. It may either distribute its surplus cash to its shareholders or use it to acquire some other company. The shareholders may not really benefit much if surplus cash is returned to them since they would have to pay tax at ordinary income tax rate. Their wealth may increase through an increase in the market value of their shares if surplus cash is used to acquire another company. If they sell their shares they would pay tax at a lower, capital gains tax rate. The company would also be enabled to keep surplus and grow through acquisition.

3. Debt Capacity:

A merger of two companies, with fluctuating, but negatively correlated, cash flow, can bring stability of cash flows of the combined company. The stability of cash flows reduces the risk of insolvency and enhances the capacity of the new entity to service a larger amount of debt. The increased borrowing allows a higher interest tax shield which adds to the shareholders’ wealth.

4. Financing Cost:

The enhanced debt capacity of the merged company reduces its cost of capital, since the probability of insolvency is reduced due to financial stability and increased protection to lenders, the merged company should be able to borrow at a lower rate of interest. This advantage may, however, be taken off partially or completely by increase in the shareholders’ risk on account of providing better protection to lenders.

6.6 INCREASED MARKET POWER\textsuperscript{16}:

A merger can increase the market share of the merged company. As discussed earlier, the increased concentration or market share improves the profitability of the company due to economies of scale. The bargaining power of the company vis-à-vis labour, suppliers and buyers is also enhanced. The merged company can also exploit technological breakthroughs against

\textsuperscript{16} Supra Note 1, P.22.
obsolescence and price wars. Thus, by limiting competition, the merged company can earn super-normal profit and strategically employ the surplus funds to further consolidate its position and improve its market power.

6.7 Motives Which Add Shareholders’ Value:

The Basic purpose of merger and acquisition is to achieve faster growth of the corporate business. But the companies which engage in merger and acquisition, having the main purpose of creating a higher shareholder value than the sum of the company involved. Behind this purpose of creating a higher shareholder value, the company, which engage in merger and acquisition, has the following motives which add shareholders’ value. These are

(1) Synergy: This refers to the fact that the combined company can often reduce duplicate departments or operations, lowering the costs of the company relative to the same revenue stream, thus increasing profit.\(^{17}\)

(2) Increased revenue/Increased Market Share: This motive assumes that the company will be absorbing a major competitor and thus increase its power (by capturing increased market share) to set prices.\(^{18}\)

(3) Cross Selling: For example, a bank buying a stock broker could then sell its banking products to the stock broker’s customers, while the broker can sign up the bank’s customers for brokerage accounts. Or, a manufacturer can acquire and sell complementary products.

(4) Economies of Scale: For example, managerial economies such as the increased opportunity of managerial specialisation. Another example is purchasing economies due to increased order size and associated bulk-buying discounts.\(^{19}\)

(5) Taxes: A profitable company can buy a loss maker to use the target’s loss as their advantage by reducing their tax liability. In the United States and many other countries, rules are in place to limit the ability of


\(^{18}\) Ibid.

\(^{19}\) Supra Note 1, P. 24.
profitable companies to “shop” for loss making companies, limiting the tax motive of an acquiring company.

(6) Geographical or other diversification: This is designed to smooth the earning results of a company, which over the long term smoothen the stock price of a company, giving conservative investors more confidence in investing in the company. However, this does not always deliver value to shareholders.

(7) Resource transfer: Resources are unevenly distributed across companies and the interaction of target and acquiring company resources can create value through either overcoming information asymmetry or by combining scarce resources.20

6.8 MOTIVES WHICH ARE CONSIDERED NOT TO ADD SHAREHOLDER’S VALUE21:
Besides the motives which add shareholders value, there are several motives those are considered not to add shareholder’s value. These are:

(1) Empire building: Managers have larger companies to manage and hence more power.

(2) Manager’s compensation: In the past, certain executive’s 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. Although some examples show that compensation is linked to profitability rather than mere profits of the company.

(3) Vertical integration: Companies acquire part of a supply chain and benefit from the resources. However, this may not add any value since although one end of the supply chain may receive a product at a cheaper cost; the other end now has lower revenue. In addition, the supplier may

20 Supra Note 16.
21 Supra Note 1, P.24
find more difficulty in supplying to competitors of its acquirer because the competition would not want to support the new conglomerate.

6.9 CONCLUSION:

Corporate merger and acquisition is defined as the process of buying, selling and integrating different corporations with the desire of expansion and accelerated growth opportunities. This kind of association in any form plays an integral role when it comes to business and economy as it results in significant restructuring of a business. It is a tool used by the companies for the purpose of expanding their operations often aiming at an increase of their long term profitability. It depends upon the motives of the company’s. There is no one single motive or reason for corporate mergers and acquisition, but a multitude of motives such as synergistic operating economies, diversification, taxation advantage, growth advantage, production capacity reduction, managerial motives, acquisition of specific assets, acquisition by management or leveraged buyout causes corporate mergers and acquisitions.

There may be many other reasons motivating corporate mergers and acquisitions in addition to the above ones viz. profit enhancement for the company, achieving efficiency, increasing market power, tax and accounting opportunities, growth as a goal and many speculative goal, etc. depending upon the circumstances and prevailing conditions within the company and the economy of the country. Depending upon the motives, the form of corporate mergers and acquisitions are decided by the acquirer or both the acquirer and the acquired. Financial factors and market power also motivates such corporate mergers and acquisitions. Corporate mergers and acquisitions generally succeed in generating cost efficiency through the implementation of economies of scale. It may also lead to tax gains and can even lead to a revenue enhancement through market share gain. The principal benefits from mergers and acquisitions can be listed as increased value generation, increase in cost efficiency and increase in market share.

Mergers and acquisitions often lead to an increased value generation for the company. It is expected that the shareholder value of a company after
mergers or acquisitions would be greater than the sum of the shareholder values of the Parent companies. An increase in cost efficiency is affected through the procedure of mergers and acquisitions. This is because mergers and acquisitions lead to economies of scale. This in turn promotes cost efficiency. As the parent company merge to form a bigger new company, the scale of operations of the new company increases. As output production rises there are chances that the cost per unit of production will come down.

An increase in market share is one of the plausible benefits of mergers and acquisitions. In case a financially strong company acquires a relatively distressed one, the resultant organization can experience a substantial increase in market share. The new company is usually more cost-efficient and competitive as compared to its financially weak parent organization. Thus, in the global business markets, pre-determination of motives and objective are most essential for the corporate mergers and acquisition decisions, which further enhance the value of share’s of the shareholders.

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