Mergers & Acquisitions

Ref. No. M&As – 072009MSF04

For any clarification regarding this book, please write to FedUni giving the reference number of the book, and the page number.

While every possible care has been taken in preparing the book, FedUni welcomes suggestions from students for improvement in future editions.

Contents

Curriculum

Mergers and Acquisitions: An Overview: Various Forms of Corporate Restructuring – Restructuring – Underlying Issues – Merger Waves – Mergers and Acquisitions in India.

Maximization of Organization Value: Definition of Strategy – Process of Strategic Planning – Alternative Strategy Methodologies – Approaches to Strategy Formulation – Formulating a Competitive Strategy – Diversification Strategy – Internal vs. External Growth – Diversification Planning, Mergers and the Carryover of Managerial Capabilities – A Strategic Approach to Mergers and Acquisitions.

Mergers and Acquisitions: Different Forms: Various Types of Mergers – The Merger and Acquisition Process – Participants in the Merger and Acquisition Process – Post-Merger Management/Post-closing Integration, Due Diligence, The Merger Integration Work Streams Model – Reasons for Failure of Mergers and Acquisitions.

Methods of Valuation of Firms: Various Approaches to Valuation – Discounted Cash Flow Model – Equity Valuation Models – Firm Valuation Models – Valuation – Other Approaches – Selection of Appropriate Valuation Method – Valuation – A Case Study.

Theories of Mergers: Efficiency Theories – Information and Signaling – Market Power – Tax Considerations – Agency Problems and Managerialism – Hubris Hypothesis – Free Cash Flow Hypothesis – Value Increases by Redistribution.

Sell-offs and Divestitures: Factors Involved in Divestment Decisions – Explanation and Rationale for Gains to Sell-offs – Divestitures – Spin-offs – Equity Carve-outs – Decision Process: Divestiture and the Spin-off.

Modalities of Payment – Tax Implications: The Forms of Financing – Theories of the Method of Payment on Abnormal Returns – Junk Bonds – Post-Merger Financial Leverage – Tax Implications – Accounting for Mergers and Acquisitions – Methods of Accounting for Amalgamation.

Joint Ventures: Strategic Alliances – Joint Ventures – Rationale behind Joint Ventures – Key Issues in a Joint Venture – Managing International Joint Ventures – Reasons for Failure of Joint Ventures.

Going Private and Leveraged Buyouts: 'Going Private' Transactions – Leveraged Buyout – Sources of LBO Financing – Characteristics of an Ideal Leveraged Buyout Candidate – Sources of Gains in LBOs – Management Buyouts – Management Buy-Ins – Leveraged Cash Out – LBO and Corporate Governance – Leveraged Buyouts in India.

ESOPs and MLPs: Types of Pension Plans – ESOPs: The Underlying Philosophy – History of ESOPs in the US – Types of ESOPs – Mechanics of ESOPs – ESOPs and Corporate Performance – Role of ESOPs in Mergers and Acquisitions – ESOP Practices in India – An Overview – Master Limited Partnerships.

International Mergers and Acquisitions: Theory of a Multinational Enterprise – Motives behind International Mergers and Acquisitions – Reasons for Failure of Mergers and Acquisitions – Global Mergers and Acquisitions – Indian Scenario – Tax and Regulatory Issues in Cross-border Mergers and Acquisitions.

Corporate Control – Buy-back of Shares and Exchange Offers: The Nature of Cash Share Repurchases – Dividend like Effects of Share Repurchases – Basic Stock Repurchase Model – The Theories behind Share Repurchase – Share Repurchases as a Potentially Unique Signaling Mechanism – Criticism of the Potential Unique Signaling Benefit of Repurchases – The Rationale behind the Popularity of Buy-backs – Implications for Investors – The Indian Scenario – Share Buy-back by DLF – A Case Study – Concept of Exchange Offers.

Takeover Defenses: Friendly vs. Hostile Takeovers – Takeover Defenses – Preventive Anti-takeover Measures – Corporate Charter Amendments – Golden Parachute – Active Anti-takeover Defenses – Takeover Defenses – A Case Study – Regulation of Takeovers in India.

Management Guide for Merger and Acquisition Activity: Diversification and Mergers in the Long Range Planning – The Rules for Successful Mergers – Significant Determinants of the Merger Activity – Value Based Planning – Merger Analysis in the Value Creation Framework.

Takeover Models: Free Rider Problem, Initial Shareholding, and the Equilibrium Bid – Preemptive Bidding and Entrance Costs – Choice of the Medium of Exchange – Bidder Elimination and Value Reduction Strategies – Takeover Methods and Capital Structure.

Mergers and Acquisitions – Regulatory Control: Evolution of Regulatory Control of Mergers and Acquisitions in India – Compliance under the Companies Act, 1956 – Regulatory Framework of Takeovers in India – Takeover Regulations under SEBI – The Provisions under the Competition Act, 2002 – Implications under the Income Tax Act, 1961.

Turnaround Management: Getting the Danger Symptoms – Choosing Appropriate Turnaround Strategy – Implementation of the Change Process and its Monitoring – Debt Restructuring – Corporate Debt Restructuring Mechanism – Nursing of Distressed Firms – Liquidation of Firms – Bankruptcy – BIFR and Its Role.

.

Chapter 1

Mergers and Acquisitions: An Overview

After reading this chapter, you will be conversant with:

- Various Forms of Corporate Restructuring
- Restructuring – Underlying Issues
- Merger Waves
- Mergers and Acquisitions in India

In a rapidly changing world, companies are facing unprecedented turmoil in global markets. Severe competition, rapid technological change, and rising stock market volatility have increased the burden on managers to deliver superior performance and value for their shareholders.

In response to these pressures, an increasing number of companies around the world are dramatically restructuring their assets, operations, and contractual relationships with shareholders, creditors, and other financial stakeholders. Corporate restructuring has facilitated thousands of organizations to re-establish their competitive advantage and respond more quickly and effectively to new opportunities and unexpected challenges. Corporate restructuring has had an equally profound impact on the many more thousands of suppliers, customers, and competitors that do business with restructured firms.

Generally, most of the corporate growth occurs by internal expansion, when a firm's existing divisions grow through normal capital budgeting activities. Neverthless, if the goals are easily achieved within the firm, it may mean that the goals are too small. Growth opportunities come in a variety of other forms and a great deal of energy and resources may be wasted if an entrepreneur does not wait long enough to identify the various dynamics which are already in place. The most remarkable examples of growth and often the largest increases in stock prices are a result of mergers and acquisitions. M&As offer tremendous opportunities for companies to grow and add value to shareholders' wealth. M&As is a strategy for growth and expansion. M&As are expected to increase value and efficiency and thereby increase shareholders' value. M&As is a generic term used to represent different types of corporate restructuring exercises.

VARIOUS FORMS OF CORPORATE RESTRUCTURING

Business firms in their pursuit of growth, engage in a broad range of restructuring activities. Actions taken to expand or contract a firm's basic operations or fundamentally change its asset or financial structure are referred to as corporate restructuring activities. Corporate restructuring is a broad umbrella that covers many things. One of them is the merger or takeover. From the viewpoint of the buyer, M&A represent expansion and from the perspective of the seller it represents a change in ownership that may or may not be voluntary. In addition to mergers, takeovers, and contests for corporate control; there are other types of corporate restructuring like divestitures, rearrangements, and ownership reformulation.

These corporate restructuring activities can be divided into two broad categories – operational and functional. Operational restructuring refers to outright or partial purchase or sale of companies or product lines or downsizing by closing unprofitable, and non-strategic facilities. Financial restructuring refers to the actions taken by the firm to change its total debt and equity structure.

An overview of all these restructuring activities, is shown in a summarized form in Table 1. The grouping is a bit random but indicates the direction of the emphasis in these various practices.

Table 1: Forms of Restructuring Business Firms

Expansion
Mergers and Acquisitions
Tender offers
Asset acquisition
Joint ventures
Contraction
Spin-offs
Split-offs

Divestitures
Equity carve-outs
Assets sale
Corporate control
Takeover defenses
Share repurchases
Exchange offers
Proxy contests
Changes in ownership structures
Leveraged buyout
Junk bonds
Going private
ESOPs and MLPs

Each type of activity mentioned in the above table is briefly explained below:

EXPANSION

Expansion is a form of restructuring, which results in an increase in the size of the firm. It can take place in the form of a merger, acquisition, tender offer, asset acquisition or a joint venture.

Merger

Merger is defined as a combination of two or more companies into a single company. A merger can take place either as an amalgamation or absorption.

Amalgamation

This type of merger involves fusion of two or more companies. After the amalgamation, the two companies lose their individual identity and a new company comes into existence. A new firm that is hitherto, not in existence comes into being. This form is generally applied to combinations of firms of equal size.

Example: The merger of Brooke Bond India Ltd., with Lipton India Ltd., resulted in the formation of a new company Brooke Bond Lipton India Ltd.

Absorption

This type of merger involves fusion of a small company with a large company. After the merger the smaller company ceases to exist.

Example: The recent merger of Reliance Petroleum Limited with Reliance Industries Ltd. After the merger, Reliance Petroleum Limited ceased to exist while Reliance Industries Limited expanded and continued.

Tender Offer

Tender offer involves making a public offer for acquiring the shares of the target company with a view to acquire management control in that company.

Example: (1) Tech Mahindra Limited gave an open market offer at Rs.58 per share for 20% of paid-up capital in Satyam Computer Services Ltd.

(2) AstraZenca Pharmaceuticals AB, a Swedish firm, announced an open offer to acquire 8.4% stake in AstraZenca Pharma India at a floor price of Rs.825 per share.

Asset Acquisition

Asset acquisitions involve buying the assets of another company. These assets may be tangible assets like a manufacturing unit or intangible assets like brands. In such acquisitions, the acquirer company can limit its acquisitions to those parts of the firm that coincide with the acquirer's needs.

Example: The acquisition of the cement division of Tata Steel by Laffarge of France. Laffarge acquired only the 1.7 million ton cement plant and its related assets from Tata Steel.

The asset being purchased may also be intangible in nature. For example, Coca-Cola paid Rs.170 crore to Parle to acquire its soft drinks brands like Thums Up, Limca, Gold Spot, etc.

Joint Venture

In a Joint Venture, two companies enter into an agreement to provide certain resources towards the achievement of a particular common business goal. It involves intersection of only a small fraction of the activities of the companies involved and usually for a limited duration. The venture partners according to the pre-arranged formula, share the returns obtained from the venture. Usually, the multinational companies use this strategy to enter into foreign market.

Example: Tata Motors entered into a joint venture with a South African company, Imperial Group, to market its pick-up vehicles in the region.

CONTRACTION

Contraction is a form of restructuring, which results in a reduction in the size of the firm. It can take place in the form of a spin-off, split-off, divestiture or an equity carve-out.

Spin-offs

A spin-off is a transaction in which a company distributes on a *pro rata* basis all of the shares it owns in a subsidiary to its own shareholders. Hence, the stockholders proportional ownership of shares is the same in the new legal subsidiary as well as the parent firm. The new entity has its own management and is run independently from the parent company. A spin-off does not result in an infusion of cash to the parent company.

Example: Air-India has formed a separate company named Air-India Engineering Services Ltd., by spinning-off its engineering division.

Split-offs

In a split-off, a new company is created to takeover the operations of an existing division or unit. A portion of the existing shareholders receives stock in a subsidiary (new company) in exchange for parent company stock. The logic of split-off is that the equity base of the parent company is reduced reflecting the downsizing of the firm. Hence, the shareholding of the new entity does not reflect the shareholding of the parent firm. A split-off does not result in any cash inflow to the parent company.

Split-ups

In a split-up the entire firm is broken up in series of spin-offs, so that the parent company no longer exists and only the new offsprings survive. A split-up involves the creation of a new class of stock for each of the parent's operating subsidiaries, paying current shareholders a dividend of each new class of stock, and then dissolving the parent company. Stockholders in the new companies may be different as shareholders in the parent company may exchange their stock for stock in one or more of the spin-offs.

Example: The Andhra Pradesh State Electricity Board (APSEB) was split-up in 1999 as part of the Power Sector reforms. The power generation business and the transmission and distribution business was transferred to two separate companies called APGENCO and APTRANSCO respectively. APSEB ceased to exist as a result of the split-up.

Divestiture

A divestiture is a sale of a portion of the firm to an outside party, generally resulting in an infusion of cash to the parent. A firm may choose to sell an undervalued operation that it determines to be non-strategic or unrelated to the core business and to use the proceeds of the sale to fund investments in potentially higher return opportunities. It is a form of expansion on the part of the buying company.

Example: The Indian Government sold 10% share in Power Grid Corporation of India Ltd through a public issue in 2007.

Equity Carve-out

An equity carve-out involves the sale of a portion of the firm through an equity offering to outsiders. New shares of equity are sold to outsiders who give them ownership of a portion of the previously existing firm. A new legal entity is created. The equity holders in the new entity need not be the same as the equity holders in the original seller.

Assets Sale

It involves the sale of tangible or intangible assets of a company to generate cash. When a corporation sells off all its assets to another company, it becomes a corporate shell with cash and/or securities as its sole assets. The firm may then distribute the cash to its stockholders as a liquidating dividend and go out of existence. The firm may also choose to continue to do business and use its liquid assets to purchase other assets or companies.

CORPORATE CONTROL

Firms can also restructure without necessarily acquiring new firms or divesting existing corporations. Corporate control refers to the third group of corporate restructuring activities, which involves obtaining control over the management of firm. Control is the process by which managers influence other members of an organization to implement the organizational strategies. The various techniques of obtainers corporate control are explained below.

Takeover Defenses

With the high level of hostile takeover activity in recent years, takeover defense, both pre-bid and post-bid have been resorted to by the companies. Pre-bid defenses also called preventive defenses are employed to prevent a sudden, unexpected hostile bid from gaining control of the company. When preventive takeover defenses are not successful in fending off an unwanted bid, the target implements post-bid or active defenses. These takeover defenses intend to change the corporate control position of the promoters.

Share Repurchases

This involves the company buying its own shares back from the markets. This leads to reduction in the equity capital of the company. This in turn strengthens the promoter’s controlling position by increasing his stake in the equity of the company. It is used as a takeover defense to reduce the number of shares that could be purchased by the potential acquirer.

Example: DLF approved buy-back of shares of the company up to 10 percent of the paid-up capital at Rs.600 per share through the open market route.

Exchange Offers

It provides one or more classes of securities, the right or option to exchange part or all of their holdings for a different class of securities of the firm. The terms of exchange offered necessarily involve new securities of greater market value than the pre exchange offer announcement market value. Exchange offer involves exchanging debt for common stock, which increases leverage, or conversely, exchanging common stock for debt, which decreases leverage. They help a company to change its capital structure while holding the investment policy unchanged.

Proxy Contests

A proxy contest is an attempt by a single shareholder or a group of shareholders to take control or bring about other changes in a company through the use of the proxy mechanism of corporate voting. In a proxy fight, a bidder may attempt to use his or her voting rights and garner the support from other shareholders to expel the incumbent board or management.

CHANGES IN OWNERSHIP STRUCTURE

Changes in the ownership structure represent the fourth group of restructuring activities which results in a change in the restructure of ownership in the firm. A firm's ownership structure affects, and is affected by other variables, and these variables also influence market value. These variables include the levels of principal-agent conflicts and information asymmetry and their effects on other variables such as the firm's operating strategy, dividend policy and capital structure. The various techniques of changing the ownership structure are explained below.

Leverage Buyout

Leveraged buyout is a financing technique where debt is used in the acquisition of a company. The term is often applied to a firm-borrowing fund to buy-back its stock to convert from a publicly owned to a privately owned company. A management buyout is a LBO in which managers of the firm to be taken private are also equity investors.

Going Private

It refers to the transformation of a public corporation into a privately held firm. It involves purchase of the entire equity interest in a previously public corporation by a small group of investors.

ESOP

An employee stock option plan is a mechanism whereby a corporation can make tax deductible contributions of cash or stock into a trust. The assets are allocated to the employees and are not taxed until withdrawn by them. ESOPs are involved in mergers and LBOs in two ways: as a financing vehicle for the acquisition of companies, including through LBOs and as an anti takeover defense.

Example: Gitanjali Ltd offered ESOP to its permanent employees and it was priced at Rs.145 per share of face value Rs.5 each.

MLPS

A master limited partnership is a type of limited partnership whose shares are publicly traded. The limited partnership interests are divided into units which trade as shares of common stock. In addition to tradability it has the advantage of limited liability for the limited partners.

This kind of structure is however not prevalent in our country, though there was a move some time back to design necessary regulatory framework for floating such organizations particularly in the contest of divergent needs of IT sector.

RESTRUCTURING – UNDERLYING ISSUES

Corporate restructuring which includes many forms of business and financial activities as seen above raises several questions like –

- Are they good or bad for the economic health of the nation?
- Do they divert the energies of managers from bona fide economic activity to financial manipulation?
- Do they use up financial resources which otherwise would be employed in real investment activities.
- Why has such heightened merger activity been a phenomenon of the last 20 years?

To answer these questions we need to look at the theory or theories explaining these restructuring activities. We will try to explain this gradually as we progress into the subsequent chapters.

Let's begin with the major merger movements that have taken place in the United States since the 1890s.

MERGER WAVES

The United States of America has witnessed five periods of merger activity, often referred to as merger waves, each wave having been dominated by a particular type of merger. These periods were characterized by high level of cyclic activity, that is, high levels of mergers followed by periods of relatively fewer mergers. All the merger movements occurred when the economy experienced the sustained high growth rates and coincided with particular developments in business environments, because firms are motivated to make large investment outlays only when the business prospects are favorable. When such favorable business prospects are joined with changes in competitive conditions directly motivating a new business strategy, M&A activity will be stimulated.

THE FIRST WAVE – 1897-1904

The mergers of the first wave consisted mainly of horizontal mergers, which resulted in a near monopolistic market structure. This merger period is known for its role in creating the large monopolies. The first billion-dollar mega merger deal between US Steel and Carnegie Steel took place during this period. The resulting steel giant merged 785 separate firms. At one time, US Steel accounted for as much as 75% of the steel making capacity of the United States.

Some of today's industrial giants originated in the first merger wave. These include General Electric, Navistar International (formerly International Harvester), Du-Pont Inc., Standard Oil, Eastman Kodak and American Tobacco Inc. Some of these companies like American Tobacco (enjoyed 90% market share) and Standard Oil (enjoyed 85% market share) were truly dominant firms by the end of the first merger wave. During this wave there were 300 major combinations covering many industrial areas and controlling 40% of the nation's manufacturing capital. More than 3,000 companies disappeared during this period as a result of mergers.

Another feature of this wave is the formation of trusts, where the investors invested funds in a firm and entrusted their stock certificates with directors who ensured that they received the dividends for their trust certificates. These trusts were formed by dominant business leaders, such as J P Morgan of the House of Morgan and John D Rockefeller of Standard Oil and National City Bank, as a response to the poor performance of many of the nation's businesses as they struggled with the weak economic climate. They used their voting powers to force multiple mergers in certain industries in an effort to reduce the level of competition allowing the surviving companies to enjoy certain economies of scale. Liberalization of corporate laws was also one of the reasons behind the resounding success of this merger wave.

This merger movement accompanied major changes in economic infrastructure and production technologies. It followed the completion of transcontinental railroad system, the advent of electricity, and the increased use of coal. The completed rail system resulted in the development of a national economic market and thus the merger activity represented to a certain extent the transformation of regional firms into national firms.

As firms expanded they exploited economies of scale in production and distribution. In pursuit of economies of scale, an expansion process took place in many manufacturing industries in the US economy. The expansion of the scale of business also required greater managerial skills and lead to specialization in management.

Financial factors led to the end of the first merger wave. First, the ship building trust collapse in the early 1900s brought to light the dangers of fraudulent financing. Secondly, the stock market crash of 1904 followed by the banking panic of 1907, led to the closure of many banks and paved the way for the formation of the Federal Reserve System. The era of easy availability of finance, one of the basic ingredients of takeovers, ended resulting in the halting of the first wave. Further, the application of anti-trust legislations, which was earlier lenient, became very stringent. The Federal Government under President Theodore Roosevelt and subsequently under President William Taft made a crackdown on large monopolies. For example, Standard Oil was broken into 30 companies such as Standard Oil of New Jersey (subsequently renamed as Exxon), Standard Oil of New York (renamed as Mobil), Standard Oil of California (renamed as Chevron) and standard oil of Indiana (subsequently renamed as Amoco).

Table 2

Year	Number of Mergers
1897	69
1898	303
1899	1,208
1900	340
1901	423
1902	379
1903	142
1904	79

Source: Patrick A. Gaughan – Mergers, Acquisitions and Corporate Restructurings.

THE SECOND WAVE – 1916-1929

Like the first wave, the second merger movement also began with an upturn in business activity. Several industries were consolidated during the second merger wave. The result was an oligopolistic industry structure rather than monopolies. The consolidation pattern which was established in the first merger wave, continued in the second merger wave also. The combinations in this period occurred outside the previously consolidated heavy manufacturing industries. The most active were the banking and the public utilities industries. A large number of mergers occurred in industries like primary metals, petroleum products, food products, chemicals and transportation equipment.

A large portion of the mergers in the 1920s represented product extension mergers like IBM and General Foods, market extension mergers like in food retailing, departmental stores, and vertical mergers in the mining and metal industries.

The second merger period witnessed the formation of many prominent corporations that still operate today. These include General Motors, IBM, Union Carbide Corporation and John Deere.

Between 1926 and 1930 a total of 4,600 mergers took place and between 1919 and 1930 12,000 manufacturing, mining, public utility, and banking firms disappeared. The development of a nationwide rail transportation system combined with the growth of motor vehicle transportation, continued to transform local markets into national markets. The proliferation of radios in homes as a major source of entertainment enhanced the competition among firms. Marketers took advantage of this new advertising medium to start national brand advertising. This led to the beginning of the era of mass merchandising.

Mergers in this wave were facilitated by the limited enforcement of anti-trust laws and the federal government's encouragement for the formation of business cooperatives to enhance the nation's productivity as part of the war effect. The firms were urged to work together, rather than compete with each other during wartime. The government maintained these policies even after the war ended.

The second merger wave came to an end when the stock market crashed on October 29, 1929. The crash resulted in a dramatic drop in the business and investment confidence. Business and consumer spending was curtailed, thereby worsening the depression. After the crash, the number of corporate mergers declined dramatically.

Investment bankers played a key role in the first two phases of mergers. They exercised considerable influence among the business leaders. A small number of investment bankers controlled the majority of capital available for financing mergers and acquisitions. The investment banking industry was more concentrated in those years than it is today.

THE 1940s

The Second World War and the early post-war years were accompanied by growth of the economy and an increase in merger activity. However, the merger movement was much smaller than the earlier ones.

Economists pointed out that government regulations and tax policies are the motivating factors behind mergers. During this period, larger firms acquired smaller privately held companies for motives of tax relief. Due to the high estate taxes, transfer of businesses within families was very expensive and hence these businesses were sold to other firms. These mergers did not result in increased concentration because they involved smaller companies, which did not represent a significant portion of the total industry's assets.

As this period did not feature any major technological changes or dramatic developments in the nation's infrastructure, the merger movement was smaller compared to the earlier ones.

THE THIRD WAVE – 1965-1969

The merger activity reached its then historically highest level during this period. This was due to the booming economy of this period. This period is known as a conglomerate merger period, as small or medium-sized firms adopted a diversification strategy into business activities outside their traditional areas of interest. During this period, relatively smaller firms targeted larger firms for acquisition. 80% of the mergers that took place were conglomerate mergers that were more than just diversified in their product lines. For example, ITT acquired such diversified businesses like car rental firms, bakeries, consumer credit agencies, luxury hotels, airport parking firms, construction firms, etc.

The conglomerate movement was due to the tougher anti-trust enforcement. Armed with tougher laws, the federal government adopted a stronger anti-trust stance, coming down heavily on both horizontal and vertical mergers. Firms with financial resources, which sought to expand, found that the only available alternative was to form conglomerates.

The rapid growth in management science accelerated the conglomerate movement. With the wide acceptance of management principles, graduates believed that they possessed the broad based skills necessary to manage a wide variety of organizational structures. Hence such managers believed that they could mange the corporate organization that spanned various industry categories. The belief that conglomerate mergers could be manageable became a reality.

Around 6,000 mergers took place in the US economy during this period and lead to the disappearance of around 25,000 firms. Because most of these mergers were conglomerates, they did not result in increased industrial concentration.

Investment bankers did not finance most of the mergers in this period. The booming stock market prices provided equity financing to many of the conglomerate takeovers. As the mergers financed through stock transactions were not taxable, they had an advantage over cash transactions, which were subject to taxation.

Many of the acquisitions that took place during this period were followed by poor financial performance. Many of the mergers failed as managers of the diverse enterprises often had little knowledge of the specific industries that were under their control. For example, Revlon, a firm that has an established track record of success in the cosmetic industry, saw its core cosmetic industry suffer when it diversified into unrelated areas such as health care.

Table 3

Year	Number of Mergers
1963	1,361
1964	1,950
1965	2,125
1966	2,377
1967	2,975
1968	4,462
1969	6,107
1970	5,152

Source: Patrick A Gaughan – Mergers, Acquisitions and Corporate Restructurings.

THE FOURTH WAVE – 1981-1989

Following the recession in 1974-1975 the US economy entered a long period of expansion during which the merger and acquisition trend went upward. Hostile mergers played a significant role in the fourth wave. Takeovers are considered healthy or hostile by the reaction of the target company's board of directors. If the board accepts the takeover it is considered friendly and if it opposes, it is deemed to be hostile.

Although the number of hostile deals is not very high, the figure is significant in terms of value of mergers and acquisitions. The size and prominence of the merger and acquisition targets distinguishes the fourth merger period from the other three waves. The fourth wave was a period of mega mergers. Some of the largest firms in the world (Fortune 500 firms) became the target of acquirers.

There was a great degree of concentration within the oil industry, as it experienced a high level of merger activity. The oil and gas industry accounted for 21.6% of the total dollar value of mergers and acquisitions between 1981 and 1985. Another industry, which experienced high level of merger activity, is the drugs and medical equipment industry. Deregulation in some of the industries was the main reason behind the disproportionate number of mergers and acquisitions. For example, deregulation of the airline industry led to numerous acquisitions and consolidations in this industry.

The fourth wave also witnessed the emergence of corporate raider. The raider's income came from the takeover attempts. The raiders earned handsome profits without taking control over the management of the target company. They attempted to takeover a target and later sell the target shares at a price higher than that which was paid originally.

The fourth wave featured several other unique and interesting characteristics, which differentiate it from the other waves. Investment bankers played an aggressive role. M&A advisory services became a lucrative source of income for investment banks. The merger specialists at investment banks and law firms developed many techniques to facilitate and prevent takeovers.

Another important feature is the increased use of debt to finance acquisitions. The yield on junk bonds was significantly higher than that of investment grade bonds. Hence the ready availability of finance helped even small firms to acquire large well-established firms. The phenomenon of leveraged buyout emerged. This merger wave also featured innovations in acquisition techniques and investment vehicles. The investment bank Drexel Burnham Lambert pioneered the growth of the junk bond market.

Table 4

Year	Number of Mergers
1981	2,395
1982	2,346
1983	2,533
1984	2,543
1985	3,001
1986	3,336
1987	2,032
1988	2,258
1989	2,366

Source: Patrick A Gaughan – Mergers, Acquisitions and Corporate Restructurings.

FIFTH WAVE – 1992-TILL DATE

The current merger activity can be described as the fifth wave. There was once again increased activity of mergers in 1992. Mega mergers, as in the fourth wave began to take place in the fifth wave also. The number of hostile deals was less than strategic mergers.

With the recovery of the economy in 1992, companies sought to expand and mergers were seen as a quick and efficient way to do so. Unlike the deals of 1980's the transactions, of the '90s emphasized on strategy more than quick financial gains. Most of the deals were financed through the increased use of equity.

Deregulation and technological changes led to high level of merger activity in the fifth wave. Banking, telecommunications, entertainment, and media industries were some of the leading consolidating industries. There was a dramatic growth in the banking sector in the 1990s as the banks grew larger than the central banks. Banks looked to take advantage of the economies of scale in this industry by expanding into new markets and found mergers and acquisitions to be the fastest way to do so.

There was a movement towards the oligopolistic market structure due to the volume of consolidating mega mergers that occurred in many industries. As companies acquired or merged with other companies, the number of competitors declined. The resulting companies were large and only a few competitors commanded a relatively high market share. For example, in beverages industry companies like Coco-cola with 44.5% market share, Pepsi with 31.4% market share and Cadbury Schweppes with 14.4% market share were the few major competitors.

The phenomenon of globalization led to the breaking up of geographical barriers for entry into another country. The growth in the merger activity was no longer confined to the US companies. US firms aggressively purchased foreign firms. Later, by 1995 foreign firms made major purchases of the US firms. The fifth wave spread to Europe in the late 1990s.

Table 5

Year	Number of Mergers
1990	2,074
1991	1,877
1992	2,574
1993	2,663
1994	2,997
1995	3,510
1996	5,848
1997	7,800
1998	7,809
1999	9,278
2000	9,566
2001	8,290
2002	7,303
2003	7,983
2004	9,783

Source: Merger Stat Review.

The emergence of internet and the intelligent application of information technology have resulted in a paradigm shift in the operations of firms. The impact of the wave is most visible in sectors such as telecommunications, entertainment and media, banking and financial services.

Table 6: Major Mergers in the Telecom Sector

Acquirer	Target
Vodafone	Mannesman
MCI Worldcom	Spirit
Bell Atlantic	GTE
AT & T	MeCaw Cellular
SBC	Ameritech
US West	Global Crossing
Bell Atlantic	NYNEX
SBC	Pacific Telesis

Table 7: Major Mergers in Media and Entertainment Sector

Acquirer	Target
America On-Line (AOL)	Time Warner
Viacom	CBS
Walt Disney	Capital Cities/ABC
AT & T	Media One
Time Warner	Turner Broadcasting

Table 8: Recent M&A

Date	Acquirer	Target	Value in US $ Million
08-3-2005	BHP Billiton Ltd.	WMC Resources Ltd.	7696.8
10-1-2005	Standard Chartered Plc.	Korea First Bank	3277.6
09-3-2005	Philip Morris Indonesia PT.	Hanjaya Madala Sanpoerma Tbk.	3091.2
14-2-2005	Investor Group	Cal PERS/First Wasington-Ret	2680.0
17-1-2005	Fosters Group Ltd.	Southcorp Ltd.	2465.9
11-1-2005	Doosan Heavy Inds & Constr Co.	Daewoo Heavy Industries & Mach	1827.6
31-1-2005	Transurban Group	Hills Motorway Group	1804.9
07-3-2005	LLP Power Australia Energy	SPI Australia Grp-Energy Bus	1684.3
14-4-2005	Ramsay Health Care Ltd.	Affinity Health Ltd.	1098.8
17-2-2005	Ju Babcock & Broarn, GPT	Babcock & Brown-German Real Es	696.3

Source: Thomson Financial.

MERGERS AND ACQUISITIONS IN INDIA

Mergers and acquisitions in India can be divided into two phases. The first phase characterizes more of friendly takeovers, whereas the second phase of acquisitions is characterized by Foreign Direct Investments (FDIs). Chronologically, we can relate the first phase to the pre-liberalization era, and the second phase to post-liberalization era, which started in 1991.

THE PRE-LIBERALIZATION ERA (UPTO 1990)

During the licensing era, several companies had indulged in unrelated diversifications depending on the availability of licenses. Takeover bids, mergers and amalgamations were not rare. The companies thrived in spite of their inefficiencies because the total industry capacity was restricted due to licensing. Over a period of time the companies became conglomerates with a sub-optimal portfolio of assorted businesses.

Despite the unfavorable economic environment, the corporate sector has witnessed incidents of takeover bids from time to time. Since 1986, both friendly takeover bids on negotiated basis and hostile bids through hectic buying of equity shares of select companies from the market have been reported frequently. Instances of corporate raids by non-resident Indians as well as Indian industrial entrepreneurs on domestic corporate undertakings were many. For example, NRI's during 1988 made the following raids on corporate undertakings in India:

Swaraj Paul and Sethia groups attempted raids on Escorts Ltd. and DCM Ltd., respectively but did not succeed. The Hindujas raided and took over Ashok Leyland and Ennore Foundries and secured strategic interests in IDL Chemicals and Astra IDL. The Chhabria Group acquired stake in Shaw Wallace, Dunlop India and Falcon Tyres.

Prominent industrial groups in the country have also been active in takeover bids. For example, the Goenka group from Calcutta successfully tookover Ceat Tyres, Herdilla Chemicals, Polychem etc. The Oberoi Group has taken over Pleasant Hotels of the Rane Group. Mahindra and Mahindra has taken over Allwyn Nissan; the Jindal Group has acquired Shalimar Paints. History was created by Tata Tea in September, 1988 when it made a public offer to takeover Consolidated Coffee Ltd. and acquired 50% of the company's equity from resident shareholders in December, 1989.

Four companies, namely Hindustan Computers, Hindustan Reprographics, Hindustan Telecommunications and Indian Computer Software Co., were merged to form HCL Ltd.

There has also been an active arrangement of takeover of sick undertakings by the Board for Industrial and Financial Reconstruction (BIFR). Some of the takeovers arranged by BIFR are, takeover of Hyderabad Allwyn Ltd., by Voltas Ltd., Mahindra Nissan Allwyn Ltd., by Mahindra and Mahindra and Miami Pharma Ltd., by Lakme.

THE POST-LIBERALIZATION ERA (1990 ONWARDS)

Liberalization in the '90s and the recession in the economy have created new challenges for the Indian corporate sector. The policy of decontrol and liberalization together with globalization of the economy has exposed the corporate sector to rigorous domestic and global competition. Greater competition, freer imports, lack of economies of scale, over-creation of capacities, unwanted diversifications, funds constraints, and cost and time over-runs have become some of the new-found areas of concern. Therefore, restructuring of corporate India has now become a major theme. Companies are engaged in various efforts to consolidate themselves in areas of their core competence and divest those businesses where they do not have any competitive advantage. Consequently, as an option, mergers and acquisitions are emerging as the key corporate activities. The changes in government regulations will make M&A an even more viable business strategy.

According to the Securities and Exchange Board of India (SEBI) working paper titled "Impact of Takeover Code Regulations on Corporate Sector in India – A Critical Appraisal", the major users of the acquisition mechanisms were Indian companies, which accounted for 85 percent of the total takeovers.

Since SEBI (Substantial Acquisitions of Shares and Takeovers) Regulations, 1997 came into existence, 1,011 companies have been taken over for various purposes, which include consolidation, change in control in management and substantial acquisition. The most important objective of the acquisitions has been change in the management control. The number of open offers grew from two in 1994 to 98 in 2001-02. Bulk of M&A deals have been on cash basis.

Among the industries where the takeovers were more common, the finance and information technology industries scored heavily on the number of companies acquired, but the amounts involved in these industries were small. On the basis of amounts spent, the electronic and electrical industry occupied the first position, followed by metals and cement and construction.

Since entry barriers are low in the new economy, the rate of creation of new companies is extremely high and so are the chances of M&As. Since most Internet start-ups are small, unilocational outfits, staffed by fewer people compared to brick and mortar behemoths, the actual process of integration is less burdensome and less painful. M&As enabled the widening of the portfolio of products and services, increase geographical coverage, and reduce the marketing costs and gestation period.

Very often, M&As have been found useful to consolidate the market position. For instance, in the cement industry, the French firm Lafarge bought the cement unit owned by Tisco and Gujarat Ambuja acquired DLF Cement and half of Tata's share in ACC to capture the major share of the market between the two of them. It is easier to acquire companies than set-up additional capacities.

The bidding war for licenses for the fourth cellular company to operate in each of India's 21 telecom zones shook up the country's fledgling cellular market. This forced some smaller groups to sell out because their pockets were not deep enough to bid for more licenses or to pump in funds to grow their business. The larger ones consolidated their market share through buyouts.

In case of global mergers of multinational companies, their Indian setups merge by default. Though the merger then is a part of global strategy rather than local market compulsions, it has effects on the Indian market too. Like it happened when ANZ Gindlays Bank and Standard Chartered Bank merged (leading to large-scale business and manpower restructuring in their respective Indian outfits) or the HP-Compaq merger (which was expected to shake up the computer hardware market in India).

However, the firm-level positive results from M&A deals, are yet to be strongly recognized. A recent KPMG study found that only 30% of cases of M&As in India created shareholders' value. In 39% of such deals, there was no discernible difference, while in 31% of cases, the shareholder value was diluted. The finding, though shocking to most, stems from imperfections, which exist in most economies and more distinctly in India.

The Indian banking sector, with far too many loss-making units, could have possibly benefit from mergers, but M&As have failed to perform. The efficient operation of the takeover mechanism requires that vast quantities of information be widely available, which is not the case in India. Besides, there are huge transaction costs involved in takeovers, which hamper the efficiency of the mechanism. If information about a firm's operation is, or is perceived to be, asymmetric, it may pay rational managers even in rational markets to be narrow-minded. This would lead to short-term measures and to lower rates of investment than would otherwise be the case. The first to get hit, in the circumstance, is the shareholders' value.

The empirical findings are contrary to the expected results, mainly because increase of shareholders' value is not always the only motivator for M&As. Often mergers are initiated because companies face the threat of existence. The threat may be caused from the size or nature of a particular market or from demand for greater scale of economies, or when multinationals with access to relatively cheaper source of capital, seek to gain a market share through acquiring domestic firms.

In sectors where intangible asset advantages like brand names add to the cost of capital advantage, the pressure on domestic firms to be taken over is quite high. Hence, the number of M&As have increased drastically in lifestyle associated product markets like fast moving consumer goods, white goods and automobiles.

Hence, when the market compulsions and cost considerations drive M&As, shareholders' value is likely to be maintained at the same level. It requires great management skills to amalgamate different operational cultures, reorient manpower to common goals and streamline activities to core strengths to reap the fruits of M&A deals.

M&As, which lead to higher market concentration do not effectively result in higher market power. Theorists of industrial organization have not found a direct correlation between the two variables and have supported a case to case study to evaluate whether M&As generate greater economic efficiency or undue exclusive rights. Most nations follow the US model where anti-trust provisions are implied in generalities, leaving the courts free to interpret specific practices.

In India, the Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 defines, dominance specifically – (regardless of whether consumer interests were harmed or not) – to be not more than 25 percent. The Act does not take into account anti-trust practices of extra-territorial origin. With cross-border M&As getting increasingly popular, there could also be a conflict of laws of different countries.

The Competition Bill, 2001, which intended to replace the MRTP Act, 1969, defines dominant position as a position of strength enabling a firm to operate independent of prevailing competitive forces, affecting competitors' and consumers' interests.

In such an atmosphere where competition laws are still in a fluid state, M&As take effect on a level playing field and the protection of interests of producers and consumers alike will still take some time. Till then, it is unlikely to expect large-scale productivity increases or FDI inflows through M&As. However, companies are going in for strategic alliances, mergers, acquisitions or even hostile takeovers to gain market power.

Mergers & Acquisitions (M&A) have been a major source of corporate growth in India in recent past. India has shown the second highest growth rate in M&A activities during first half year of 2005, second only to Japan. Indian M&A activity is spreading as Indian companies are acquiring companies overseas also. In the first half of 2005 the total value of M&A deals reached US $6.9 billion from US$ 2.9 billion in 2004. As opposed to more number of deals in Telecom/IT sector in 2004, the number of deals in the manufacturing sector has increased in 2005. The following table shows some of the biggest M&A deals during 2004-2005.

Table 9: Biggest M&A Deals in 2004-2005

Acquirer	Target	Value in US $ Million
Holcim' Gujarat Ambuja Cement	Associate Cement Companies	800
UB Group	Shaw Wallace	350
Videocon Group	Thomson	290
Tata Iron & Steel Company	Nat Steel, Singapore's Steel miller	284
AV Birla Group	Ultra Tech Cem Co	281
Matrix Laboratories	Docpharma	263
Reliance Infocomm	FLAG Telecom	210
VSNL	Tyco Global Network	130

Source: http://money.cnn.com

Most Recent M&A Deals

According to global consultancy firm Grant Thornton's annual Dealtracker, the number of M&A deals announced in 2008 fell to 445 from 676 in 2007. The value of these deals fell from $51.11 billion in 2007 to $30.72 billion in 2008. Telecom, pharma and health care, banking and financial services and IT& ITeS were the leaders as far as sectoral values were concerned during the year.

The following table shows number of deals, and their value in percentage to total worth of deals in various sectors during this period.

Table 10

Sector	Number of Deals	% of Value
Financial Sector	36	20%
Telecom Sector	04	16%
Food and FMCG Sector	27	13%
IT Sector	43	5%
Cement and Building	05	10%

Financial Sector: About 36 deals were recorded in this sector, amounting to a total value of Rs.50.8 billion. Some of the important deals were: Centurion Bank has become 'Centurion Bank of Punjab' with the acquisition of Bank of Punjab at a cost of Rs.3.6 billion. Another Strategic merger was Industrial Development Bank of India that acquired its subsidiary IDBI Bank worth Rs.7.6 billion.

Telecom Sector: In this Sector, four deals amounted to a total value of Rs.41.4 billion. The largest deal is related to the telecom businesses of the Hong Kong-based Hutchison Telecommunications in India. Hutchison had so far operated in separate joint ventures in the various telecom circles where it provided mobile telephony services in India. Hutchison's joint venture partners – the Essar Group, the Kotak Mahindra Group and the IndusInd Group – sold their stakes in three Hutch mobile telecom service operating companies – Hutchison Essar Telecom, Hutchison Telecom East and Fascel, for Rs.30.1 billion ($691 million). This was effected by a fresh issue of shares to these three Groups in Hutchison Max Telecom. In another deal, Sing Tel acquired 5.84% equity stake in Bharti Telecom valued at Rs.10.9 billion.

On September 5, 2005, VSNL announced its proposal to acquire 100% stake in Tata Power Broadband Ltd. (TPBB) from the Tata Power company for a consideration of Rs.2.39 billion. With this, the TPBB will become a wholly-owned subsidiary of VSNL.

Foods and FMCG Sector: In this sector, 27 deals, valued at Rs.34.2 billion, were recorded. The main deal in this sector is of Vijay Mallya's United Breweries (UB) Group's acquisition (through Group entities Mc Dowell & Co., Phipson Distillery, United Spirits and United Breweries Holdings) of a controlling stake in the Jumbo Group's Shaw Wallace & Company at a price of Rs.16.2 billion ($371.6 million). The deal is made up of an acquisition of a 50 percent stake from the promoters (including a non-compete premium) a tender offer for an additional 25 percent from other shareholders, and the acquisition of two distribution subsidiaries. In another deal McLeod Russell India (part of the B M Khaitan Group) acquired a 90 percent stake in Williamson Tea Assam for Rs.2.1 billion ($48.2 million). Of this, a 70 percent stake came through the acquisition of holding company Borelli Tea Holdings from Williamson Tea of UK, while the rest is to be acquired by a tender offer to other shareholders.

Media group Deccan Chronicle acquired 100% Equity shares in Odyssey for a cash consideration of Rs.61 crore. This acquisition will help Deccan Chronicle to increase its profits because Odyssey has lined up major expansion plans, including growth in western and northern India by March 2008.

Overseas Deals

The acquisition of Indian companies by foreign companies is a common phenomenon over the years; however, today, there are Indian companies that are acquiring foreign companies abroad. Some of the important cross-border deals have been discussed below.

Cross-border acquisitions showed more influence in cement industry. The Swiss cement major, Holcim, which acquired a 67 percent stake in Ambuja Cement India Ltd. (ACIL) for Rs.27.3 billion, acquired Associate Cement Company. On September 1, Singapore based Colgate-Palmolive (Asia) Pte. Ltd acquired 10.94% stake in Colgate-Palmolive (India) Ltd.

Indian companies also acquired foreign companies. The main overseas deal was the Videocon Group's acquisition of Thomson's color picture tube business in China, Poland, Mexico, and Italy for a total of $290 million.

Four Soft Limited, a leading provider of transportation, logistics and supply-chain process management software solutions company, has acquired, for a consideration of Rs.830 million through its wholly-owned subsidiary, Four Soft BV, Netherlands, 100% shares of DCS Transportation and Logistics Solutions division, a UK headquartered Transport and Logistics Software solutions major, with operations in UK, The Netherlands, US, France & Germany.

Box: The Future Outlook
Now the Government has permitted 100 percent FDI in townships, housing, built-up infrastructure, construction-development projects, and 74 percent in telecommunications services. Recently Government of India has increased upper limit for FDI in domestic airlines from 40% to 49%, in Banking sector from 26% to 30%. With these announcements more significant M&A deals are expected in several sectors.

SUMMARY

- Business firms in pursuit of their growth objectives, engage themselves in a wide range of activities like expansion, shrinkage, restructuring of assets and ownership structures.
- Expansion can be carried out by way of Mergers and Acquisitions, Tender Offers and Joint Ventures. The merger activity has expanded and includes various additional activities of corporate restructuring and control. The usage of tender offers and joint ventures has also increased along with merger activities.
- The recent years have also seen the usage of divestitures in the merger activities. Other major changes taking place in the ownership structure in the recent years include: usage of exchange offers and share repurchases altering the ownership share in the firm; greater use of leverage and increased use of lower-rated bonds for expansion; public corporations moving back to private ownership representing management buyouts and leveraged buyouts, etc. Companies which are troubled by control issues are taking anti-takeover measures in an attempt to discourage takeovers.
- In India also, the liberalization of the economy has lead to increased merger and acquisition activity. Mergers and Acquisitions have become a necessity in the changing business environment to ensure that businesses attain the appropriate size.
- Restructuring of businesses to bring-in better focus has become necessary. The Indian enterprise is currently restructuring itself broadly on these lines. There are open offers, buy-backs, sale of plants or brands, change in equity, mergers, reverse mergers, etc. But for the fluid state of competition laws etc., there could have been much more action.

Chapter 2

Maximization of Organization Value

After reading this chapter, you will be conversant with:

- Definition of Strategy
- Process of Strategic Planning
- Alternative Strategy Methodologies
- Approaches to Strategy Formulation
- Formulating a Competitive Strategy
- Diversification Strategy
- Internal vs. External Growth
- Diversification Planning, Mergers and the Carryover of Managerial Capabilities
- A Strategic Approach to Mergers and Acquisitions

The business world has changed drastically. Markets, instruments, financing and relationships have become exceedingly complex. The economic environment has shifted dramatically and in order to prosper or even to survive in such an environment, the strategy formulation has become very important. It is no longer possible to take a simple, idealistic view of what should be done and how it should be done.

Merger and Acquisition activity is taken up by business firms within a broader framework of long range strategic planning. This chapter will present a review of the planning process and explore the strategic perspective of building value through diversification and mergers.

DEFINITION OF STRATEGY

Strategy represents decisions that represent the future of the firm. It is the logic that gives direction to the activities of the organization. It defines the relationship between an organization and its environment and between a firm and its competitors. It is concerned with the most important decisions made in an enterprise. Strategy represents a firm to external constituencies. It guides the actions of the organizational members. Strategy is articulated by top management in plans that are implemented at lower levels and updated overtime.

The profit potential of the firm is determined by its own strategic choices. The value of the firm is determined by its ability to earn a return on its capital in excess of the cost of capital. While the cost of capital is determined by the capital markets, its profit potential is determined by its own strategic choices like the choice of an industry or a set of industries in which the firm operates (industry choice), the manner in which the firm intends to compete with other firms in its chosen industry (competitive positioning) and the way in which the firm expects to create and exploit synergies across the range of businesses in which it operates (corporate strategies).

Strategy can be formulated in different ways. Strategic planning is a behavior and a way of thinking, which requires diverse inputs from all the segments of the organization. Everyone must be involved in the strategic planning process.

Strategic planning is concerned with the future of the organization. The top management is responsible for its formulation. While many people in the organization are involved in its planning, the responsibility of its success or failure rests with the top management.

A merger, acquisition, restructuring and planning decision is a strategic choice. These decisions have to fit into long-range strategic planning framework, which the firm establishes.

PROCESS OF STRATEGIC PLANNING

Strategy is the process by which a company’s longer term mission and goals are translated into shorter term objectives and projects. The standard process involves mapping a firm’s comparative strengths and weaknesses into market opportunities and threats in order to fulfill the long-term goals and short-term objectives. The strategic planning process generally takes place as follows:

GETTING READY

An organization must first assess if it is prepared to adopt strategic planning. While a number of issues must be addressed in assessing whether the organization is ready or not, the determination essentially comes down to whether an organization’s leaders are truly committed to the effort, and whether they are able to devote the necessary attention. For example, when there is a funding crisis, or when the founder is about to leave or when the environment is unstable, then it does not make sense to make a strategic planning effort.

An organization that determines, it is indeed ready to begin strategic planning must perform five tasks to pave the way for an organized process:

- Identify specific issues or choices that the planning process should deal with;
- Clarify roles (who does what in the process);
- Create a Planning Committee;
- Develop an organizational profile;
- Identify the information that must be collected to help make sound decisions.

COMMUNICATING THE MISSION AND VISION

A mission statement is like an introductory paragraph that lets the reader know where the writer is going, and also shows that the writer knows where he or she is going. Similarly, a mission statement must communicate the essence of an organization to the reader. An organization's ability to communicate its mission indicates its focus and purposefulness. A mission statement usually describes an organization in terms of –

- *Purpose* – why the organization exists, and what it seeks to accomplish,
- *Business* – the main method or activity through which the organization tries to fulfill this purpose,
- *Values* – the principles or beliefs that guide the members of an organization as they pursue its purpose.

While the mission statement summarizes the what, how and why of an organization's work, a vision statement presents an image of what success will look like. With mission and vision statements in hand, an organization takes an important step towards creating a shared and rational idea of what it is strategically planning for.

ASSESSING THE SITUATION

Once an organization has committed to why it exists and what it does, it must then carefully look at its current situation. The strategic planning, thinking, and management is an understanding of resources and a vision to the future environment, so that an organization can successfully respond to changes in the environment. Assessing the situation therefore, involve obtaining current information about the organization's strengths, weaknesses, and performance-information that will highlight the critical issues the organization face and strategic plan it must address. These could include a variety of basic concerns, such as funding issues, new program opportunities, changing regulations or changing needs in the client population, and so on. The point is to choose the most important issues to address. The planning committee should agree on not more than five to ten critical issues around which to organize the strategic plan.

The products of step three include a data base of quality information that can be used to make decisions; and a list of critical issues which demand a response from the organization – the most important issues the organization needs to deal with.

DEVELOPING STRATEGIES, GOALS AND OBJECTIVES

Once an organization's mission has been confirmed and its critical issues of restructure identified, it is time to figure out what to do about them: the broad approaches to be taken (strategies), and the general and specific results required (the goals and objectives).

Strategies, goals, and objectives may come from individual inspiration, group discussion, formal decision-making techniques, and so on. But the bottom line is that, in the end, the leadership agrees on how to address the critical issues.

This can take considerable time and flexibility. Discussions at this stage frequently will require additional information or a re-evaluation of conclusions reached during the situation assessment. It is even possible that new insights will emerge which change the thrust of the mission statement. It is important that planners are not afraid to go back to an earlier step in the process and take advantage of available information to create the best possible plan.

The end of this stage would result in an outline of the organization's strategic directions – the general strategies, long range goals, and specific objectives of its response to critical issues.

COMPLETING THE WRITTEN PLAN

Once the mission has been expressed, the critical issues identified, and the goals and strategies agreed upon, the next step essentially involves putting everything down on a paper. Usually, one member of the planning committee, the executive director, or even a planning consultant will draft a final planning document and submit it to be reviewed to all key decision makers (usually the board and senior staff). This is also the time to consult with the senior staff to determine whether the document can be translated into operating plans (the subsequent detailed action plans for accomplishing the goals proposed by the strategic plan) and to ensure that the plan answers key questions about priorities and directions in sufficient detail to serve as a guide. Revisions should not be dragged on for months, but action should be taken to answer any important questions that are raised at this step. It would certainly be a mistake to conceal conflict at this step just to finish the process more quickly, because the conflict, if serious, will invariably undermine the strength of the strategic directions chosen by the planning committee.

Three key elements of a strategic planning process are creativity which promotes strategy formulation, consistency which directs strategy evaluation and structure which controls strategy implementation.

ALTERNATIVE STRATEGY METHODOLOGIES

There are different methods through which a strategy can be formulated. Let us look at some of these approaches.

SWOT ANALYSIS

A SWOT analysis of the firm may provide a useful starting point for developing a strategic planning process and to stimulate a strategic thinking in the organization. Identifying the strengths, weaknesses, opportunities and threats depends on the judgment of the managers hence a careful analysis should be made.

GAP ANALYSIS

A GAP analysis helps in identifying the gap between the goals and projections. The GAP analysis involves a reasonable assessment of the future based on the firm's existing capabilities. The divergence in such goals and projections stimulates an assessment whether the goals should be revised or how the organization could augment its capabilities in order to close the gap between goals and the projections.

TOP-DOWN AND BOTTOM-UP APPROACHES

The top-down approach initially involves the overall projections of the firm and then the requirements to individual segments so that the overall results of the company could be achieved. The bottom-up approach involves the projections of individual segments and adding up these with the result, representing the outlook for the company as a whole.

COMPETITIVE ANALYSIS

The competitive position of the firm is determined by important factors involved in the demand and supply conditions. Hence, the degree of product substitutability and nature and structure of the costs are analyzed for strategic planning.

SYNERGY

This method analyzes how extra gains are to be achieved. Synergy can be a valid concept if it is based on reality.

DELPHI TECHNIQUE

A questionnaire is developed to obtain information on the problems or issues. This is distributed by mail to all the individuals. The responses obtained are summarized into a feedback report and returned with a second questionnaire designed to explore more deeply into the ideas generated by the first questionnaire.

GROUP DISCUSSION TECHNIQUE

A group leader begins with a statement of the problem. Ideas are generated from an unstructured group discussion. The aim is to reach a consensus decision or to make a decision based on a majority voting procedure.

APPROACHES TO STRATEGY FORMULATION

Basically three different approaches are followed in the process of strategy formulation. They are: (i) Boston Consulting Group Approach, (ii) The Porter Approach, and (iii) The Adaptive Process.

BOSTON CONSULTING GROUP APPROACH

This approach lays emphasis on three concepts – the experience curve, the product life cycle and the portfolio balance.

The experience curve represents the volume and cost relationships. As the volume of the output increases, costs fall at a geometric rate. The firm with the largest cumulative output will have lower costs signifying a strategy of early entry and price policies to develop the volume.

The product life cycle concept says that every product or line of business passes through four stages – introduction, growth, maturity and decline. The growth in sales is quick during the first two stages and the entry is simple. The entry becomes difficult in the last two stages as the growth slows down because the present players would have cost advantages. Substitutes for the products emerge in the declining stage and the sales decrease. Firms which have not achieved a favorable position on the experience curve become unprofitable and either merge or exit from the industry.

Related to the product life cycle is the concept of the portfolio balance. In the early stages of the product life cycle rapid growth may require substantial investments. These segments require more funds than what is actually generated. As requirements for growth decrease the funds generated would be more or sufficient for the current investment requirements. Portfolio theory helps to find out and combine the attractive investment segments with the cash generating segments and eliminate the unattractive segments. The cash inflows will balance the total corporate investments.

PORTER APPROACH

The nature of competition in an industry in large part determines the content of strategy, especially business-level strategy. Based as it is on the fundamental economics of the industry, its profit potential is determined by competitive interactions. Where these interactions are intense, profits tend to be whittled away by the activities of competing. Where they are mild and competitors appear passive, the profit potential tends to be high. Yet a full understanding of the elements of competition within an industry is easy to overlook and often difficult to comprehend.

The Porter approach emphasizes on three parts: (i) Selection of an attractive industry, (ii) Developing a competitive advantage through cost leadership, and (iii) Developing attractive value chains.

According to Porter an attractive industry or strategic group is one in which the entry barriers are high, suppliers and buyers have only modest bargaining power, substitute products or services are few, and the rivalry among competitors is stable.

A matrix is developed to formulate generic strategies. Cost leadership and product differentiation form the basis for competitive advantage. Cost advantage can be achieved by considering a wide range of factors including the learning curve of the BCG matrix.

Porter's value chain concept relates all the support activities of infrastructure, human resource management, technology development, and procurement to the primary activities of inbound logistics, marketing sales and services.

Porter's approach helps in finding an industry in which a smaller number of firms can cooperate due to the high entry barriers. When the barriers to entry are high the costs of entry or acquisition will permit only a normal rate of return.

ADAPTIVE PROCESSES

Various other authors while giving their approaches have offered more diverse options than available in the above two approaches. They viewed strategy more as an adaptive process or a way of thinking. They emphasized on the uniqueness of every firm. According to this adaptive process, "the firm's competitive position is defined by a bundle of unique resources and relationships and that the task of general management is to adjust and renew these resources and relationships as time, competition, and changes erode their value".

The adaptive process of strategy formulation involves matching resources to investment opportunities under environmental uncertainty and uncertain competitor's actions and reactions. This kind of uncertain problems can be solved by an iterative solution process. This method involves various processes and not closed-form of mathematical solutions. It entails the different ways of thinking which assesses the competitor's actions and reactions taking into consideration the changing environments.

A well-formulated approach can guide firms accurately to a right decision.

FORMULATING A COMPETITIVE STRATEGY

One of the most important elements in strategic planning is to continuously assess the firm's environment. In order to determine what is happening in the environment, the firm should analyze its industry, competitors, and social and political factors.

An analysis of the industry enables the firm to recognize the key factors required for competitive success in the industry and also the opportunities and the threats present in the industry. An analysis of the competitors of the firm enables a firm to find out the capabilities and the limitations of the existing competitors and their probable future moves. Finally, the analysis of the societal factors, the firm's strengths and weaknesses relative to the present and the future competitors can be ascertained.

The environmental assessment is made to present the firm with a number of strategic alternatives. To choose from a strategic alternative the firm has to consider whether goals and policies are appropriate to exploit industry opportunities and deal with the industry threats. It is also necessary for the firm to examine whether the goals and policies match the managerial, technological, and financial resources available to it and whether the timing of goals and policies appropriately reflects the ability of the organization to change. A set of feasible strategic alternatives are then worked out based on the results obtained from the analysis. One strategy, which best relates to the firm's situation to external opportunities and threats, is chosen from this set of feasible strategic alternatives. Let us look at each of these aspects in greater detail.

BUSINESS GOALS AND POLICIES

Business goals of the firm are formulated with respect to size, growth, stability, technology, flexibility, etc. The objectives of the size refer to the size a firm must achieve in order to attain the cost levels that enable the firm to operate profitably. These objectives are basically established to effectively use the fixed resources which the firm owns or which it intends to buy. The objectives of growth relate to the attainment of a favorable price/earnings multiple for the firm's shares or to increase the ratio of the market value of the firm's common stock to its book value. These objectives are usually expressed in terms of sales, total assets, market price per share, or earnings per share. The objective of flexibility refers to the firm's ability to operate in a wide variety of product markets. Technological objective refers to the ability of the firm to possess technological capabilities in the rapidly advancing technologies.

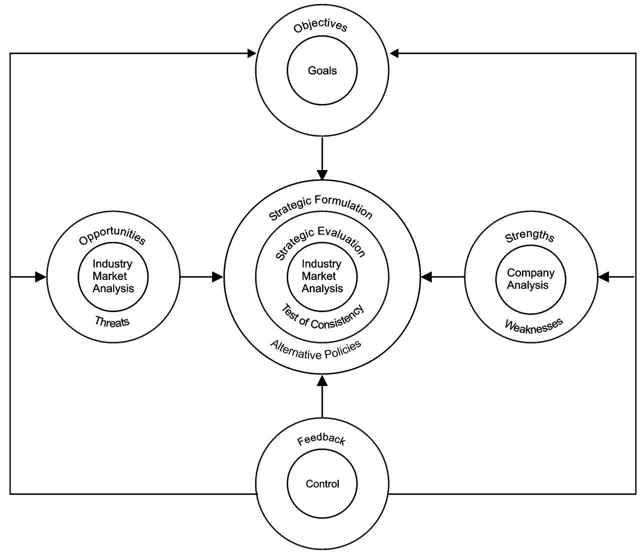
Whether stated in general or specific form, the goals are to be quantified to facilitate their comparison with the potential for achieving them.

Aligning the firm to its changing environments. Difficult choices have to be made to close a prospective gap between the firm's objectives and its potential based on its present capabilities. Analysts always come across difficult alternatives as whether the firm should change its environment or capabilities, the costs of the changes, risks associated with such changes, rewards if successful etc., while formulating a strategy. Since the stakes involved in such processes are very high a detailed iterative process should be carried out. The process should be repeated several times from the point of view of different management functions and some times of the total enterprise.

The emphasis is on the effective alignment of the firm with its environment through different approaches. One approach tries to find products related to the needs and wants of the customer that will provide large markets. A second approach focuses on the technological bottlenecks the solution being creation of new markets. A third strategy emphasizes on the economic criteria including growth prospects and appropriate stability.

A diversification strategy may be formulated when it becomes necessary for the firm to alter its product-market mix or range of capabilities to reduce or close the strategic gap. Thus, a key connection between planning and diversification or mergers lies in the evaluation of current managerial and technological capabilities relative to the capabilities required to reach objectives.

Figure 1: Strategic Management – Layers of Thinking



Source: Robert Lawrence Kuhn – Mergers, Acquisitions and Leveraged Buyouts.

DIVERSIFICATION STRATEGY

All other things being constant, an ideal strategy is to move into a diversification program from a base or core of existing capabilities or organizational strengths. The firm should be clear on both its strengths and weaknesses and should clearly define the specific new capabilities it is seeking to obtain. If the firm does not possess a sufficient breadth of capability to use as a basis for moving into other areas, an alternative strategy may be employed.

In recent years, the nature of the firms and the boundaries of industries have become much more dynamic and flexible. This has to be kept in mind even before the carryover of capabilities in pure conglomerate mergers. In this dynamic changing world managements must relate to missions, defined in terms of customer needs, wants, or problems to be solved. Another important dimension of the concept of industries is a range of capabilities. The technological capabilities include all processes from the basic research, product design and development to interrelated manufacturing methods and obtaining feedback from consumers. Managerial capabilities include competence in the generic management functions of planning, organizing, directing, and controlling as well as specific management functions of research, marketing, finance and personnel.

CHARACTERISTICS OF A SUCCESSFUL DIVERSIFICATION STRATEGY

Some of the characteristics of a successful diversification strategy are:

Platform of Existing Capabilities

Any diversification strategy should be built on the foundation of existing competencies. This facilitates entry into new markets. A company can have multiple capabilities, but a capability qualifies as a core competence if it fulfills the following criteria:

- It should be applicable across all the product categories.
- It should not be open to duplication by competitors.
- It should result in significant value addition to the consumer.

Choice of New Markets

The markets earmarked for expansion should be growth markets with low gestation periods. A small company cannot afford to operate in markets where the gestation period is high. The telecom sector, for instance, was opened up in the year 1994. The private operators in most circles are yet to make profits. On the other hand, the software boom saw many companies diversify into the InfoTech arena with substantial rewards. The new markets should also offer room for companies to operate in a niche.

New Capabilities

Though the strategy is based on existing capabilities, companies should acquire new ones to augment the existing strengths. They could make an effort to acquire new technologies, distribution channels or adding marketing muscle.

Management Skills and Leadership

Implementation of the strategy will require strong and aggressive management. The owner/manager may have to take swift, decisive measures during the diversification effort. These could be decisions related to investment or downsizing. These decisions may be risky and face resistance from employees. Strong and visionary leadership is required to ensure successful implementation.

Employee Skills and Productivity

A skilled and autonomous workforce is a must for the diversification strategy to succeed. Employees are more productive if given autonomy.

Lean and Tenacious

Companies that can maintain a lean management structure can avoid high overhead margins. The success of the diversification ultimately hinges upon the tenacity of the personnel to see it through.

Diversifying to new markets can be a risky proposition. The risk can be minimized if companies can identify their strengths and evaluate market opportunities accordingly. The key for small companies is to identify markets where their capabilities can be profitably leveraged to create customer value.

The changing environments and the new forms of competition have created new opportunities and threats for business firms. Firms must adjust to new forces of competition from all directions. They have been forced to adopt many forms of restructuring activity. M&As will be considered first, but it should be understood that they represent only one set of the many adjustment and restructuring responses.

INTERNAL Vs. EXTERNAL GROWTH

Internal growth and mergers are not mutually exclusive activities. They are mutually supportive and reinforcing. Successful growing firms use many forms of M&As and restructuring based on opportunities and limitations. The characteristics and competitive structure of an industry will influence the strategies employed.

Growth and diversification can be achieved both internally and externally. Internal development is more advantageous for some activities and for some other external diversification is more beneficial.

The factors which support the external growth and diversification through mergers and acquisitions include the following:

- Faster achievement of goals and objectives through an external acquisition.
- Greater cost of building an organization internally, than the cost of an acquisition.

- Attainment of feasible market share with less risk, in shorter time and at lower cost.
- Inefficiently managed target.
- Tax advantages.
- Complementary capabilities.

Internal development is favored when the above given advantages are minimal. When the firms which are available for acquisition do not provide attractive opportunities for achieving the goals that have been set, internal development is more feasible from an economic perspective.

Box 1: Spectrum Brands: Charged to the Max
Spectrum Brands is a top pick among Standard and Poor's household products group. With a series of new acquisitions, Spectrum was able to build a fast growth and diversified product portpolio. Spectrum, formerly known as Rayovac Corp., is a major global manufacturer of consumer batteries, electric personal care products, lawn and garden products, and pet care and insect control product supplies. The company was founded in 1906 as 'the French Battery Company' in Madison, Wisconsin. In 1933, it was renamed as the Rayovac Company. Its headquarters is in Atlanta, Georgia. Its widely known brand names include Rayovac, VARTA, Remington, Vigoro, Cutter, and Tetra. The company sells its products in more than 120 countries and has 52 manufacturing and product development facilities. Spectrum generates approximately 45% of sales outside North America. Batteries (40% of company sales) and lawn and garden products (22%) are its largest segments. Spectrum Brands generate approximately \$2.8 billion in annualized revenues and has approximately 10,000 employees worldwide. The company's stock trades on the New York Stock Exchange under the symbol SPC. To become a leading global consumer products company, it has made a number of acquisitions over the years, which helped it diversify into different business categories and territories. In the battery category, the company made acquisitions of ROV in 1999, VARATA in 2002 and Ningbo Baowang Battery Company in 2004. These helped it enter into Latin America, European and China markets. Spectrum's desire to diversify has been apparent in recent years. In September 2003, the company acquired Remington Products, one of the leading makers of dry-shaving and personal-grooming products in the US. This acquisition was Spectrum's first diversification move outside batteries, and provided a boost to its sales and margins. In 2005, with its investment in Tetra Holding – a global supplier of pet fish and aquatics and in United Industries – a leading maker and marketer of lawn and garden care and insect control products, as well as pet supplies, Spectrum has literally become the largest pet-products supplier in the world.

Source: www.businessweek.com

DIVERSIFICATION PLANNING, MERGERS AND THE CARRYOVER OF MANAGERIAL CAPABILITIES

Growth through mergers and diversification represents a very good alternative to be taken into account in business planning. The external growth contributes to opportunities for effective alignment to the firm's changing environments. The primary reason for acquiring or merging with another business is to produce improved cash flow or to reduce the risk faster or at a lower cost than achieving the same goal internally. Thus, the goal of any acquisition is to create a strategic advantage by paying a price for the target that is lower than the total resources required for internal development of a similar strategic position.

Another reason is the expectation on the part of the diversifying or acquiring firm that it has or will have excess capacity of general managerial capabilities in relation to its existing product market activities. Moreover, there is an expectation that in the process of interacting with the generic management activities, the diversifying firms will develop industry specific managerial experience and firm specific organization capital overtime.

Four factors have contributed to the increased diversification by business firms:

ADVANCES IN MANAGERIAL TECHNOLOGY

Important changes in the management technology include issues like development in theory and practice of planning, increased role of management functions in the firm's operations, the development and use of formalized decision models, increased recognition of quality and continuity of the firm's management organization as an important economic variable etc. These factors have made it beneficial to spread these abilities over a greater number of activities. Conversely, these management capabilities are not evenly distributed throughout industries giving an opportunity for firms to extend their capabilities to other firms and to new areas in order to increase the returns on investments in both management and physical assets.

INCREASED TECHNOLOGICAL CHANGE

The opportunities for diversification have increased along with the demands to change. The expertise of technology is spread unequally among various business firms and industries. The prospects of economic profits from the supply of advanced technological capabilities to industries and firms which need them provide an increased incentive to diversify.

LARGE FIXED COSTS AND STAFF SERVICES

Fixed cost of business firms have increased due to the need to maintain an affective competitive position in the world economy and the resultant larger management capabilities. Investments in managerial organizations have always resulted in economies of scale rather than investment in physical assets. Hence, the economies derived from spreading the fixed costs for managerial staff functions over a wide range of activities have increased.

DEVELOPMENT OF EQUITY MARKETS

The trends in the equity markets have strengthened the influence of the above mentioned factors in encouraging diversification by external diversification. In the equity markets stock which had a potential for growth in earnings and dividends, were highly valued. Hence, growth stocks had higher P/E ratio. This increased interest in the growth stimulated mergers in various ways. The search for product markets with growth opportunities intensified.

Both internal and external investment programs may be successful or unsuccessful. Firms may try either or both approaches in their efforts to increase shareholder value.

Box 2: Merger Myth – Diversification Lowers Your Risk

Why is diversification into unrelated businesses so risky? The simple answer is that you probably aren't very familiar with the industry you're venturing into. Thus, you'll overlook critical risk factors during due diligence. You're likely to pay too much. And, once you've signed on the dotted line, you'll have trouble monitoring the new acquisition's performance.

Paint It Red Instead?

Despite these warnings, you may still be considering an unrelated acquisition – buying a company outside your current core business. If so, here are some guidelines you should follow:

Don't Horse Around: No shortcuts allowed here. Due diligence must be thorough and flawless. Examine all the risk factors; know what you're buying. Your trusty old due diligence checklists will be of little use in assessing a different type of enterprise.

A Horse, A Horse, My Kingdom for a Horse: Make sure the existing management team is capable of running the business and will stay on after the acquisition. Remember: You don't know the business. The last thing you want is to have to run it.

Don't Bite the Hand That Feeds You: Create handsome incentives for the existing management team. Keep them committed to the company's success and align their rewards with your company's performance objectives.

Prepare for the Long Haul: If the management team will be staying on for only a few years, make sure there's a solid succession plan and that the next layer of management is highly qualified to run the business.

Don't Kick a Dead Horse: If the business starts to decline, stepping in to run it could be fatal. In fact, this is where conglomerates most often blunder: Rather than selling the company, as an investor would an unprofitable stock, they try belatedly to turn it around.

Diversifying out of your expertise is chancy and often calamitous – but making the move with wisdom, caution, and exhaustive preparation could be a horse of a different color.

Source: www.strategy4u.com

A STRATEGIC APPROACH TO MERGERS AND ACQUISITIONS

As described earlier a merger and acquisition decision is a strategic choice. A strategic approach to mergers and acquisitions implies that they are made after a full analysis of the underlying strengths of the acquirer, and identification of candidate's strategic fit with its existing activities. The following table shows the possible strategic reasons for a merger or a takeover matched with the suggested ways of achieving the aim.

Table: Strategic Opportunities

Present Situation	Strategy
Growing steadily but in a mature market with limited growth.	Acquire a company in a younger market with a higher growth rate.
Operating at maximum productive capacity.	Acquire a company making similar products operating substantially below capacity.
Under-utilizing management resources.	Acquire a company into which the talents can be extended.
Marketing an incomplete product range, or having the potential to sell other products or services to your existing customers.	Acquire a company with product range which is complementary.
Lacking key clients in a targeted sector.	Acquire a company with the right customer profile.
Need to increase market share.	Acquire an important competitor.
Need to widen capability.	Acquire a company with key talents and/or technology.
Need more control of suppliers or customers.	Acquire a company which is, or which gives access to a significant customer or supplier.
Preparing for floatation but need to improve balance sheet.	Acquire a suitable company with the right customer profile.

SUMMARY

- In the rapidly changing environment, all business decisions have to be made from the strategic point of view. Various companies engage in annual strategic planning to provide a purpose and direction for the business.
- The strategic planning process can be performed based on a set of formal procedures and/or informally in the minds of the managers.

- According to the BCG and Porter approaches, well-formulated principles can guide firms in taking the right decisions.
- While forming a strategy, the firm needs to exploit its set of capabilities and opportunities effectively in relation to its changing environments. For making the strategy process effective, the firm should have a rapid information feedback system to improve its capabilities for adapting to change, correcting errors, and seizing new opportunities.
- A company's value is determined by its expected net cash flow and is relative to the level of risk. An accurate measure of value and management of value requires assessment of the competitive environment in which the company operates.
- Doing this includes analyzing both the external and internal conditions that will influence performance. These steps should be performed in the annual strategic planning process. The results of the strategic plan should be tied to the ultimate goal of creating shareholder value.

Chapter 3

Mergers and Acquisitions: Different Forms

After reading this chapter, you will be conversant with:

- Various Types of Mergers
- The Merger and Acquisition Process
- Participants in the Merger and Acquisition Process
- Post-Merger Management/Post-closing Integration
  - Due Diligence
  - The Merger Integration Work Streams Model
- Reasons for Failure of Mergers and Acquisitions

The business world has changed drastically. Markets, instruments, financing and relationships have transformed to become exceedingly complex. The economic environment has shifted dramatically and in order to prosper or even to survive in such an environment, the strategy formulation has become very important. It is no longer possible to take a simple, idealistic view of what should be done and how it should be done.

The pursuit of growth and the need to access new markets are driving companies all over the world to undertake mergers and acquisitions. This phenomenon is becoming part of the strategic planning of many corporate bodies seeking not only to exploit existing core competencies but also to build new ones for the future. While the motives or influences leading to mergers are multiple, varied and complex, the potential for concentration of economic power is inherent in the phenomenon of mergers.

When two businesses combine their activities, the combination may take the form of acquisition (takeover) or a merger (amalgamation). The distinction between a merger and an acquisition is not very clear. The methods used for mergers are often the same as the methods used to make takeovers. However, theoretically there can be a subtle difference between the two, as can be interpreted from the following definitions:

Acquisition or Takeover: The purchase of a controlling interest by a company in the voting share capital of another company, usually by buying the majority of the voting shares is called an acquisition or a takeover. Idea Cellular acquiring Escotel is an example of an acquisition.

Merger: A business combination that results in the creation of a new reporting entity formed from the combining parties, in which the shareholders of the combining entities come together in a partnership for the mutual sharing of the risks and the benefits of the combined entity, and in which no party to the combination obtains control over the other. An example of a merger is Daimler-Benz and Chrysler.

The main reason for any business organization to combine is to increase the shareholder wealth. This increase usually comes from the effects of synergy. In this chapter we shall discuss in detail the various types of mergers and the process undergone by firms to accomplish a merger or an acquisition.

VARIOUS TYPES OF MERGERS

Merger or acquisition depends upon the purpose for which the target company is acquired. A company will seek to acquire the other company only when it has arrived at its own developmental plan to expand its operations after a thorough analysis of its own internal strength. It has to aim at a suitable combination where it could have opportunities to supplement its funds; secure additional financial facilities, eliminate competition and strengthen its market position. Based on the reason why firms combine, mergers can be divided into three categories: (i) Horizontal mergers, (ii) Vertical mergers, and (iii) Conglomerate mergers.

HORIZONTAL MERGER

A horizontal merger involves a merger between two firms operating and competing in the same kind of business activity. The main purpose of such mergers is to obtain economies of scale of production. The economies of scale is obtained by the elimination of duplication of facilities and operations and broadening the product line, reduction in investment in working capital, elimination of competition in a product, reduction in advertising costs, increase in market share, exercise of better control on market, etc.

Horizontal mergers result in decrease in the number of firms in an industry and hence such type of mergers make it easier for the industry members to join together for monopoly profits. Horizontal mergers also have a potential to create monopoly power on the part of the combined firm enabling it to engage in anti-competitive practices. Hence, in many countries, restrictive business practices legislation, enforce strict regulations on the integration of competitors. Horizontal mergers of even small enterprises may create conditions triggering concentration of economic power and oligopoly.

The merger of Centurion Bank and Bank of Punjab, Oriental Bank of Commerce and GTB in Banking Sector, Tata Industrial Finance Ltd., with Tata Finance Ltd., in Finance Sector. A big merger between Holicim and Gujarat Ambuja Cement Ltd., with Associated Cement companies is also a merger in the manufacturing industry. Essar-Hutch and BPL's mobile merger, VSNL's acquisition of Chennai based Dishnet DSL's Internet Service Provider (ISP) are some other horizontal mergers that took place recently.

VERTICAL MERGERS

A vertical merger involves merger between firms that are in different stages of production or value chain. They are combination of companies that usually have buyer-seller relationships. A company involved in a vertical merger usually seeks to merge with another company or would like to takeover another company mainly to expand its operations by backward or forward integration. The acquiring company through merger of another unit attempts to reduce inventories of raw material and finished goods, implements its production plans as per objectives and economizes on working capital investments. In other words, in vertical combination, the merging company would be either a supplier or a buyer using its product as an intermediary material for final production.

Firms integrate vertically between various stages due to reasons like technological economies, elimination of transaction costs, improved planning for inventory and production, reconciliation of divergent interests of parties to a transaction, etc. Anti-competitive effects have also been observed as both the motivation and the result of these mergers.

Examples: Nirma's bid for Gujarat Heavy Chemical (backward integration) or Hindalco Bidding for Pennar Aluminium (forward integration). Videocon Group's acquisition of Thomson's Colour Picture Tube Business in China.

CONGLOMERATE MERGERS

Conglomerate mergers involve merger between firms engaged in unrelated types of business activity. The basic purpose of such combination is utilization of financial resources. Such type of merger enhances the overall stability of the acquirer company and creates balance in the company's total portfolio of diverse products and production processes and thereby reduces the risk of instability in the firm's cash flows.

Conglomerate mergers can be distinguished into three types: (i) Product extension mergers, (ii) Geographic market extension mergers, and (iii) Pure conglomerate mergers.

i. **Product extension mergers** are mergers between firms in related business activities and may also be called concentric mergers. These mergers broaden the product lines of the firms.

ii. **Geographic market extension mergers** involve a merger between two firms operating in two different geographic areas.

iii. **Pure conglomerate mergers** involve merger between two firms with unrelated business activities. They do not come under product extension or market extension mergers.

Within the broader category of conglomerate mergers two types of conglomerate firms can be distinguished:

a. **Financial Conglomerates:** Financial conglomerates provide a flow of funds to each segment of their operations, exercise control and are the final financial risk takers. They undertake strategic planning but do not participate in operating decisions.

b. **Managerial Conglomerates:** Managerial conglomerates transmit the attributes of financial conglomerates still further. They not only assume financial responsibility and control, but also play a role in operating decisions and provide staff expertise and staff services to the operating entities. By providing managerial guidance and interactions on decisions, managerial conglomerates increase the potential for improving performance.

THE MERGER AND ACQUISITION PROCESS

The acquisition process can be divided into a planning stage and an implementation stage. The planning stage consists of the development of the business and the acquisition plans. The implementation stage consists of the search, screening, contacting the target, negotiation, integration and the evaluation activities. In short, the process of acquisition can be summarized in the following steps:

i. Develop a strategic plan for the business (Business plan).

ii. Develop an acquisition plan related to the strategic plan (Acquisition plan).

iii. Search companies for acquisitions (Search).

iv. Screen and prioritize potential companies (Screen).

v. Initiate contact with the target (First contact).

vi. Refine valuation, structure the deal, perform due diligence, and develop financing plan (Negotiation).

vii. Develop plan for integrating the acquired business (Integration plan).

viii. Obtain all the necessary approvals, resolve post-closing issues and implement closing (Closing).

ix. Implement post-closing integration (Integration).

x. Conduct the post-closing evaluation of acquisition (Evaluation).

DEVELOPING THE BUSINESS PLAN

As discussed earlier, a merger or an acquisition decision is a strategic choice. The acquisition strategy should fit the company's strategic goals of increasing the net cash flows and reduce risk.

A business plan communicates a mission or vision for the firm and a strategy for achieving that mission. A well-structured business plan consists of the following activities:

i. Determining where to compete, i.e., the industry or the market in which the firm desires to compete.

ii. Determining how to compete. An external industry or the market analysis can be made to determine how the firm can most effectively compete in its chosen market(s).

iii. Self-assessment of the firm by conducting an internal analysis of the firm's strengths and weaknesses relative to the competition.

iv. Defining the mission statement by summarizing where and how the firm has chosen to compete and the basic operating beliefs of the management.

v. Setting objectives by developing quantitative measures of performance.

vi. Selecting the strategy most likely to achieve the objectives within a reasonable time period subject to constraints identified in the self-assessment.

The strategic planning process identifies the company's competitive position and sets objectives to exploit its relative strengths while minimizing the effects of its weaknesses. The firm's Mergers and Acquisitions strategy should complement this process, targeting only those industries and companies that improve the acquirer's strengths or lessen the weaknesses.

BUILDING THE ACQUISITION PLAN

After a proper analysis of the various available options if it is determined that a merger or an acquisition process is appropriate to implement the business strategy then an acquisition plan is prepared. This plan focuses on the tactical rather than the strategic issues. The acquisition plan defines the key management objectives for the takeover, resource constraints, appropriate tactics for implementing the proposed transactions and the schedule or a time table for completing the acquisition. It furnishes a proper guidance to those responsible for successfully completing the transaction by providing valuable inputs to all the later phases of the acquisition process.

Management Objectives

Management objectives are both financial and non-financial. The financial objectives include a minimum rate of return or operating profit, revenue and cash flow targets to be achieved within a specified time period. Non-financial objectives address the motivations for making the acquisition that support the achievement of the financial returns pre-determined in the business plan.

Resource Assessment

The assessment of the resources involves the determination of the maximum amount of resources available to assign to the merger or acquisition. This information is useful in the selection of the right candidate for the merger or the acquisition. The resources available generally include the financial resources like the internal cash flows in excess of the normal operating requirements plus funds from equity and the debt markets. If the target is identified, resources should also include funds which the combined firm can raise by issuing equity or by increasing leverage. It is the management's perception about the likely risks that it would be exposed to by virtue of acquisition that determines the financial implications. These risks may be:

i. **Operating Risk:** It refers to the ability of the acquirer to manage the acquired company. The risk is higher in conglomerate mergers. The limited understanding of the business operations of the newly acquired firm may negatively impact the integration effort and the ongoing management of the combined companies.

ii. **Financial Risk:** It refers to the acquirer's willingness and the ability to leverage a transaction as well as the willingness of shareholders to accept near-term earnings per share dilution. The acquiring company tries to maintain certain level of financial ratios such as the debt to equity and interest coverage ratio to retain a specific credit rating. The incremental debt capacity of the firm can be estimated by comparing the relevant financial ratios to those of comparable firms in the industry. The difference represents the amount of money that the firm can borrow without making the current credit rating vulnerable.

iii. **Overpayment Risk:** It refers to the possibility of dilution in the earnings per share or reduction in the growth of the firm because of paying more than the economic value of the acquired firm.

Time Table

A time table or a schedule that recognizes all the key events that should take place in the acquisition process is the final component of a properly structured acquisition plan. It should be both realistic and aggressive to motivate all the participants in the process to work as fast as possible to achieve the management objectives established in the acquisition plan. The schedule should also include the names of the individuals who will be responsible for ensuring that the set objectives are achieved.

THE SEARCH PROCESS

After the firm has developed a viable business plan that requires an acquisition to realize the firm's strategic direction and an acquisition plan the search for the right candidate for acquisition begins. The search for a potential acquisition candidate generally takes place in two stages:

i. The first stage of the search process involves establishing a primary screening process. The primary criteria based on which the search process is based include factors like the industry, size of the transaction and the geographic location. The size of the transaction is best defined in terms of the maximum purchase price a firm is willing to pay. It can be expressed as the maximum purchase price to earnings, book, cash flow or revenue ratio or a maximum purchase price stated in terms of rupees.

ii. The second stage involves developing the search strategy. Such strategies generally involve using computerized database and directory services to identify the prospective candidates. Law, banking and accounting firms also form valuable sources from which information can be obtained. Investment banks, brokers and leveraged buyout firms are also useful sources although they are likely to require an advisory fee.

THE SCREENING PROCESS

The screening process starts with the reduction of the initial list of potential candidates identified by using the primary criteria such as the size and the type of the industry. In addition to the primary criteria employed, secondary selection criteria include a specific market segment within the industry or a specific product line within the market segment. Other measures like the firm's profitability, degree of leverage and the market share are also used in the screening process.

FIRST CONTACT

The contact phase of the process involves meeting the acquisition candidate and putting forward the proposal of acquisition. It could run through several distinctively identifiable phases that need a little more elaboration.

Alternative Approach Strategies

The approach employed for contacting the target depends on the size of the company and whether it is publicly or privately held. For small companies in which the buyer has no direct contacts, a letter expressing interest in a joint venture or marketing alliance is enough. Thorough preparation before the first contact is essential for that alone enables the acquirer to identify the company's strengths and weaknesses and be able to explain the benefit of the proposal to the client convincingly. A face to face meeting is then arranged when the target is willing to entertain the idea of an acquisition. Contact is made through an intermediary for a medium sized company. The intermediaries might include members of the acquirer's board of directors, accounting firm, lender or an investment banker. For a large sized company, contact is made through an intermediary but, it is important that the contact is made with the highest level of the management of the target firm.

Discussing Value

Valuation of the target company is the most critical part of a deal. A conservative valuation can result in collapse of the deal while an aggressive valuation may create perpetual problems for the acquiring company. The commonly used valuation methods are:

i. **Discounted Cash Flow Method:** In this method, valuation represents the present value of the expected stream of future cash flow discounted for time and risk. This is the most valid methodology from the theoretical standpoint. However, it is very subjective due to the need to make several assumptions during the computations.

ii. **Comparable Companies Method:** This method is based on the premise that companies in the same industry provide benchmark for valuation. In this method, the target company is valued vis-á-vis its competitors on several parameters.

iii. **Book Value Method:** This method attempts to discover the worth of the target company based on its Net Asset Value.

iv. **Market Value Method:** This method is used to value listed companies. The stock market quotations provide the basis to estimate the market capitalization of the company.

Acquirers rarely rely on a single method for valuation. Normally, the target companies are valued by various methods. Different weights are assigned to the values computed by various methods. The weighted average valuation helps in eliminating the errors that may creep in, if a single method is relied upon. Neither the buyer nor the seller will be in a position to establish the exact value for the business unless a detailed evaluation is done. The best solution is to determine a range.

Preliminary Legal Documents

The common first step in a merger or an acquisition transaction is to negotiate a bilateral: (i) Confidentiality agreement, and (ii) A letter of intent.

i. **Confidentiality Agreement:** In the confidentiality agreement, the buyer requests the seller to make available the historical data and the collateral information. The seller also requests the acquirer to furnish similar information to assess the financial credibility of the seller. It is important for the seller to do this to identify whether the buyer is capable of raising the finance to complete the transaction. The confidentiality agreement is mutually binding on both the parties and it covers only that information which is not available publicly. It should also have a reasonable expiry date.

ii. **Letter of Intent:** The letter of intent represents the parties' preliminary agreement to agree. It carries the principle areas of agreement between the two parties. It formally specifies various issues like, the reason for the agreement between the parties, the major terms and conditions, the responsibilities of both the parties while the agreement is in force, the mode of payment of fees, the expiration date etc. The letter of intent also includes conditions like an agreement that selected personnel of the target company will not compete with the merged firm for some period of time if they would have to leave. The agreement may also indicate the amount of the purchase price to be kept in the escrow if the buyer wishes.

   A sound letter of intent usually contains the provisions that bind the two parties. Other standard conditions include the need for signed employment contracts for key executives of the selling company and the completion of all other necessary documents. Failure to satisfy any of these requirements may make the agreement ineffective. The letter of intent may create legal liabilities if one of the parties is later accused of not negotiating the definitive agreement in good faith.

NEGOTIATION

The negotiation phase of the acquisition process consists of many activities conducted simultaneously by various members of the acquisition team. The actual purchase consideration is determined during this phase. This is different from the preliminary valuation of the target company made when the first contact is made.

Defining the Purchase Price

The purchase consideration can be defined in three ways: (i) the total consideration, (ii) the total purchase price or the enterprise value, and (iii) the net purchase price. Each definition differs from the other with respect to the purpose which it serves.

Total Consideration

The total consideration consists of cash or stock or new debt issues or combination of any of them. Total consideration is the term commonly used in the legal documents to describe the different types of payment to be made to the shareholders of the target company. The payment may also include non-financial assets (such as the real estate) which are also referred as payment in kind. Each component of the total consideration should be viewed in present value terms. The stock component of the total consideration is the current value of the future dividends or net cash flows, or the acquiring company's stock price per share times the number of shares to be exchanged for each outstanding share of the seller's stock. (The estimation of this exchange ratio is shown below). The new debt issue component is the present value of the cumulative interest payments plus principal, discounted at some appropriate market rate of interest. It can be represented as:

$$PV_{TC} = C + PV_S + PV_{ND}$$

Where,

PV_{TC} = Present value of total consideration,

C = Cash consideration,

PV_S = Present value of stock issued, and

PV_{ND} = Present value of new debt issued.

Calculation of Exchange Ratio from the Perspective of the Acquired and the Acquiring Firm

Whenever a firm 'A' acquires another firm 'B', the compensation to the shareholders of the acquired firm is usually paid in the form of shares of the acquiring firm. In other words, shares of firm A will be given in exchange for shares of firm B. Thus, the exchange ratio is a very important factor in any kind of merger. Firm A will want to keep this ratio as low as possible, while firm B will want it to be as high as possible. In any case, both firms would ensure that post-merger, their equivalent price per share will at least equal their pre-merger price per share. Given below is the model developed by Conn and Nielson for determining the exchange ratio. The symbols used in this model are:

ER = Exchange ratio

P = Price per share

EPS = Earning per share

PE = Price earning multiple

E = Earnings

S = Number of outstanding equity shares

AER = Actual exchange ratio.

In addition, the acquiring, acquired and combined firms will be referred to by subscripts A, B and AB respectively.

Firm A would ensure that the wealth of its shareholders is preserved. This implies that the price per share of the combined firm is at least equal to the price per share of firm A before merger:

$$P_{AB} \geq P_A$$

For the sake of simplicity consider that,

$$P_{AB} = P_A$$

Price earnings ratio of the combined firm x Earnings per share of the combined firm gives the Market Price per share.

$$P_{AB} = PE_{AB} \times EPS_{AB} = P_A \qquad \ldots(1)$$

Earnings per share of the combined firm can be expressed as:

$$EPS_{AB} = (E_A + E_B)/[S_A + S_B\,(ER_A)] \qquad \ldots(2)$$

ER_A = number of shares of firm A given in lieu of one share of firm B.

Substituting formula of EPS_{AB} in equation (1) we get –

$$P_A = PE_{AB}\,(E_A + E_B)/[S_A + S_B\,(ER)]$$

From the above equation, we may solve for the value of ER_A as follows:

$$ER_A = -\,(S_A/S_B) + [(E_A + E_B)\,PE_{AB}]/P_AS_B$$

After discussing the maximum exchange ratio acceptable to the shareholders of firm A above, we will now calculate the minimum exchange ratio acceptable to the firm B(ER_B). The basic condition is –

$$P_{AB}\,(ER_B) \geq P_B \qquad \ldots(3)$$

Using the equality form of above equation and substituting P_{AB} from equation 1 in equation 3 we get –

$$PE_{AB} \times EPS_{AB} \times ER_B = P_B$$

Substituting the value of EPS_{AB} from equation 2 in the above equation, and solving the equation for ER_B we get –

$$ER_B = P_BS_A/[(PE_{AB})\,(E_A + E_B) - P_BS_B].$$

Illustration 1

The particulars of Alpha and Beta is as follows:

Particulars	Alpha	Beta
Profit (Rs. in cr.)	100	75
No. of Shares (crore)	20	25
EPS (Rs.)	5	3
P/E Multiple	30	10
Market Price (Rs.)	150	30

Alpha proposes to acquire Beta and gives its shares in exchange of the shares of Beta.

Solution

$$ER = \frac{-S_1}{S_2} + \frac{(E_1 + E_2)PE_{12}}{P_1S_2}$$

$$ER = \frac{-20\,cr}{25\,cr} + \frac{(100\,cr + 75\,cr)\,PE_{12}}{150\,(25\,cr)} = -\,0.8 + 7/150\ P/E$$

Thus, the maximum exchange ratio at different levels of PE are:

P/E	20	25	30	35	40	50
ER	0.13	0.36	0.6	0.83	1.06	1.53

Total Purchase Price or Enterprise Value

The total purchase price or the enterprise value of the target firm consists of the total consideration plus the market value of the target firm's debt assumed by the acquiring company. The value often quoted in the financial press and other media as the purchase price is the enterprise value because it is most visible to those not familiar with the details of the transaction. It is the approximate figure of the total investment made by the acquiring firm to purchase the target firm. It does not measure the liabilities the acquirer assumes nor does it measure the potential to recover a portion of the total consideration paid to the target company's shareholders by selling the undervalued or redundant assets. This can be represented as:

$$PV_{TPP} = PV_{TC} + PV_{AD}$$

Where,

PV_{TPP} = Present value of total purchase consideration,

PV_{AD} = Present value of assumed debt, and

PV_{TC} = Present value of total consideration.

The Net Purchase Price

The net purchase price is the total purchase price plus other assumed liabilities less the proceeds from the sale of redundant target assets on or off the balance sheet. The net purchase price is the most comprehensive measure of the actual price paid for the target firm. It includes all known cash obligations assumed by the acquirer as well as any portion of the purchase price that is recovered through the sale of assets. It may be larger or smaller than the total purchase price.

$$PV_{NPP} = PV_{TPP} + PV_{OAL} - PV_{DA}$$

Where,

PV_{TPP} = Present value of total purchase consideration,

PV_{OAL} = Present value of other assumed liabilities, and

PV_{RA} = Present value of sale of discretionary or redundant assets.

The negotiation phase also involves other activities which happen simultaneously. They are refining valuation, deal structuring, due diligence and developing the financing plan.

Refining Valuation

Improving the preliminary valuation based on new information revealed during due diligence provides the starting point for negotiating the agreement of purchase and sale. The buyer should review the historical data of the past five years. The 5 years of the historical data should be normalized or adjusted for non-recurring gains, losses, or expenses. Non-recurring gains or losses result from either the sale of land, equipment, patents, software or copyrights. Non-recurring expenses include settlement of litigation, employee bonuses, etc. These adjustments are made to allow the buyer to normalize the irregularities in the historical information and to better understand the underlying dynamics of the business.

The normalized historical data will help the buyer project a minimum of 5 years of cash flows and adjust the projected cash flows for the amount and timing of anticipated synergy. The assumptions on which the buyer makes the projections also have to be clearly mentioned.

Structuring the Deal

Deal structuring involves meeting the needs of both the parties by dealing with issues of risk and reward by constructing an appropriate set of compensation, legal, tax and accounting structures. It is the process of identifying and satisfying most of the priority objectives of the parties involved in the transaction subject to their tolerance for risk.

The decisions made throughout the deal structuring process influence various attributes of the deal. These attributes include how the ownership is determined, how assets are transferred, how the interests of the ownership are protected, and how the risk is shared among the parties to the transaction. Other aspects like the type, number, and complexity of the documents required for closing, the type of approval required and the time needed to complete the transaction are also dictated by this document. The process starts with the determination by each party of their initial negotiating positions, potential risks, alternatives for managing risk, and levels of tolerance for risk, and the conditions under which either of the parties would withdraw from the deal.

DUE DILIGENCE

The basic function of due diligence is to assess the benefits and the costs of a proposed acquisition by inquiring into all relevant aspects of the past, present and the predictable future of a business to be purchased. Due diligence is of vital importance to prevent "unpleasant surprises" after completing the acquisition. The due diligence should be thorough and extensive. Both the parties to the transaction should conduct their own due diligence to get the accurate assessment of potential risks and rewards. There is no precise definition of the term, 'due diligence'. Generally, it is a process of enquiry and investigation about proposed merger deal. It is a judgment process of the deal. The due diligence consists of five strands, viz.,

- The verification of assets and liabilities.
- The identification and quantification of risks.
- The protection needed against such risks which will in turn feed into the negotiations.
- The identification of synergy benefits.
- Post-acquisition planning.

Due Diligence Required by Law

In most cases, due diligence is not required by law, but in the following circumstances it becomes a legal requirement.

- According to the Cadbury Report, due diligence report is required for significant acquisitions, because the full board of directors of the purchasing company should review significant acquisitions.
- A financial report is required if it is a major acquisition that needs shareholders' approval and the companies involved are listed companies governed by regulations of London Stock Exchange.
- In European public deals, synergy papers including due diligence report are required.
- The US courts have found due diligence report as one of the key data for management. An independent investigation must double-check the data.
- In India, a merchant banker has to conduct due diligence to ensure the acquirer's financial position, and chance of implementation of terms of merger condition by the parties by giving A Due Diligence certificate to the SEBI.

In a merger both the parties will conduct due diligence. In an M&A deal, due diligence can be conducted from different perspectives. Following table shows various due diligence topics and their focus on enquiry.

Table 1: Due Diligence Topics and their Focus on Enquiry

Due Diligence Topics	Focus of Enquiries	Expected Results
Financial	Historical records, review of management and systems.	Confirms underlying profits. Provides basis for valuation.
Legal	Various contractual Acts in the country.	Warranties and indemnities, validation of all existing contracts, sale and purchase agreement.
Commercial	Market conditions, competitive position and target's commercial prospects.	Sustainability of future profits, planning, decision on strategy to be adopted for the combined business.
Tax	Existing tax levels, liabilities and arrangements.	Avoid any unforeseen tax liabilities, opportunities to optimize position of combined business.
Management	Management quality, organizational structure.	Identification of key integration issues, outline of new structure for the combined business.

Buyer Due Diligence

The main objective of undertaking due diligence by the buyer is to identify and to confirm the source of value and lessen the potential liability by trying to eliminate the flaws that reduce value.

The due diligence exercise is carried out by a team of executives from the acquirer, their Investment Bankers, Solicitors and Chartered Accountants. The team should have members with experience of all dimensions of the business like finance, marketing, human resources, operations, legal, etc. The members should have in depth knowledge of the industry and the operations to be reviewed. The exercise should cover all material factors which are likely to affect the future of the business.

Due diligence exercise covers careful study of information in public domain like financial statements, corporate records like minutes of meetings, past prospectuses, share price movements, etc. All contracts entered into by the firm with lenders, suppliers, customers, franchisee, lease agreements, asset purchases agreements, etc., need to be carefully studied. Special attention should be given to litigations, contingent liabilities, environmental disputes, liens and encumbrances, product warranties, inter-company transactions, tax disputes, etc.

Due diligence should always be conducted in the shortest possible period in the interest of maintaining a cooperative relationship at the time of negotiations. A long and detailed due diligence, is likely to uncover all the items that the buyer will use as an excuse to lower the purchase price. Hence, there is a possibility that the seller may seek to stop the process before the appropriate time. The best possible solution is to agree to a shortened period.

Seller's Due Diligence

Though the major part of the due diligence procedure is carried out by the buyer, the seller also has to perform certain aspects of due diligence on the buyer. In such a process the seller may determine whether the buyer has the financial resources to finance the agreed purchase price.

DEVELOPING THE FINANCING PLAN

One of the very important activities in the negotiation phase is to develop a financing plan. This activity is a key input in determining the purchasing price, as it helps in identifying a practical limit of the amount of the purchase price the buyer can offer the seller. According to the capital budgeting theory, an investment should be funded as long as its net present value is greater than or equal to zero. Applying the concept of capital budgeting to acquisition financing, we can determine the purchase price as the present value of the target company, plus the synergy created by combining the acquiring and target companies discounted at the acquirer's cost of capital.

Based on the purchase price determined, a financing plan is attached to the acquirer's business and the acquisition plan and is used to obtain the financing for the transaction. A financing plan is usually used as a marketing or sales document to negotiate the best possible terms for financing the proposed transaction.

Obtaining Bridge or Interim Financing

If the payment is made only through cash, then the buyer can obtain the financing from traditional sources like banks, investment bankers, insurance companies, underwriters, venture capitalists, leveraged buyout funds, etc. Banks usually provide temporary or bridge financing primarily to pay all or a portion of purchase price and meet possible working capital requirements until permanent financing is found. The lending by banks is usually asset based, for which assets such as accounts receivable, land, fixed equipment or inventory is kept as the collateral.

Mezzanine Financing

Mezzanine financing refers to the sub-ordinated debt financing which typically includes the characteristics of both debt and equity. There are significantly fewer sources of sub-ordinated debt than there are of senior debt or equity, so it is often considered to be specialty financing.

Sub-ordinated debt is substantially riskier than senior debt since the lender generally has a lesser right over the collateral and cash flow than the senior lender. As a result, subordinated debt is rather an expensive financing. Hence, such lenders usually ask for equity in the form of warrants, to supplement what they would have earned as interest income to get capital gains at a later date for the higher risk which they have accepted.

Permanent Financing

Permanent financing usually consists of long-term unsecured debt, popularly called junk bonds. Such financing can be obtained through the services of investment bankers or underwriters who by virtue of their market reputation can raise funds via a private placement with ease. Such debt is sub-ordinate to the bank debt if the firm goes bankrupt.

Venture Capital Firms

Venture capitalists are also a significant source of funds for financing both start-ups and acquisitions. The venture capital firms identify and screen opportunities, transact and close deals, monitor and add value, and raise additional capital. Venture capitalists have a high appetite for risks, which is evident from the fact that they lend even when the traditional sources like banks, financial institutions, etc., are not ready to lend. They consider high risk in search of high profits.

Seller Financing

Seller financing represents a very important source of financing for buyers. In this form of financing the seller agrees to defer the receivable of a portion of the purchase price until a future date. Thus, the buyer's overall risk is reduced because he is required to block less capital when the deal is finalized. In addition, the operational risk gets shifted to the seller, in case the buyer defaults on his loan obligation.

DEVELOPING THE INTEGRATION PLAN

Making the combined firm perform in line with the expectations is a difficult task. For the result to be in line with expectations proper planning is needed before the agreement of purchase and sale is signed. Once the documents are signed, the buyer will lose the leverage over the seller. The decisions made in the pre-closing have great influence on the post-closing integration activity. Without adequate planning, integration is unlikely to provide the synergies anticipated by, at the cost included in, and within the time provided in the acquisition plan.

The benefit packages, contracts for employees, retention bonuses, etc., all should be negotiated before closing. Covenants and conditions in the contract also impact integration. Earn-outs, payments to the seller based on the future performance, and deferred purchase price mechanisms, involving the placement of some portion of the purchase price in the escrow account until certain conditions have been realized can limit the buyer's ability to effectively integrate the target into the acquirer's operations.

Successful integration of the firms requires getting the employees in both the firms to work towards the achievement of the common goals. This is achieved through trust and mutual cooperation.

An integration manager should be selected prior to the closing of the deal. Factors critical to the acquired company's success during the initial integration period like key managers, vendors and customers and what is needed to retain, these valued assets should be identified.

CLOSING

Closing is the final legal procedure where the company changes hands. It consists of all necessary shareholder, regulatory and third party consents. All the necessary legal approvals are attained at this stage. Considerable planning before closing is essential to minimize the obstructions that a target company may place before the buyer. Proper care must be exercised to ensure that all the necessary filings required by law have been made. Non-compliance with the law may delay or prevent the merger or acquisition. Many transactions also require approval of the shareholders of both the acquiring and the target companies before the ownership is legally transferred.

At the end of the closing phase a closing document is prepared which is a definitive agreement of purchase and sale that indicates all the rights and obligations of both the parties before and after closing. The complexity of the transaction determines the length of this document. The document mainly outlines the following features of the deal:

Purpose of Acquisition

The reason why the merger or the acquisition is taking place is mentioned.

Price

The purchase price or the total consideration may be fixed at the time of closing, subject to future adjustment or contingent to future performance as the case may be.

Allocation of Price

The allotment of the purchase price to both the parties is agreed upon. This helps in eliminating the chance that the parties involved will take different positions for tax purposes.

Payment Mechanism

Payment may be made at the time of closing by cheques or wire transfer. Some portion of payment can also be deferred by issuing a promissory note to the seller. A portion of the purchase price can also be put in escrow account to facilitate settlement of claims in future.

Assumption of Liabilities

In an asset purchase the assets which are to be accepted by the buyer are listed in detail. Those liabilities not accepted by the buyer are retained by the seller. In case of a share transaction or a merger, all the known and the unknown liabilities are assumed by the buyer.

Representations and Warranties

Representations and warranties cover all the areas which are of the greatest concern to both the parties. They are intended to provide for full disclosure of all the information relevant to the transaction.

Covenants

Covenants cover the obligations of both the parties between the signing of the definitive agreement and closing.

Conditions for Closing

Certain pre-conditions set in the definitive agreement have to be met before the close of the contract. The pre-conditions include the assumption that the seller would abide by the representations and warranties and will live up to the obligations under the covenants.

Indemnification

The seller at a later date in the definitive agreement will have to indemnify the buyer, the liability that may arise out of misrepresentations or breaches of warranties or covenants. Similarly, the buyer also indemnifies the seller. The period of indemnity is limited to usually a year.

Other documents which are required to complete the transaction of a merger or an acquisition are:

- Mortgages, loan agreements, trade names and trademarks.
- Supplier and customer contacts.
- Distributor and sales representative agreements.
- Stock option and employee incentive programs.
- Insurance policies, coverage and claims pending.
- Pending litigations for and against each parties.
- Articles of incorporation, bylaws and corporate seals.

POST-CLOSING INTEGRATION

This is the most important integration phase in the acquisition process. We will discuss this phase in greater detail later in the chapter.

POST-CLOSING EVALUATION

The post-closing evaluation is done to determine, if the acquisition is meeting expectations, to determine corrective actions if necessary, to identify what was done and what should be done to avoid making the same mistakes in the future acquisitions.

Success of the merger can be measured by evaluating the actual performance of the firm after the merger against the performance anticipated in the acquisition plan. Only a few acquiring firms closely monitor the performance of the acquisition according to the plan. Many firms commonly overlook this phase and fail to find out the effectiveness of the acquisition process. The lessons can sometimes be embarrassing, but help not to commit the same mistakes in the future acquisitions.

The success or failure of the deal determines which questions to ask when trying to collect the lessons learned. Whatever be the result, the questions are straight forward but the answers are invaluable.

Table 2: Postmortem Questions

What to ask after a Successful deal?	What to ask after the deal has failed?
What went well for the successful acquisition of the process?	Was missing the acquisition a gain or a loss for the company?
What were the problems encountered during the acquisition process?	If it was a loss what could be the better alternative?
How can the acquisition process be improved to uncover those problems earlier?	If it was a gain, what went wrong?
Is the acquisition in line with the expectation?	How could the flaws be identified earlier and how could the time be saved?

Source: Harvard Business Review on Mergers and Acquisitions.

PARTICIPANTS IN THE MERGER AND ACQUISITION PROCESS

Moving from the concept stage to a completed transaction requires a group of highly skilled advisors. Each advisor specializes in a specific aspect of the merger and acquisition process. Understanding the roles of the various players is helpful in identifying the type of resources required for a specific transaction. There are many professionals who play an essential role in the successful completion of a deal. The role played by such professionals can be explained as follows:

INVESTMENT BANKERS

Mergers and Acquisitions is one of the most admired departments in I-banking. It is a fee based advisory department which, works with companies in various industries that wish to acquire other companies. Such acquisitions could be in the form of combining of equal sized companies (mergers), or the purchase of a smaller company by a larger one (acquisitions). Mergers and Acquisitions departments of the investment banking firms also give consultancy services on strategy for hostile takeovers, as well.

Investment bankers are always at the forefront of the acquisition process. They offer strategic and tactical advice, screen potential buyers and sellers, make initial contact with a seller or buyer and provide negotiation support, valuation and deal structuring. Investment bankers help to identify the firm's strategic objectives and assist in evaluating alternative strategies for achieving these objectives.

The main objectives of an investment banker would be to assist companies in achieving their strategic financial objectives like growth, shareholder liquidity and maximization of shareholder value. To fulfill such objectives, the investment bankers provide the following services.

i. **Identification of Areas for Restructuring:** After understanding the long-term business plan, investment bankers help in identifying the business lines, products, technologies, processes to be hived off or acquired as the case may be. This stage involves an in-depth study of cost structures, make or buy decisions, financial viability, valuations, etc.

ii. **Buyer/Seller Identification:** On identifying the need, the buyers or sellers, are to be identified too. In this context, investment bankers can assist in identifying and interacting with the potential buyers or sellers and short list them for further plans of action.

iii. **Structuring and Valuation:** Valuation of businesses is the most critical aspect of M&A exercise. Equally critical is structuring the transaction. The transaction has an impact on cash flows, profitability and taxability. The structured solution has to optimize all these aspects.

iv. **Negotiations:** Through presentations and interaction the investment bankers negotiate the deal at the best possible terms. They bring to the table their rich negotiating experience of several deals.

v. **Legal Compliance:** Investment bankers also have adequate in-house expertise to handle the legal compliances of the transaction. This involves compliance with Company Law, Income Tax, and Excise and Sales Tax legislations. They also draft the legal agreements wherever necessary. They also help in obtaining the necessary RBI/Government approvals.

Table 3: INDATA Ranking of Investment Bankers In India, 2003

Rank 2003	Advisor	Number of Deals	Value of Deals Rs. mn	Value of Deals US $ mn
1	DSP Merrill Lynch	16	29,188	648
2	ICICI Securities	14	24,585	546
3	JM Morgan Stanley	10	16,470	366
4	Rabo India Finance	5	12,147	269
5	HSBC Securities & Capital Markets (India) Pvt. Ltd.	8	11,584	257
6	Pricewaterhouse Coopers Ltd.	12	10,384	230
7	Kotak Mahindra Capital Company Limited	6	9,591	213
8	Ernst & Young	10	8,569	190
9	Ambit Corporate Finance Pvt. Ltd.	12	7,808	173
10	KPMG Corporate Finance	4	7,517	167
11	JP Morgan	2	7,052	156
12	Citigroup (previously Salomon Smith Barney India Pvt. Ltd.)	10	6,386	141
13	McKinsey & Co.	1	6,241	138
14	ING Vysya Investment Banking	5	6,016	133
15	Lazard India	4	5,275	117

Source: www.dspml.com

Note: It is an annual INDATA survey of Corporate Finance deals in India, conducted by India Advisory Partners (IAP), an independent advisory group providing corporate finance advice on Indian deals to international companies. It includes deals with Indian targets only.

LAWYERS

The legal framework surrounding a typical transaction has become so complicated that no one individual can have sufficient expertise to address all the issues. In large and complicated transactions, legal teams consist of more than a dozen lawyers each of whom represents a specialized aspect of the law. The areas of expertise include tax, employee benefits, real estate, anti-trust, securities and intellectual property. In a hostile takeover the team may also include litigation experts.

ACCOUNTANTS

Services provided by accountants include advice on the optimal tax structure, financial structuring and on performing financial due diligence. A transaction can be structured in many different ways, with each having different tax implications for the parties involved. Tax accountants are vital in determining the appropriate tax structure. Accountants also perform the role of auditors by reviewing the target's financial statements and operations through a series of interviews with senior and middle level managers.

VALUATION EXPERTS

The valuation experts may be appointed either by the bidder or the target to determine the value of the company. They build models that incorporate various assumptions such as costs or revenue growth rate.

INSTITUTIONAL INVESTORS

Institutional investors include public and private pension funds, insurance companies, investment companies, banks and mutual funds. Although a single institution cannot influence a company's actions, a collection of institutions can. Such shareholders can announce how they intend to vote on a matter and advertise their position in order to seek support. Institutional investors now have more influence than ever before.

ARBITRAGEURS

When a bid is made for a target company, the target company's stock price often trades at a small discount to the actual bid. This reflects the risk that the offer may not be accepted. Arbitrageurs buy the stock and make profit on the difference between the bid price and the current stock price if the deal is consummated. They place themselves in a position to influence the outcome of a takeover attempt. Arbitrageurs also provide market liquidity during transactions. With the number of merger arbitrageurs increasing, they are becoming more proactive in trying to anticipate takeover situations. Their objective is to identify the target before the potential acquirer is required by law to announce its intentions.

POST-MERGER MANAGEMENT/POST-CLOSING INTEGRATION

For a merger to succeed, much work remains to be done after the deal has been signed. The strategy and business model of the old firms may no longer be appropriate, when a new firm is formed. Each firm is unique and presents its own set of problems and solutions. It takes a systematic effort to combine two or more companies after they have come under a single ownership.

All deals do not result in post-merger integration. Generally, acquirers tend to fall under two broad categories – strategic buyers and financial buyers. Financial buyers buy a business to ultimately sell it again. They do not buy the new company with an intention to integrate the acquired business into the existing entity. They do not try to manage the business. They only provide the financial support. On the other hand, strategic buyers intend to integrate the acquired company into the existing entity. They are interested in making a profit by managing the business for a long period of time. The strategic acquirer may choose to manage the acquisition as a separate subsidiary in a holding company environment or merge it with another business. In this chapter, we will look at only such strategic acquirers who acquire a firm and who intend to integrate the target company with its own entity.

Post-merger integration is an important stage of the mergers and acquisitions process. The integration process is useful to achieve proper staffing requirements, eliminate redundant assets and generate the financial returns expected by the shareholders. The path towards post-merger integration involves a series of decisions. Integration can create a sense of shared purpose for everyone in the newly combined company. This helps the employees to take up rather than resist the change in the newly formed enterprise.

Everything that is useful should be combined. Hence, a merger involves combining both domestically and globally all resources, processes and responsibilities of the buying and selling company. The resources of a firm include human resources at the board, management, and support levels. Moreover, financial, tangible and intangibles resources (company name, brand name of the seller) should also be integrated. The processes of a firm include the management systems, their compensation plans, etc. Finally, the responsibilities include their commitment to various stakeholders (customers, suppliers, shareholders, bondholders, employees and society), to the law, etc. The final integration will be to combine the newly integrated resources, processes and responsibilities into one single successful whole.

There is no one best particular way to integrate two organizations. There is also no defined process or a method that can guide integration planning and decision-making.

DUE DILIGENCE

The integration process begins with due diligence. "A large part of what makes a deal successful after you complete it, is what you do before you complete it".

– *S Barr, CFO Magazine.*

Before the closing of the deal, the buyer should engage in a thorough due diligence review of the seller's business. The purpose of the review is to detect any financial and business risks that the buyer might inherit from the seller. The due diligence team can identify ways in which the assets, processes, and other resources can be combined in order to realize cost savings and other expected synergies. The planning team can also better understand the necessary sequencing of events and the resulting pace at which the expected synergies may be realized. Considering how and over what time period the integration will be implemented is important in determining the magnitude and timing of the cash flows of combined companies used in making the final assessment of value.

The integration planning involves human resource, customer and supplier issues that have to be addressed when there is a change in ownership. These issues are resolved as a part of the acquisition agreement. Buyers have the opportunity to use the results of the due diligence investigations to insert into the agreement the appropriate representations (claims) and warranties (promises). The acquisition agreement between the buyer and the seller can also set conditions for the post-merger integration at the consent of both the parties. For instance, the firm which is being acquired can insist on continuing authority for its CEO.

An acquisition agreement has a great impact on the future life of the new company. It can strengthen a merger by eliminating potential future controversies and establishing useful guidelines for future behavior or it can weaken it by creating more problems than it solves.

Due diligence identifies, validates or disputes the business reasons for the proposed merger or acquisition transaction. The challenge for many M&A teams is collecting and going through vast amounts of data to make a rational purchase decision, often under extremely tight time constraints. Due diligence for mergers and acquisitions requires broad and deep data analysis of assets and liabilities, including large balance sheet items such as accounts receivable, inventory and accounts payable to establish fair market value. It also means analyzing collections of receivables and inventory to identify doubtful accounts or obsolete stock, and analyzing cash receipts and billing files using historical trends to assess the reliability and adequacy of cash flows. To effectively discharge due diligence on these activities powerful analytical tools, which can handle various data with speed and confidence are required.

Elements for Successful Integration

Issues involved in post-merger integration ranges from managing cultural differences to integrating employee's compensation and benefit systems to standardizing operations. The key elements identified for a successful post-merger integration are as follows:

Vision: In many successful mergers, as soon as the merger is announced, the companies form an integration team, which acquires information from the managements of both the companies about their expectations. Senior management executives in both companies also have discussions on the future vision, goals, values and policies of the new company. This helps design a vision for the new entity. While creating a new vision, it should be ensured that integration enhances the shareholder value. The information gathering process should also ensure that there is less resistance to change to speed up the process.

Strategic Leadership: The next important thing is to appoint a key executive, who has the ability and influence to organize resources to carry-out a smooth transition and integration. The executive is responsible for the entire integration process, from planning to implementation. Often, this leader also happens to be the head of the joint integration team. Alternatively, there can also be a separate head for the integration team, who forms a link between the operational level and top management.

Action Plan: Successful mergers have in common a comprehensive plan and implementation process that is effective and also shortens the integration period. The plan should have clear-cut definitions for various responsibilities and should be periodically reviewed by the integration team. The integration process should be streamlined to increase efficiency.

From the above it is clear that what we need is a comprehensive method that can be customized to each specific organization and purpose. Let us look at one such model.

THE MERGER INTEGRATION WORK STREAMS MODEL

There are different but strongly interdependent and continuing sets of responsibilities that are critical for the success of any merger integration. They are:

i. Integration leadership roles and responsibilities,

ii. Integration planning and implementation,

iii. Communication,

iv. Structure and Staffing,

v. Re-recruiting,

vi. Cultural Integration,

vii. Human capital related integration,

viii. Measurement and feedback, and

ix. Project Management.

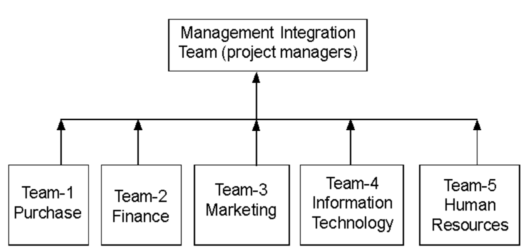
Integration Leadership Roles and Responsibilities

Integration begins with a clear strategic direction, objectives and a determination of the primary value drivers of the combined entity. Both the firms come to an agreement regarding the integration process and the time to be taken to complete the process. Important governance issues and the desired level of integration for the new company are discussed as early as possible since they have a significant impact on the strategic planning of the business.

The post-merger integration organization should consist of both a management integration team and a series of integration work teams. The project managers and the team who would work on the process are selected from both the companies. The responsibilities are shared by the executive staff of both the companies so that coordination and communication become a critical link.

Each team known as task forces would be responsible for integrating a specific portion of the integration plan. The team's primary responsibility is to coordinate the task forces and the overall process. The task forces make up the majority of the integration infrastructure. The task forces together with their respective teams are primarily responsible for designing transition plans, capturing synergies, and implementing the action items required for successful business integration.

Figure 1: Model for Integration Infrastructure



Other team members might include advisors, such as investment bankers, accountants, attorneys and consultants. To be effective, the work teams should have access to accurate timely information and adequate resources.

Box 1: Key Management Integration Team Responsibilities	
1.	Building a master schedule of what should be done, by whom and by what date.
2.	Determining the required economic performance for the combined entity.
3.	Establishing work teams to determine how each function and business unit will be combined (for example, structure, job design and staffing level.)
4.	Focus the organization on meeting ongoing business commitments and operational performance targets throughout the integration process.
5.	Create an early warning system consisting of performance indicators to ensure that both the integration effort and the business stay as planned.
6.	Monitor and expedite key decisions.
7.	Establish a rigoros communication campaign to aggressively and repeatedly support the integration plan, addressing both internal (employees) and external (customers, suppliers, etc.) constituencies.

Source: Donald De Pamphilis – Mergers, Acquisitions and Other Restructuring Activities.

The leaders of the task force should be those individuals who are senior having the authority to get things done. The task forces, like the core integration team should include balanced representation from both the companies. This balance serves as a symbolic and a purely practical business necessity. The teams leading the task forces should be encouraged to bring in ideas into the process to cultivate creativity by encouraging solutions rather than by dictating processes and procedures. The teams should be given access to adequate resources, accurate and timely information, as well as timely feedback.

Task forces can also form sub-teams (composed of people of both companies) to serve as primary matter experts, planners and implementers of major sub-categories of issues. For instance, the task force in human resources can create various sub-teams for compensation and rewards, retirement, health and welfare, etc. Each team will be responsible to coordinate with other sub-teams and task forces on issues of mutual dependence.

Planning and Implementation

During the negotiation stages of the merger deal only, the parties to the deal should begin planning the integration of the two businesses. Guidance should be obtained to set the appropriate time to begin integration planning and to establish deal specific protocols that will govern the sharing of information and the coordination of activities.

An initial meeting is organized to provide a coordinated start to the planning process. The objectives of such a meeting include gaining clear understanding of the task force's purpose, roles, responsibilities, deadlines and other issues. The leaders of the task force are given an overview of the deal, the expected synergies and the strategic parameters that have already been decided as a result of the negotiations. The meeting gives an early opportunity to identify and discuss potential functional and cultural differences.

Preparation of the Charter

Given the complexity of merger integration the task force's initial step in the planning process should be to provide a detailed, customized charter to help their sub-teams start on the job quickly. The charter serves several important purposes which include planning, role clarification, resourcing, scheduling, establishment of accountability and responsibility, etc. The charter typically includes:

Objective Statement: The objective statement describes the goal of the new organization.

Specific Synergy Targets: This lists all the present known synergy possibilities that fall under each task force's responsibilities. The description of the project along with the estimated value of the target, the time for accomplishment and the list of any other task forces that are linked with this synergy are given.

Sub-team Resourcing Requirements: It contains the list of key individuals who should be involved in the various issues and responsibilities of the task forces.

Data and Documentation Requirements: This gives specific requests for information that will be needed for sufficient understanding of the partner organization and its relevant business processes.

Initial Identification of Issues: This component identifies issues, tasks, responsibilities, policies, decisions, synergy explanations and other points that require thorough planning for the transition.

Integration Plan Document

The integration plan document outlines the specific expectations for the integration plan and gives examples of the types of data and the level of data required which depends on the level of transaction's scope, timing, complexity, objectives and the synergy targets that have been identified.

Box 2: Steps in the Planning Process
The task force planning and implementation process typically takes place as follows: 1. Current situation is analyzed to get a basic understanding. 2. Data is collected and documented in information, process maps and measures. 3. The integration solution is identified and the integration process designed. 4. Integration plans are developed and the road map for installation is made. 5. Approval is obtained from the top authorities to go ahead with the integration project. 6. Detailed preparation of the procedure to implement the proposed design is made through announcements, scheduling, etc. 7. Training sessions are conducted to aid in the installation activities. 8. Every step in the implementation activity is measured and monitored and any deviation from the standard is adjusted. 9. The integrated firm is handed over to the management or the owners. 10. Finally, the integration project is completed.

Source: Donald DePamphilis – Mergers, Acquisitions and Other Restructuring Activities.

Successful merger integration results from careful planning followed by effective implementation. The implementation of the integration plan starts with communication and includes organizing the structure of the new company, its staffing, cultural and functional integration.

Communication

At the time of a merger or an acquisition transaction communication has to be used effectively so that rumors do not become the main source of information to the stakeholders. Before the public announcement of an acquisition or a merger is made the integration team should prepare a communication plan. The plan should contain the key messages as well as the specifications of target stakeholders and appropriate media for conveying the messages to each group.

An effective communication in a merger and acquisition transaction is guided by the following principles:

i. **Communication should be a Priority and Linked to the Strategic Objectives of Integration Effort:** Any message about a particular goal should always be communicated along with adequate reasons for doing so and the benefits likely to be achieved out of it. The messages should be conveyed to all the stakeholders who will be the most effected by any change.

ii. **Communication should be honest:** All stakeholders should be made aware of the realistic limits and goals so that they would be prepared to face any worst scenario. Changes in the work practices and compensation may be viewed as breaking on commitments made by the prior management. This may result in losing of key employees besides de-motivating them. To minimize this, potential changes must be explained honestly and precisely so that they can understand why they are being made.

iii. **Communication should be proactive:** Unless the announcement of a merger would harm one or both the parties the communication process should be started well in advance with ample lead time and should be spread early so that a defensive position is not needed when people get to know about the merger.

iv. **Communication should be consistent:** It should be ensured that the communication to all stakeholders is consistent. Consistent communication helps people to absorb and internalize the true content of the messages. It conveys the intention of the new organization to live up to commitments made to its major stakeholders. It is a first step to build-up confidence between the management of the new company and its stakeholders.

v. **Communication should be repeated through various channels:** Communication should be made through various channels like newsletter articles, internal memos, videotapes, and specifically face to face interaction. The last is the most effective change management tool available to management. Regular scheduled meetings also form an excellent medium of communication during the crisis period. All external communication in the form of press releases should be coordinated with the public relations department to ensure that the same information is released to employees. Internal e-mail systems, voicemail, or intranets may be used to facilitate employee communications.

vi. **Communication should be two way:** An organization should establish mechanism for two way feedback. All stakeholders should get an opportunity to give and get feedback during the design, testing and implementation of all change factors. Feedback is obtained on all work processes that will be integrated, on specific goals set to be achieved during the Mergers and Acquisitions transaction and also the lessons to be applied to future mergers and acquisitions.

A special department can be formed which is given the responsibility to take care of the entire organization-wide communication. The department may help formulate messages, set-up delivery channels, create opportunities for communications and conduct communication events. If a merger related communication is poorly planned, the results may be unclear roles, insufficient follow-up, and lack of fine tuning once the implementation has begun. On the other hand a well-designed and planned communication plan breaks down barriers to change.

Box 3: Develop and Implement a Communication Plan

Availability of accurate and reliable information has an important role in managing the changes which follow the takeover. The acquiring organization, therefore, must make a consciously planned and systematic effort at informing people about its plans, policies, corporate values, etc. It is also necessary to regularly update people regarding the changes occurring in the organization (its strategies, structure, procedures, etc.) through an extensive use of a variety of channels of communication, example, meetings, circulars, house journals, etc.

For instance, when Esab India Ltd., tookover the welding division of Indian Oxygen Ltd., in 1991, within a year it found tremendous cultural frictions between the new and the old staff. The three newly acquired factories were operating as islands, with little integration with rest of the organization. Things started changing, when in 1993, the company created channels of communication between the old and the new divisions. Day-long fortnightly meetings were organized for different levels of management. These meetings would start with an overview of the company's financial and marketing issues given by the Managing Director, and would be followed by discussions on specific operational problems.

> It is important to note that the aim of these communication efforts is not to tell the employees only about the positive side of the changes; this may, in fact, create more misinformation, and, in the long run, harm the credibility of the new management. Nor it is necessary for the management to wait till they can provide the "final" picture; besides the fact that people do not really expect stability to arrive very soon after the takeover, the delay in receiving information would confirm their worst fears, and aggravate their anxieties.

Source: www.geocities.com

A communication plan during an integration effort typically consists of four phases. In the first phase the merger or the acquisition is announced to everybody.

In the second phase, various issues that may arise during the integration process are identified. These issues would arise from all the stakeholders (customers, suppliers, shareholders, lenders, employees and others) who would like to know how changes would affect the overall strategy, share prices, business operations, job security, working conditions, total compensation, etc. The human resource department should learn what employees know and want to know, what the prevailing rumors are and what the employees find most confusing. This can be achieved through surveys, interviews, focus groups or employee meetings.

In the third phase, the rollout occurs where communication should include information about the proposed changes. This should be followed by training to employees in the new skills, roles and methods that are required to manage the merged unit.

In the final stage feedback is obtained and the implementation of the integration plan is fine tuned wherever warranted.

Re-Recruiting

Retaining the Key Employees

People often leave organizations during mergers and acquisitions. Even when the key personnel remain on board, they lose their commitment, especially when the environment becomes unstable, uncertain or changes dramatically as is certain to emerge during mergers and acquisitions.

To retain the key employees, the integration team should formulate a re-recruitment plan which involves: (i) Identifying key people or groups, (ii) Understanding what motivates them, and finally, (iii) Developing and executing an action plan to address what motivates them.

i. **Identifying Key People or Groups:** People whose absence would have the most detrimental effect on the organization are the key people. All the employees who will be affected by the merger or the acquisition are identified and a list is made. The impact of their absence on the business is estimated. An employee is considered vital or important if his absence results in the loss of a key client or loss of knowledge about a core product or service or loss of crucial skills in project management.

ii. **Factors that Motivate People –** The factors that motivate people are:

    Security: All employees look for security of their job as the most important aspect at the time of a merger or an acquisition. Job security thus becomes the basic issue at all the levels of the organization during mergers. For all employees who have been identified as key, it is important to communicate that their jobs are secure at the early stage itself. Key people need to realize that they are integral to the success of the merger and they would have an important role to play in the future success of the new organization. They also need to be communicated of their pay, benefits and the potential for increment. Sometimes, "stay bonuses" are announced to protect the loss of key people until the initial reactions to the merger or acquisition have settled down. This gives some time to the decision makers to determine the dynamics of the new organization and the roles that people will fit into without the fear of losing people in the meanwhile.

Inclusion: To maintain the loyalty of key people during the merger and acquisition transaction, the company should involve the key people in the meetings or in the integration process or by sharing regular information with them. Letting the key people know what is being discussed and asking for their inputs make them feel a part of the organization.

Control: The key managers and executives develop a certain addiction to control over how things are handled and they want to maintain that control. This need to control can be satisfied if some of the merger related decisions are left to them.

Ego: The key employee's ego can be fed during integration by giving rewards like bonuses for accomplishments, inclusion in the integration process, etc.

iii. **Developing and Executing an Action Plan:** Once the key people and the key motivators are identified actions are to be taken to retain key people during a major change. Individuals or the groups who are important to the organization's future success are identified and the impact of losing them is quantified. This is compared to the cost of retaining them in the organization. Re-recruitments actions are then initiated.

Additionally, exit interviews are conducted for employees who have announced their resignations. Exit interviews can be a valuable tool in understanding how the integration that the company is undertaking is affecting employees' general fear about the happenings in the merged unit and their motivation to stay.

STRUCTURE AND STAFFING

Effective planning and staffing for a post-merger organization is one of the most important integration works.

Structure

A properly structured organization should support the acceptance of a culture in the new company that is desired by the top management. The structure of an organization depends on the previous organization charts and the needs of the business. The previous organization charts provide insights into how individuals from both the target and the acquiring company will interact within the new company since they reveal the past experience and also the future expectations of individuals with regard to reporting relationships. Structure should also facilitate decision-making, provide internal controls, and promote behaviors consistent with the mission and principles of the new company.

There are three basic organizational structures: (i) Functional, (ii) Product or Service, and (iii) Divisional.

i. In a functional organization, the people are assigned to various departments such as finance, marketing, sales, customer service, etc. This type of structure is highly centralized.

ii. In a product or service organization the functional specialists are grouped, based on product line or the service offering. Each product line or service has its own functional staff. This type of structure is more decentralized.

iii. In divisional organization structure, the groups of products are combined into independent divisions or strategic business units. Each unit has its own management team and is highly decentralized.

Centralized vs. Decentralized

A decentralized structure may slow down the pace of integration, as there is no single authority to determine policies. On the other hand, a centralized structure may make the post-merger integration much easier since the senior management has the authority to dictate policies and govern all aspects of the combined companies. Though centralized management provides easier integration, it can also be detrimental if the policies imposed are not appropriate for the operating units.

Instead, a right structure during the integration phase may be an evolving one. The structure may be centralized during the initial integration phase so that decisive and timely action can be taken based on the available information. Once the integration is relatively completed, the new company can move to a more decentralized structure.

Merging the Corporate Boards

Mergers have significant impact on the boards of both the companies. In a merger of companies of comparable size, the members of the boards of both the firms are merged into the new company board. As part of the merger agreement, a planned reduction in the board of the combined company is made. In a merger between firms of different sizes the smaller company's board will not generally be included in the new company's board when the target company is fully integrated with the acquirer. However, if the acquired company is to be operated as a subsidiary of the acquirer its board may remain the same.

Integrating Senior Management

The historical performance of the individual companies and their respective organizations will provide a crucial insight into the selection of the appropriate candidates for the senior management positions in the new company. The team should agree on a new strategy for the combined companies and select people who are best suited to implement it.

Integrating Middle Management

Like the senior management level, middle level jobs should also be given to people having superior integration skills. Senior managers should be given the responsibility of selecting the middle level managers.

The process for creating a proper structure requires inputs from all the levels of management. It should be consistent with the combined firm's business strategy. Before establishing a structure, the integration team should agree on the specific functions that need to be carried out to run the combined business. These should reflect the specific roles and responsibilities of each function. Once the functions have been identified, the personnel required for executing each function have to be identified from the available workforce within the organization and local community, describing the ideal structure to meet the roles and responsibilities assigned by the senior management.

Functional Integration

The integration team also has to determine the extent to which the operations and support staff are to be centralized or decentralized. The main areas of focus for integration should be: information technology, manufacturing and operations, finance, sales, marketing and research and development.

i. **Manufacturing and Operations:** The integration process involves re-evaluating the overall capacity, identifying the potential for future cost reductions, determining the age and the condition of facilities and the compliance with environmental laws. Manufacturing capabilities which duplicate the capabilities of the acquirer should be considered and the better of the two selected. The production planning and materials ordering functions need to work closely together, because the quantity and composition of the materials ordered depends on the accuracy of sales projections. Consolidation of plant starts with the adoption of a common set of systems and standards for all the manufacturing activities. Certain facilities can be closed when there is excess capacity.

ii. **Information Technology:** Each company's quality and effectiveness of systems is revalidated and a new information system is established. The process should focus on hardware, software, technical support, communications capabilities, and compatibility of existing systems.

iii. **Sales:** The extent of integration of sales force of the two firms depends on their relative size, the nature of their products and markets, and the geographic location. A small sales force can be combined easily when the products sold are similar. The sales force should be kept separate if the products sold require an in-depth understanding of the customers' needs and a detailed knowledge of the product. The sales force should also be kept separate when the product or service is sold to specific markets. Integration of the sales force may result in significant cost savings by eliminating duplicate sales representatives and reducing travel, entertainment and training expenses.

iv. **Marketing:** The degree of integration of the marketing function depends on the global nature of business the diversity and uniqueness of product lines and the pace of change in the marketplace. A worldwide operated business is inclined to decentralize marketing operations with more concentration on the local markets.

v. **Purchasing and Supply Chain Management:** Managing the purchasing function and supply management of the merged firm efficiently can reduce the total costs of goods and services purchased by merged companies by 10-15%. The newly combined company may choose to realize savings by reducing the number of suppliers by identifying the most critical suppliers of both the acquirer and the acquired companies.

vi. **Research and Development:** The integration team responsible for managing the integration of R&D activities needs to define future areas of R&D collaboration and set priorities for future research subject to senior management approval. Research of both the companies can make a detailed effort and get to know each others' work. The projects are ranked according to their impact on the key stakeholders. The projects receiving the highest scores are then funded while the rest are discarded.

Staffing Plans

Following the determination of the appropriate organizational structure and the pool of current and potential employees available to staff the new organization, a detailed staffing plan can be developed. Some employees are generally lost in the efforts to form a new company. Other employees who have remained with the organization have to be trained to fill the critical positions. An early development of staffing plan provides an opportunity to include key personnel from both the firms in the integration effort.

Compensation

Merging the compensation plans is one of the most challenging activities of the integration process. The extent of integration of the compensation plans depends on whether the two companies are going to be managed separately or remain integrated. When the companies are to be integrated, the new plan will be designed in consultation with the acquired unit's management.

Staffing Process

The organization should provide a variety of process maps, tools and templates for the managers and employees to use when candidates are to be rated and interviewed and staffing decisions are made. The following are a comprehensive model of staffing:

a. The areas of priority are identified and a comprehensive plan for rationalization and consolidation is developed. The strategic business plan and major parameters of the deal are combined with specific due diligence information and cost projections to provide a variety of scenarios to senior managers.

b. The mission critical jobs, which are needed in carrying out the business plan of the new organization are identified and assessed.

c. The specific skills required on the mission critical jobs are established. Data is collected from the existing as well as new sources of information.

d. The required skills for each job is defined and noted down so as to accurately portray the specific behavior, attitudes and actions that the organization perceives as essential to the success of those particular roles.

e. A list of all the candidates from both the companies is prepared. Other interested candidates are also considered.

f. Multiple raters are asked to make a survey and assess each candidate against the set competencies.

g. Team interviews are conducted. A competency based interview guide is then used to determine specific evidence of the candidate’s behavior and achievements in each major competency area.

h. The rating team meets to decide on the final candidates. Specific details are discussed with respect to creating the best offers and opportunities for all candidates involved.

i. A communication plan is prepared and completed. The successful candidates are notified of their selection after the approval of the functional executive officer.

j. The hiring managers individually meet the selected candidates to plan approaches to key issues, work out details of the transition to the new organization, set priorities and define the developmental opportunities. Additional orientation and training is given to employees who are selected from the acquired and the other organizations.

Structure and Staffing decisions are always very difficult to be made and always charged up politically. The following are the general principles to be followed while making any structure and staffing decisions:

a. The structure and staffing decision process should be started with a due diligence analysis of the human capital and the organization in general. Such formal process should be used to discover, compare and contrast organizational structures, depth of talent, management processes and individual styles. Various situations of reduction in number of employees and consolidation are developed and their costs estimated so that an approximate range of total staffing synergies can be provided along with their costs of implementation.

b. The structure and staffing decisions should be based on strategic considerations and on the determination of the new company’s organization business plans. A strategic guide identifies the facilities to be closed or consolidated, products to be updated or exploited, research initiatives to be funded or discontinued and other business processes to be used in the new company. Only when this strategic translation process takes place will it be possible for the task forces to determine the exact work requirements, structures, role descriptions and staffing needs in order to carry out their specific functions in the new organization.

c. Structure and Staffing decisions should start as early as possible. To gain a full understanding of the important relationships and realities of the new organization people need to see an organizational chart. An organizational chart serves as an essential clarification and instructional role, helping to improve the effectiveness of communication and decision-making processes and developing an atmosphere of common understanding. It also provides an opportunity to include the key personnel from both the firms in the integration effort.

d. The two organizations involved in the deal will need to determine their own optimal level of involvement and assessment. Inputs should be obtained from the current organization, the new organization and the current hiring manager and the data from an external assessment tool or an interview with an outside professional.

e. Communicate openly about the process to make decisions on structure and staffing. The greatest barrier to change in any kind of organization is the organization's lack of communication about tough structural and staffing decisions. The information about the process that will be followed in making structural and staffing decisions should be widely propagated throughout the organization.

f. In order to work effectively the hiring managers have to be trained about the steps and responsibilities of the selection process.

g. Identify and correct the mistakes. Any mistake which has been made in the structure and staffing decisions should be identified and corrected promptly. This kind of response is required to set and maintain the objective as expected.

h. **Capture and Retain Knowledge:** Many key people are likely to leave the organization during the time of a merger or an acquisition. Thereby the organization loses the technical talent. This can be avoided by conducting exit interviews with such candidates. Some acquirers pay knowledge bounty to prevent institutional knowledge from leaving the organization along with the departing employees.

i. **Start the Development and Team Building Process:** The new team formed should be brought together as quickly as possible to help with the necessary steps of formulating and establishing an identity. This is necessary to promote clear understanding and commitment of the new organization's strategy, business plan, its core values and cultural objectives.

An enterprise fails to establish proper and effective structure and staffing process under the following conditions:

i. **When the Acquirer makes all Staffing Decisions Independently:** When the acquirer makes all the decisions, there is every scope for a bias to creep in the selection procedure. Many able and capable people may not even be considered. A new organization primarily with all its managers from the acquirer company will then be unable to capitalize on the acquired company's assets.

ii. **When the Staffing Decision is made at a Later Date:** When an organization takes the 'wait and see attitude' and is initially unwilling to spend the time required to make difficult decisions about structure and staffing is ultimately prone to fail to establish a proper process for structure and staffing. Press announcements further complicate this attitude by creating unrealistic expectations.

iii. **When the Acquirer Plans to Employ a New Team:** Sometimes, the acquirer plans to employ new staff completely. This option is not practical in today's times where separation and the loss of institutional knowledge might prove to be too costly.

Cultural Integration

Culture refers to the common set of values, traditions and beliefs that influence the behavior of a person. Large and diverse businesses have a culture and a series of subcultures that reflect the local conditions. When two companies with different cultures merge, the newly formed company will take on a new culture that may be quite different from either the acquirer's or the target's culture. A company's culture is created and continuously strengthened by processes that take place in –

a. Rules and policies,

b. Goals and measures,

c. Compensation and recognition,

d. Staffing and selection,

e. Training and development,

f. Ceremonies and events,

g. Leadership behavior,

h. Communication, and

i. Organizational structure.

The above factors collectively make up the environment that surrounds the work force which in turn builds the organizational culture.

The cultural issues specific to a company depend on size and maturity, on the industry in which the company is operating, and also the geographic location.

i. **Company Size and Maturity:** Companies operating in the introductory stage are usually unstructured and informal in terms of certain rules and regulations like the dress code, etc. Compensation may largely contain stock options and other forms of deferred income (though not very common in the Indian corporate world). Company policies are either non-existent or not in the written form. On the contrary, firms in the mature phase have structures well-defined internal controls, compensation structures and employment policies. Employees have clearly defined job descriptions.

ii. **Industry:** High technological firms irrespective of their size are often more informal and flexible in terms of the working hours, dress code, etc. Companies dealing directly with the public often have a formal dress code and require a high level of decorum to instill a sense of confidence and trust in the public.

iii. **Geographic Location:** Integrating companies situated in two different parts of the world (cross-border transactions) face language barriers and different customs, working conditions, work ethics and legal structures creating an entirely new set of challenges. If the cultures are extremely different, integration may not be appropriate.

iv. **A New Corporate Culture:** When two different companies with different corporate cultures merge a new culture may emerge in the combined firm that may be noticeably different to the previous cultures of the individual companies. Generally cultural differences are less in mergers taking place in the same industry and of comparable sizes than in cross industry or cross-border transactions and companies of different sizes and maturity. A company's culture is something that evolves over a long period of time and hence any change in culture has to be carefully managed.

The first step in achieving cultural integration is to develop a cultural profile of both the target and the acquirer. The data or the information may be obtained from the employees, surveys, interviews and by observing the management styles and practices in both the companies. The information is then used to analyze how different or similar both the companies are and the competitive strengths and weaknesses of the two cultures. After a thorough review of the information the senior management must decide those characteristics of both cultures that are to be highlighted in the new business.

Techniques for Integration

Sharing common goals, standards, services and space can be highly effective and practical way to integrate different cultures.

Shared Goals: Common goals drive different units of an organization to cooperate and work together. For instance, at the functional level similar procedures for the new product development can propel the different units of the organization to work together as teams to launch the product by the target date. Although having common goals is very useful for the integration process, specific goals of individuals are also important.

Shared Standards: Shared standards or practices enable the adoption of the best practices found in one unit by the other unit. The standards of a company include operating procedures, technological specifications, ethical values, internal controls, employees performance measures, comparable reward systems, etc., throughout the combined companies.

Shared Services: Some of the services can be centralized. These centralized services provide services to the other operating units. Usually, centralized services include accounting, internal audit, legal, public relations, etc.

Shared Space: Integration of acquired company's and target company's employees in the same offices is a highly desirable way to improve communication and idea sharing. Sharing the same research centers, library, etc., also facilitates communication and cooperation.

Box 4: Humanizing Corporate Takeovers

A successful takeover, above all, calls for a synthesis of two dissimilar cultures. The acquiring company, for example, may have an entrepreneurial and risk-taking style of functioning, while the target company may have an extreme bureaucratic and procedural orientation. Such cultural collisions have an unsettling impact on employees of both the organizations. It is necessary, not only to familiarize the new management team about the cultural differences, but also helps to develop relevant skills for managing through them. Similarly, in the post-takeover phase, joint workshops for the key and influential executives of both the organizations can be of immense help in sharing mutual perceptions and evolving a common understanding of the problems of transition.

For instance, when Godrej Soaps took over Trans elektra Domestic Products, it managed the transition with a clear focus on enabling the employees to manage the change. Several rounds of meetings were held with the managers of Transelektra to alleviate their anxieties. In addition, many middle-level managers were sent to various Godrej sites for training so that they could have a first-hand experience of the kind of systems and practices which were likely to be brought into Transelektra. Later, these managers were made the change agents to train the Transelektra people, which also helped in smooth transition.

Source: Dr. Madhukar Shukla – Humanizing Corporate Takeovers, www.geocities.com

Human Capital Integration

Some functions bear more responsibility for the overall integration success and the human resource function is one of them. The human resource role plays a strategic role for enterprise wide integration and a support role for business units in transition.

The greatest difficulty in most merger deals has been consistently found to be people and cultural issues, areas over which the human resource can exercise some positive influence. The human resource backed by a supportive and proactive senior leadership team has the greatest ability to influence integration results in a positive direction. The human resource function has priorities that fall under two distinct phases. The first phase includes transition responsibilities like organizational structure, selection and staffing, compensation, benefits and retention. The second phase includes responsibilities for full integration like rationalization and alignment of all the acquired company's organizational and human resources, processes, to directly support the business objective of the new company. Proper human capital integration eliminates proliferation of practices that no longer support business needs. They help in quickly and powerfully reinforcing the new culture and drive the behavior of the employees toward key objectives.

Measurement and Feedback

During the integration process there should always be sufficient mechanisms for tracking and reporting on the results. This can be done with the use of different types of merger integration measures. The formal tracking of an integration process helps perform the following functions:

- Determine whether the transition is proceeding according to plan.
- Ensure a good flow of communication.
- Stress upon the need for corrections in the course of integration.
- Involve more number of people in the combination process.
- Send a message about the new company's culture.

Usually, separate but interrelated measurement processes must be continually managed in the following areas during merger integration.

i. **Integration Measures:** These measures are necessary in assessing specific integration events and hence determining whether the overall integration approach in accomplishing the mission of leading the organization through the process of change. Brief surveys of the task force members and employee focus groups are some of the examples of these measures.

ii. **Operational Measures:** These measures are necessary in identifying the impact of the merger on the ability of the organization to conduct its continuing day-to-day business. A business must continue in the midst of the most disruptive conditions. Examples of such measures include statistics that indicate variation in the production or quality, inability to process accounts receivable in the timely manner, etc.

iii. **Process and Cultural Measures:** These measures are necessary to determine the status and the effectiveness of the condition of merger driven efforts and cultural integration efforts to revamp the business processes or elements of the organizational culture. Examples of such measures include reports on the status of completion of the task forces integration plans, surveys, focus group for the employees, etc.

iv. **Financial Measures:** These measures are necessary in tracking and reporting on whether the organization is achieving the expected synergies of the deal. Summaries of the actual synergy projects in process, elements of a synergy process, are some of the examples of such measures.

Project Management

Project management is a central part of the integration planning process. Successful merger integration results from careful planning followed by effective implementation and follow-up. Making project management a dedicated core function of the integration process will pay-off in many ways. Some of the tools and processes that help in project management are:

a. **Integration Timeline:** An overall integration timeline helps in having an effective grasp of key steps in the process of integration. The executive staffs of both the companies are briefed on the integration process before the public announcement of the merger. Such an arrangement gives enough time for the project managers to be selected and to start off the planning for the integration immediately after the initial public announcement. The integration timeline should be flexible and revised as and when the project progresses. It is used as a regular element of communication, to advise the organization of what progress has been made and the essential steps to be taken at a particular time.

b. **Consolidated Project Plan:** A consolidated project plan is a fundamental tool in keeping the overall integration effort moving. This tool involves the consolidation of the individual task forces' plans into one comprehensive plan for integration. The particular components are owned and managed by individual task forces, but the overall consolidation plan and its distribution are managed by its core team. The consolidation project plan helps in:

- Prioritizing the work which drives the deal value directly and are obligatory for accomplishing the core work.
- Establishing accountability to the executive staff, the core team members etc. The review is aimed at assessing the progress and the priorities.
- Furthering communication and involvement throughout the organization.
- Reporting the progress of the integration process at every stage of the project.

REASONS FOR FAILURE OF MERGERS AND ACQUISITIONS

There are various reasons why mergers and acquisitions fail. The most common of these reasons are:

i. **Payment of High Price:** The key to a successful M&A is when the maximum price and not a penny more is paid. While the shareholders of the acquired company, particularly if they receive cash, do well, the continuing shareholders are burdened with overpriced assets, which dilute future earnings. This will come into sharp focus in the year following the merger as companies are forced by the new merger accounting rules to revalue and write off goodwill booked in prior-year acquisitions.

ii. **Culture Clash:** Lack of proper communication, differing expectations, and conflicting management styles due to differences in the corporate culture contribute to failure of implementation plan and hence failure of the merger.

Box 6: Humanizing Corporate Takeovers
One of the reasons for the dismal performance of the Warner Hindustan-Parke Davis merger was the absence of a well-defined strategy to merge the two cultures. Both were well-established companies with strong, but different cultures: While Parke Davis was a people-driven company with a participative culture, Warner Hindustan was a more task-focused and formal organization. Even though the merger focused on rationalizing the facilities, restructuring and allocation of designations, the cultural and procedural issues were left unattended. The differences in the cultural orientations and operating rules created many operational bottlenecks and resulted in lowering of performance.

Source: Dr. Madhukar Shukla – Humanizing Corporate Takeovers, www.geocities.com

iii. **Overstated Synergies:** An acquisition can create opportunities of synergy by increasing revenues, reducing costs, reducing net working capital and improving the investment intensity. Overestimation of such synergies may lead to a failure of the mergers.

iv. **Failure to Integrate Operations:** Once the firms merge management must be prepared to adapt plans in the light of changed circumstances or inaccurate prior information. Inability to do so plans leads to the failure of the merger.

v. **Inconsistent Strategy:** For mergers and acquisitions to succeed they must be driven by a sound business strategy. Inaccurate assessment of the strategic benefits of the merger may lead to its failure.

vi. **Poor Business Fit:** When the product or service does not naturally fit into the acquirer's marketing, sales, distribution systems or geographic requirement, it no longer remains an ideal fit. Such a firm delays efficient integration and may also lead to the failure of the mergers.

vii. **Inadequate Due Diligence:** The process of due diligence helps in detecting any financial and business risks that the buyer might inherit from the seller. Inadequate due diligence results in the failure of the merger.

viii. **Over Leverage:** Cash acquisitions frequently result in the acquirer assuming too much debt. Future interest costs consume a great portion of the acquired company's earnings. An even more serious problem results when the acquirer resorts to cheaper short-term financing and then has difficulty refunding on a long-term basis. A well-planned capital structure is critical for a successful merger.

ix. **Boardroom Split:** When mergers are structured with 50/50 board representation or substantial representation from the target, care must be taken to determine the compatibility of the directors following the merger. A failure to focus on this aspect of the merger can create or worsen a culture clash and slow down or prevent integration.

x. **Regulatory Delay:** The announcement of a merger is a dislocating event for the employees and other constituents of one or both companies. It is customary to have detailed plans to deal with potential problems immediately following an announcement. However, when there is the possibility of regulatory delay, the risk of substantial deterioration of the business increases as time goes on, with valuable employees and customer and supplier relationships being lost. This loss is a key consideration in evaluating whether a particular merger should be undertaken.

SUMMARY

- Mergers could be of three types – horizontal, vertical and conglomerate. Horizontal mergers are associated with providing economies of scale. Vertical mergers achieve cost efficiencies by internalizing transactions. Financial conglomerates improve the resource allocation in the combined firm whereas the managerial and concentric conglomerates show potentials for synergy and transfer of managerial capabilities.
- The first two phases of the acquisition process, namely – the business plan and the acquisition plan, define the overall strategic direction for the business, the key objectives, and the available resources and tactics for completing an acquisition.
- Various participants like the investment bankers, lawyers, accountants etc., are involved at various stages of the acquisition process.
- Mergers and acquisition often fail to achieve the desired objective. The reason can be any one or two or more combination of factors such as payment of high price, overestimated synergies, inconsistent strategy, inadequate due diligence, clash of corporate cultures, improper business fit, etc.

Chapter 4

Methods of Valuation of Firms

After reading this chapter, you will be conversant with:

- Various Approaches to Valuation
- Discounted Cash Flow Model
- Equity Valuation Models
- Firm Valuation Models
- Valuation – Other Approaches
- Selection of Appropriate Valuation Method
- Valuation – A Case Study

Every asset, whether financial or real, has value. Value is an expression of an asset's worth. An asset can be measured in terms of sentimental value or financial value. Some of the definitions of value or valuation as defined in different dictionaries are described below. Each of these differs from the other in language, but fundamentally mean the same.

"Value is the rate of worth set upon a commodity."

"Value is the intrinsic worth of a thing."

"Value is worth that property or those properties of a thing, which render it useful or estimable."

Valuation is the, "act of determining the value or the price of anything", or "estimation of things' worth specially by a professional valuer."

Definition of Value: The two most frequently used definitions for financial assets are:

Fair Market Value: The amount at which property would change hands between a willing seller and a willing buyer when neither is acting under any compulsion and when both have reasonable knowledge of the relevant facts.

Investment Value: It is the specific value of a company to a particular investor for individual investment reasons. Strategic or investment valuations used in M&A transactions typically include synergistic benefits.

Business Valuation is supported by Two Basic Economic Principles:

Principle of Substitution: A buyer would not pay more for an asset than it would cost to acquire or create some other asset that would provide equal or greater economic utility to the owner.

Principle of Future Benefits: A buyer would not pay more for an asset than the present value of the future benefits the asset is expected to deliver to the owner after adjusting the time value of money and the risk of realizing those future benefits when expected.

VARIOUS APPROACHES TO VALUATION

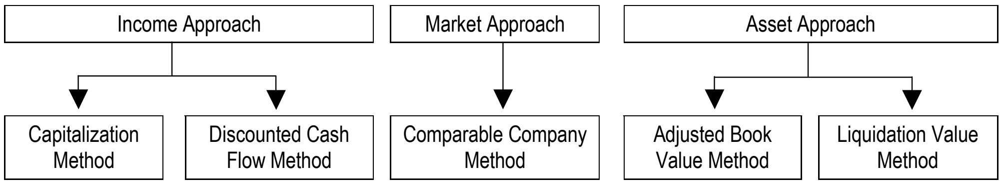
Understanding the value is very important not only to invest in assets, but also to manage them successfully. Every asset can be valued, but some assets are easier to value than others, and the inputs for valuation vary depending on the nature of asset. There are different valuation techniques in use but the basic principle of valuation remains the same.

Valuation is a highly specialized process. It requires the knowledge and experience of professionals. Valuation of firm(s) as a going concern is the basis for any investment exercise. The determination of the right value of a business is essential to maintain a long-term success of the investment. Any company under consideration for sale needs proficient, objective valuation, whether its stock is privately owned by one individual, closely held by several individuals or publicly traded on one or more of the major exchanges or in the over the counter market. An entity also requires careful valuation when it has no stock, but is part of a larger whole – whether as an operating division or simply a product line.

There are various approaches and methodologies to valuate a firm. Some of the very common approaches to valuation are the Asset approach, Income approach, and the Market approach. The cost or asset approach measures the value of asset by the cost to reconstruct or replace it with another of like utility. The income approach relates the value of the firm to the present value of its expected future cash flows. The market or comparable company method estimates the value of the firm in relation to the value of other similar firms based on various parameters like earnings, sales, book value, cash flows, etc.

Businesses vary in the nature of their operations, the markets they serve and the assets they own. Hence, the body of knowledge in business valuation has established three primary approaches by which businesses can be appraised. The three approaches are again divided into different types. The three basic approaches to valuation can be grouped as under:

Figure 1: Approaches to Valuation



Each approach brings a unique focus on value. The income approach looks at future returns discounted to reflect their relative level of risk, the market approach establishes value based on the price paid for alternative investments, and the asset approach establishes value based on a hypothetical sale of the company's underlying assets. Let us look at each of them in detail:

INCOME APPROACH

An income approach focuses on the expected benefits from investing in the business and the required return for assuming the risk and uncertainty associated with achieving these benefits. It involves valuation based on discounted future benefits of earnings cash flows dividends or other benefit streams. The appropriate discount rate is chosen based on the risk or uncertainty involved in the future expected cash flows. Theoretically, the most appropriate method for the going concern operating entity. Its is not frequently used for new generation or emerging industries given difficulties in projecting future earnings and establishing an appropriate cost of capital or discount rate. The difference in the number of periods, i.e., one versus multiple, establishes a difference between the two principal methods within the income approach.

Capitalization Method (single period): This is a simpler method under the income approach and involves the capitalization of the return at the cost of capital for a company for one year. Here, the return chosen should be a representative of the company's anticipated long-term future performance. The basic assumption in this method is that company will have stable earnings and constant growth.

Discounted Cash Flow Method (multiple period): The value of business is defined as the present value of financial benefits of ownership into perpetuity. This method involves two stages. The first stage involves forecasting of cash flows for a specific number of years and the second stage involves estimating the terminal value, i.e., the value for all the years after the forecast period. The length of forecasting years depends upon the growth and maturity levels of the company. It requires substantially more information to value a company with discounted cash flow method. Unless the company being valued has very stable earnings and constant growth, the multiple period discounting method should not be used.

MARKET APPROACH

The market approach is widely used to value private firms. In this, value of assets is derived from the pricing of comparable assets in the market and standardizing using a common variable. The comparable assets in the market would imply assets with similar cash flow, risk and growth potential. Relative valuation method is one of the best known methods under the market approach to valuation.

Relative Valuation or Comparable Company Approach: Relative valuation or comparable company approach to valuation values an asset or a firm based on how an exactly identical firm (in terms of risk, growth rate and cash flows) is priced. Relative valuation is much more likely to reflect the current mood of the market, since it attempts to measure the relative value and not the intrinsic value.

ASSET APPROACH

The asset approach is primarily used to value a business when the primary goal in the acquisition process is to achieve control of the assets owned by the target. It is also used in capital intensive industries or in acquisitions where the non-operating assets can be sold off to recover some of the acquisition cost. The asset approach to valuation is done either on the premise of a going concern or liquidation.

Adjusted Book Value: This technique entails a restatement of the balance sheet by replacing the book value of assets and liabilities with their respective fair market values. This approach is frequently used in valuing holding companies or businesses that are significantly under-performing. It is often an inappropriate valuation approach for companies having significant intangible value. However, a cost approach may also be used to establish a floor value for a business using a liquidation method.

Liquidation Method: When the asset or the firm is valued, based on the liquidation premise, then it is called the 'liquidation value' method. Under this method, it is assumed that the operations of the business will cease and liquidation will occur. The assets are valued at the proceeds they generate in a sale. The costs involved in liquidating the business must be subtracted, while determining the net proceeds.

Replacement Cost: The approach states that the assets of a business are worth their cost of replacement. The approach is most suitable to businesses that have substantial amounts of tangible assets whose actual cost of replacement can be easily determined. In case of businesses whose primary assets consist of intellectual property, it may be very difficult to determine the actual cost of replacing the firm's intangible assets using this method. The accuracy of this approach is heavily dependent on the skill and specific industry knowledge of the appraisers employed to conduct the study.

It is simple but involves the most tedious process of valuation. Its disadvantage is the difficulty in getting accurate information, as it is difficult to find out replacement costs of the assets which have been depreciated, rendered technologically obsolete and inoperative.

ROLE OF VALUATION IN ACQUISITION ANALYSIS

Valuation plays a central role in acquisition analysis. The fair value for the target firm has to be decided by the bidding firm and the target firm has to determine a reasonable value for itself before taking a decision whether to accept or reject the project.

In takeover analysis, the effect of synergies on the combined value of the two firms has to be considered before the decision is made on the bid. Further the effect of value, of changing management and restructuring the target firm will have to be taken into account in deciding on a fair price.

DISCOUNTED CASH FLOW MODEL

The discounted cash flow approach to valuation estimates the intrinsic value of an asset, based on the fundamentals. The intrinsic value of an asset is the present value of the benefits associated with it. The value is derived by expecting the future cash flow and then discounting them with the appropriate discount rate. The discount rate depends on the risk associated with the future cash flows. The discounted cash flow approach is the foundation on which all the other approaches to valuation are based. Some of the advantages of this approach are:

i. The value is estimated as a sum of all components that make up the enterprise value, instead of just the equity. This helps in identifying and understanding the separate investment and financing sources of value for the equity holders.

ii. It can be applied to the company as a whole and also to individual business units.

iii. It is consistent with the capital budgeting process familiar to most companies.

iv. It is not only simple to carry on with personal computer tools, but also sophisticated enough to deal with complex situations.

v. It helps in identifying the key leverage areas and hence helps in the search for value creating ideas.

BASIS FOR DISCOUNTED CASH FLOW VALUATION

The discounted cash flow approach to valuation is based on the concept of time value of money. The value of an asset is computed as the present value of all expected future cash flows that the asset generates. It is represented as:

$$\text{Value} = \sum_{t=1}^{t=n} \frac{CF_t}{(1+k)^t}$$

Where,

n = life of the asset,

CF_t = cash flow period t, and

k = discount rate.

The discount rate is the function of the risk of the estimated cash flows. Riskier assets have higher discount rates and safer assets have lower discount rates.

TYPES OF DISCOUNTED CASH FLOW MODELS

There are many discounted cash flow models in existence. However, the extent of variation in different models is limited to only a few dimensions.

There are basically two models to the discounted cash flow valuation:

i. Equity discounted cash flow models.

ii. Firm valuation models.

The cash flow to equity model is used to value only the equity stake in the business. The value of equity is obtained by discounting the cash flows to equity. The cash flows to equity are all cash flows remaining after meeting all expenses, reinvestment needs, tax obligations and net debt payments. These cash flows are discounted at the rate of return required by equity investors in the firm. It is represented as:

$$\text{Value of equity} = \sum_{t=1}^{t=n} \frac{\text{CF to Equity}}{(1+k_e)^t}$$

where,

CF to equity = Expected cash flow, and

k_e = Cost of equity.

The dividend discount model is a specialized case of equity valuation; it is the oldest discounted cash flow model, where the value of the equity is the present value of expected future dividends.

The cash flow to firm approach is used to compute the value of the entire firm, which includes cash flows available to all the suppliers of capital to the firm like the equity holders, bondholders and preferred stock holders. The value of the firm in this approach is obtained by discounting all expected cash flows of the firm after meeting all operating expenses, reinvestment needs and taxes, but before any payments to either debt or equity holders. Such cash flows are discounted at the weighted average cost of capital which is the cost of the different components of financing used by the firm.

The above two approaches are based on discounting the expected cash flows. However, the relevant cash flows and discount rates are different under each model.

STEPS IN DISCOUNTED CASH FLOW VALUATION

There are five steps in estimating the value of a firm under discounted cash flow model. They are:

i. Estimation of free cash flows.

ii. Estimating the growth in earnings.

iii. Computing the cost of capital.

iv. Estimating the continuing terminal value.

v. Determination of value of a firm.

Each of the above steps is discussed below in detail.

ESTIMATION OF FREE CASH FLOWS

The value of an asset is directly proportional to its capacity to generate cash flows. Hence, the first step in the discounted cash flow approach to valuation, is to estimate the free cash flows for the explicit forecast period. The estimation of cash flows is based on three basic principles. They are:

i. **Cash Flows should be After Taxes:** This means that all cash and non-cash items like depreciation that are subject to taxes should be considered while estimating the cash flows of a project.

ii. **Cash Flows should be Incremental:** This means that all cash inflows and outflows that can be directly or indirectly attributed to the project should be considered while estimating the cash flows of the project.

iii. **Cash Flows and Discount Rates should be Consistent:** If the cash flow is to the equity investors the discount rate should be the cost of equity and if the cash flow is to the entire firm, then the discount rate should be the weighted average cost of capital. The discount rate must be in post-tax terms.

Cash Flows should be After Taxes

Any project which is expected to generate income is also subjected to tax liability. An analyst often is faced with a choice of two different tax rates, i.e., the effective tax rate and the marginal tax rate while analyzing the impact of taxes on cash flows. The effective tax rate is the widely reported tax rate in the financial statements which is given as the total tax paid as a proportion of the total income generated by a business. The marginal tax rate is defined as the tax on the last rupee of income generated in the business. The marginal tax rate depends on the government regulations and gives what firms have to pay as taxes on their marginal income.

Reasons for Differences in the Marginal and Effective Tax Rates

There are three reasons for the effective tax rate being different to the marginal tax rate.

i. There is always a difference in the accounting standards followed by firms for tax purposes and reporting purposes. Some firms use straight-line depreciation method for reporting purpose and accelerated depreciation for tax purposes resulting in reported income being higher than taxable income on which the taxes are based.

ii. The tax credits used by firms to reduce the taxes that they pay in turn reduce the effective tax rate below the marginal tax rate.

iii. When firms defer tax payments to future periods, the effective tax rate will be different from the marginal tax rate.

The income generated by the firm's existing assets and projects is marginal. Hence, marginal tax rate is more appropriate rate used to estimate the tax liability. Moreover, if the same tax rate has to be applied to earnings every period, marginal tax rate is the safer choice as none of the reasons mentioned above can be perpetually regular. It is very important that the tax rate to be used to compute the terminal value be the marginal tax rate.

Non-cash charges (accounting expenses that reduce income, but does not create a cash outflow for the firm) also have a significant impact on the cash flows if they affect the tax liability. Non-cash charges such as depreciation reduce the taxable income, but do not cause a cash outflow. As a result, depreciation is added back to the net income to arrive at the cash flows on a project. For some projects, which generate large depreciation charges, the significant portion of the net present value can be attributed to the tax benefits of depreciation which is written as:

Tax benefit of depreciation = Depreciation x Marginal tax rate.

Illustration 1

Apex Ltd. is evaluating an investment proposal to manufacture trucks for Horizon Ltd. The project will require an initial investment of Rs.10 lakh in plant and equipment. This initial investment will be depreciated straight line down to a salvage value of Rs.2 lakh at the end of 8 years. The project will generate revenues of Rs.3 lakh and will incur operating expenses of Rs.1 lakh in the first year. These revenues and expenses are expected to grow at around 5% a year over the remaining 7 years of the project. The marginal tax rate for the company is 36%. Estimate the free cash flows to the firm. Also verify the effect of depreciation on the net present value of the project (Assume the cost of capital at 10%).

Solution

(Amount in Rs.)

	1	2	3	4	5	6	7	8
Revenues	3,00,000	3,15,000	3,30,750	3,47,290	3,64,650	3,82,880	4,02,030	4,22,130
Less: Operating expenses	1,00,000	1,05,000	1,10,250	1,15,760	1,21,550	1,27,630	1,34,010	1,40,710
Less: Depreciation	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000
= EBIT	1,00,000	1,10,000	1,20,500	1,31,530	1,43,100	1,55,250	1,68,020	1,81,420
EBIT(1 – t) [t = 36%]	64,000	70,400	77,120	84,180	91,585	99,360	1,07,530	1,16,110
Add: Depreciation	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000
FCFF	1,64,000	1,70,400	1,77,120	1,84,180	1,91,585	1,99,360	2,07,530	2,16,110
PV of FCFF	1,49,076	1,40,750	1,33,017	1,25,795	1,18,975	1,12,440	1,06,460	1,00,920

Present value of after tax operating cash flows = Rs.9,87,433

Salvage value of the project = Rs.2,00,000

PV of salvage value of the project = $2{,}00{,}000/(1.10)^8$

= Rs.93,280

Net present value of the project = –10,00,000 + 9,87,433 + 93,280

= Rs.80,713.

Present value of tax savings from depreciation

= $(100{,}000 \times 0.36) \times \text{PVIFA}_{(10\%,\ 8\ \text{years})}$

= $36{,}000 \times \text{PVIFA}_{(10\%,\ 8\ \text{years})}$ = Rs.1,92,060.

Without the depreciation tax benefits of Rs.1,92,060, the net present value of the project would have been negative.

Cash Flows should be Incremental

The second important principle which should be followed while estimating cash flows is the incremental cash flow principle. It means that, only those cash flows which affect the inflow or outflow that is a direct or indirect consequence of taking up a particular project for which the valuation is done should be included. Many factors that arise in the context of capital budgeting such as (i) the sunk costs, (ii) working capital, (iii) opportunity costs, and (iv) allocated costs can be dealt with by using the incremental cash flow principle.

i. **Sunk Costs:** Sunk costs are expenses that have been incurred before the project analysis is done and cannot be recovered if the project is not taken up. Since such expenses cannot be recovered if the project is rejected, hence, sunk costs are to be ignored.

ii. **Working Capital:** Working capital is the difference between current assets and current liabilities. Working capital affects the cash flows, but does not affect the accounting income of the firm. In an attempt to estimate the effect of changes in working capital on the cash flows, the current portion of long-term debt and cash should be eliminated while estimating the working capital. The current portion of long-term debt is eliminated for two reasons: (i) to avoid double counting, since it is already considered as part of the overall financing of the project; and (ii) since the objective of the analysis is to estimate the future working capital needs and the current portion of long-term debt is generally an unpredictable and highly variable component of working capital.

    It is inappropriate to consider the changes in the cash balances while estimating the effect of changes in working capital on the cash flows since it is difficult to prove that an increase in cash balance is a cash outflow and a decrease in cash balance is a cash inflow. Firms no longer keep large amounts of idle cash when they can earn interest on their cash balances. Hence, while estimating the effect of changes in working capital on the cash flows, only non-cash working capital is considered. Non-cash working capital is the difference between current assets and current liabilities excluding the current portion of long-term debt.

    Non-cash working capital = (Inventory + Accounts Receivable)
    – (Accounts Payable + Taxes Payable)

    Now, an increase in non-cash working capital can be viewed as a cash outflow as more money is tied-up in the assets and a decrease in non-cash working capital as release of cash or a cash inflow and the same cannot be easily deciphered, if the cash component is also included in the working capital estimate.

Working capital requirements on a project is a function of the expected growth in revenues and expenses on the project. However, it varies from business to business. Some businesses such as the retail industry require high working capital and some businesses as in the service industry do not require much of working capital.

It is very important to determine the working capital requirements on every project, because a change in working capital affects cash flows. Failure to consider working capital requirements in investment analysis has two serious consequences.

i. Working capital tends to increase in the initial years of growth of a project, and these increases cause cash outflows. Ignoring working capital needs in investment analysis leads to overestimation of after tax cash flows.

ii. Even when the working capital is recovered at the end of the project, the present value of cash flows generated by changes in working capital will be negative. As a result, the net present value of a project will be overstated if working capital is not included in the analysis. Projects showing a positive net present value when working capital is ignored may later show negative net present value when the working capital needs are taken.

From the above discussion, it is clear that the after tax cash flow to the firm can be estimated after incorporating the investment needs, the projection needs of the operating income and the working capital requirements. It is given as:

After tax cash flow to the firm

= EBIT (1 – t) + Depreciation – Capital expenditure
– Change in working capital.

iii. **Opportunity Cost:** Opportunity cost of an investment is the expected return that would be earned in the next best investment.

Many businesses use resources which are already a part of the business and which will just be transferred to the new project. The use of such resources creates a potential for an opportunity cost which might be a significant portion of the total investment needed on the project. The opportunity cost usually takes the form of the lost rental revenue or the foregone sale price or the cost of replacing the asset. Hence, the present value of opportunity costs estimated should be added to the initial investment while estimating the net present value of the project.

iv. **Allocated Costs:** Costs that cannot be traced directly to the business units in a firm are called the allocated costs. Costs that are not directly traceable to revenues generated by individual products or divisions are charged across all the divisions based on the revenues, or profits or assets. The effect of such an allocation on investment analysis is analyzed in terms of whether they create incremental cash flows.

Cash Flows and Discount Rates should be Estimated Consistently

The cash flows and the discount rates used on the cash flows have to be estimated consistently in terms of inflation and also the investor group being analyzed.

There are two basic approaches to deal with leverage. The first is to estimate the cash flows associated with debt financing, i.e., the interest and principal payments and then to calculate the residual cash flows left over for equity investors. This cash flow to equity has to be discounted at the cost of equity, which reflects the expectations of equity investors. This present value is compared to the equity investment in the project to calculate the net present value or the internal rate of return. The second approach is to calculate the cumulative cash flows to both the equity investors and the lenders of the firm and then discount it at the cost of capital which is obtained as the weighted average of the rate of return of the equity investors and the after tax cost of borrowing. The resultant net present value is compared to the total investment required in the project to calculate the net present value or internal rate of return.

If the cash flows to equity are discounted at cost of capital, the net present value will be overstated since the cost of capital is usually much lower than the cost of equity. Similarly, when the cash flow to the firm is discounted at the cost of equity, the net present value will be understated.

Inflation can be dealt in two ways while estimating the cash flows. The first method is by incorporating the expected inflation into the estimates of future cash flows resulting in nominal cash flows for the project and then to discount these cash flows at the nominal discount rate which also incorporates expected inflation. The second method is to estimate the cash flows in real terms and discount these real cash flows at a real discount rate.

$$\text{Real cash flow}_t = \text{Nominal cash flow}_t / (1 + \text{Expected inflation rate})^t$$

Similarly, the relation between nominal and real rates is given as:

$$\text{Nominal discount rate} = (1 + \text{Real discount rate})\ (1 + \text{Expected inflation}) - 1$$

If nominal cash flows are discounted at real rate, the net present value will be overstated and if real cash flows are discounted at the nominal rate, the resultant net present value will be understated.

Illustration 2

Estimating the cash flows to equity and cash flows from debt.

The following background information is available

EBIT	=	Rs.500 lakh
Capital expenditure	=	Rs.300 lakh
Depreciation	=	Rs.200 lakh
Revenue	=	Rs.7,000 lakh
Working capital as a percentage of revenue	=	25%
Tax rate	=	36%

The revenues and earnings are expected to grow at a stable growth of 5% for 5 years.

Capital expenditures are offset by depreciation.

Estimate the free cash flow to the firm and the free cash flow to the equity holders.

Solution

Free Cash Flow to the Firm (FCFF) = EBIT (1 – t) + Depreciation and Amortization – Capital expenditures – Change in non-cash working capital.

(Rs. in lakh)

	0	1	2	3	4	5
EBIT	500	525	550	580	610	640
– Taxes	180	189	198	210	220	230
– (Cap exp. – Depreciation)	100	105	110	115	120	126
– Change in WC*		90	90	95	105	100
FCFF	220	141	152	160	165	184

* Estimation of change in working capital. (Rs. in lakh)

Revenues	7,000	7,350	7,720	8,100	8,510	8,930
Working capital	1,750	1,840	1,930	2,025	2,130	2,230
Change in WC		90	90	95	105	100

Illustration 3

ABC Ltd. requires an initial investment of Rs.12 lakh for its new store for which Rs.4 lakh would come from borrowing at an interest rate of 8%. The interest is paid for 5 years and the entire principal with interest is repaid at the end of the sixth year. The interest expenses are tax deductible at a rate of 36%, but the principal payments are not. The cash flows to the firm are expected to be Rs.80,000 initially. These cash flows are expected to grow at a rate of 30% for the first 4 years and at 75% from the fifth year. Estimate the free cash flow to equity.

Solution

Free cash flow to equity	=	(Net operating income – Interest) + Depreciation and amortization – Capital expenditure – Change in working capital – Principal repayments + Proceeds from new debt issues.

or

FCFE = FCFF + Borrowing – Interest (1 – t) – Principal repaid

(Amount in Rs.)

Year	FCFF	Borrowing	Interest (1 – t)	Principal repaid	FCFE
0	(12,00,000)	4,00,000			(8,00,000)
1	80,000		20,480		59,520
2	1,04,000		20,480		83,520
3	1,35,200		20,480		1,14,720
4	1,75,760		20,480		1,55,280
5	3,07,580		20,480		2,87,100
6	5,38,265		20,480	4,00,000	1,17,785

ESTIMATING THE GROWTH IN EARNINGS

The value of the firm is the present value of expected future cash flows generated by the firm. The most important input in valuation is the growth rate used to forecast future revenues and earnings. Growth of a firm is basically estimated in three ways:

i. Historical growth rate;

ii. Analysts estimates of growth; and

iii. Fundamental determinants of growth.

i. **Historical Growth Rate:** The historical growth rate can be estimated by looking at the growth in the firm's past earnings, assuming that the future will be a reflection of the past. While past growth might not be a good indicator of future growth it conveys information that can be valuable while making estimates for the future. There are certain difficulties faced while estimating the growth rate in earnings. The average growth rates can be complicated depending on how the average is estimated. The presence of negative earnings in the past also makes the estimation of growth rates complicated.

ii. **Analysts Estimates of Growth:** Equity research analysts track the firm to come up with the right estimate of its growth and to use that growth rate in valuation. Forecast of growth by analysts will be better than using historical growth rates, because in addition to the historical data analysts also use other information that may be useful in predicting future growth. Analysts use additional information like the firm specific information that has been made public since the last earnings report, macro economic information that may impact future growth, information revealed by competitors on future prospects, private information about the firm, public information other than earnings etc.

While many firms are widely followed by analysts, the quality of growth estimates especially over longer periods is poor.

iii. **Fundamental Determinants of Growth:** Determination of the growth from the fundamentals of the firm involve determination of the amount reinvested into new assets and the quality of these investments, with investments widely defined to include acquisitions, building up distribution channels or even expanding marketing capabilities. Let us begin by looking at the relationship between fundamentals and growth in equity income and then move on to consider the determinants of growth in operating income.

Growth in Earnings from Equity

When valuing equity in aggregate, we consider the net income as earnings and when valuing equity per share, we consider the earnings per share as earnings.

Growth in Earnings per Share

The growth rate is primarily determined by the relationship between the percentage of earnings retained by the firm and the return on equity on its projects. Firms that have higher retention ratios and earn higher returns on equity usually have much higher growth rates in earnings per share than firms who do not have such characteristics. This relationship can be explained as follows:

Growth rate in earnings in a particular year is the excess of earnings which the firm has earned over the previous year. It is given as:

$$g_t = \frac{NI_t - NI_{t-1}}{NI_{t-1}}$$

Where,

g_t = Growth rate in net income, and

NI_t = Net income in year t.

From the definition, of net income, the net income in year t – 1, given as:

NI_{t-1} = Book value of equity $_{(t-2)}$ x Return on equity $_{(t-1)}$

Similarly, the net income in year t is given as:

NI_t = [Book value of equity $_{(t-2)}$ + Retained earnings $_{(t-1)}$] x ROE_t

Assuming that the return on equity is unchanged over the years:
$ROE_t = ROE_{t-1} = ROE$

Then the growth rate is obtained as:

$$g_t = \frac{\text{Retained Earnings}_{t-1}}{NI_{t-1}} \text{ x ROE}$$

= Retention ratio x Return on equity

g_t = b x ROE

Note: Here, we assume that the firm's only source of equity is the retained earnings and also the firm has not raised additional equity capital by issuing new shares.

Growth Rate in Net Income

To obtain the relationship between growth in net income and fundamentals, we need a measure of that investment that goes beyond retained earnings. To obtain such a measure we have to look at how much equity the firm reinvests into its businesses in the form of net capital expenditures and investments in working capital.

Equity reinvested

= Capital Expenditure – Depreciation + Change in working capital

– (New debt issued – Debt repaid)

$$\text{Equity reinvestment rate} = \frac{\text{Equity Reinvested}}{\text{Net Income}}$$

Expected growth in net income = Equity Reinvestment Rate x Return on Equity

Unlike retention ratio, the reinvestment rate can be well above 100% because firms can raise new equity.

Determinants of Return on Equity

The return on equity affects both the earnings per share and the net income growth of the firm. It also depends on the leverage decisions of the firm. Increasing the leverage in the firm will lead to a higher return on equity, if the pre-interest after tax return on capital employed exceeds the after tax interest rate paid on debt.

$$ROE = ROC + D/E\ [ROC - i\ (1 - t)]$$

Where,

$$ROC = \frac{EBIT(1-t)}{BV\ of\ Debt + BV\ of\ Equity}$$

Where,

D/E = BV of debt / BV of equity,

i = Interest rate on debt, and

t = Tax rate on ordinary income.

From the above equation the growth rate can be represented as:

$$g = b\left(ROC + \frac{D}{E}[ROC - i(1-t)]\right)$$

Growth Rate in Operating Income

Growth in operating income is determined by the total amount reinvested into the business and the return earned on such capital invested.

Expected growth rate$_{EBIT}$ = Reinvestment rate x Return on capital

Total reinvestment = Capital expenditure – Depreciation + Change in working capital

Reinvestment rate = Reinvestment/EBIT (1 – Tax rate)

Illustration 4

Alpha Ltd. operates in the pharmaceutical industry. The firm is expected to pass through two phases of growth (i) initial high growth, and (ii) a stable growth period. The tax rate for the firm is 40%. The following parameters are available for the firm:

	Initial Growth Phase	Stable Growth Phase
Return on assets	25%	18%
Debt equity ratio	1	1
Interest rate on debt	12%	10%
Pay-out ratio	24%	?
Growth rate	?	10%

Estimate the growth rate of revenues for the firm in the initial growth phase.

Solution

Growth rate for the initial phase can be given by the formula.

$$g = b\left(ROA + \frac{D}{E}[ROA - i(1-t)]\right)$$

b = 1 – Pay-out ratio

g = (1 – 0.24) [0.25 + 1 [0.25 – 0.12 (1 – 0.4)]]

= 0.76 x 0.428 = 0.3253 or 32.5% approximately

Pay-out ratio in the stable growth phase = 1 – b

$$= 1 - \frac{g}{ROA + \frac{D}{E}\left[ROA - i(1-t)\right]}$$

$$= 1 - \frac{0.1}{0.18 + 1\left[0.18 - 0.1(1-0.4)\right]}$$

$$= 1 - 0.333 = 0.6667 \text{ or } 66.67\%$$

COMPUTING THE COST OF CAPITAL

The cost of capital represents the opportunity cost of investing, creditors and shareholder funds in one particular business instead of others with equivalent risk. It is the discount rate which is used to convert expected future free cash flows into present value for all investors.

The following points should be remembered while estimating the cost of capital for it to be consistent with the discounted cash flow approach:

- Since the free cash flows represent the cash available to all contributors of capital the cost of capital should be the weighted average of all costs of all sources of capital like debt, equity, etc.
- Since the free cash flow is estimated after taxes, the discount rate also should be computed after taxes.
- Since the expected free cash flow is estimated in nominal terms, nominal rate of return obtained from real rates and expected inflation should be used.
- Since each provider of capital expects a return that compensates the risk taken, the systematic risk taken by each of them has to be adjusted.
- Since market values represent the true economic claim of each type of financing market value, weights are employed to each financing element.

The weighted average cost of capital is given as:

$$WACC = k_d(1-T)\frac{B}{V} + k_p\frac{P}{V} + k_e\frac{S}{V}$$

Where,

k_e = Cost of equity,

k_d = Cost of debt,

T = Marginal tax rate,

B = Market value of interest bearing debt,

V = Market value of the enterprise being valued (V = B + P + S),

k_p = Cost of preference capital,

P = Market value of the preferred stock, and

S = Market value of equity.

In this section, we will discuss the approaches followed to estimate the cost of various forms of financing.

Cost of Equity

The cost of equity is the rate of return that investors require to make an equity investment in a firm. There are two approaches to estimate the cost of equity. They are:

i. The Capital Asset Pricing Model, and

ii. The Arbitrage Pricing Model.

i. **Capital Asset Pricing Model:** The capital asset pricing model or the CAPM measures risk in terms of non-diversifiable variance and relates expected returns to this risk measure. The non-diversifiable risk for an asset is measured by its Beta which is used to yield an expected return. The CAPM equation is given as:

Expected return or $k_e = R_f + \beta(R_m - R_f)$

Where,

K_e	=	Cost of Equity,
R_f	=	Risk-free rate,
R_m	=	Expected return on the market risk,
$R_m - R_f$	=	Market risk premium, and
β	=	The non-diversifiable risk for an asset.

The Risk-free Rate

The risk-free rate is the return on an asset that has no default risk and is completely uncorrelated to returns on anything else in the economy. Two conditions have to be met for an asset to be risk-free. (i) There can be no default risk, and (ii) There can be no reinvestment risk.

Securities issued by the government have no default risk because government controls the printing of currency. It is assumed that the government would fulfill its promises at least in nominal terms. Hence, the Treasury Bill rate is usually taken as the risk-free rate and the historical premium earned by a broad equity market index over and above this security rate is used to estimate the expected return on the market. The cost of equity thus obtained is used as a discount rate for each year's cash flows.

For a long-term investment to have an actual return equal to the expected return there should be no reinvestment risk. For such an investment, the current long-term government bond rate (with the bond duration matched up to the duration of the project or asset being analyzed) is used as the risk-free rate. The historical premium earned by a broad equity market index over and above this long-term government security rate is used to estimate the expected return on the market. The cost of equity thus obtained is used as a discount rate for each year's cash flows.

It is also very important that the risk-free rate be consistent with the cash flows discounted. The currency in which the risk-free rate is denominated and whether it is a real or nominal risk-free rate is determined by the currency in which the cash flows are estimated and whether the estimation of these cash flows is done in real or nominal terms.

The Market Risk Premium: The market risk premium or the price of taking risk is the difference between the expected rate of return on the market and the risk-free rate of return over a measurement period. The market risk premium can be based on *ex-post* estimates, i.e., on historical data assuming that the future will be like the past or on *ex-ante* estimates that try to forecast the future. *Ex-ante* estimates of market premium are based on the current value of the share market relative to the projections of earnings or cash flows.

Three fundamental principles determine the size of the premium:

– **Variance in the Economy:** Economies with more volatility associated with them have higher premiums. Premium for emerging markets which have high growth and high risk are larger than premiums for developed markets. This means that the higher the uncertainty associated with future growth in the economy, higher is the risk premium.

– **Political Risk:** Markets that are prone to potential for political instability have higher risk premiums because political instability might transform into economic instability.

– **Structure of the Market:** Markets in which large, diversified and stable companies are listed have low risk premium. As more and more small and riskier companies are listed in the market, the average risk premiums for investing in such markets will also increase.

Determination of Beta of a Firm: For listed companies, using published estimates of beta is the easiest approach. If the betas from different sources vary by more than 0.2 or if the beta of a company is more than 0.3 from the industry average, then the industry average beta should be used. An industry average beta is typically more stable and reliable than the individual company beta, because measurement errors tend to cancel out. For unlisted companies, industry averages can be used.

Analysts' estimate of a beta of a firm is based on three variables: (i) Type of business of the firm, (ii) Degree of operating leverage in the firm, and (iii) Financial leverage of the firm.

i. **Type of Business of the Firm:** Beta measures the risk of the firm relative to the market index. Beta is high for firms which are more sensitive to the market conditions. Thus, beta is expected to be higher in cyclical firms where the revenues and operating income tend to move strongly with the economy than in non-cyclical firms.

ii. **Degree of Operating Leverage:** The operating leverage examines the effect of the change in the quantity sold (revenues) on the change in EBIT of the company and is measured by calculating the degree of operating leverage. The degree of operating leverage is a function of the cost structure of the firm and a firm having high operating leverage, i.e., a firm having high fixed costs relative to the total costs will have high inconsistency in the EBIT than a firm producing a similar product with low leverage.

iii. **Degree of Financial Leverage:** The financial leverage measures the effect of change in EBIT on the EPS of the company. The interest payments made on the debt increase the variance in the net income, with higher leverage increasing the income during the boom period and decreasing the income during recession. An increase in the financial leverage will increase the equity beta of the firm. When all the firm's risks are borne by the stockholders, i.e., when the beta of the debt is zero and the debt has a tax benefit to the firm, then:

$$\beta_L = \beta_U [1 + (1 - t) (D/E)]$$

Where,

β_L = levered beta for equity in the firm

β_U = unlevered beta of the firm (i.e. beta of the firm without any debt)

t = corporate tax rate

D/E = debt/equity ratio.

The unlevered beta is determined by the type of business in which it operates and its operating leverage. Thus, it is clear that a company's equity beta or the levered beta is determined by the riskiness of the business and the amount of financial leverage it has taken.

Let us now see the effect of leverage on the beta of a firm.

Consider a firm which had a beta of 0.90 and a debt equity ratio of 1.65%, with a tax rate of 33%.

Unlevered beta of the firm

= Current beta/[1 + (1 – Tax Rate) (Current Debt/Equity)]

= 0.90/[1 + (1 – 0.33) (0.0165)]

= 0.90/1.0110055 = 0.89

The levered beta at different levels of debt can be estimated as:

Levered beta = Unlevered beta [1 + (1 – Tax Rate) (Debt/Equity)]

If the firm increases its debt equity ratio to 10%, its equity beta would be

Levered beta (@ 10% D/E) = 0.89 [1+ (1 – 0.33) (0.10)]
= 0.89 [1.067]
= 0.95

Levered beta (@ 20% D/E) = 0.89 [1+ (1 – 0.33) (0.20)]
= 0.89 [1.134]
= 1.01

From the above we can observe that as the financial leverage increases, the beta of the firm increases consequently leading to a higher cost of equity.

Illustration 5

In March 2005, the 20-year G-Sec was trading at 7%. The premium earned by the government securities over the past 20 years is 6.5%. Estimate the cost of equity of a company XYZ with a beta of 1.02.

Solution

According to the Capital Asset Pricing Model, the cost of equity is given as:

$k_e = R_f + \beta\ (R_m – R_f)$

Therefore, cost of equity = 7% + 1.02 (6.5%)
= 7% + 6.63% = 13.63%

Illustration 6

AB & Co. is a private firm operating in the textile industry. It has a debt/equity ratio of 0.2. The tax rate applicable to the firm is 36%. Estimate the beta of AB & Co. if its debt ratio is 0.23. The following information for other publicly traded textile firms is available.

Firm	Beta	Debt/Equity
XY Ltd.	1.10	0.24
PQ Ltd.	1.22	0.33
CD Ltd.	1.35	0.22
NM Ltd.	1.20	0.20

Solution

Average Beta of the comparable firm = 1.217 or 1.22 approximately.

Average Debt/Equity ratio = 0.2475 or 0.25 approximately.

$\beta_L = \beta_U\ [1 + (1 – t)\ (D/E)]$

Where,

β_L = Levered beta for equity in the firm

β_U = Unlevered beta of the firm (i.e., beta of the firm without any debt)

t = Corporate tax rate

D/E = Debt/equity ratio.

Unlevered beta for comparable firms

= 1.22 / [1 + (1 – 0.36) (0.25)]

= 1.22/1.16 = 1.05

Equity beta for AB & Co.

= 1.05 [1 + (1 – 0.36) (0.23)]

= 1.05 x 1.15

= 1.21 approximately.

ii. **Arbitrage Pricing Model:** The capital asset pricing model defines security return as a function of one factor, i.e., the market index and is measured as a rate of return on the market portfolio. The arbitrage pricing model considers more than one beta. Each beta measures the sensitivity of a stock's return to different underlying factors in the economy. Five fundamental factors which are considered are:

a. The industrial production index, a measure of how well the economy is doing in terms of actual physical output.

b. The short-term real interest rate, a measure of difference between the yield on treasury bills and the consumer price index.

c. Short-term inflation, a measure of unexpected changes in the consumer price index.

d. Long-term inflation, measure of the difference between the yield to maturity on long-term and short-term government bonds.

e. Default risk, a measure of the difference between the yield-to-maturity on Aaa$^-$ and Baa$^-$ rated long-term corporate bonds.

The APM cost of equity is given as:

$$K_e = R_f + [E(F_1) - R_f]\,\beta_1 + [E(F_2) - R_f]\,\beta_2 + \ldots\ldots\ldots\ldots + [E\,(F_k) - R_f]\,\beta_k$$

Where,

$E\,(F_1)$ = The expected rate of return on a portfolio that resembles the kth factor independent of all other factors.

β_k = The sensitivity of the stock return to the kth factor.

Studies suggest that the arbitrage pricing model explains expected returns better than the single factor capital asset pricing model. Industries which are more sensitive to unexpected changes in the above factors are subjected to higher market premiums and hence, require a high cost of equity.

Illustration 7

The Treasury Bill is being traded at 4.5%. Assume that three different factors are considered. The following additional information is available as:

	Factor 1	Factor 2	Factor 3
Risk Premium	4%	4.5%	3%
Beta	1.25	0.95	1.15

Estimate the cost of equity.

Solution

Using the Arbitrage pricing model, the cost of equity is computed as:

Cost of equity = 4.5% + (1.25 x 4%) + (0.95 x 4.5%) + (1.15 x 3%)

= 4.5 + 5 + 4.275 + 3.45 = 17.225%.

The Cost of Debt

The cost of debt measures a firm's current cost of borrowing funds to finance its projects. The cost of debt for a firm depends on two factors. (i) The level of interest rates in the economy, and (ii) The default risk of the company.

As the level of interest rate increases, the cost of debt for a firm also increases. Similarly, as the default risk of a firm increases the cost of borrowing money will also increase. Default risk can be measured by using the bond rating for the firm. Higher rating leads to lower interest rates and lower ratings lead to higher interest rates. If bond ratings are not available, the rates paid by the firm on its borrowings may provide a measure of its default risk.

A tax advantage is associated with debt. Since the interest paid on debt is tax deductible, the after tax cost of debt is a function of the tax rate. The after tax cost of debt is less than the pre-tax cost of debt because of tax benefits that accrue from paying interest. As the tax rate increases, the benefits also increase. Since the interest expenses save taxes at a margin, i.e., they are deducted from the last rupee of income, the correct tax rate to be used is the marginal tax rate.

After tax cost of debt = Pre-tax cost of debt (1 – Tax Rate)

Interest creates tax benefit only when the firm has enough income to cover its interest expenses. Firms that have operating losses will not get any tax benefit in the year it incurs losses. The after tax cost of debt will be equal to the pre-tax cost of debt in that year.

Cost of Preferred Stock

The cost of preferred stock is the return which the preference shareholders expect for investing in the preference shares. The preference stock creates many of the same obligations as debt, but without the tax advantage. The cost of preferred stock is given as:

k_p = Dividend per share/Market price per preference share.

This approach assumes that preferred stock is perpetual and dividend is constant in rupee terms forever.

If any special feature exists in a preferred stock such as convertibility or callability the preferred stock has to be valued separately to have a good estimate of the cost of preferred stock. Preferred stock is riskier than debt, but safer than equity. Hence, the pre-tax cost of preferred stock is higher than the pre-tax cost of debt and lower than the cost of equity.

For hybrid securities, i.e., securities which share some of the features of both equity and debt the cost is estimated as a combination of both debt and equity. Hybrid securities pay a predictable (fixed or floating) rate of return or dividend until a certain date. At that date the holder has a number of options including converting the securities into the underlying share. Therefore unlike a share the holder has a 'known' cash flow and unlike a fixed interest security, there is an option to convert to the underlying equity. Common examples of hybrid securities include convertible preference shares. The debt and equity components are not only broken down separately but also treated separately.

Calculation of Weights

Weights are assigned to the equity and debt components based on the market value and not the book value since the cost of capital measures the cost of issuing securities that are issued at the market value.

ESTIMATING THE CONTINUING TERMINAL VALUE

Firms that reinvest substantial portions of their earnings and that earn high returns on such investments grow at high rates. As a firm grows, over a period of time, it finds it more difficult to maintain high growth and in due course, from a particular point of time the rate will grow at a rate less than or equal to the growth rate in the economy in which it operates. This growth rate called the stable growth rate can be continued in perpetuity. A company's expected cash flow can be separated into two periods and the value of the company can be defined as:

Value = Present value of cash flow during the explicit forecast period + Present value of cash flow after the explicit forecast period.

Hence, the value of all cash flows beyond that point can be estimated as a terminal value for the going concern. The estimation of cash flows is stopped at sometime in the future and the terminal value is computed which reflects the value of the firm at that point.

$$\text{Value of the firm} = \sum_{t=1}^{t=n} \frac{CF_t}{(1+k_c)^t} + \frac{\text{Terminal Value}_n}{(1+k_c)^n}$$

There are three ways to complete the terminal value.

i. **Liquidation Value Method:** The liquidation value method assumes that the firm would cease to operate in the future and sell its assets to the highest bidder. There are two ways to estimate the liquidation value.

   According to the first method, the liquidation value is the book value of the assets adjusted for inflation during that period. In the second method, the value of the asset is determined based on the earning power of the asset. The expected cash flows from the assets is estimated and then discounted to the present using the appropriate discount rate.

   In case of equity valuation, the estimated value of debt outstanding in the terminal year has to be deducted from the liquidation value to arrive at the liquidation proceeds for equity investors.

ii. **Multiple Approach:** The second approach to estimate the terminal value is the multiple approach. The value of the firm in the future years is estimated by applying a multiple to the firm's earnings or revenues in that year. In valuing a firm, multiples like the book value to sales can be used to get the terminal value and while valuing equity, multiples like the price earnings ratios can be used to estimate the terminal value.

   Using multiples to estimate the terminal value is more suitable while using the comparable company approach to value the firm. The consistent way to estimate the terminal value in a discounted cash flow model is to use either the liquidation value or a stable growth model.

iii. **Stable Growth Model:** This approach assumes that the cash flows beyond the terminal year will grow at a constant rate forever and the terminal value is calculated as:

$$\text{Terminal Value}_t = \frac{\text{Cash Flow}_{t+1}}{r - g_{stable}}$$

   Where,

   r = Cost of capital of the firm, and

   g = Growth rate for the stable phase.

$$\text{Terminal Value of Equity} = \frac{\text{Cash flow to Equity}_{n+1}}{\text{Cost of Equity}_{n+1} - g_n}$$

   The cash flow to equity can be defined as dividends or as free cash flow to equity.

Assumptions

Three things are assumed while estimating the terminal value using the stable growth model in the discounted cash flow valuation.

i. **Length of the High Growth Period:** Analysts often face difficulty about the length of the high growth period of the firm to be considered. Three factors are taken into account while considering how long a firm will be able to maintain high growth.

   a. *Size of the firm* – Small firms in large markets will have the potential for high growth over longer periods than larger firms, because they have more scope to grow and a larger prospective market.

b. *Existing growth rate and excess returns* – Firms that witness high growing revenues are more likely to sustain these revenues for the next few years.

c. *Magnitude and sustainability of competitive advantages* – If there are entry barriers in the industry and a firm has a competitive advantage over others the firm can maintain high growth for longer periods. This is the most important determinant of the length of the high growth period.

ii. **Characteristics of a Stable Growth Firm:** Firms in the stable growth have less risk, use more debt, have lower or no excess returns and reinvest less than high growth firms.

Firms with stable growth are less risky because as firms mature they are less exposed to market risk and their betas are closer to one which is the average market beta. It is very difficult for firms with stable growth to maintain excess returns. It should be assumed that in the stable phase the firm's return on equity and capital will move towards industry averages.

Debt Ratios and Cost of Debt: As a firm matures, its debt capacity increases. Stable growth firms use more debt than high growth firms. Hence, while valuing a firm the debt ratio used to compute the cost of capital changes and while valuing equity, the change in the debt ratio will lead to the change in both the cost of equity and the expected cash flows. Whether the debt ratio in the stable period moves towards a more sustainable level depends on the managers' views on debt and how much power stockholders have in these firms. If managers are willing to change their debt ratios and stockholders retain some power, then it is reasonable to assume that the debt ratio will move to a higher level in stable growth, if not it is safer to leave the debt ratio at existing levels.

To determine what debt ratio and cost of debt to use in stable growth, the financial leverage of larger and more mature firms in the industry is to be considered. One solution is to use the industry average debt ratio and cost of debt as the debt ratio and cost of debt for the firm in stable growth.

Stable growth firms reinvest less than the high growth firms. It is very important not only to capture the effects of lower growth on reinvestment, but also ensure that the firm reinvests enough to sustain its stable growth rate in the terminal phase.

iii. **Transition to Stable Growth:** Once the length of the high growth period is determined, the pattern of change from the high growth phase to the stable growth phase at some time in the future has to be considered. There are three distinct patterns through which a firm can shift to a stable phase. Firstly, the two stage model where a firm maintains its high growth rate for a particular period of time and then becomes a stable firm abruptly. Secondly, the three stage model, where the firm maintains its high growth rate for a period and then has a transition period, where its characteristics change as it approaches stable growth. Finally, the n stage model, where the characteristics of the firm change each year from the initial period to the stable growth period.

Selection of the growth pattern depends on the firm being valued. The two stage model is more suitable to firms with moderate growth rates where the shift will not be too significant. The three stage model is more suitable to firms with very high growth rates in operating income as it allows for a gradual adjustment not only in the growth rates but also in the risk characteristics, return on capital and reinvestment rates towards stable growth levels. For very young firms or for firms with negative operating margins, using the n stage model is more appropriate.

Figure 2

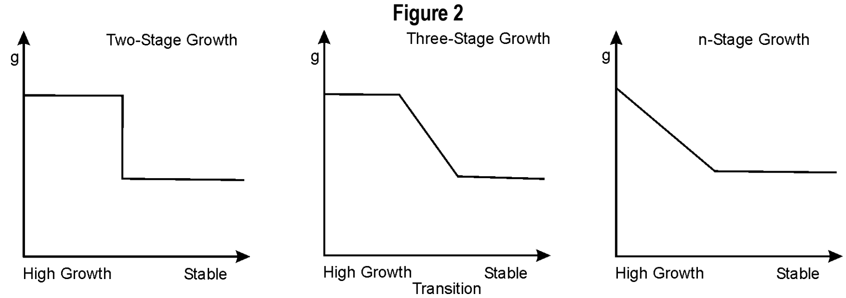


Illustration 8

Alpha India Ltd. is trying to buy Beta India Ltd. Beta India Ltd., is a small biotechnology firm that develops products that are licensed to major pharmaceutical firms. The development costs are expected to generate negative cash flows of Rs.10 lakh during the first year of the forecast period. Licensing fee is expected to generate positive cash flows of Rs.5, 10, 15 and 20 lakh during 2-5 years respectively. Due to the emergence of competitive products cash flows are expected to grow annually at a modest 5% after the fifth year. The discount rate for the first five years is estimated to be 15% and then drop to 8% beyond the fifth year. Calculate the value of the firm.

Solution

Year	Cash Flows	Discount Rate @15%	Present Value
1	(10)	1.15	(8.69)
2	5	1.323	3.779
3	10	1.521	6.575
4	15	1.749	8.576
5	20	2.011	9.945

Total sum of present value = 20.185

$$\text{Terminal Value}_t = \frac{\text{Cash Flow}_{t+1}}{r - g_{stable}}$$

Cash Flow_{t+1} = $\text{Cash flow}_t (1 + g)$

= 20 (1 + 0.05) = 21 lakh

Terminal Value = 21/(0.08 – 0.05)

= Rs.700 lakh

Present value of terminal value = 700/2.011 = 348.08

Value of the firm = Rs.20.185 + Rs.348.08 = Rs.368.265 lakh.

DETERMINATION OF VALUE OF A FIRM

The last stage in the process of valuation involves determining the exact value of the firm and then interpreting the results obtained from such valuation.

The following are the general steps followed in estimating the value of the firm using the discounted cash flow approach:

i. Discount the forecasted free cash flow to the present at the weighted average cost of capital.

ii. Discount the terminal value to the present value at the weighted average cost of capital. Since the terminal value is expressed as a value at the end of the explicit forecast period, discounting is done for the number of years in the explicit forecast period. For example, if the forecast is made for 5 years, discounting is done for 5 years and not 6 years.

iii. Calculate the value of operation by adding the present value of the explicit forecast period to the present value of the terminal value.

iv. Add the value of any non-operating assets like excess marketable securities and investments in unrelated subsidiaries whose cash flows were not included while computing the free cash flow of the firm.

v. Deduct the market value of all debt, hybrid securities and other claims to estimate the value of equity. The value of accounting liabilities like reserves that are quasi equity should not be deducted. Only the values of those items which are consistent with the cash flows are deducted. If cash flows from an item are excluded (interest bearing debt and related interest expense) while estimating the free cash flows, then the value of liability is deducted. If the cash flows are not excluded (reserves for deferred taxes) the value is not deducted while estimating the value of equity.

EQUITY VALUATION MODELS

The equity valuation model estimates the value of equity in a firm by discounting cash flows to equity at a rate of return required by equity investors. There are two models that determine the value of equity:

i. Dividend discount model, which defines the cash flows to equity as dividends, and

ii. Free cash flow to equity model, which defines free cash flow to equity as the residual cash flow left over after meeting interest and principal payments and providing for capital expenditures to maintain existing assets and create new assets for future growth.

Dividend Discount Model: According to the dividend discount model, the value of stock is the present value of the dividends discounted at the rate appropriate to the risk of the cash flows. Dividend discount model is the simplest model to estimate the value of equity. The general version of the model is given as:

$$\text{Value per share of stock} = \sum_{t=1}^{t=\infty} \frac{(\text{DPS}_t)}{(1+k_e)^t}$$

Where,

PS_t = Expected dividends per share, and

e = Cost of equity.

There are two basic inputs to the model. They are the expected dividends and cost of equity.

The Gordon Growth Model: This is the simplest model designed to value a firm in the steady state with dividends growing at a rate that can be sustained forever. The value of the stock in the Gordon model is given as:

$$\text{Value of stock} = \frac{\text{DPS}_1}{k_e - g}$$

Where,

DPS_1 = Expected dividends for the next period,

k_e = Required rate of return for equity investors, and

g = Growth rate in dividends forever.

The model is simple and a dominant approach to value equity, but the use is limited to firms that are growing at a stable rate. It is best suited for firms growing at a rate compared to or lower than the nominal growth in the economy and which also have well-established dividend pay-out policies, which they intend to continue in the future.

Two-stage Dividend Discount Model: The two-stage dividend discount model allows for two stages of growth – an initial phase where the growth rate is not stable and a subsequent steady state where the growth rate is stable and is expected to remain so for a long-term. The model is based upon two stages of growth, an extraordinary growth phase that lasts for n years and a stable phase that lasts forever afterwards. It is given as:

$$V_0 = \sum_{t=1}^{t=n} \frac{DPS_t}{(1 + k_{e,h})} + \frac{V_n}{(1 + k_{e,h})^n}$$

Where,

$$V_n = \frac{DPS_{n+1}}{(k_{e,s} - g_n)}$$

Where,

DPS = Expected dividends per share in year t,

k = Cost of equity,

h = High growth period,

s = Stable growth period,

P = Price at the end of year n, and

g_n = Steady state growth rate forever after year n.

Limitations of this Model

Defining the length of the supernormal growth period: It is difficult to specify the **supernormal** growth period with precision since the growth rate is expected to reduce to a stable level after this period, and the investment increases as this period becomes longer. Though the supernormal growth period can be related to product life cycle and projects opportunities, it is not easy to convert these qualitative terms into quantitative terms.

The change of high supernormal growth to a lower stable growth rate at the end of the supernormal growth period: It is unrealistic to assume such a sudden change in the growth rate. There should be a gradual change over a time period rather than a sudden change of growth.

The terminal price calculated in this model is derived from Gordon model and hence it suffers from the limitations of the Gordon model: The terminal value is sensitive to the assumptions about the stable growth, the underestimation or overestimation of which will lead to significant errors in the value calculated.

Uses of the Model

It is most suitable to firms that register high growth and they also expect to maintain this growth rate for a certain period of time after the growth rate tends to decline.

It is also suitable for firms with modest growth rates in the initial phase.

Determinants of the Value of Growth: The factors which influence the value of growth are:

- *Growth Rate during Extraordinary Growth Period:* The higher the growth rate during supernormal growth period, the higher the estimated value of growth.
- *Length of the Extraordinary Growth Period:* The longer the supernormal growth period, the greater the value of growth.

- *Profitability of Projects:* The profitability of projects is a determinant of supernormal growth rate and the stable growth rate. When the projects become more profitable, both the growth rates increase, and the resulting value from supernormal growth will be greater.
- *Riskiness of the Stock or Equity:* Depending on the risk associated with the equity investment, the discount factor to be used is determined. The higher the risk, the higher the discount rate and lower the supernormal growth.

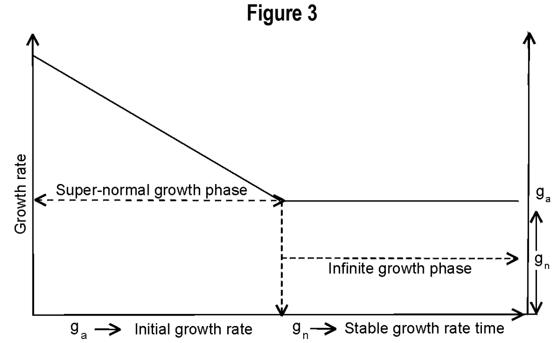
H-Model

This model is similar to the two-stage model except that a gradual change in the growth rate is assumed rather than a sudden change. This is explained in Figure 3.

Assumptions under H-Model

- The growth rate of earnings starts at a high initial rate and declines over the supernormal growth period linearly.
- Dividend pay-out is constant over a time period and not affected by the shifting growth rates.

Figure 3



Value of the Stock

The value of the stock P_o as per this model is given by,

$$P_0 = \underbrace{\frac{DPS_0\ (1+g)}{r-g_n}}_{\text{Stable Growth}} + \underbrace{\frac{DPS_0 H\ (g_a - g_n)}{r-g_n}}_{\text{Supernormal Growth}}$$

Where,

P_0 = Present value of the share

DPS_t = Dividend per Share in year t

r = Required rate of return on equity

g_a = Initial growth rate

g_n = Growth rate at the end of 2H years which extends to an infinite period.

Limitations of the Model

The decline in the growth rate is assumed to follow a strict structure based upon the initial growth rate, the stable growth rate and the length of the supernormal growth period. Large deviations from this assumption affect the value significantly. When growth rate declines, pay-out ratio has to increase, but the assumption of constant pay-out ratio violates this rule.

Best Use

This model is best suited to those firms which have a high growth rate in the beginning and a gradual decline in the growth rate over a time period.

Illustration of Value of Equity of the firm using the Two-Stage DDM

ETN Ltd. is the world's largest manufacturer of electronic goods. It reported earnings per share of Rs.5.7 on March, 2005 and it paid dividends per share of Rs.2.28. The following are the various other inputs available for the firm.

Particulars	High Growth Period	Stable Growth Period
Length of the period	4 years	Perpetual after 4 years
Expected growth rate	?	8%
Beta	1.3	1.15
Return on assets	15%	15%
Debt to equity ratio	1	1
Dividend pay-out ratio	40%	?
Interest rate on debt	8%	8%

The tax rate for the firm is 40%. The Treasury Bill is being traded at 7% and the market premium is 5%. Estimate the value of the equity of the firm using the dividend discount model.

Solution

Expected growth rate during high growth period (g)

$$= b\left(\text{ROA} + \frac{D}{E}[\text{ROA} - i(1-t)]\right)$$

$$= 0.6\ [0.15 + 1\{0.15 - 0.08(1 - 0.4)\}]$$

$$= 0.1512 \text{ or } 15.12\%$$

Pay-out ratio for the stable growth period

$$= 1 - \{g/\text{ROA} + D/E\ [\text{ROA} - i\ (1 - t)]\}$$

$$= 1 - \{0.08/0.15 + 1[0.15 - 0.08(1 - 0.4)]\}$$

$$= 1 - 0.317$$

$$= 0.683 \text{ or } 68.3\%$$

Estimation of the Value of Equity

Year	EPS	DPS	Discount Rate @ 13.5% *	Present Value
1	6.56	2.624	1.135	2.311
2	7.55	3.070	1.288	2.344
3	8.69	3.477	1.462	2.378
4	10.00	4.003	1.659	2.411

Total present value of dividends = Rs.9.45

Terminal price = Expected divided per share$_{n+1}$/(r – g_n)

Expected earnings per share = 10(1 + 0.08) = 10.8

Expected dividends per share = 10.8 x 0.683 = 7.37

Terminal price = 7.37/(0.1275 – 0.08) = Rs.155.15

Present value of terminal price = 155.15/1.659 = Rs.93.52 app.

Value of the firm's equity = Rs.9.45 + Rs.93.52 = Rs.102.97

Workings

***Cost of Equity**

	High Growth Phase	Stable Growth Phase
$k_e = R_f + \beta\ (R_m - R_f)$	7% + 1.3(5%) = 13.5%	7% + 1.15(5%) = 12.75%

Three Stage Dividend Discount Model: The three-stage dividend discount model allows for an initial period of high growth, a transitional period where growth declines and a final stable growth phase. It does not impose any restrictions on the pay-out ratios. This is shown in figure 4.

$$V_0 = \underbrace{\sum_{t=1}^{t=n1} \frac{EPS_0(1+g_a)^t \pi_a}{(1+k_{e,h})^t}}_{\text{High Growth Phase}} + \underbrace{\sum_{t=n1+1}^{t=n2} \frac{DPS_t}{(1+k_{e,t})^t}}_{\text{Transition}} + \underbrace{\frac{EPS_{n2}(1+g_n)\pi_n}{(k_{e,s}-g)_n(1+r)^n}}_{\text{Stable Growth Phase}}$$

Where,

EPS_t = Earnings per share in year t,

DPS_t = Dividends per share in year t,

g_a = Growth rate in high growth phase (last n_1 periods),

g_n = Growth rate in stable phase,

π_a = Pay-out ratio in high growth phase,

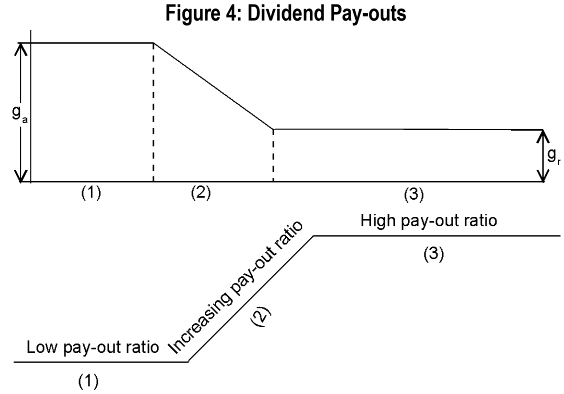
π_n = Pay-out ratio in stable growth phase, and

k_e = Cost of equity in high growth (h), transition (t) and stable growth (s).

The model requires more number of inputs like year specific pay-out ratios, growth rates and betas.

It is best suited to firms which are growing at supernormal growth rates in the initial period after which the differential advantage of the firm is expected to diminish leading to a gradual decline in the growth rates leading to a stable growth rate.

Figure 4: Dividend Pay-outs



(1) High Stable Growth

(2) Declining Growth

(3) Infinite Stable Growth.

Illustration 9

Sunrise India Ltd. is a leading retail firm. It has posted extraordinary growth both in revenues and profits and has got lot of returns to its shareholders. Analysts assume that the earnings per share will grow at a rate of 35% a year for the next 5 years. The rate of return on the market is 12.5%. The market premium is expected to be at 5.5%. The following additional information for the firm is also available:

Current Earnings/Dividend

Earnings per share = Rs.10.5

Dividend per share = Rs.1.6

Inputs for the high growth period

Length of the high growth period = 5 years

Expected growth rate = 35% (based on the projection of analysts)

Beta during high growth period = 1.5

Return free rate of return = 7%

Dividend pay-out ratio = 12%

Inputs for the transition period

Length of the high growth period = 5 years

Expected growth rate = decline from 35% in year 5 to 5% in year 10 in linear increments

Beta during transition period will drop from 1.5 to 1.0 in the 10th year in linear increments

Dividend pay-out ratio = increase from 12% to 50% in year 10 in linear increments

Inputs for the stable growth period

Length of the high growth period = Forever after 10 years

Expected growth rate = 5%

Beta during stable growth period = 1.0

Dividend pay-out ratio = 50%

Solution

Estimation of Cost of Equity

Cost of equity during high growth phase

7 + 1.5 (5.5) = 15.25

Cost of equity in the transition phase

Year 6 7 + 1.4 (5.5) = 14.7

Year 7 7 + 1.3 (5.5) = 14.15

Year 8 7 + 1.2 (5.5) = 13.6

Year 9 7 + 1.1 (5.5) = 13.05

Year 10 7 + 1.0 (5.5) = 12.5

Estimation of expected earnings per share, dividends per share and cost of equity for both high growth period and transition phase.

(Amount in Rs.)

Period	EPS	Pay-out ratio	DPS	Cost of Equity	Present Value
1	14.17	12%	1.7	15.25%	1.47
2	19.14	12%	2.30	15.25%	1.732
3	25.83	12%	3.10	15.25%	2.025
4	34.87	12%	4.18	15.25%	2.37
5	47.08	12%	5.65	15.25%	2.80
6	60.73	19.6%	11.90	14.70%	5.10
7	74.70	27.2%	20.32	14.15%	7.63
8	87.40	34.8%	30.41	13.60%	10.06
9	97.01	42.4%	41.13	13.05%	12.03
10	101.86	50%	50.93	12.50%	13.24

Terminal Price = (101.86 x 1.05 x 0.50)/(0.125 – 0.05)

= 53.47/0.075 = Rs.712.93

Present value of Terminal Price

= 712.93/$(1.1525)^5$ (1.147) (1.1415) (1.136) (1.1305) (1.125)

= 712.93/3.8457

= Rs.185.38

Present value of dividends in high growth phase	=	Rs.10.397
Present value of dividends in transition phase	=	Rs.48.060
Present value of terminal price at the end of transition	=	Rs.185.380
Value of the share	=	Rs.243.837

Limitations of Dividend Discount Model: Though the dividend discount model is simple and spontaneous it has its own limitations. According to some analyst, the model is only useful to value a limited number of stocks which are stable and pay high dividends. Some of the limitations are as under:

i. Dividend discount model is used to value only those stocks which pay high dividends. However, if the dividend pay-out ratio is adjusted to reflect the changes in the expected growth rates, a reasonable value can be obtained even for non-dividend paying firms. A high growth firm paying no dividends at present can still be valued based upon dividends that it is expected to pay-out when the growth rate declines. If the payout ratio is not adjusted to reflect the changes in the growth rates the dividend discount model will underestimate the value of non-dividend paying or low dividend paying stocks.

ii. The dividend discount model does not reflect the value of unutilized assets. It only provides a conservative estimate of value by estimating only the present value of dividends.

iii. The model does not consider other ways of returning cash to the shareholders except dividends.

Free Cash Flow to Equity Model: The dividend discount model does not capture the true capacity to generate cash flows for stockholders because many firms do not pay all the free cash flows as dividends. Hence, the free cash flow to equity model is a more appropriate approach to value the firm. The free cash flow model estimates the value of equity as the present value of the expected free cash flow to equity over time. The free cash flow to equity is defined as the residual cash flow left over after meeting interest and principal payments and providing for capital expenditures to maintain existing assets and create new assets for future growth. The FCFE is given as:

FCFE = Net income + Depreciation – Capital Spending – Change in working capital – Principal Repayments + New debt issues

In special cases where the capital expenditures and working capital are expected to be financed at the target debt financing ratio and the principal repayments are made from the new debt issues, the FCFE is given as:

FCFE = Net income + (1 – Debt financing ratio) (Capital expenditures – Depreciation) + (1 – Debt financing ratio) Change in working capital.

The value of the stock under the free cash flow to equity model is given as:

$$V_0 = \sum_{t=1}^{t=n} \frac{FCFE_t}{(1+k_e)} + \frac{V_n}{(1+k_e)^n}$$

Where,

$$V_n = \frac{FCFE_{n+1}}{(k_e - g_n)}$$

Where,

FCFE = Expected FCFE per share in year t,

k_e = Required rate of return for equity investors,

V_n = Price at the end of the year n, and

g_n = Growth rate forever after year n.

The free cash flow to equity model also has four basic inputs as in the dividend discount model. (i) A defined length of the high growth period, (ii) Specified free cash flow to equity during each period of growth, (iii) Rate of return that shareholders would demand for holding the stock, and (iv) Terminal price at the end of the high growth period.

The length of the high growth period and the rate of return required by shareholders are estimated in the same way as in the dividend discount model. However, the estimation of free cash flow to equity and the terminal price is different from the dividend discount model:

- **Free Cash Flow to Equity:** Once the earnings for each period are determined the net capital expenditures, working capital needs and debt financing needs are specified to arrive at the free cash flow to equity. The capital expenditures and the working capital needs should be adjusted to reflect the changes in the expected growth. High growth companies comparatively have higher net capital expenditures and working capital needs.
- **Terminal Price:** The difference in the estimation of the terminal price in the dividend discount model and the free cash flow to equity model lies in the cash flow used. The dividend discount model uses the expected dividends after the high growth period as the free cash flow whereas the free cash flow to equity model uses the free cash flow to equity after the high growth period as the cash flow. It is given as:

$$\text{Value of stock} = \frac{FCFE_{n+1}}{r - g_n}$$

The value from the FCFE model provides a better estimate while valuing firms for takeovers or where there is reasonable chance of changing corporate control.

Illustration 10

BA&T is a large company operating in the cement industry. Given its large size it is unlikely that the firm will grow at a rate faster than the economy in the long-term. The free cash flow to the firm in 2004 was Rs.4 per share. The following additional information for the year 2005 is available.

Earnings per share	= Rs.4.5
Capital Expenditure per share	= Rs.4.15
Depreciation per share	= Rs.3.30
Change in working capital/share	= Re.1
Debt financing ratio	= 30%

The earnings, capital expenditure, depreciation, and working capital are all expected to grow at 6% a year. The beta of the stock is 1.1. The Treasury Bill rate is 7%. Estimate the value per share using the free cash flow to equity method. (Assume the market premium to be 6%).

Solution

Cost of equity = 7% + 1.1(6%) = 13.6%

Earnings per share	=	Rs.4.5
Less: (Capital Expenditure – Depreciation) (1 – Debt financing ratio)	=	0.595
Less: Change in working capital (1 – Debt financing ratio)	=	0.7
= Free cash flow to Equity	=	3.205
Value per share	=	$\dfrac{3.205(1.06)}{0.136 - 0.06}$
	=	Rs.44.70.

FCFE Valuation and Dividend Discount Model

The FCFE and the dividend discount model yield similar results under two conditions. Firstly, when the dividends are equal to the free cash flow to equity the values obtained under both the methods are same. Secondly, when the FCFE is greater than the dividends but the excess cash, i.e., (FCFE – Dividends) is invested in projects having a net present value of zero, the values will be same. However, more often the results obtained from both the methods are different.

Firstly, when the FCFE is greater than the dividend and the excess cash either earns below-market interest rates or is invested in negative net present value projects, the value from the FCFE model will be greater than the value from the dividend discount model. Secondly, if the firm borrows the money to pay the dividends, the firm may become over-levered (relative to the optimal) leading to a loss in value. Finally, paying too much in dividends can lead to capital rationing constraints where good projects are rejected, resulting in a loss of value.

The difference between the value obtained from the FCFE model and the value obtained from the dividend discount model can be considered as a factor of the value of controlling a firm. It measures the value of controlling dividend policy by capturing the higher FCFE value.

To know which of these methods is more suitable to evaluate the market prices, the openness of the market for corporate control is verified. If there is a good probability that the firm can be taken over or its management changed, the market price will reflect that probability and in such cases the value of FCFE is a more appropriate benchmark. As changes in the corporate control become more difficult due to the size of the firm or due to any market regulations on takeovers, the dividend discount model is more appropriate benchmark for comparison.

FIRM VALUATION MODELS

FREE CASH FLOW TO FIRM MODEL (FCFF)

It estimates the value of the firm as the present value of the sum of all cash flows to all claim holders in the firm, including equity shareholders, preference share holders and bond holders, discounted back at the cost of capital. There are two ways of measuring free cash flow to a firm:

Free cash flow = Free cash flow to equity + Interest expense (1 – Tax rate) + Principal repayments – New debt issues + Preferred dividends.

or

Free cash flow = EBIT (1 – Tax rate) + Depreciation – Capital expenditure – Change in working capital.

The free cash flow to firm model is similar to the free cash flow to equity model except for variations in the cash flow used and the rate of return required. The free cash flow to firm is based on the operating income growth rather than net income growth. The discount rate is the cost of capital rather than the cost of equity. Hence, the present value of cash flows provides an estimate of the value of the firm rather than just value of equity.

The main difference between the FCFE model and the FCFF model lies in the estimation of growth rates. Because of the existence of leverage consequently the growth rate is high in the FCFE model relative to the growth rate in the FCFF model.

The growth rate in earnings per share can be estimated as:

$$g_{EPS} = b\,\{ROA + D/E\,[ROA - i\,(1 - t)]\}$$

Where,

b = Retention ratio = 1 – Pay-out ratio

$$\text{Pay-out ratio} = 1 - b$$

$$= 1 - g/\{ROA + D/E\ [ROA - i\ (1 - t)]\}$$

$$= 1 - \frac{g}{ROA + \frac{D}{E}[ROA - i(1-t)]}$$

Where,

ROA = Return on Assets,

= EBIT (1 – t) (BV of debt + BV of equity),

D/E = Debt/Equity ratio,

i = Interest rate on debt, and

t = Marginal tax rate.

When the return on assets earned by a firm on its projects exceeds the after tax interest rate, increased leverage will increase the growth rate in earnings per share. The cash flow to the firm is a pre-debt cash flow and hence is not affected by the increase in leverage. Thus, the growth rate in EBIT for the same firm will depend upon only the retention ratio and the return on assets and will generally be lower.

$$g_{EBIT} = b\ (ROA)$$

The growth in capital expenditures, depreciation and capital spending will be identical for the purposes of calculating the FCFE and FCFF.

The general model of the free cash flow to firm model allows for two stages in growth – a supernormal growth phase in the initial period followed by a stable growth rate forever afterwards.

It is given as:

$$V_0 = \sum_{t=1}^{t=n} \frac{FCFE_t}{(1+k_e)} + \frac{V_n}{(1+k_e)^n}$$

Where, $V_n = \dfrac{FCFF_{n+1}}{(k_e - g_n)}$

Where,

FCFE = Expected FCFF per share in year t,

k_e = Weighted average cost of capital,

V_n = Value of the firm at the end of year n, and

g_n = Growth rate forever after year n.

The value of equity can be estimated by subtracting the market value of outstanding debt from the value of the firm.

Advantages of Firm Valuation using the FCFF Model

i. The cash flows relating to the debt do not have to be considered explicitly since the free cash flow to the firm is a pre-debt cash flow.

ii. The free cash flow to firm model is more suitable especially in cases where the leverage is expected to change significantly over time because estimating the new debt issues and debt repayments when the leverage is changing becomes very cumbersome as the number of years increase.

Illustration 11

Raymond Inc., a leader in the development and manufacture of household products in India, reported EBIT of Rs.1,200 lakh in 2004 prior to depreciation of Rs.350 lakh. The capital expenditures in 2004 amounted to Rs.420 lakh and working capital was 10% of the revenues (which were Rs.13,000 lakh). The firm has outstanding debt yielding a pre-tax interest rate of 8%. The tax rate for the firm is 40% and the Treasury Bill rate is 7%. The most recent beta for the firm is 1.10. The debt equity ratio of the firm was 50%.

The firm expects revenues, earnings, capital expenditures and depreciation to grow at 9.5% a year from 2005-09 after which the growth rate is expected to drop by 4% (capital spending will offset depreciation in the steady state period). The company also plans to lower its debt/equity ratio to 25% for the steady state resulting in the pre-tax interest rate drop to 7.5%. The annual market premium of the firm is 6%.

Estimate the value of the firm.

Solution

Base Year Information (2004)

Earnings before interest and taxes	= Rs.1,200 lakh
Capital expenditure	= Rs.420 lakh
Depreciation	= Rs.350 lakh
Revenues	= Rs.13,000 lakh
Working capital as a percentage of revenues	= 10%
Tax rate	= 40%

High Growth Phase

Length of high growth phase	= 5 years
Expected growth rate in FCFF	= 9.5%
Beta	= 1.10
Cost of debt	= 8%
Debt ratio	= 50%

Stable Growth Phase

Expected growth rate in FCFF	= 4%
Cost of debt	= 7.5%
Debt ratio	= 25%

The forecasted cash flows to the firm over the next five years are given as follows:

(Rs. in lakh)

	2005	2006	2007	2008	2009	Terminal Year
EBIT	1,314	1,438.83	1,575.52	1,725.19	1,889.09	1,964.65
– tax @ 40%	525.6	575.53	630.21	690.07	755.64	785.86
– (cap exp- Dep)	76.65	83.93	91.91	100.64	110.20	114.61
– change in WC *	123.5	135.23	148.08	162.15	177.55	81.86
FCFF	588.25	644.14	705.32	772.33	845.7	982.32
PV of FCFF @ 9.2%	538.69	540.16	541.64	543.13	544.21	

Cost of equity for the high growth phase

= 7% + 1.1(6) = 13.6%

Cost of capital during the high growth phase

= 13.6 x 0.5 + 8 (1 – 0.4) x 0.5

= 6.8 + 2.4 = 9.2%

*** Estimation of Change in Working Capital**

(Rs. in lakh)

Revenues	13,000	14,235.0	15,587.33	17,068.12	18,689.59	20,465.10	21,283.70
WC	1,300	1,423.5	1,558.73	1,706.81	1,868.96	2,046.51	2,128.37
Change in WC		123.5	135.23	148.08	162.15	177.55	81.86

Estimation of Beta for the stable phase – As the firm reduces its debt, the interest rate goes down. With the reduced debt the equity in the firm will be less risky and the new beta of equity can be calculated as:

New Beta = Old beta/(1 + (1 – t) Old D/E)} x {1 + (1 – t) New D/E ratio}

= {1.1/(1 + (1 – 0.4) 0.5)} x {1+ (1 – 0.4) 0.25}

= 0.846 x 1.15 = 0.97 approximately

Cost of equity for the stable growth phase

= 7% + 0.97(6) = 12.82%

Cost of capital during the stable growth phase

= 12.82 x 0.75 +7.5 (1 – 0.4) x 0.25

= 9.615 + 1.125 = 10.74

Terminal Value = 982.32/(0.1074 – 0.04) = 14,639.64

Present Value of Terminal Value

= 14,639.64/$(1.092)^5$ = 9,421.8

Value of the firm

= 2,707.83 + 9,421.8 = Rs.12, 129.63 lakh.

Adjusted Present Value Model (APV)

The value of the firm in the adjusted present value approach is estimated in three steps.

The first step is to value the firm without debt. Secondly, estimate the present value of the interest tax savings generated by borrowing a given amount of money. Finally, estimate the effect of borrowing the amount on the probability that the firm will go bankrupt, and also the expected cost of bankruptcy. The value of levered firm can be written as:

Value of levered Firm = Value of unlevered firm + Present value of tax benefits of debt – Present value of expecte bankruptcy costs.

Value of Unlevered Firm: The value of the unlevered firm is estimated by valuing the firm as if it had no debt, i.e., by discounting the expected free cash flow to the firm at the unlevered cost of equity. The general model of the value of the unlevered firm is given as:

$$\text{Value of the unlevered firm} = \frac{FCFE_0(1+g)}{k_{ue}-g}$$

(Here, we assume that the growth rates in the cash flows of the firm are constant and perpetual).

Where,

$FCFE_0$ = Current after tax operating cash flow to the firm,

g = Expected growth rate, and

k_{ue} = Unlevered cost of equity.

The unlevered cost of equity is estimated from the unlevered beta of the firm which is given as:

$$\beta_{unlevered} = \frac{\beta_{current}}{1+(1-t)\frac{D}{E}}$$

Where,

$\beta_{unlevered}$	=	Unlevered beta of the firm,
$\beta_{current}$	=	Current equity beta of the firm,
t	=	Tax rate for the firm, and
D/E	=	Current debt/Equity ratio.

Thus, the unlevered beta can be used to calculate the unlevered cost of equity.

- **Expected Tax Benefit from Debt:** The second step in the adjusted present value approach is to calculate the value of the expected tax benefits from the given level of debt. In most countries interest payments made by a company are deductible for tax purposes. Hence, the overall taxes paid by a company are lower, if the company employs debt in its capital structure.

  The tax benefit depends on the tax rate of the firm. Such a benefit accrued is discounted at the cost of debt to reflect the riskiness of this cash flow.

  Value of tax benefits when the tax savings are viewed as perpetuity

  $$= \frac{(\text{Tax rate})(\text{Cost of debt})(\text{Debt})}{\text{Cost of debt}}$$

  = Tax rate x Debt

  $= t_c D$

  The firm's marginal tax rate which is assumed to be constant overtime is used as the tax rate.

- **Estimating the Expected Bankruptcy Costs:** The third step is to evaluate the effect of the given level of debt on the default risk of the firm and on expected bankruptcy costs. Hence, the probability of default with additional debt and the direct and indirect cost of bankruptcy are calculated. The probability of bankruptcy costs can be estimated from the bond ratings given by different agencies at each level of debt or by using the observed approximation of default probabilities for each rating or the statistical approaches to estimate the value of default based upon the firm's characteristic at each level of debt. The bankruptcy costs can be estimated from various studies that have looked at the magnitude of this cost in actual bankruptcies.

  The present value of the expected bankruptcy costs is estimated as:

  PV of expected bankruptcy costs = P_a (BC)

  Where,

P_a	=	the probability of default after the additional debt,
BC	=	the present value of bankruptcy costs, and

- **Estimation of Value of the Firm:** The value of the levered firm is obtained by adding the net effect of debt to the unlevered firm value. It is given as:

  $$\text{Value of the levered firm} = \frac{FCFE_0(1+g)}{k_{ue}-g} + t_c D - P_a BC$$

- **Advantages and Limitations of the Adjusted Present Value Approach:** Since the cash flows used in this method are the cash flows prior to the debt payments, this approach is more suitable when there is significant leverage or when leverage changes overtime (though the weighted average cost of capital used to discount cash flows to the firm, has to be adjusted for changes in leverage).

  One of the benefits of the APV approach is that it separates the effects of debt into different components and allows the analyst to use different discount rates for each component.

However, the adjusted present value approach to valuation also has its own disadvantages. Estimating the probabilities of default and the cost of bankruptcy is a very complicated issue. Many analysts ignore the bankruptcy costs leading to a conclusion that the firm value increases with increase in the level of debt.

ECONOMIC VALUE ADDED

There are two methods of calculating EVA:

1. Residual income method
2. Refined earnings method.

Residual Income Method

This method can also be called the spread method because it involves computation of the spread between two returns of same risk level.

Steps involved in arriving at EVA:

1. Calculate the current returns.
2. Subtract (1) from the returns available in an equal-risk category.
3. Multiply the result obtained in (2) by the amount to be invested.

EVA number should be positive. Any negative value of EVA is not a good sign for an acquirer to choose a company to acquire. EVA of a firm can be calculated by,

1. Computing the net profit after tax, which it generates in a given period.
2. Dividing the result of (1) by the total capital invested.
3. Subtract the Weighted Average Cost of Capital (WACC) from (2).
4. Multiply the result of (3) by the total capital of the firm.

The above steps can be mathematically stated as follows:

$$\text{EVA} = \left(\frac{\text{NOPLAT}}{\text{Total Capital}} - \text{WACC}\right) \text{ (Total Capital)}$$

$$= \text{(Spread over WACC) (Total Capital)}$$

$$= \text{Excess return generated over cost of capital}$$

Where,

$$\text{WACC} = \left(\frac{\text{Book Value of Debt}}{\text{Total Book Value}}\right) \text{(Cost of Debt) (1 – Tax Rate)} + \left(\frac{\text{Book Value of Equity}}{\text{Total Book Value}}\right) \text{(Cost of Equity)}$$

Note: Cost of equity is calculated based on the CAPM model.

NOPLAT = Net Operating Profits Less Adjusted Taxes

From the foregoing discussion, it is clear that profitability is captured in the first component of the equation and the growth is captured in the second component. But a firm should not try to add value to the shareholder's wealth by just making an attempt to increase profitability. Because if low earning projects are not omitted for the calculation of profits, the return on capital employed will increase but EVA will be destroyed especially if those projects despite earning a low value were yielding a return higher than the cost of capital. This is because, these projects were adding value to the firm.

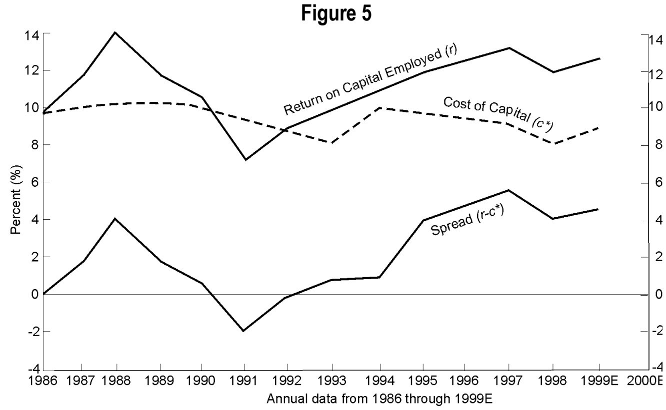
Refined Earnings Method

According to this method, EVA is calculated as follows:

EVA= (Sales – Operating expenses) – (WACC) (Net assets)

In this method, WACC is multiplied by the net asset to arrive at the capital charge. Then this capital charge and other expenses are subtracted from the revenues received to arrive at the EVA. If this EVA is a positive figure, then the firm is said to have earned high quality profits. This method focuses on the factors that create growth in a company. It also helps the management and analysts to recognize that true growth can be created by increasing the firm's return on capital or by reducing WACC.

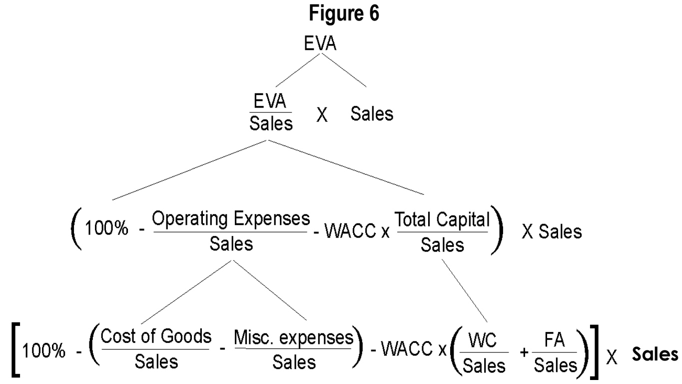
Figure 5



EVA Analysis

Traditional earnings analysis sometimes may not clearly provide an intuitive conclusion about the choice of the firm to make investments for an investor. But a firm's performance can be measured through EVA analysis by breaking EVA into its components as given in figure 6.

Figure 6



Though Economic Value Added (EVA) is conceived as a popular measure, there is little evidence that suggests companies with a high value of EVA performed well above the market. Moreover, the portfolios built using other measures of corporate valuation are seen to outperform those built based on EVA.

APPLICABILITY AND LIMITATIONS OF DCF VALUATION

The discounted cash flow approach is a perfect model, which can be used when a firm has positive future cash flows. The expected cash flows can be reliably estimated and there exists a proxy for risk which is required in computation of discount rates. However, in real life situation the valuer faces some practical challenges.

These limitations become apparent in the following cases:

- **Asset Rich Firms:** DCF valuation reflects the value of all the assets, which produce cash flows. The firm may have some assets, which do not produce any cash flows. For example, surplus land, unutilized floor space in factory buildings, staff quarters, etc. The value of such assets will not be reflected in the DCF valuation. The same limitation also applies, to a lesser extent, to underutilized assets, as their values will be understated in the DCF model.
- **Firms in Distress:** The firms in financial distress may have negative current and future cash flows. The present value of such firms will be a negative figure under the DCF method. Further such firms have a high probability of going bankrupt.

  This violates the basic premise of the DCF approach, which views a firm as a going concern.
- **Mergers/Takeovers:** A key driver in several merger/takeover transactions is the expected synergy between the two firms. The challenge involved in such a valuation exercise is understanding the nature and form of the synergy and estimating its value in financial terms to compute its impact on the expected cash flows. The second challenge involves estimating the effect of the resultant change in management (due to the merger or the takeover) on the discount rates due to the change in the risk profile of the firm. This limitation is more pronounced when the transaction involves a hostile takeover.
- **Cyclical Firms:** The cash flows of cyclical firms tend to shadow the performance of the economy. The earnings and cash flows are high during the boom periods and are low during recessionary periods. The valuations can be misleading if the explicit forecast period does not cover the entire economic cycle. However, this is an onerous task and the resulting valuation can be highly subjective depending on the valuer's assumptions about the timing and the duration of the phases of the economic cycle.
- **Firms with Product Options:** Firms often have unutilized product options which do not generate any current cash flows. For example, for companies involved in oil exploration, winning the right to drill oil and gas in a particular region represents a product option. Similarly, firms may also have unutilized intellectual property rights like patents and copyrights. If DCF model is applied to such valuations, the firm will be grossly undervalued. Some practitioners have overcome this limitation either by obtaining the market value of such options or by applying the option pricing model for their valuation. The resultant value of the option is added to the value obtained from DCF valuation to arrive at the true value of the firm.
- **Firms in the Process of Restructuring:** Firms in the process of restructuring are often involved in activities like selling assets, acquiring other assets, changing the capital structure, dividend policy etc., Similarly, some firms may also change from publicly traded to private firms. Such changes make the estimation of future cash flows more difficult and affect the riskiness of the firm.

VALUATION – OTHER APPROACHES

In practice, a wide variety of valuation approaches are employed, but the data considered in various approaches differ to a great extent. The various methods might provide different business values. In the previous section, we have discussed the widely used discounted cash approach to valuation. Now, we will discuss some of the other methods namely, the comparable company approach and asset-based valuation approach.

COMPARABLE COMPANY APPROACH

The objective in the discounted cash flow approach to valuation is to value the assets based on their cash flows, growth and risk characteristics whereas the objective in the comparable company approach is to value assets based on how similar assets are priced in the market place. It is also termed as relative valuation. There has been a widespread usage of this approach to valuation in recent years.

Basis of Relative Valuation

The relative valuation or the comparable company approach to valuation is based on the principle of substitution which states that "one will pay no more for an item than the cost of acquiring an equally desirable substitute". In this approach, the value of a firm is derived from the value of comparable firms, based on a set of common variables like earnings, sales, cash flows, book value etc.

As a first step to relative valuation, prices are standardized to form multiples and then these multiples are compared with firms that are comparable. Prices can be standardized based upon earnings, book value, revenues or sector-specific variables.

Advantages of Relative Valuation

i. Valuation based on multiples and comparable firms can be done with fewer assumptions and at a faster rate than the discounted cash flow valuation.

ii. The relative valuation is simple and easy to understand and present to clients than the discounted cash flow valuation.

iii. The relative valuation measures the relative value of the asset rather than the intrinsic value and hence it reflects the current atmosphere of the market.

The valuation process applying to the relative valuation approach is a five staged exercise.

i. Analysis of a firm,

ii. Identification of comparable firms,

iii. Comparison and analysis,

iv. Selection of valuation multiples,

v. Valuation of the firm.

i. **Analysis of a Firm:** As a first step in relative valuation a valuer is required to make an in depth analysis of the firm to get rich insights into the financial and operational aspects.

   The profitability of the firm may be analyzed by looking at the operating profit margins and the net profit margins. Further, analysis may be made by analyzing the return on capital employed and the return on net worth. The liquidity position may be analyzed from the current ratio and quick ratio. The interest coverage and the debt service coverage ratio would provide indicators to the solvency position. The efficiency of the operations can be captured from the ratios like inventory turnover, fixed assets turnover, debtors' turnover, etc. The cash flows of the firm need to be carefully studied and a sensitivity analysis may be conducted. The capital structure of the firm also needs to be analyzed.

   The qualitative analysis includes assessing the position of the firm in the industry, market share, competitive advantage (if any) etc. For example, Reliance Industries plays a dominant role in the petrochemical industry in India and commands a better valuation multiple than IPCL. The managerial evaluation is also important as the competence and integrity of the management have a greater bearing on the valuation. For example, one of the factors due to which Infosys Technologies commands high valuation is the market perception of its exemplary corporate governance. The ownership pattern plays its part as MNC firms, historically, have been given higher valuation vis-à-vis domestic firms, as they are considered to be better managed.

ii. **Identification of Comparable Firms:** A comparable firm is one with cash flows, growth potential and risk similar to the firm being valued. It is ideal that price multiples used in a comparable firm analysis be those for firms with similar operating and financial characteristics. Firms within the same industry are the most suitable. The process begins with a thorough analysis of the industry in which the firm operates. The valuer has to carefully assess the general profile of the industry, competitive structure, demand-supply position, installed capacities, pricing system, availability of inputs, government policies and regulatory framework, etc.

    The next step involves identification of firms with comparable profile. The parameters for identification of such firms include product profile, scale of operations, markets served, cost structures, geographical location, technology, etc.

    However, even within narrowly defined industries, it is often difficult to find identical multiples for similar firms. Firms within the same industry frequently have different strategies, growth opportunities and profitability, creating comparability problems. One way of dealing with these issues is to average across all the firms in the industry. This way the various sources of non-comparability cancel out so that the firm being valued is comparable to a typical industry member. Another approach is to focus only on those firms, which are most similar in the industry.

    Once the potential comparable firms are identified, each of the firm is analyzed based on the predetermined parameters. From the firms which are identified three to five specific firms, which bear a close similarity with the firm being valued, are selected.

iii. **Comparison and Analysis:** The historical financial statements (balance sheet, profit & loss account and cash flow/funds flow statement) of the firm being valued and the comparable firms are to be analyzed, so as to identify the dissimilarities between them. The dissimilarities essentially arise due to variations in accounting policies. Some of the common areas of dissimilarities are method of inventory valuation, depreciation policies, valuation of intangible assets, treatment of off balance sheet items, etc. Once such dissimilarities are identified appropriate adjustments are to be made to make the firms comparable.

    The next step involves computation of a set of valuation multiples for the comparable firms.

iv. **Selection of Valuation Multiples:** The price of a stock is a function of both the value of the equity in a company and the number of shares outstanding in the firm. Since stock prices are determined by the number of units of equity in a firm, they cannot be compared across different firms. To compare the values of "similar" firms in the market, you need to standardize the values in some way. Values can be standardized relative to the earnings firms generate, to the book value or replacement value of the firms, to the revenues that firms generate or to measures that are specific to firms in a sector.

    Many different market multiples are used. Some are quiet popular and are widely used and accepted in a specific industry, while some use the same one or two multiples in every appraisal. Since multiples of different levels of operating performance or financial position disclose different information about the firm being valued, care should be taken to select valuation multiples. Some of the multiples are discussed here.

- **Earnings Multiples:** Earnings multiples are the most commonly used measures of relative valuation. Among the earnings multiples the most commonly used multiple is the price earnings ratio. Other multiples used are the price earnings growth ratio, the relative P/E etc.
- **Book Value Multiples:** The price-book value ratios are quiet useful in investment analysis primarily because book value provides a relatively stable spontaneous measure of value that can be compared to the market price. For investors who suspect the accuracy of the discounted cash flow estimates of value, the book value is a much simple benchmark for comparison. Secondly, given reasonably consistent accounting standards across firms, price-book value ratios can be compared across similar firms for signs of under or over valuation. Finally, even firms with negative earnings, which cannot be valued, using price-earnings ratios, can be evaluated using price-book value ratios. There are far fewer firms with negative book value than there are firms with negative earnings.
- **Revenue Multiples:** A revenue multiple measures the value of the equity or a business relative to the revenues that it generates. Other things remaining equal, firms that trade at low multiples of revenues are viewed as cheap relative to firms that trade at high multiples of revenues.

  Revenue multiples have proved to be attractive to analysts for a number of reasons.

  Revenue multiples are available even for the most troubled firms and for very young firms unlike earnings and book value ratios which become negative for some firms. Thus, the potential for bias created by eliminating firms in the sample is far lower. Second, unlike earnings and book value, which are heavily influenced by accounting decisions on depreciation, inventory, R&D, acquisition accounting and extraordinary charges, revenue is relatively difficult to manipulate. Third, revenue multiples are not as unstable as earnings multiples and hence are less likely to be affected by year-to-year swings in firm's fortune. For example, the price-earnings ratio of a cyclical firm changes much more than its price-sales ratios, because earnings are much more sensitive to economic changes than revenues.
- **Sector-specific Multiples:** While earnings, book value and revenue multiples are multiples that can be computed for firms in any sector and across the entire market, there are some multiples that are specific to a particular sector. While there are certain conditions under which sector-specific multiples can be justified, they are dangerous for two reasons. First, since they cannot be computed for other sectors or for the entire market, sector-specific multiples can result in persistent over or under valuations of sectors relative to the rest of the market. Second, it is more difficult to relate sector specific multiples to fundamentals, which is an essential ingredient to using multiples well. The result will not only vary from company to company, but will also be difficult to estimate.

  The measurement of sector-specific multiples varies from sector to sector though they share some general characteristics. They are similar in the following characteristics. The numerator is usually enterprise value – the market values of both debt and equity netted out against cash and marketable securities. The denominator is defined in terms of the operating units that generate revenues and profits for the firm.

  For commodity companies such as oil refineries and gold mining companies, where revenue is generated by selling units of the commodity, the market value of the commodity can be standardized by dividing the value with the reserves that these companies have.

Value per commodity unit = (Market value of equity + Market value of debt)/Number of units of commodity in reserves.

For manufacturing firms that produce a homogeneous product (in terms of quality and units), the market value can be standardized by dividing by the number of units of the product that the firm produces or has the capacity to produce.

Value per unit product = (Market value of equity + Market value of debt)/ Number of units produced.

For subscription-based firms such as cable companies, internet service providers and information providers (such as TheStreet.com), revenues come from the number of subscribers to the base service provided. Here, the value of a firm can be stated in terms of the number of subscribers.

Value per subscriber = (Market value of equity + Market value of debt)/Number of subscribers.

The above discussed multiples can be classified into two types viz., equity multiples and value multiples. Equity multiples are used to value a company from the view point of equity shareholders, where as the value multiples are used to value the firm as a whole.

Equity Multiples

Equity multiples are primarily used to measure the value of equity. An Equity multiple requires two variables – one variable is market value of equity and another variable is either earnings, revenues or book value of equity.

- **Price-Earnings Ratio (P/E):** The simplicity of the P/E ratio makes it the most widely used valuation multiples. It is defined as the ratio of the market price of the share to the earnings per share.

  PE = Market price per share/Earnings per share

  This multiple is more appropriate for most profitable companies with a stable capital structure that is consistent with the capital structure of the selected companies.

- **PEG Ratio:** The PEG ratio is defined as the price earnings ratio divided by the expected growth rate in earnings per share.

  PEG ratio = Price earnings ratio/Expected growth rate in earnings.

  If the expected growth rate in earnings per share here in the above equation is based upon earnings in the most recent year (current earnings), the PE ratio that should be used is the current PE ratio. If it is based upon the past earnings, the PE ratio used should be the past PE ratio. The forward PE ratio should never be used in this computation, since it may result in a double counting of growth.

- **Relative PE Ratio:** Relative price earnings ratios measure a firm's PE ratio relative to the market average. It is obtained by dividing a firm's current PE ratio by the average for the market.

  Relative PE = Current PE_{Firm}/Current PE_{Market}

- **Price/Book Value Ratio:** This ratio compares an investor's assessment of a company's wealth at a particular point of time with the company's reported financial position. This ratio is calculated by using the following formula:

  $$\text{Price-to-Book Value} = \frac{\text{Market Price per Share}}{\text{Book Value per Share}}$$

- **Price-to-Sales Ratio:** Price-to-Sales Ratio is one of the revenue multiples, which measures the value of the equity in relation to the gross revenue of the company.

  Price-to-Sales Ratio = Market price per share/Revenue per share.

Value Multiples

Equity multiples focus only on the value of equity, whereas the value multiples are used in valuing the firm or its operating assets as whole. Value multiples are used to give better judgment than equity multiples when comparing companies of different financial leverage ratios. Two variables are used in value multiples. One of those two variables is a variable, which indicates estimate of the value of a firm or its operating assets and another variable is a measure of revenues, earnings or book value.

- **Enterprise Value/Operating Earnings Multiples:** EV/EBITDA is firm's value multiples used as an alternative to P/E multiples. The advantage of this multiple is that it is a capital-neutral. This multiple is particularly usefull in valuing the firm with a negative net income or equity earnings, firms with high depreciation and capital intensive firms.
- **Value/Book Capital:** This ratio can be computed in two different methods. In the first method, value of the firm is termed as Firm value and cash-in-hand is treated as part of capital and in second method, value of the firm is termed as Enterprise value (EV) and cash- in-hand is not included in capital.

  Hence, Value/Book Capital = (Market Value of Equity + Market value of debt)/(Book value of equity + Book value of debt)

  Enterprise Value (EV)/Invested Capital = (Market Value of Equity + Market value of debt-cash-in-hand)/(Book value of equity + Book value of debt cash-in-hand).

v. **Valuation of the Firm:** The final step involves valuing the firm in relation to the comparable firm. This requires applying the multiples identified to the firm being valued. This is a highly subjective process. This process may provide several different values depending on the multiple applied. In such possibility, average value may be computed based on the values depending on the multiple applied. In case the valuer believes that a particular multiple(s) is/are more important, weighted arithmetic average may be used by assigning appropriate weightages that reflect the comparative importance of each multiple.

   Despite the fact that the use of multiples is simple, there are four steps in using them soundly. First, the multiple is defined consistently. Second, there should be a sense of how the multiple varies across firms in the market. In other words, a high value, a low value and a typical value of the multiple in question should be identified. Third, the fundamental variables that determine each multiple and how changes in these fundamentals affect the value of the multiple are identified. Finally, the actual comparable firms are found out and adjusted for the differences between the firms on fundamental characteristics.

Illustration 12

Compute the value of Sigma Ltd. with the help of the comparable firms approach using the following information:

Sales	Rs.100 cr.
Profit after tax	Rs.15 cr.
Book value	Rs.60 cr.

The valuer feels that 50% weightage should be given to earnings in the valuation process. Sales and book value may be given equal weightages. The valuer has identified three firms which are comparable to the operations of Sigma Ltd.

(Rs. in crore)

Particulars	Alpha Ltd.	Beta Ltd.	Gamma Ltd.
Sales	80	120	150
Profit After Tax	12	18	25
Book Value	40	90	100
Market Value	120	150	240

Solution

The valuation multiples of the comparable firms are as follows:

Particulars	Alpha	Beta	Gamma	Avg.
Price/Sales Ratio	1.50	1.25	1.60	1.45
Price/Earnings Ratio	10.00	8.33	9.60	9.31
Price/Book Value Ratio	3.00	1.66	2.40	2.35

Applying the above multiples, the value of Sigma is as follows:

Particulars	Multiple	Parameters	Value
Price/Sales	1.45	100	145.00
Price/Earnings	9.31	15	139.65
Price/Book Value	2.35	60	141.00

The weightages to P/S ratio, P/E ratio and the P/BV ratio are 1, 2 and 1 respectively. Thus the weighted average value will be:

= [(145 x 1) + (139.65 x 2) + (141 x 1)]/4 = Rs.141.32 cr.

The value of Sigma Ltd., using the comparable firms approach, is Rs.141.32 cr.

Disadvantages of Relative Valuation

Though relative valuation has its own strengths compared to the discounted cash flow valuation, these strengths might sometimes prove to be weaknesses:

i. Relative valuation sometimes leads to inconsistent estimates of value because key variables like risk, growth and cash flows are ignored.

ii. The fact that multiples reflect the market mood also implies that using relative valuation to estimate the value of an asset can result in values that are too high, when the market is over valuing comparable firms, or too low, when it is under valuing these firms.

iii. The lack of transparency regarding the underlying assumptions in relative valuation makes them particularly vulnerable to manipulation.

Discounted Cash Flows Vs. Comparable Company Approach

Discounted cash flow valuation and relative valuation generally yield different estimates of value for the same firm. Even within relative valuation, different estimates of value are obtained depending upon which multiple is used and on what firms the valuation is based on.

The reason for the differences in value between discounted cash flow valuation and relative valuation is the different views of market efficiency, or in particular, market inefficiency. In discounted cash flow valuation, it is assumed that the markets make mistakes and that these mistakes are corrected over time. These mistakes can often occur across entire sectors or even the entire market. In relative valuation, it is assumed that while markets make mistakes on individual stocks, they are corrected on average. Thus, a stock may be over valued on a discounted cash flow basis but under valued on a relative basis, if the firms used in the relative valuation are all overpriced by the market. The reverse would occur, if an entire sector or market were under priced.

ASSET-BASED VALUATION APPROACH

All firms cannot be evaluated using the discounted cash flow method or the comparable company method. Some firms which are underperforming usually generate no cash flows and therefore they do not have general intangible value. The value of such firms can be obtained from the hypothetical sale price of its assets. Thus, the primary circumstance where the asset approach (also called the cost approach) would be used is to value a firm whose value is limited to the total of specific tangible assets, because it fails to generate any intangible value.

Asset or cost methods are conducted under either a going concern or a liquidation principle. When the valuation is conducted based on the going concern assumption it is called, ‘the adjusted book value approach’ and when it is conducted based on the liquidation principle it is termed as, ‘the liquidation value approach’.

Adjusted book value approach to valuation is an asset approach where the valuation is done by estimating the market value of the assets and liabilities of the firm as a going concern. The going concern principle is based on the assumption that the business will continue to operate and the appraisal of assets is done at their value “in use”.

The liquidation value method is based on the principle of liquidation. It is based on the assumption that the operations of the business will cease and liquidation will occur. The costs involved to liquidate the business must be considered and subtracted in determining the net proceeds.

From the above, it is clear that the asset approach is different from the conventional book value method. The conventional approach relies on the historical book value of assets and liabilities while in the asset approach the valuation of assets and liabilities is done based on their fair market value.

This is because book value of assets cannot be an indication of market value since it typically reflects only the historical cost of assets. There is no attempt in the depreciation process to report assets at what they are actually worth. Since it is not wise to assume that specific assets are worth the amount at which they are carried in the company’s books, the market value is a better choice. The market value of an asset is dependent on many factors, including the market of available substitutes, technological changes and inflation. Some assets depreciate in market value over the years, but some like real estate appreciates.

Method of Valuation

Whether we determine the fair market value or the liquidation value, the common procedure under asset approach is to adjust the company’s balance sheet accounts from book values based on accounting computations to market value. The approach begins with valuation of all the assets of the firm. The adjustments are made as follows:

Valuation of Tangible Assets

- **Current Assets:** Current assets constitute a major block on the asset side of the balance sheet. Current assets usually include cash, inventory, accounts receivable, etc.
- **Cash:** Cash generally does not require any adjustment unless the cash position is either excessive or deficient.
- **Accounts Receivable:** Debtors or accounts receivable are generally valued at their book value. However, allowances should be made for any doubtful debts. The uncollectible debts should be removed based on the primary considerations like the company’s history of collections as a percentage of total receivable, a state of economy, the state of the company’s industry, customers, etc.
- **Inventory:** Depending upon the industry – retail, wholesale or manufacturing the composition of inventory will vary. Inventory is valued depending on its nature.
- **Raw Material:** Raw material is valued under last-in-first-out method or first-in-first-out method or average cost method and may need to be adjusted to reflect shrinkage, obsolescence or similar factors.

- **Work-in-progress:** Work-in-progress can be valued either based on the cost, i.e., cost of materials plus processing costs incurred or based on the sales price, i.e., sale price of the finished product less cost incurred to convert the work-in-progress into sales.
- **Finished Goods:** Finished goods are valued at current realizable sale value after deducting provisions for packing, transportation, selling costs, etc.
- **Prepaid Expenses:** The prepaid account generally does not require any adjustment as long as the buyer can acquire the benefits of the item purchased or receive a refund for the advance payment.
- **Other Assets:** Some of the assets which usually require adjustment are marketable securities, other non-operating assets, bill receivable, etc. If these items are not used in the company's operations they should be removed from the balance sheet. Other items should be removed from the balance sheet. Other assets should be converted to market value based on the benefit that they provide to the company.
- **Fixed Assets:** Fixed assets constitute substantial portion of the asset side of the balance sheet in capital intensive companies. Land is valued at its current market price. Buildings are normally valued at replacement costs. However, appropriate allowances are to be made for depreciation and deterioration in its conditions. Similarly, plant and machinery, capital equipments, furniture, fixtures, etc., are to be valued at fixed costs net of depreciation and allowances for deterioration in conditions. An alternative method of valuing plant and machinery involves estimation of the prevailing market price of similar used machinery plus the cost of transportation and erection.
- **Intangible Assets:** The valuation of intangible assets like brands, goodwill, patents, trademarks and copyrights, distribution channel, etc., is a controversial area of valuation. Several major companies (consumer goods in particular) believe that brands are its most valuable assets. The idea of intangibles as financial assets emerged in the mid-eighties. As intangibles have significant financial value, their absence from the valuation distorts the true financial position of a company. Hence, to ensure that the valuation of a company is reflective of its true intrinsic worth, it has become necessary for companies to determine the values of their brands.

However, there is a large element of subjectivity in the process of valuation of intangibles. The two popular methods of valuing intangibles are given below:

i. **Earnings Valuation Method:** This method of valuation is widely accepted in most markets around the world. The value of an intangible like any other asset is equal to the present value of the future earnings attributable to it. This is a two-staged process involving:

    a. Determining the future earnings attributable to the intangible asset; and

    b. Applying an appropriate multiplier to determine its present value.

    The main drawback of this approach is that the future projections of the earnings may be optimistic. Further, the process of determining the multiplier is highly subjective. Due care has to be taken for the above factors, failing which the intangible asset may be overvalued. Unscrupulous companies may possibly overvalue the intangibles and use brand values as a tool for window dressing.

ii. **Cost Method:** This method involves stating the value of the intangible asset at its cost to the company. This is relatively easy when the intangible asset is acquired. The money paid to buy the brands can be directly stated. (For example, Coca-Cola paid Rs.170 cr. to acquire the soft drinks brands of Parle). It is more difficult to value the brand when the intangible asset has been developed in-house by the company. The methodology involves determining the cost incurred in developing the intangible asset. The process of identification of the costs incurred is characterized by a great degree of subjectivity. This may have a significant impact on the final valuation.

Liabilities

The valuation of liabilities is relatively simple. It must be noted that share capital, reserves and surpluses are not included in the valuation. Only liabilities owed to outsiders are to be considered. All long-term debt like loans, bonds, etc., are to be valued at their present value, using the standard bond valuation model. This involves computing the present value of the debt servicing (both principal and interest payments) by applying an appropriate discount rate. Current liabilities include amount due to creditors, short-term borrowings, provision for taxes, accrued expenses, advance payment received, etc. Normally, such current liabilities and provisions are taken at their book value.

Non-recurring or Non-operating Assets and Liabilities

Items or activities, which are not expected to recur are called non-operating. Non-operating assets are assets not needed to maintain the anticipated level of business activity. For example, gains or losses on sales of assets, marketable securities, investments or interest paid on non-operating debt.

While assessing the value of the firm, non-operating assets are usually added to the operating value of the firm to arrive at the total value.

Off Balance Sheet Assets:

– ***Asset related liabilities:*** Liabilities related to assets that were adjusted also may require adjustment.

– ***Interest bearing debt:*** If the interest charged on a bill payable is a fixed rate that is significantly different from the market rate on the valuation date, the debt should be adjusted.

– ***Deferred taxes:*** A deferred tax liability may be appropriate based on the amount of deferred tax due on assets written up from book to market value.

Off Balance Sheet Liabilities:

There are always some common unrecorded items like the guarantee and warranty obligations, pending litigation or other disputes like taxes and employee claims or environmental or other regulatory issues. Such liabilities should be quantified and deducted while estimating the firm value.

Valuation of the Firm

The ownership value of a firm is the difference between the value of the assets (both tangible and intangible) and the value of the liabilities. Normally, no premium is added for control as assets and liabilities are taken at their economic values. On the other hand, a discount may be necessary to factor in the marketability element. The market for some of the assets may be illiquid or may fetch a slightly lesser price, if the buyer does not perceive as much value of the asset to his business. Hence, a discount factor may be applied.

Asset intensive companies or underperforming businesses that lack operating value because they generate inadequate returns are often valued by the asset approach. This approach is more appropriate for appraisal of controlling interests that possess the authority to cause the sale that creates the cash benefit to shareholders. Whether using the adjusted book value method to determine the value of the assets in use or liquidation value to determine their worth in liquidation conditions, the asset approach involves adjusting balance sheet accounts to market value. The adjustments are made to reflect the value of non-operating assets or asset surpluses or shortages that may exist in companies whose operating value is determined by income or market approach.

SELECTION OF APPROPRIATE VALUATION METHOD

Firms or assets can be valued using any of the four methods of valuation, they being – discounted cash flow valuation approaches that discount cash flows to arrive at a value of equity or value of the firm, relative valuation approaches that base value upon multiples, asset based valuation approaches that estimate what the assets owned by a firm are worth currently and option pricing approaches that use contingent claim valuation. Selection of the right model for valuation is critical to arrive at a reasonable value. Matching the valuation model to the asset or firm being valued is as important a part of valuation as understanding the models and having the right inputs.

In the discounted cash flow valuation, cash flows to equity are discounted at the cost of equity to arrive at a value of equity or cash flows to the firm are discounted at the cost of capital to arrive at the value for the firm. The cash flows to equity themselves can be defined in the strictest sense as dividends or in a wider sense as free cash flows to equity. These models can be further categorized on the basis of assumptions of growth into stable growth, two-stage and three-stage models.

In the relative valuation model, either equity or firm value are used as the measure of value and are related to a number of firm-specific variables – earnings, book value and sales. The multiples can be estimated by using comparable firms in the same business or from cross-sectional regressions that use firms from a broader range.

There are two ways to determine the value of a firm using asset based valuation techniques can be determined. One is liquidation value, where the value of the firm is arrived as the value which the market will be willing to pay for its assets, if the assets were liquidated today. The other is replacement cost, where we evaluate how much it would cost to replicate or replace the assets that a firm has in place today.

Contingent claim models can also be used in a wide range of circumstances. When the option to delay making an investment decision is considered, we can value the patent or the undeveloped natural resource as an option. The option to expand may make young firms with potentially large markets trade at a premium on their discounted cash flow values. Finally, equity investors may derive value from the option to liquidate troubled firms with substantial debt.

The values obtained from the various approaches as described above can be very different and choosing which one to use is an important issue. This choice of an appropriate method depends upon several factors described as under:

BUSINESS CHARACTERISTICS

The appropriate approach to valuation depends on the firm or the asset being valued. The marketability of the firm/asset is an important character. Estimation of liquidation valuation and replacement cost valuation are easiest for firms that have separable and marketable assets. For instance, the liquidation value for a real estate company can be estimated because its properties can be sold individually and the value of each property can be calculated easily. For mature businesses and businesses, which are separable and marketable, liquidation and replacement method are more suitable. For firms, which are growing and are neither separable nor marketable, the other methods are more appropriate.

TIME PERIOD

In discounted cash flow valuation we consider a firm as a going concern that may last into perpetuity. On the other hand, in liquidation valuation, we estimate value by assuming that the firm will cease its operations today.

In relative valuation and contingent claim valuation, we take an intermediate position between the two. Based on these assumptions, we can conclude that the discounted cash flow valuation, is used if the time horizon is longer, and relative valuation can be used, if we have a shorter time horizon. This explains why discounted cash flow valuation is more prevalent in valuing a firm for an acquisition and relative valuation is more common in equity research and portfolio management.

BELIEFS ABOUT MARKETS

Every approach to valuation assumes about markets and how they work or fail to work. In a discounted cash flow valuation, we assume that market prices deviate from intrinsic value but they correct themselves over long periods. In relative valuation, we assume that markets are on average right and that while individual firms in a sector or market may be mispriced, the sector or overall market is fairly priced. In asset-based valuation models, we assume that the markets for real and financial assets can deviate and that you can take advantage of these differences. Finally, in option pricing models, we assume that markets are not very efficient at assessing the value of flexibility that firms have and that option pricing models will therefore give an advantage. In each and every one of these cases, though, we assume that markets will eventually recognize their mistakes and correct them.

REASONS FOR DOING VALUATION

The valuation approach used will vary depending on the reason for which valuation is done. For example, relative valuation can be used when valuation is done to find out the most under or over priced firm in the sector. If valuation is done to purchase a company, the intrinsic value of the company has to be found out and hence the discounted cash flow approach to valuation is more suitable.

CASH FLOW GENERATING CAPACITY

Based on their capacity to generate cash flows, assets can be categorized into three groups – assets that are either generating cash flows currently or are expected to do so in the near future, assets that are not generating cash flows currently but could in the future in the event of a contingency and assets that will never generate cash flows.

The first category, which consists of assets that are either generate cash flows currently and are expected to do so in the near future include mostly the publicly traded companies and these firms can be valued using discounted cash flow models. Here, there is no distinction drawn between negative and positive cash flows and hence young, start-up companies that generate negative cash flow can also be valued using discounted cash flow models.

The second group includes assets such as drug patents, undeveloped oil or mining reserves and undeveloped land. These assets may generate no cash flows currently, but could generate large cash flows in the future under favorable conditions. While expected values using discounted cash flow models can be estimated by assigning probabilities to these events, there is a possibility that the value of the assets be understated. We can value these assets using option pricing models.

Assets that are never expected to generate cash flows like a residential house (which is not fetching any rent) can only be valued using relative valuation models.

UNIQUENESS

In a market where hundreds of stocks are traded and thousands of assets are bought and sold every day, it may be difficult to think about an asset or a firm that is so unique without having any comparable assets. For assets, which are a part of a large group of similar assets with no or very small difference, the relative valuation can be used since assembling comparable assets (firms) and controlling for a difference is simple. For businesses that are truly unique, discounted cash flow valuation will give a better estimate of value.

Once the approach is decided, there are further choices to make within a particular approach like – whether to use equity or firm valuation in the context of discounted cash flow valuation, which multiple should be used to value firms or equity in the context of relative valuation and what type of option is embedded in a firm in the context of option pricing models.

CHOOSING THE RIGHT DISCOUNTED CASH FLOW METHOD

The model used in valuation should be modified to match the characteristics of the asset being valued, rather than making an asset fit the pre-specified valuation model. There is no one 'best' model. The appropriate model to use in a particular setting will depend upon a number of the characteristics of the asset or firm being valued.

i. **Choosing the Right Cash Flow:** When the assumptions to value a firm under the firm approach and the equity approach are consistent, then the value obtained under both the approaches will be the same. For firms with stable leverage, i.e., firms that have debt ratios that are not expected to change during the period of valuation, there is not much to choose between models in terms of inputs needed for valuation. The debt ratio is used to estimate the free cash flows to equity in the equity valuation model and to estimate the cost of capital in the firm valuation model. Any model, which the analyst is comfortable with can be used in such circumstances.

   For firms that have too much or too little leverage, i.e., unstable leverage and, which want to move towards their optimal or target debt ratio during the period of valuation, the firm valuation approach is much simpler to use, because it does not require cash flow projections from interest and principal payments and is much less sensitive to errors in estimating leverage changes. The calculation of the cost of capital requires an estimate of the debt ratio, but the cost of capital itself does not change as much as a consequence of changing leverage as the cost of equity.

   The dividend discount model is used when the free cash flow to equity cannot be estimated because of insufficient information about the debt payments and reinvestments or, because there is difficulty in defining what comprises debt. Also, when the only cash flow a shareholder is expected to get from the equity investments is the dividends, because there are significant restrictions on stock buy-backs and other forms of cash return and the shareholders have very little or no control over the management of a firm, the dividend discount model is used.

ii. **Using Current or Normalized Earnings:** Usually, the earnings reported in the current financial statements of the firm are used as the base for projections. However, for some firms, which report negative earnings or abnormally high earnings in the current year, the current year earnings cannot be taken as the base as they do not reflect the firm's own history of earnings.

   Therefore, when current earnings are negative or abnormal for a short period, they can be replaced with a normalized value, which is estimated by looking at the company's history or industry averages and value the firm based on these normalized earnings. For some firms the negative earnings are unlikely to disappear. This tendency may threaten the survival of the firm. For such firms, if current earnings are replaced by normalized earnings, we tend to over value the firm.

   If the firm is likely to go bankrupt, then the option pricing model (if financial leverage is high) or a model based on liquidation value (if there is no leverage) provide meaningful values. If, on the other hand, the firm is unlikely to go bankrupt, the operating margins over time have to be adjusted to better levels and value the firm based on the expected cash flows.

iii. **Growth Pattern:** While valuing firms, several assumptions are made about the growth rate in earnings and revenues. Various factors are considered while taking decisions about the growth of the firm. The pattern of growth will influence the level of current growth in earnings and revenues.

> Stable growth firms report earnings and revenues growing at below the nominal growth rate in the economy they operate in. For such firms, the constant growth discounted cash flow provides a good estimate of value. Moderate firms report earnings and revenues growing at a rate moderately higher than the nominal growth rate in the economy. For such firms, the two-stage discounted cash flow model is used for valuation since it provides enough flexibility in terms of capturing changes in the underlying characteristics of the firm. High growth firms, report earnings and revenues growing at a rate much higher than the nominal growth rate in the economy. For such firms, the three-stage discounted cash flow model is used to capture the longer transition to stable growth that is natural in high growth firms.

The competitive advantage enjoyed by a firm over other firms also acts as a source of growth. The expected growth rates for firms, which have specific sources of competitive advantage (i.e., those which are likely to disappear suddenly) is likely to follow the two-stage process where growth is high for a certain period and drops abruptly after that to a stable rate. The expected growth rate for firms that have general sources of growth (advantage which is more likely to erode overtime) is more likely to follow the three-stage discounted cash flow model.

CHOOSING THE RIGHT RELATIVE VALUATION MODEL

The various multiples used in relative valuation model are based either on earnings or book values or on revenues. In determining multiples, we use current values or forward values or forecasted values. Since the values we obtain are likely to be different using different multiples, deciding which multiple to use can make a big difference to the estimate of value. The multiples to be used can be determined by using any of the following methods:

Multiples which best fit the firm should be used. Depending on the objective for which valuation is done the appropriate multiple has to be selected. For example, if a firm has to be sold, a multiple which gives the highest value for the company is selected. The management of the firm should also play an active role in deciding which multiple to use to value a company and what firms will be viewed as comparable firms. Theoretically defined, comparable firms are those firms, which not only operate in the business in which the firm operates, but also are similar in terms of the size or the market served. However, in practice it is very difficult to find a comparable firm and the firms that are finally identified as comparable firms are often firms with different business mixes and significantly different from the firm being valued in risk and growth characteristics.

If there are a large number of firms similar to the one being valued in existence and if these are traded in the financial markets then the approach is acceptable. But if the firm is unique and there are not many firms listed in the market, it is more appropriate to use a cross sectional regression to estimate the multiple. It is a regression analysis where the observations are measured at the same point in time or over the same time period but differ along another dimension. For example, an analyst may regress stock returns for different companies measured over the same period against differences in the companies' yields for the period. Such a regression can use all the firms in the universe and control for the differences in the underlying asset.

The approach to use for relative valuation depends upon what the task is defined to be. If the objective is to stay on a particular sector and make judgments on which stocks are under or over valued, sector based relative valuation should be used. If there is more scope and the objective is to find under or overvalued stocks across the market, a second approach in addition to the first should be used.

VALUATION – A CASE STUDY

NATIONAL ALUMINIUM COMPANY LIMITED

Established in 1981 as a public sector enterprise, Nalco has the largest aluminium unit in Asia which is also one of the largest aluminum complexes in the world. It undertakes various activities of aluminum and related processes like refining, smelting, bauxite mining, casting, railway operations, port operations, and power generation. It started pioneering practices and state-of-the-art technology in its manufacturing units across the country to attain its vision to become "a company of global repute in the aluminum sector", driven by its mission to attain business growth, gain competitive advantage, and satisfaction of customers and investors.

Commissioned during 1985-87, it became a star performer in the production and export of alumina and aluminum, driven through a self-sustained growth. It produces ingots, sows, billets, wire rods, alloy wire rods, cast strips, and rolled products of aluminum metal. It even manufactures calcined alumina, alumina hydrate, zeolite-A, and special products like specialty hydrate/alumina. It started mechanized storage and ship handling facilities basically to export alumina in bulk and import caustic soda on the northern arm of the inner harbor of Visakhapatnam port along the Bay of Bengal. Besides aluminum, it also deals in chemicals and electricity segments.

The Government of India established Nalco mainly to exploit the large deposits of bauxite discovered in the East Coast areas of India. After incorporation, it not only fulfilled the aluminum requirements in India but also acquired technological edge in the production of this strategic metal in accordance with the global standards. Looking at Nalco's performance, the Government of India conferred Navratna status on 28th April 2008. Nalco's elevation to this elite Navratna status is considered to bring in significant changes in the history of aluminium industry in India.

Background

History of Nalco can be traced to 1975, when the Government of India first discovered bauxite mines in its east coast area. Nalco's Feasibility Report was prepared in 1979 and the union government took the investment decision in 1980. Government entered into Indo-French Collaboration Agreement and formed the company 'Nalco' in January 1981. Late Prime Minister Smt. Indira Gandhi laid the foundation stone in March the same year. In the year 1982, the Company signed a major Euro-Dollar Loan agreement and started civil work.

In 1985, it commissioned port facilities and Bauxite mines. Alumina refinery and captive power plant started in September 1986 while the smelter plant started operations in March 1987. It first sold its aluminium in May 1987 and from the following year onwards, it started exporting its Alumina and Aluminium produce. During the late 1990s, it undertook some significant financial restructuring. In September 1998, it achieved zero-debt status and went for equity capital restructuring of Rs.12.88billion to Rs.6.44billion in March 1999. Later, the company strengthened its position by increasing its production capacity, sales and exports.

Being a government company, central government/state government hold most of the company's shares. They alone hold 87.1475% of the company's shares while Institutions hold 9.1165% and Non-Institutions hold 3.7360% shares as of December 2008.

NALCO's corporate office is located in Bhubaneswar. Its main bauxite mine is located on Panchpatmali hills in Orissa. Started in November 1985, this is a fully mechanized opencast mine with the capacity of 6.3 million tpa. This mine mainly serves feedstock to Alumina Refinery at Damanjodi, which provides alumina to the company's smelter at Angul and exports the balance Alumina to overseas markets through Visakhapatnam Port. Its capacity is 21,00,000 tpa.

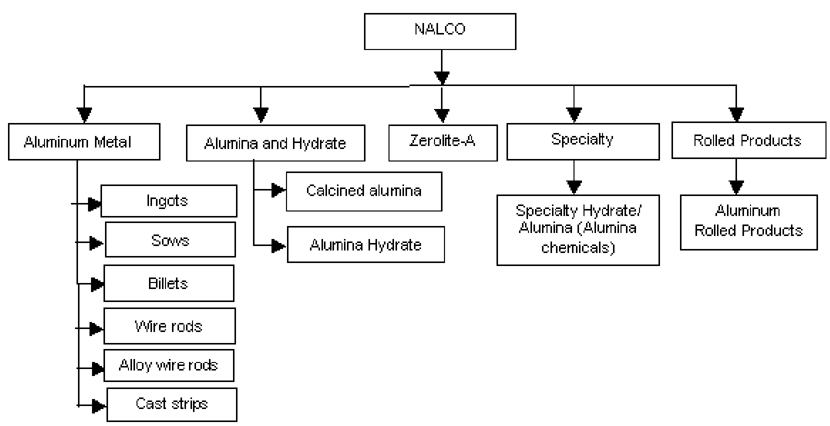
The aluminium smelter located at Angul with a capacity of 460000 tpa, has in place energy efficient state-of-the-art technology for smelting and pollution control. NALCO has a rolled products unit with a capacity of 50000 MT which works in integration with the smelter plant at Angul. This unit produces aluminum cold rolled sheets and coils from continuous caster route, based on the advanced technology of FATA Hunter, Italy.

In order to provide firm supply of power to the Smelter at Angul, the company started a captive power plant comprising 8x120 MW clusters. The power plant was later expanded to provide 1200MW. It also owns port facility in Visakhapatnam, which has a mechanized storage and ship handling facilities for exporting Alumina in bulk and importing Caustic Soda.

Business Model

Company through its various manufacturing units primarily produces aluminum. The various products of aluminum the company produces are – Aluminum metal, Alumina and Hydrates, Zerolite-A, special alumina chemicals, and aluminum rolled products.

Figure 2: Nalco Products



Source: Company Website, Icfai Research Team.

Company's Strategy

Nalco plans to grow in domestic as well as in global markets for which it is planning to invest Rs.400 billion in both Greenfield and Brownfield projects for the next five years. "In order to emerge as a company of global repute, we have drawn ambitious growth plans worth Rs.400 billion for the next five years. These include smelter and power projects in Indonesia and Iran," said Nalco chairman R C Pradhan.

On the domestic front, it plans to expand its existing operations in Orissa at a cost of Rs.60 billion. With this expansion, bauxite mining capacity of the company will increase to approximately 9 million tons annually while the alumina refining will be enhanced to 3 million tons, and aluminum smelting will increase to 0.63 million tons and power generation will increase to 1,700 MW.

The company entered into an agreement with Bharat Earth Movers Limited (BEML) to produce aluminum rail wagons and later to produce aluminum rail coaches and metro coaches. Both the companies would jointly develop these products with Nalco supplying the aluminum extrusions after conversion from its billets and ingots through a third party. The aluminum wagons are coaches that have key benefits such as lightweight, higher carrying capacity, environment friendliness, lower lifecycle costs etc.

The company plans to start an Aluminum Park in Angul as a joint venture with Orissa Industrial Infrastructure Development Corporation (IDCO). For this purpose, the company had acquired 500 acres of land and both the companies together will manage basics like infrastructure, communication and power supply.

The Company also plans to set up a mining complex, and a refinery in Andhra Pradesh at a cost of Rs.70 billion; and a smelter and a power complex in Ib Valley in Jharsuguda district in Orissa with Rs.85 billion. It even plans to enter into a joint venture to set up a cement plant based on fly ash with an investment of Rs.3 billion. Additionally, many projects are in the pipeline at various stages, aimed at backward integration to ensure smooth and economic sourcing of raw materials.

On the international front, the Company has plans to expand its operations to Indonesia, South Africa and Iran. It plans to invest Rs.140 billion for a 0.5 million-ton smelter and a 1250MW captive power plant in Indonesia. It also plans to invest Rs.160 billion for a smelter and power plant in South Africa. It also proposes to set up a 0.31 million-ton smelter in Iran investing Rs.40 billion.

Nalco plans to infuse a mix of debt and equity to fund all its Greenfield and Brownfield expansions, which take place in India and abroad. The construction of these projects would span from three to five years as a result of which, the company requires funds mainly from 2011-12. For the fund requirements, the company plans to go for equity offer followed by raising debt.

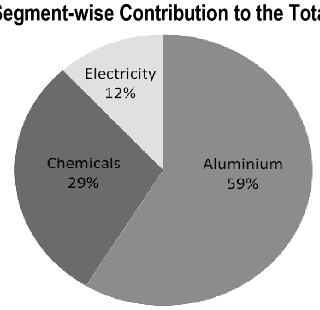
For all their expansion plans, companies essentially need raw materials, which play a huge role in the growth of a manufacturing business. Having captive bauxite mines and a captive power plant, Nalco has the benefits of low-cost raw materials and power. The only concern for the company is the coal supply, for which it adopted a new strategy to use ‘washed’ coal for the first time to continue its work at the smelter in Damanjodi and power plant in Angul. It plans to use 90,000 tons of washed coal at its facilities in the financial year 2008-09.

The main idea of the company is to supplement 25% of the total coal requirement of Damanjodi through washed coal, which is costlier than regular coal. But the supply of the washed coal is expected to be uninterrupted. Washed coal price is approximately Rs.2,500-3,000 per ton whereas the price of regular coal is approximately Rs.1,000-1,200 per ton.

Segmental Analysis

Nalco mainly deals in aluminum, chemicals, and electricity segments. Most of the company’s revenue comes from the aluminum segment.

Figure 3: Segment-wise Contribution to the Total Revenue



Source: Company Website.

Aluminum sales decreased to Rs.38.67 billion for the period 2007-08 from Rs.43.60 billion for the period 2006-07, while sales from chemical segment decreased during the period 2007-08 to Rs.11.03 billion from Rs.15.17 billion. Electricity sales also dropped to Rs.0.017 billion.

The capital expenditure incurred was Rs.5.44 billion for aluminum, Rs.4.36 billion for chemicals and Rs.4.40 billion for electricity for the financial year 2007-08. The Aluminum segment has assets worth Rs.31.77 billion and liabilities worth Rs.4.48 billion; chemical segment has Rs.22.78 billion worth assets and Rs.3.12 billion worth liabilities while the electricity segment has Rs.17.65 billion and Rs.6.18 billion worth assets and liabilities respectively as on March 31, 2008. Depreciation for the same period was Rs.1.18 billion for aluminum segment, Rs.1.03 billion for chemical segment, and Rs.0.58 billion for electricity segment.

Future Outlook

As discussed earlier, Nalco has plans to grow in domestic as well as in global markets for which it plans to invest Rs.400 billion in both Greenfield and Brownfield projects for the next five years. The overseas expansion with Rs.270,000 million may take some time to take-off, as the company is yet to attain financial closure amid the global economic slowdown.

For Iran and Indonesia projects, company is to finalize the financial tie-ups and secure finances. Besides this, Nalco's proposed aluminum smelter in South Africa is bearing the brunt of global economic slowdown as aluminum prices have fallen by 60% from the peak levels of the previous year i.e. 2008. Additionally, company may be affected with the variation in the project cost if it is postponed. However, the expansion plans in India can be completed with the ample cash in hand. If required, it can raise a minimum amount in the debt market being a zero debt company.

Industry analysts opine that approximately 40 percent of global aluminum capacity is making loss today; and as a result many big players are trimming production. Nalco being dependent on overseas market for its earnings will also get affected abruptly. It may see its cost of production perilously close to its selling price. They expect a fall in revenues by about 10 percent and a drop in net profits at around 25 percent in 2009-10. If the company faces problem in selling its products, then the stock will pile up leading to suspension of some of its activities.

Looking at the challenging time, Nalco chairman said, "We have to be prepared for all types of eventualities."

Profit and Loss Account of Nalco for the Financial Years 2006-07 and 2007-08

Rs. in million

Particulars	2006-07	2007-08
Net Sales/Operating Income	59401.90	49888.00
Expenditure		
Raw Material	5301.10	5208.60
Manufacturing and Other Expenses	12340.20	13900.50
Personnel	3928.80	5529.70
Selling, distribution and administration expenses	2349.00	3054.50
Cost of Goods Sold	23919.10	27693.30

Particulars	2006-07	2007-08
EBITDA	35482.80	22194.70
EBITTDA %	59.73%	44.49%
Depreciation & Amortization	3171.30	2811.00
Operating Expense/EBIT	32311.50	19383.70
Interest and Financial Charges	11.20	15.10
Other Income	4016.50	5547.70
Profit before Extraordinary Item and Tax	36316.80	24916.30
Extraordinary Item	–112.60	–250.40
Profit Before Tax	36204.20	24665.90
Provision for TAX	12390.20	8350.70
Profit after Tax/ Profit available to Shareholders	23814.00	16315.20
Dividends	5877.40	5276.60
No. of Shares Outstanding in Million	644.30	644.30
EPS Rs.	36.96	25.32
Dividend per Share	9.12	8.19

Source: Adapted from Company Financial Reports, Icfai Research Team.

Balance Sheet of Nalco as on 31.03.2007 and 31.03.2008

Rs. in million

Particulars	31.03.2007	31.03.2008
Application of Funds		
Fixed Assets/Gross Block	98756.70	114727.10
Less: Depreciation	53231.80	56063.10
Net block	45524.90	58664.00
Investments	0.00	1150.30
Current Assets		
Cash and Bank Balance	36865.30	35164.60
Inventories	6349.60	6866.50
Debtors	341.30	606.50
Other Current Assets	2120.40	2364.70
Loans and Advances	4064.20	5411.00
Total Current Assets	12875.50	15248.70
Current Liabilities and Provisions	12186.10	15408.80
Net Current Assets	689.40	–160.10
Total Assets	83079.60	94818.80
Sources of Funds		
Shareholders Funds		
Share Capital	6443.10	6443.10
Reserves & Surplus	70509.10	82301.40
Total Shareholders Funds	76952.20	88744.50
Deferred Tax Liability	6127.40	6074.30
Total Liabilities	83079.60	94818.80

Source: Adapted from Company Financial Reports, Icfai Research Team.

Calculate the share value of Nalco by making valid assumptions and substantiate your assumptions (WACC=13%). Use the FCFF method of DCF valuation to value the company.

Solution

Nalco has already announced its aggressive expansion plans at the domestic and international fronts. Demand for aluminium is on the decline and raising funds may not be easy. At this juncture if company goes ahead with its expansion plans it may lead to negative returns. Based on these facts, company may not continue its aggressive plans. It may postpone its plans slightly. Based on these assumptions, Nalco is valued.

Assumptions regarding the sales, margins, CAPEX and working capital are shown in the following table:

Particulars	FY 09	FY 10	FY 11
Sales growth	8.00%	9.00%	12.00%
EBITDA Margins	52.92%	51.42%	50.92%
CAPEX as a % of sales	44%	49%	62%
Change in working capital % of sales	2%	1%	-1%

During the first stage (FY09 to FY11) company gradually increases its sales and CAPEX. EBITDA Margins will slightly reduce with the increase in cost of production. By the end of first stage working capital may end up in negative.

While in the second stage (FY 12 to FY 17), sales growth be expected to gradually decline from 20% in FY 12 to 8% in FY 17. EBITDA margins are expected to reduce from 47% in FY12 to 41% by FY17. CAPEX of the company would decrease from 69% on sales in FY12 and stabilize at 15% on sales by FY17. At this stage change in working capital will decrease from 4% in FY12 to 2% by FY17.

From FY 17 onwards, the company is expected to attain the long-term stabilization stage and its cash flows are expected to grow at 5% till the perpetuity. Also the return on invested capital will remain at 13%.

It is assumed that Depreciation would remain at 5%.

Effective tax rate for the company is 33%.

FCFF = NOPLAT-CAPEX – Change in working capital+ non-cash operating expenses (depreciation)

Where,

NOPLAT (Non-operating profit less adjusted tax) = EBIT (1 – T)

Calculations of FCFF and present values for the two stages are given in the next page.

Terminal value = NOPLAT (1 + g)(1 – (g/ROIC))/ (WACC – g)

Where, g = 5%, WACC =13%, and ROIC= 13%

= Rs.35613.49 * (1+0.05)*(1-(0.05/0.13))/ (0.13-0.05)

= Rs.287647.40million

Present value of TV = 287647.40*PVIF$_{(13\%, 8.25)}$

= Rs.104,945.37million

Enterprise Value = ∑ Present values of FCFF from FY 09-FY 16 + Present value of TV

= –14,488.62 + 104,945.37

= Rs.90,456.76million

Value of Equity = Enterprise value – Value of debt + Cash + Investments

Value of Debt, Cash and Investments are taken at book value by the end of FY 08.

= 90,456.76 – 0 + 35,164.60 + 1150.30

= Rs.126,771.66 million

Value per Share = Value of Equity/No of outstanding shares

= Rs.126,771.66/644.30

= Rs.196.76

Free Cash Flow to Firm

(Rs. in million)

	31.3.09	31.3.10	31.3.11	31.3.12	31.3.13	31.3.14	31.3.15	31.3.16	31.3.17
Net sales/operating Revenue	53879.04	58728.15	65775.53	78930.64	93138.15	108040.26	123165.89	136714.14	147651.27
Growth in %	8.00%	9.00%	12.00%	20.00%	18.00%	16.00%	14.00%	11.00%	8.00%
EBITDA	28512.79	30198.02	33492.90	37097.40	42843.55	47537.71	52961.33	57419.94	60537.02
EBITDA Margin%	52.92%	51.42%	50.92%	47.00%	46.00%	44.00%	43.00%	42.00%	41.00%
Depreciation	3232.74	3523.69	3946.53	4341.19	4656.91	5402.01	6158.29	6835.71	7382.56
EBIT	25280.05	26674.33	29546.37	32756.21	38186.64	42135.70	46803.04	50584.23	53154.46
EBIT %	46.92%	45.42%	44.92%	41.50%	41.00%	39.00%	38.00%	37.00%	36.00%
Effective tax	8342.42	8802.53	9750.30	10809.55	12601.59	13904.78	15445.00	16692.80	17540.97
NOPLAT	16937.63	17871.80	19796.07	21946.66	25585.05	28230.92	31358.04	33891.44	35613.49
CAPEX	23844.42	28558.11	40596.03	54262.18	18627.63	21608.05	18474.88	20507.12	22147.69
Change in Working Capital	1328.78	300.94	–399.62	3157.23	2794.14	3241.21	3694.98	4101.42	2953.03
Free Cash Flow to firm	–5002.83	–7463.57	–16453.81	–31131.56	8820.18	8783.67	15346.47	16118.60	17895.33
Growth	–201%	49%	120%	89%	–128%	0%	75%	5%	11%
PV of FCF	–4,852.28	–6,406.17	–12,497.98	–20,926.47	5,246.80	4,623.96	7,149.38	6,645.21	6,528.94
Cumulative PV of FCF	–4,852.28	–11,258.45	–23,756.43	–44,682.90	–39,436.10	–34,812.14	–27,662.76	–21,017.56	–14,488.62
Continuing Value									287647.40
PV of Continuing Value									104,945.37
Enterprise value									90,456.76
Market value of Debt									0.00
Cash									35,164.60
Value of Equity									126,771.66
Fundamental value per share									196.76

SUMMARY

- Every asset whether real or financial has value. Value is the worth of something. Understanding the value and the source of value of an asset is important to invest in assets and also to manage them successfully. Every asset can be valued, but some assets are easier to value than others and the input for valuation varies depending on the asset.
- There are various approaches to valuation. The most commonly used method is the discounted cash flow valuation. In this method, the value of the asset is estimated by calculating the present value of the expected cash flows on that asset, discounted at the rate that reflects the risk of the cash flows.
- The second is the relative valuation where the value of an asset or the firm is computed relative to how similar assets are priced in the market. The adjusted book value approach involves estimation of the market value of the assets and liabilities of the firm as a going concern.

- Selection of the right model for valuation is critical to arrive at a reasonable value. It is not only important to match the valuation model to the asset or firm being valued but understanding a particular model and having the right inputs is also very important.
- The first problem faced in analyzing a potential merger involves determining the value of the acquired firm. M&As, restructuring and corporate control in their proper perspective, are all various forms of capital budgeting activities. Investment decisions and their evaluation by capital budgeting analysis are important for the firm as the consequences of the decision will continue for a number of years. Besides, the asset expansion requires substantial outlays, which must be arranged in advance. Hence, a proper valuation method has to be adopted to estimate the value of the target firm.

Chapter 5

Theories of Mergers

After reading this chapter, you will be conversant with:

- Efficiency Theories
- Information and Signaling
- Market Power
- Tax Considerations
- Agency Problems and Managerialism
- Hubris Hypothesis
- Free Cash Flow Hypothesis
- Value Increases by Redistribution

The strategy of mergers and acquisition is adopted for a variety of reasons. The reason might be to increase the buying power with the suppliers, achieve consolidation of supply or markets, or to achieve a distribution network for the existing product line or to reduce the risk through product diversification. Whatever be the fundamental reason, one thing that all merger and acquisition strategies have in common is the desire to strengthen the existing business and help its growth. Various analysts have proposed various theories to explain the motives behind corporates using mergers and acquisition strategies. We shall now take a deeper look at each of them.

EFFICIENCY THEORIES

Efficiency theories of mergers suggest that Mergers and Acquisitions (M&As) provide a mechanism by which capital can be used more efficiently and that the productivity of the firm can be increased through economies of scale. According to these theories mergers and acquisitions have the potential for social benefits. These theories can be further divided as:

- Differential Efficiency Theory,
- Inefficient Management Theory,
- Synergy,
- Pure Diversification,
- Strategic Realignment to Changing Environments, and
- Undervaluation.

DIFFERENTIAL EFFICIENCY THEORY

According to the differential efficiency theory of mergers, if the management of firm X is more efficient than the management of firm Y and if firm X acquires firm Y, the efficiency of firm Y is likely to be brought up to the level of firm X. As per the theory, this increased efficiency of firm Y is to be attributed to the merger.

The theory implies that some firms operate below their potential and as a result have below average efficiency. Such firms are most vulnerable to acquisition by other more efficient firms in the same industry. This is because firms with greater efficiency would be able to identify firms with good potential but operating at lower efficiency. They would also have the managerial ability to improve the latter’s performance.

However, a difficulty would arise when the acquiring firm is over-optimistic and overestimates its ability to improve the performance of the acquired firm. This may result in either the acquiring firm paying too much for the acquired firm or the acquirer not improving the acquired firm’s performance up to the level of the acquisition value given to it.

The managerial synergy hypothesis is an extension of the differential efficiency theory. It states that a firm, whose management team has greater competency than is actually required by the current responsibilities in the firm, may seek to utilize the surplus resources by acquiring and improving the efficiency of a firm, which is less efficient due to lack of adequate managerial resources. Thus, the merger will create a synergy, since the surplus managerial resources of the acquirer combine with the non-managerial organizational capital of the acquired firm.

Particularly, when these surplus resources are indivisible and cannot be released, a merger enables them to be optimally utilized. Even if the firm has no opportunity to expand within its industry, it can diversify and enter into new areas. However, since it does not possess the relevant skills related to that business, it will attempt to gain a ‘toehold entry’ by acquiring a firm in that industry, which has organizational capital along with inadequate managerial capabilities.

Box 1: Sun, MySQL Merger: Open Source Synergy
Sun Microsystems has acquired a major database vendor MySQL at the acquisition cost of US$1 billion through open sources. With this acquisition both the company would be benefitted such as the Sun gets ownership of a major player in the open-source software industry while MySQL gets the backing of a multibillion-dollar, established systems company. This agreement is the largest software deal through open-source. And the merger makes Sun the owner of a critical part of the popular LAMP (Linux Apache MySQL Perl/Python/PHP) open-source software stack. Sun already has been offering up its own software to open source, even basing its development tools strategy on the open source NetBeans platform. The deal was applauded by open-source CRM vendor SugarCRM, PHP (Hypertext Preprocessor) tools vendor Zend Technologies, and SpringSource, makers of the open source Spring Framework for Java development. The CEO of the Sun Microsystems explained that the deal as its entrance into the database market and will offer global support offerings for MySQL which will generate the database business of the $15 billion and after this acquisition the MySQL overcomes its biggest impediment which were unable to extend its mission from last couple of years. "With this acquisition by Sun, we'll be able to offer those customers even better service, a full stack and at the same time heterogeneous solutions running on a number of platforms with a number of environments," Mickos said. "It strengthens our ability to serve our existing customers and very importantly serve the new customers coming over as enterprises move over to Web-based architectures in their enterprise infrastructure." The management of both the companies are believing that there are synergies in putting the two companies together that will allow MySQL to grow more rapidly and allow Sun to grow more rapidly."

Source:http://www.pcworld.com/businesscenter/article/141439/sun_mysql_merger_open_source_synergy.html.

INEFFICIENT MANAGEMENT THEORY

This is similar to the concept of managerial inefficiency but it is different in that inefficient management means that the management of one company simply is not performing up to its potential. Another control group is in a position to manage the assets of the firm more effectively. Inefficient management simply represents management that is incompetent in the complete sense. In the differential efficiency theory or the managerial synergy hypothesis, the management seeks to complement the management of the acquired firm and has experience in the particular line of business activity of the acquired firm. Hence, it is more likely to be the basis for horizontal mergers. On the contrary, inefficient management theory could be the basis for conglomerate mergers also.

SYNERGY

Synergy refers to the type of reactions that occur when two substances or factors combine to produce a greater effect together than that which the sum of the two operating independently could account for. It refers to the phenomenon 2 + 2 = 5. In mergers, this means the ability of a combination of two firms to be more profitable than the two firms individually. In anticipation of such synergistic benefits, acquirer firms incur the expenses of the acquisition process and still pay premium for the shares of the target shareholders. Synergy allows the combined firm to have a positive Net Acquisition Value (NAV).

$$NAV = V_{XY} - [V_X + V_Y] - P - E$$

Where,

V_{XY} = the combined value of the two firms,

V_Y = the market value of the shares of Y firm,

V_X = X's measure of its own value,

P = premium paid for Y, and

E = expenses of the acquisition process.

Rearranging the above equation:

$$NAV = [V_{XY} - (V_X + V_Y)] - (P + E)$$

Where,

$[V_{XY} - (V_X + V_Y)]$ represent the synergistic effect.

This sum must be greater than the sum of P + E to validate going forward with the merger. If it is not greater than the sum of P + E, there will be an overpayment for the target.

Financial Synergy

The impact of a corporate merger or acquisition on the costs of capital to the acquiring or the combined firm refers to financial synergy. The managerial synergy hypothesis is not relevant to the conglomerate type of mergers because a conglomerate merger implies several and often successive acquisitions in various diversified areas. Under such conditions, the managerial capacity of the firm will not develop quickly enough to be able to transfer its efficiency to several newly acquired firms in a short time. Additionally, managerial synergy is applicable only in cases where the firm acquires other firms in the same industry.

Financial synergy occurs as a result of the lower costs of internal financing versus external financing. A combination of firms with different cash flow positions and investment opportunities may produce a financial synergy effect and achieve lower cost of capital. If the cash flows of the two firms are not perfectly correlated, the firms may reduce risk. If the instability in the cash flows is reduced due to acquisition, suppliers may consider the firm to be less risky. It is less likely that the firm would become technically insolvent. Tax saving is another considerations. The combined debt capacity of the merged firm may be greater than the sum of their individual capacities before the merger.

The theory of financial synergy also states that when the rate of cash flow of the acquirer is greater than that of the acquired firm, capital is relocated to the acquired firm and hence, its investment opportunities improve.

Operating Synergy

The operating synergy theory of mergers state that economies of scale and economies of scope exist in an industry and that before a merger takes place, the levels of activity at which the two firms operate are insufficient to exploit these economies.

The economies of scale refer to the spreading of the fixed costs over increasing levels of production. Economies of scale are mostly seen in businesses having substantial fixed overhead expenses. Economies of scope refer to using a specific set of skills or an asset, which is currently being used to produce a specific product or service or to produce related products or services.

Operating economies of scale are achieved through horizontal, vertical and conglomerate mergers. Operating economies occur when the resources like people, equipment and overheads are indivisible. The productivity of such resources increases when they are spread over a larger number of units of output. For instance, expensive equipment in manufacturing firms should be utilized at optimum levels to decrease the cost per unit of output.

Operating economies in specific management functions such as production, R&D, marketing or finance may be achieved through a merger between firms, which have proficiencies in different areas. For instance, when a firm whose core competence is R&D, merges with another firm having a strong marketing strategy; the two businesses would complement each other after the merger.

Operating economies are also achieved in generic management functions such as, planning and control. According to the theory, even medium-sized firms need a minimum number of corporate staff. For instance, when the capabilities of corporate staff of a firm responsible for planning and control are underutilized and such a firm acquires another firm, which has just reached the size at which it needs to increase its corporate staff, the acquirer's corporate staff would be fully utilized, thus achieving economies of scale.

Vertical integration, i.e., combining of firms at different stages of the industry value chain also helps in achieving the operating economies. This is because vertical integration reduces the costs of communication and bargaining.

Box 2: RIL-RPL Merger: A Dinosaur in the making Merger on same Track

There was at least a façade of business synergies in the merger of the original Reliance Petroleum Limited (RPL) with Reliance Industries Ltd. (RIL). Such a synergy is not evident between the new RPL and RIL. Three years hence and with RPLs new 29-million-ton refinery commissioned, a dinosaur is indeed in the making through the merger of Reliance Petroleum (RPL) and RIL. The combined entity will boast a refining capacity of 62 million tons (1.24 million barrels a day) and status as India's largest company in terms of revenue and earnings.

The proposed merger fits in perfectly with the style perfected by the Reliance group. The original Reliance Petroleum, which made its IPO in 1993, was merged with Reliance Industries in 2002. And now comes the merger of the re-born Reliance Petroleum with RIL. The classic strategy of the group has been to execute and commission large, capital-intensive projects on the balance-sheet of new companies and, once the project is implemented or operations stabilize, merge them with RIL. The advantage in this is that RIL is protected from the risks of project execution while its balance-sheet is insulated from taking on large equity or debt burden.

Similar Track

Call it coincidence or design, the merger announcements of both the original RPL and the re-born one, were made on a Friday of the last weekend of February and the board meetings to finalize the merger were both scheduled within the first three days of March. The merger announcement of the original RPL was made on Friday, March 1, 2002 while the board meeting was held on Sunday, March 3. In the present instance, the announcement has been made on Friday, February 27 while the board meeting to finalize the merger is scheduled for Monday, March 2. This is, of course, only a symbolic similarity. There are larger, more serious similarities between the two mergers.

First, the merger in 2002 came on the back of a difficult period for RIL in its (then) main business of petrochemicals. The company had seen a fall in sustainable earnings growth in two of the three quarters ending December 31, 2001. Petrochemical prices were soft and the economy was down, leading to demand contraction.

The last couple of quarters of this fiscal have similarly been difficult ones for RIL; earnings actually declined in the third quarter ended December 2008 – the first such decline in 12 quarters. There are also murmurs in the market – unsubstantiated, of course – about potential losses facing the company in crude futures market positions, currency exposure and in the foray into retailing. Back in 2002, the merger of the original RPL was backdated to be effective from April 1, 2001 and speculation then was that this was done to mask the under-performance of RIL by combining the cash-rich RPL business with itself. Going by this logic, chances are high that the current merger will also be with retrospective effect from April 1, 2008.

Second, the merger of the original RPL in 2002 benefited RIL in terms of a large depreciation cover along with other tax benefits as RPL supplied a couple of products to RIL. In the present instance, the merged RIL will benefit tremendously from the tax benefits that the new RPL enjoys by virtue of its location in a Special Economic Zone (SEZ). Such benefits include income-tax exemption for 100 percent of profits derived from exports in the first five years of operations of the RPL refinery and 50 percent of profits for the next five years. Besides, the new refinery will not have to pay excise duty and service tax for products and services, respectively, sourced from within India. It will also be exempt from stamp duties on land transactions and loan agreements.

The third similarity is likely to be in the share exchange ratio. If past mergers are any indication, the ratio could be skewed in favor of RIL shareholders. The merger of the original RPL where each share of RIL was exchanged for 11 of RPL favored RIL's shareholders. Speculation on the exchange ratio for the present merger ranges between 1:16 and 1:19 based on the market prices of the two shares.

Assuming that similarly, the 70.38 percent shares held by RIL in RPL are extinguished; that Chevron's holdings are bought back by RIL and extinguished; and assuming a share exchange ratio of 1:16 (based on closing price of Rs.1,265 for RIL and Rs.76 for RPL on dated 27th February 2009), RIL will have to issue 6.92 crore fresh shares that will see its equity increasing from Rs.1,454 crore to all of Rs.1,522 crore.

While the number of shares issued could be marginally higher based on the exchange ratio, the fact remains that the addition to RILs equity will be nothing compared to what it might have been had the Rs.27,000 crore refinery project been executed on its books. And that will be the biggest benefit of the merger and is the fundamental reason why it is being considered now.

Source: http://www.blonnet.com/iw/2009/03/01/stories/2009030151040700.htm

PURE DIVERSIFICATION

Diversification provides numerous benefits to managers, employees, owners of the firm and to the firm itself. In addition, diversification through mergers is commonly preferred to diversification through internal growth, given that the firm may lack internal resources or capabilities required. However, the timing of diversification is an important issue since there may be several firms looking for to diversification through mergers at the same time in a particular industry. The benefits of diversification to the various stakeholders of the firm can be explained as follows:

i. **Employees:** Employees of a firm develop firm-specific skills over time, which make them more efficient in their current jobs. These skills are valuable to only that firm and job and not to any other jobs. Hence, employees have fewer opportunities to diversify their sources of earning income, unlike shareholders who can diversify their portfolio. Therefore, they seek job security and stability, better opportunities within the firm and higher compensation (promotions). These needs can be fulfilled through diversification, since the employees can be assigned greater responsibilities in the diversified firm.

ii. **Owner-managers:** Owners who are also managers of a firm will be able to retain corporate control over his firm through diversification and simultaneously reduce the risk involved.

iii. **Firm:** A firm builds up information on its employees over time, which helps it to match employees' skills profile with jobs within the firm. Managerial teams are thus formed within the firm. This information is not transferred outside and is specific to the firm. When the firm is closed, these teams are destroyed and value is lost. If the firm diversifies, these teams can be shifted from unproductive activities to productive ones, leading to improved profitability, continuity and growth of the firm.

iv. **Goodwill:** In due course of its operation, a firm develops a reputation in its relationships with suppliers, creditors, customers and others, resulting in goodwill. Various strategies like investments in advertising, employee training, R&D, organizational development, etc., are adopted to attain this goodwill. Diversification helps in maintaining the firm's reputation and goodwill.

v. **Financial and Tax Benefits:** Diversification through mergers also results in financial synergy and tax benefits. Since, diversification helps in reducing the risk, it ultimately increases the corporate debt capacity and reduces the present value of future tax liability of the firm.

Box 3: CopperCo/MinSec Merger on way to Success
Mineral Securities Ltd's proposed merger with spin-off Copper Co. Ltd. overcame its first hurdle after Copper Co. shareholders voted in favor of the transaction.
The companies, which have a longstanding relationship and share an office, aim to create a diversified base and precious metals miner with a market value of about $530 million. The enlarged company will bring together Copper Co's main asset, the Lady Annie copper mine, and MinSec's Lady Loretta lead-zinc project, both in Queensland. The merger will also take in emerging platinum producer Platmin Ltd, which is 16.4 per cent owned by MinSec.
It will also take in Tianshan Goldfields, which has a gold project in China and is 19.9 per cent owned by MinSec, and Sappes Gold, which is wholly owned by MinSec. The logic of diversification to spread risk proved compelling for the vast majority of investors. CopperCo is offering 2.2 of its shares for each MinSec share. Among other conditions, the offer stipulates an 80 per cent minimum acceptance. MinSec's 19.8 per cent stake in Copper Co. will be disposed within 12 months after the merger has been complete, by seeking shareholder approval to cancel or buy back those shares.
MinSec had changed its business model 18 months ago from spinning off mining assets into listed entities, to developing them in-house. The combined company could develop a more flexible financing structure as it strengthened its balance sheet through the divestment of non-core assets.
This merger will give us a bigger presence in equity markets and positions us to be more relevant to the market and also the pooling of human resources is critical at this time.
The outlook for the platinum price was extremely strong and slightly stronger than copper due to constrained supply of the predominantly industrial metal.
"One ounce of platinum has the same value as a quarter of a tonne of copper ... and Platmin's first project, Pilanesberg, has 250,000 ounces of platinum,"

Source:http://news.smh.com.au/business/coppercominsec-merger-on-way-to-success-20080516-2eyp.html

Costs and Benefits of Merger

When a company, say 'X' acquires another company say 'Y', then it is a capital investment decision for company 'X' and it is a capital disinvestment decision for company 'Y'. Thus, both the companies need to calculate the Net Present Value (NPV) of their decisions.

To calculate the NPV of company 'X' we need to calculate the cost and benefit of the merger.

The benefit of the merger is equal to the difference between the value of the combined identity (PV_{XY}) and the sum of the value of both firms as a separate entity. It can be expressed as:

$$\text{Benefit} = (PV_{XY}) - (PV_X + PV_Y)$$

Assuming that compensation to firm Y is paid in cash, the cost of the merger from the point of view of firm X can be calculated as:

$$\text{Cost} = \text{Cash} - PV_Y$$

Thus,

$$\begin{aligned} \text{NPV for X} &= \text{Benefit} - \text{Cost} \\ &= (PV_{XY} - (PV_X + PV_Y)) - (\text{Cash} - PV_Y) \end{aligned}$$

The net present value of the merger from the point of view of firm Y is the same as the cost of the merger for 'X'. Hence,

$$\text{NPV to Y} = (\text{Cash} - PV_Y)$$

NPV of X and Y in case the Compensation is in Stock:

In the above scenario, we assumed that compensation is paid in cash. However, in real life compensation is most of the cases is paid in terms of stock. In that case, cost of the merger needs to be calculated carefully. It is explained with the help of an illustration – Let us assume that Firm X plans to acquire firm Y. Following are the statistics of firms before the merger:

	X	Y
Market price per share	Rs.100	Rs.40
Number of shares	10,00,000	5,00,000
Market value of the firm	Rs.100 million	Rs.20 million

The merger is expected to bring gains, which have a PV of Rs.10 million. Firm X offers 2,50,000 shares in exchange for 5,00,000 shares to the shareholders of firm Y. The cost in this case is defined as:

$\text{Cost} = \alpha PV_{XY} – PV_Y$

Where,

α represents the fraction of the combined entity received by shareholders of Y.

In the above example, the share of Y in the combined entity is: – $\alpha = 2,50,000/(10,00,000 + 2,50,000) = 0.2$

Here, we assume that the market value of the combined entity will be equal to the sum of present value of the separate entities and the benefit of merger. Then,

$$PV_{XY} = PV_X + PV_Y + \text{Benefit}$$

$$= 100 + 20 + 10 = \text{Rs.}130 \text{ million}$$

$$\text{Cost} = \alpha PV_{XY} - PV_Y$$

$$= 0.2 \times 130 - 20 = \text{Rs.}6 \text{ million}$$

Hence,

$\text{NPV to X} = \text{Benefit} – \text{Cost}$

$= 10 – 6 = \text{Rs.}4 \text{ million}$

NPV to Y = Cost to X = Rs.6 million.

STRATEGIC REALIGNMENT TO CHANGING ENVIRONMENT

The strategic realignment theory suggests that firms use the strategy of M&As as ways to rapidly adjust to changes in their external environments. Strategic planning as studied earlier is concerned with the firm's environment and its constituencies and is not just an operating decision. The strategic planning approach to mergers implies that there is a possibility of achieving economies of scale or using the under utilized managerial capacity of the firm. It may also mean that by external diversification the firm acquires management skills needed for increase in its present capabilities.

Adjustment to the environment can be done through internal development also but the speed of adjustment through external diversification is faster. Timing is a very important factor in capturing the growth opportunities. When a company has an opportunity of growth available only for a limited period of time slow internal growth may not be sufficient. Competitors may respond quickly and take advantage of the slow internal growth of the company. In such cases, external growth i.e., growth through mergers and acquisitions proves to be a better alternative. Merger with another company that has the resources, such as management, office, etc., already in place helps in the speedy growth of the company.

Generally, the sources of change are many but recently the regulatory and technological changes have been the major forces in creating new opportunities for growth or threats to a firm's primary line of business.

Regulatory Change

In recent years, the merger and acquisition activity has more been happening in the industries like the financial services, telecommunications, media, etc. that have been subject to major deregulation. Deregulation helped in the reducing the artificial barriers in these industries and stimulated competition. Increased competition has made companies in these sectors resort to mergers and acquisitions to achieve greater operating efficiency.

Technological Change

Technology advancement has created new competitors, products, markets and industries. The increased use of information technology in current times is expected to boost technology's role in motivating takeovers and corporate restructuring. The large, more bureaucratic firms are often unable to demonstrate the creativity and speed which smaller firms display. With talent in short supply and short product life cycles such large firms often do not have the time or the resources to innovate. As a result, large firms often look to mergers and acquisitions as the fast and inexpensive way to acquire new technologies and proprietary knowledge. Technological acquisitions are also made as a defensive weapon to keep the important new technologies out of the competitors reach.

The growing significance of the technological change has modified the way to evaluate and value the target companies, increase the importance of intangible assets such as intellectual property and the way in which deals are structured. The speed of development of technology will drive the pace of deregulation, because the speed of technological change makes it increasingly unlikely that any one company can continue to remain a monopoly.

UNDERVALUATION

Undervaluation of the target companies can also be one of the motivating factors leading to mergers. Undervaluation refers to the target being worth more than what it is actually valued at. Undervaluation may be because of the underperformance of the management. A firm may also be undervalued according to the estimates of the acquirer possessing certain insider information about the firm, which the general market does not have.

Another important aspect of undervaluation is the difference between the market value of the assets and their replacement costs. If a company requires additional capacity to produce a particular product, it could achieve this capacity by buying a company producing the same product instead of beginning from the scratch.

The Q-ratio and Buying Undervalued Assets

The q-ratio is defined as the ratio of the market value of the acquiring firm's stock to the replacement cost of its sales. Firms, which are interested in expanding their business have a choice of investing in new plant and equipment or obtaining the assets by acquiring company, whose market value is less than the replacement cost of its assets (i.e., $q < 1$) can go in for a merger. This was the main reason behind the mergers in the 1970's, when high inflation and the interest rates led to the drop in stock prices below the book value of many firms. The high inflation also caused the replacement costs of the assets to be much higher than the actual book value of assets.

INFORMATION AND SIGNALING

A tender offer in the acquisition spreads the information that the target shares are undervalued and immediately the market revalues those shares even if the offer turns out to be unsuccessful. No particular action by the target firm or any other is necessary for occurrence of revaluation. The offer also motivates the management of the target firm to implement a more efficient business strategy on its own. No additional outside offer other than the offer itself is needed for the upward revaluation.

Analysts who oppose this theory suggest that the increase in the share value of the target firm in an unsuccessful offer is due the expectation that the target firm will be subsequently acquired by another firm. Firms, which have some special resources generally do this. The share price of the firm, which do not receive subsequent offer within five years of the unsuccessful first offer will fall to the earlier level and the share price of those firms, which receive a subsequent offer will increase.

The signaling theory is a variation to the information hypothesis. It states that certain actions convey other significant forms of information. A firm receiving a tender offer may give a signal to the market that it possesses extra value, which was not recognized by the market earlier. It may also signal that the future cash flows of the firm are likely to rise. When the acquirer uses stock to buy a firm it may signal that the target firm stock of the acquirer is overvalued. When a firm buys back its own shares, the market may take it as a signal that the management has information that its shares are undervalued and there are growth opportunities for the firm.

MARKET POWER

One of the main motives for a merger is to increase the share of a firm in the market. Increasing the market share means increasing the size of the firm relative to the other firms in an industry. This is also referred to as monopoly power. Through market power, a firm gets the ability to set prices at levels that are not sustainable in a more competitive market.

There are three sources through which market power can be achieved. They are product differentiation, entry barriers, and market share. Through horizontal integration a firm can increase its market share. In spite of considerable increase in market share, lack of significant product differentiation or barriers to entry could prevent a firm from increasing its price significantly above the marginal cost. Even in industries that have become more concentrated, there may be considerable amount of competition.

Horizontal mergers, which take place with a motive to attain market power are always of great concern to the Government because they might lead to concentration of power or monopoly. Hence, comparisons between their efficiencies versus their effects of increased concentration must be made. The Herfindahl index or the H index helps in identifying the inequality of firms as well as the degree of concentration of industry sales. The theory behind its use is that if one or more firms have relatively high market shares, it is of greater concern than the share of the largest four firms.

Example

In a market 5 firms have a market share of 10 percent each and the remaining is held by 50 firms, having a market share of 1 percent each. The H index of the industry is:

$$5(10)^2 + 50(1)^2 = 500 + 50 = 550$$

In another market one firm has a market share of 47 percent and the remaining 53 percent is held by 53 different firms having 1 percent market share. The H index of the industry is:

$$(47)^2 + 53(1)^2 = 2{,}209 + 53 = 2{,}262$$

Higher the index, higher is the market concentration.

Box 4: Merger Creates Largest IT Company in India

HP-Compaq merger has created a Rs.3,650 crore IT giant in India, surpassing the likes of TCS and Wipro to emerge as the largest IT company in the country.

Let us look at the implications of the merger on the industry.

After the Merger: The New HP in India *(Revenues: Rs.crore)*

	Compaq	HP	New HP	Sun	IBM
Desktops	856	465	1321		347
Portables	158	12	171		119
Unix servers	224	220	444	373	138
PC servers	252	95	347		126
Workstations	48	60	108	95	23
Other systems					4
Printers		460	460		
Services	224		224		774
Packaged software					81
Others		226	226	50	48
Software*	184	165	349		
Total	1,945	1,705	3,650	518	1,662

HP's $25-billion acquisition of Compaq (at 0.6325 of one newly-issued HP share for one Compaq share) ushers a new HP at $87 billion, just below IBM at $90 billion. Carly Fiorina will remain chairman and CEO of the new entity and Compaq's Michael Capellas will be the president. The acquisition closed in the year 2002.

In India, the merged entity will clearly be the number 1. Last fiscal (ending March, 2001) revenues for the two added up to Rs.3,301 crore. This takes it past the current top three in the DQ Top 20 IT companies: TCS (Rs.3,142 crore), Wipro and Infosys.

HP plus Compaq group revenues for last fiscal, including software operations HP ISO and Digital India, adds to Rs.3,650 crore, keeping it at #3 behind the HCL group (Rs.4,413 crore, including NIIT) and the Tata group (Rs.4,032 crore).

The system vendor toppers in the DQ Top 20 are Wipro (by total–not just systems–revenues), Compaq, IBM, HP. This now changes to the new HP at #1, followed by Wipro, IBM and significantly below, HCL Infosys. In India, Compaq is stronger than HP in computer systems; it's bigger (#4 vs HP's #7 in DQ Top 20) and it grew 62 percent last fiscal vs HP's sedate 35 percent.

Significantly, the new HP entity, in India, will assume the number 1 slot by revenue in PCs, Unix servers and workstations, PC servers and printers and tops by units in all these areas except for Unix servers, where Sun sold more units last year.

What do they Gain?

The big gain for the combined entity is likely to be a larger customer base. Coupled with the elimination of overlapping computer product lines, this could lead to lower costs for the same revenues.

The new entity becomes a mammoth one-stop shop spanning systems, printers, services and more, a global #2. However, the product range was largely there with HP anyway, though Compaq was much stronger in PC servers and consumer desktops.

HP gains Compaq's services business, its distribution network especially for consumer desktops, its handhelds, and of course its business customers.

Product-line synergies stem from services (Compaq gets 23 percent of its global revenues from services – 13 percent in India – with plans to push that up), peripherals (HP is the global leader in printers and is very strong in other devices including scanners) and to a smaller extent in systems (Compaq is stronger in consumer desktops, with a far better distribution network, both in India and globally). Compaq also brings in the very successful iPaq Pocket PC, which could replace the Jornada in HP's portfolio.

Source: www.ciol.com

TAX CONSIDERATIONS

Mergers and acquisitions could be a valuable means to secure the benefits of tax. The potential tax benefits resulting from the carry forward of the net operating costs and the unused tax credits carry forwards and the capital gains and the step-up in the acquired assets basis affect the return of the firms involved in tax acquisitions.

Taxes affect the merger process as well as the merger incentives. However, the method of merger and the method of payment used in the merger, affects the tax attributes of the acquired firm.

CARRY OVER OF NET OPERATING LOSSES AND TAX CREDITS

When a firm having accumulated tax losses and tax credits is acquired by another firm then the acquirer can take the benefit from certain tax benefits. However, there should be some continuity of interests of the acquirer in the target firm. The continuity of interest can be achieved by meeting two conditions. Firstly, a majority of the target corporation should be acquired in exchange for the stock of the acquiring firm. This ensures that there is continuity in interests in the merged firm. Secondly, the acquisition should have been made for legitimate business purposes and not only with an intention to benefit from the tax attributes. This is ensured when the target's operations are continued. With the establishment of continuity in interests, the merger becomes a tax free organization in which the capital gains or losses of the shareholders of the target can be deferred and the tax attributes of the target are inherited.

STEPPED UP ASSET BASIS

Acquisitions, which do not establish a continuity of interest are treated as taxable transactions. The acquiring firm can step-up or increase the tax basis of the acquired firm's assets to their fair market value and take depreciation charges on this new basis. Hence, an increase in the tax basis of the assets of the acquired firm results in greater cash flows and may also reduce any gains realized on the premature disposition of assets.

SUBSTITUTION OF CAPITAL GAINS FOR ORDINARY INCOME

A firm with very few internal investment opportunities can acquire a firm with growth opportunities so as to substitute capital gains taxes for ordinary income taxes. The acquirer makes use of the excess cash, which otherwise would have to be paid as dividends. The acquiring firm later sells the acquired firm to realize capital gains.

When the growth of the firm has slowed so that the earnings retention cannot be justified, then an incentive for sale to another firm is created. Rather than paying out future earnings as dividends subject to the ordinary personal income tax, an owner can capitalize future earnings in the sale to another firm. The buyer will be a firm, which invites additions to its internal cash flow for investment purposes. The transaction is a tax-free exchange of securities.

OTHER TAX INCENTIVES

If a firm having operating losses merges with another firm, which has taxable profits then there will be a net gain to the acquiring firm often at the expense of the government. The losses can be used to reduce the taxable income. Even if the two firms, which have merged have current profits, a merger can reduce future tax liability as the variability of cash flows is lowered after the merger. One firm's profits can be offset by other firm's losses which results in tax savings. Thus, the present value of the combined firm's tax liability is reduced. Smaller the correlation between the two firms' cash flows, larger is this effect.

The implications of the income tax provisions on the merging firms in India are given in detail in Appendix A at the end of this chapter.

Box 5: Reliance-RPL Merger: Enormous Benefits for RIL
Reliance Industries, which owns the world's biggest refinery complex, is looking at additional cash flows, tax benefits, continuity of export status and other synergies in its attempt to merge Reliance Petroleum with itself, after a 54 per cent decline in stock prices. The prime advantage for RIL appears to be using additional cash flows generated by merged company. However, it can be used to step up investment and expansion of its oil & gas exploration business. "RPL will start generating cash shortly and after the merge of RPL with RIL, the generated cash can be used further expansion of plants. The company RIL and RPL are expected to report the profit of about Rs.19,000 crore (Rs.190 billion) and Rs.4,500 crore (Rs.45 billion) in financial year 2009-10 respectively. Yet another factor motivating the merger may be the continuity of tax benefit accruing from a special economic zone for another five years. The RIL refinery enjoyed a ten-year tax holiday, sales tax deferment and other tax rebates, all of which ended a couple of years back when it sought an export-oriented unit. But the Jamnagar refinery is set to lose its EoU status, entailing tax incentives, next month as the term expires. Additionally RIL will save on transfer pricing on use of KG Basin gas and other related products between the two companies. The company will also save on taxes to be paid arising out of the transfer resulting in savings of about $1-1.5 for every barrel of crude processed. The savings will occur at a time when refining margins are under pressure because of a slump in oil prices. As for RPL, with the completion of the refinery, the cash flow generated will help Reliance Industries in enhancing its investment in exploration and production business, analysts said. On the basis of the market price of the two companies the swap ratio works out to 17 shares of RPL for every one share of RIL, however if the company opts to swap shares on the basis of book value the swap ratio will be 20:1. Hence the swap ratio has cleared by the board 17:1 ratio, which will give good impact to its investors also.

Source: http://www.rediff.com/money/2009/feb/28reliance-rpl-merger-analysts-see-big-benefits-for-ril.htmFebruary

AGENCY PROBLEMS AND MANAGERIALISM

The conflict of interest between the principal (shareholders) and agent (managers) in which the agent has an incentive to act in his own self-interest because he bears less than the total costs of his actions is called an agency problem. When managers own only a portion of the shares in the firm it causes them to work less vigorously than otherwise and encourages them to take more benefits since they do not bear the cost. The agency costs include: (i) the costs of structuring the contracts between the managers and owners, (ii) costs of monitoring and controlling the behavior of the agents by the principal, (iii) costs of bond to guarantee that the agents will make optimal decisions or the principals will be compensated for the outcome of suboptimal decisions, and (iv) loss experienced by the principal due to the divergence between the agents decision and the decision to maximize principals' interests.

ACQUISITIONS AS A SOLUTION TO AGENCY PROBLEMS

A takeover through a tender offer or a proxy fight enables outside managers to gain control of the decision processes of the target while avoiding existing managers. There is always a threat of takeover when a firm performs badly either because of inefficiency or because of agency problems. The stock markets act as an external monitoring device since the decisions made by the managers is reflected in the stock price. Low stock price will put pressure on the managers to perform more efficiently and stay in line with the interests of the shareholders. If the stock markets do not perform the role of a monitoring device to control agency problems effectively then the market for takeovers provides an external control device as a last alternative. A takeover through a tender offer or a proxy fight enables outside parties to gain control over the management control of the firm. Poor performance of the existing management either because of inefficiency or because of agency problems may lead to mergers.

MANAGERIALISM

This theory suggests that mergers are not a solution for the agency problem but are the result of the problem. Merger activity is a manifestation of the agency problems of inefficient, external investment by managers who are only motivated to increase the size of their firms. They assume that compensation is a function of the size of the firm and hence involve unprofitable investments through mergers.

The other theories motivation to Mergers and Acquisition are:

- Hubris Hypothesis,
- Free Cash Flow Hypothesis,
- Value Increases by Redistribution.

Hubris Hypothesis

Hubris hypothesis is an explanation of why mergers may happen even if the current market value of the target firm reflects its true economic value. Hubris hypothesis implies that managers' look for acquisition of firms for their own potential motives and that the economic gains are not the only motivation for the acquisitions.

Roll suggests that the takeovers are a result of the hubris hypothesis on part of the buyers. They presume that their valuations are right though the market valuation may be otherwise. The pride of the management makes them believe that their valuation is superior to the market. Thus, the acquiring company tends to overpay for the target because of over-optimism in evaluating potential synergies.

This theory is particularly evident in case of competitive tender offer to acquire a target. The parties involved in the contest may revise the price upwards time and again. The urge to win the game often results in the winners curse. The winners curse refers to the ironic hypothesis that states that the firm which overestimates the value of the target mostly wins the contest. The factors that result in the hubris spirit are the desire to avoid a loss of face, media praise, urge to project as an "aggressive" firm, inexperience, overestimation of the synergies, overenthusiastic investment bankers, etc. It is called the winner's curse in the sense that the winner is cursed to pay more than what the company is actually worth.

Free Cash Flow Hypothesis

Free cash flow is the cash flow in excess of the amounts required to fund all projects that have positive net present values, when discounted at the applicable cost of capital. Such free cash flow is usually paid back to the shareholders to maximize the share price. However, payment of the free cash flow reduces the amount of resources under the control of the management thereby reducing their power. In such circumstances, the firm has to issue new shares or borrow money from the markets for making any additional investments and hence will be subjected to monitoring of capital markets.

Value Increases by Redistribution

Redistribution among the shareholders is the main source of value increase in mergers. The gains come at the expense of other stakeholders in the firm. The expropriated stakeholders under the redistribution hypothesis include bondholders, the government (in the case of tax savings) and the organized labor.

Impact of Mergers on the Value of the Firm[1]: A Case Study

Theoretically it is assumed that mergers and demergers have a positive impact on the value of the company due to increased market power, synergy impact, concentration on core business and other qualitative and quantitative factors. Various studies done in the past showed totally opposite results but most of these studies were done in the US and other European countries. The main focus of the case is to study the financial impact of merger on the value of the company with respect to the Indian Banking and Financial Services Industry which has seen a few mergers in the last three to five years. Bank of Punjab and Centurion Bank's merger case has been evaluated by using Financial Statement Analysis (FSA), Ratio Analysis, Trend Analysis and Cross-sector Analysis.

Case Analysis: Bank of Punjab and Centurion Bank Merger.

Introduction to the Case

Financial statement analysis of Bank of Punjab, Centurion Bank and Centurion Bank of Punjab has been done. The merger of Bank of Punjab and Centurion Bank was carried out in the financial year 2005-06. The effective date for the merger was April 1, 2005. Therefore, the period selected is:

Financial years 2002-03, 2003-04, 2004-05 – As the pre-merger period, and

Financial years 2005-06, 2006-07 – As the post-merger period.

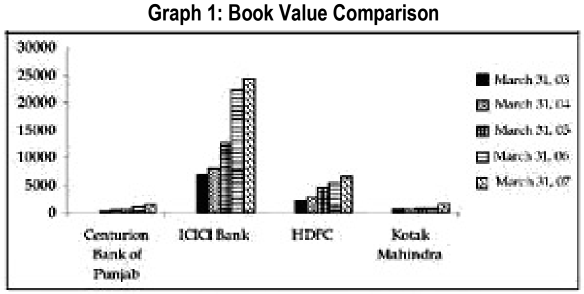
Case Analysis

There can be various connotations to the word 'value' like book value, tangible book value, intrinsic value, etc. For studying the financial impact of this merger on the value of the company book value has been considered.

Analysis Book Value Comparison

Here book value of Centurion Bank of Punjab for the post-merger period has been compared with the pre-merger book value. Before merger there were two companies, i.e., Bank of Punjab and Centurion Bank, therefore, the combined book value of both these banks has been calculated for the pre-merger period so as to make it comparable with the post-merger book value. The book value for the pre-merger period have been added assuming that the resultant company will have the combined book value. On calculating and comparing the book values for Centurion Bank of Punjab and all the other comparable banks following results have been produced. (Refer Graph 1).

Graph 1: Book Value Comparison

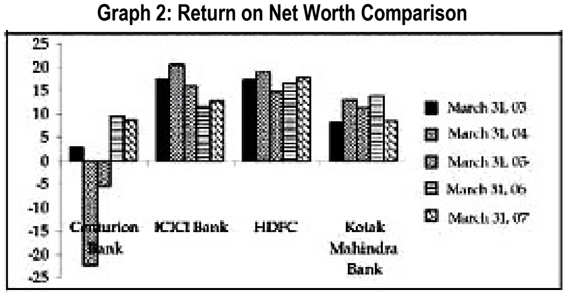


- In the year, 2003-04 the combined book value of Bank of Punjab and Centurion Bank was Rs.305.29 crore whereas in 2004-05 it increased to Rs.652.91 crore which is more than double. Such growth in the value of the company is not normal and there is some reason for this increase. On analyzing, it was found that this increase was due to the increase in the securities premium of Centurion Bank which was on account of issue of equity shares by the company.

1 Khadatkar R Anand and S Vijayalakshmi, "Impact of Mergers on the Valuation of the Firm", *Icfai Reader,* Hyderabad, October, 2008.

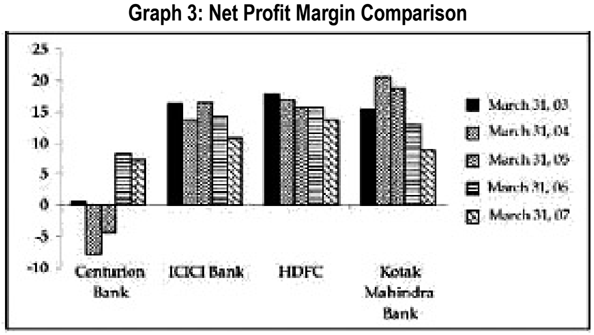
- In the year 2005-06, it can be seen that the value of the company went up to Rs.917.76 crore which is also not a normal growth in the book value. The important reason for the increase in the value of the company was increase in the profit of the company. Till 2004-05, the combined balance of profit and loss account of Bank of Punjab and Centurion Bank was negative whereas in the year 2005-06 it became positive. The increase in the profit and loss account balance is so significant that it cannot be treated as normal growth for the company.
- In the year 2006-07 also the book value of the company has shown significant growth. The main reason for this growth was the increase in securities premium amount which is related to issue of equity shares.

Graph 2: Return on Net Worth Comparison



- In the cross-sector analysis of above results it can be seen that the percentage increase in the book value of Centurion Bank of Punjab is compared with other banks in the industry. It can be seen that the growth of Centurion Bank of Punjab is more than HDFC Bank and Kotak Mahindra Bank.
- Here it can also be seen that the increase in the book value for all the other companies in the sector has increased according to normal growth rate except for ICICI Bank. In the year 2004-05 and 2005-06, the book value of ICICI Bank has shown significant growth but this is mainly due to the issue of equity shares.
- In the case of Centurion Bank of Punjab the book value of the company has increased in the year of merger significantly. This increase has not been seen in case of other banks therefore such growth cannot be attributed to other reasons common to every company in the industry and merger can be taken as an important reason for this.

Graph 3: Net Profit Margin Comparison



Thus, it can be seen that the merger of Bank of Punjab and Centurion Bank has improved the book value. Such increase in the value of the company can be attributed to the synergy created due to merger.

To study the main reasons for the increase in the book value of the company further analysis has been done, the details of which are enumerated.

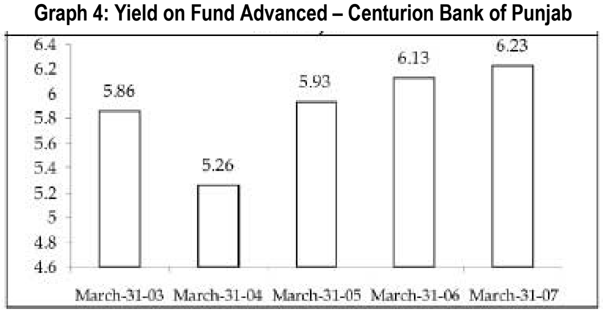
Return on Net Worth Comparison

Return on net worth is considered as one of the important indicator toward predicting the value of the company. The company with higher return on net worth will generally have higher value as compared to one with low return on net worth. Here net worth of Bank of Punjab and Centurion Bank before merger has been taken and weighted average net worth has been calculated by taking net worth of respective company as weight. This is done to make such return on net worth comparable with the post-merger return on net worth of Centurion Bank of Punjab. Graph 2 shows the return on net worth of Centurion Bank of Punjab as well as other comparable banks.

From Graph 2, it can be seen that the return on net worth of Centurion Bank of Punjab first declined in the year 2003-04 and started improving thereafter. Some of the important observations regarding return on net worth are as follows:

- The sudden decrease in the return on net worth in the year 2003-04 is due to the reduction of the share capital by decreasing the face value of the share from Rs.10 to Re.1.
- The above reduction was backed by issue of shares in the year 2004-05. Therefore, the return on net worth recovered to the extent.
- It can be seen that till 2004-05 the return on net worth was negative whereas in the year 2005-06 it has become positive, i.e., right after the merger. Therefore, it can be said that the merger improved the return on net worth.
- The main reason for such increase in the return on net worth after the merger is the increase in the net profit of the company. Earlier the net profit of Centurion Bank was Rs.25.11 crore and that of Bank of Punjab was Rs.–61.24 crore. Therefore, if the weighted average net profit before the merger is considered then it would be Rs.–36.13 crore. Whereas the net profit of Centurion Bank of Punjab after the merger has gone to Rs.87.8 crore which is a significant growth in the net profit.

Graph 4: Yield on Fund Advanced – Centurion Bank of Punjab

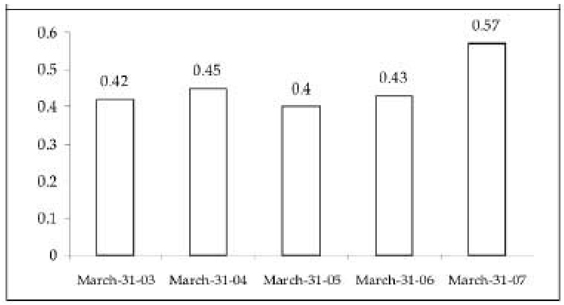


- The increase in the return on net worth of the company can be taken as one of the reasons contributing toward the increase in the value of the company.
- This shows the efficiency of the company which can be attributed to operational and financial efficiency, etc. The increase in the net profit should be further analyzed in detail to find out the area where exactly the company has shown its efficiency.
- It can be seen here that in the year of merger of Bank of Punjab and Centurion Bank, i.e., in 2005-06, the return on net worth of other banks has not shown significant increment.

- It can be said that Centurion Bank of Punjab has levered on certain things which is not common to the whole industry and it is specific to Centurion Bank of Punjab.
- The year 2005-06 was the year of merger and therefore it can be said that the merger of Bank of Punjab and Centurion bank has created various synergies for the bank which resulted in the increase in return on net worth ratio.

The return on net worth shows the ability of the company to effectively utilize its funds. Here in this case of merger it can be seen from the return on net worth ratio that the company is utilizing its funds effectively. The main reason for the increase in return on net worth in this case is the increase in net profit. This can also be verified by calculating the net profit margin ratio.

Graph 5: Share of Centurion Bank of Punjab in India's Total Advances



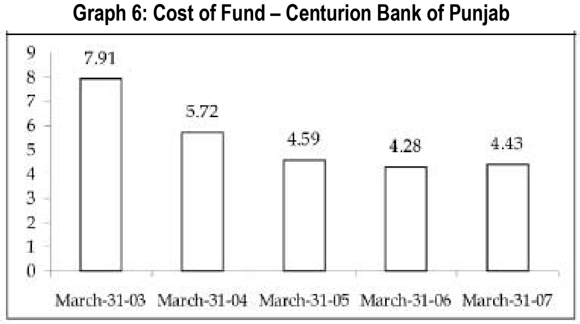
Net Profit Margin Comparison

The increase in the net profit of the Centurion Bank of Punjab after the merger can also be verified on the basis of net profit margin. For comparing the net profit margin for the pre-merger and post-merger period, net profit margins of Bank of Punjab and Centurion Bank for pre-merger period have been calculated and then the weighted average net profit margin is derived by taking the net worth as the weights. Similarly, net profit margin of Centurion Bank of Punjab for the post-merger period has been calculated. On comparing the net profit margin of Centurion Bank of Punjab and other comparable banks, following results have been produced.

Graph 3 shows that the net profit margin has shown sudden improvement in the year 2005-06 which is also the year of merger. Some of the analysis and observation regarding the net profit margin have been discussed below:

- The fall in the net profit margin of Bank of Punjab and Centurion Bank (combined) for the financial year 2003-04 and 2004-05 is due mainly due to Bank of Punjab. In this period, the income of Bank of Punjab declined whereas its expenses have increased in this period.

Graph 6: Cost of Fund – Centurion Bank of Punjab

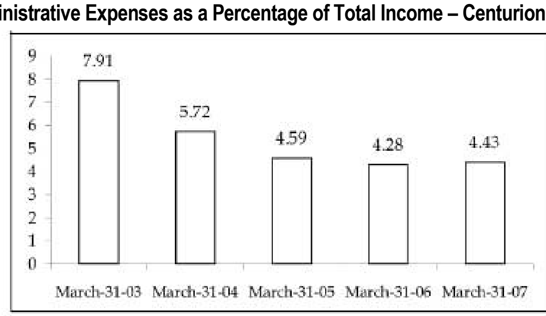


- The main year for the study is the financial year 2005-06 which is the year of merger. During this year, it can be seen that the net profit margin has increased significantly. The main reason for this increase is increase in income.
- Thus, it can be said that the merger has created some kind of synergy for the company that resulted in such an increase in the net profit margin.
- It can also be seen that the net profit margin has dropped in the year 2006-07 but still it is well above the year 2004-05. Therefore my main focus is on the change in net profit margin in the year 2005-06 from the year 2004-05.
- It can also be seen that after the merger the net profit margin of Centurion bank has increased significantly whereas the net profit margin of other banks in the industry has shown only a normal growth.
- Therefore it can be said that the increase in the net profit margin is not due to normal growth which is common to the industry, rather it is due to some factor specific to Centurion Bank of Punjab.
- Therefore it can be said that the merger of Bank of Punjab and Centurion bank has helped the company to improve its net profit margin.

The above improvement in net profit margin can be due to various synergies created by the merger process of Bank of Punjab and Centurion bank. Apparently it cannot be said which synergy has been created with this merger process that made its net profit margin grow leading to the increase in return on net worth and finally increasing the value of the company.

Therefore to find out the main reasons for the above and the type of synergy created in the merger process the financial statements of the companies have been analyzed further. First analysis of the increase in revenue has been done in detail and also analysis of the expenses has been done in detail by using various ratios.

Graph 7: Administrative Expenses as a Percentage of Total Income – Centurion Bank of Punjab



Yield on Fund Advanced

The bank's major income comes from the interest on the fund advanced by the bank. Therefore it constitutes one of the major elements in its revenue. Therefore in order to analyze the increase in the revenue of the bank, yield on fund advanced should be analyzed in detail. For this yield on fund advanced of Bank of Punjab and Centurion bank before merger and weighted average yield on fund advanced have been calculated by taking the advance amount as the weights. Similarly, yield on fund advanced of Centurion Bank of Punjab for the post-merger period has been calculated. On calculating the yield on fund advanced and comparing it following results have been produced.

Here, it can be seen that from the year 2003-04 onwards the yield on fund advanced has shown a positive trend. Here the main focus is on the year 2005-06, the year of merger.

The important findings are as follows (Refer Graph 4):

- In 2005-06, it can be seen that the yield on fund advanced has shown increment.
- This is one of the reasons for the increase in the interest income of the bank.
- It also shows the quality of the asset of the company because if the advance sanctioned by the bank turns bad, then the yield on advances will decline because of non-collection of interest on the advances sanctioned.
- This ratio depends very much on two factors, first is the Primary Lending Rate (PLR) fixed by the RBI and other is the quality of the advances sanctioned by the bank. The ratio shows that after the period of merger it has shown improvement but here not much interpretation can be done because only Centurion Bank of Punjab's comparison has been done. This ratio can be analyzed in detail when it is used in cross-sector analysis.
- As the PLR is same for all the banks, the change in this ratio will signify the quality of the advances sanctioned. Therefore, this ratio has been analyzed in detail in cross-sector analysis in the later part of the report.

Share of Centurion Bank of Punjab in Indian Economy's Total Advances

As discussed above, there has been an increase in the revenue of the Centurion Bank of Punjab. Its revenue comprises mainly of two items, i.e., interest income on the fund advanced and other income. In this, the major income for any bank will be the interest income on the fund advanced. In order to increase the revenue of the bank every bank strives to increase the advances sanctioned by it. Every bank strives to capture the maximum possible market so that the revenue for the bank can be maximum.

M&A is also one of the ways to capture the large chunk of market. Here, the share of Centurion Bank of Punjab in the total advances of all scheduled banks of India has been calculated. The market share of Centurion Bank of Punjab in total advances of Indian scheduled banks for the pre-merger and post-merger period have been found out. For calculating above ratio, the share of Centurion Bank of Punjab's advances for the post-margin period has been calculated and it has been compared with the pre-merger figures. For calculating the pre-merger period figures combined advances of Bank of Punjab and Centurion bank for the pre-merger period have been taken and the percentage share in India's total deposit has been arrived at. (Refer Graph 5)

The main observations are as follows:

- The share of Centurion Bank of Punjab in the Indian economy's total advances has increased for the year 2005-06 and 2006-07.
- The year 2005-2006 being the year of merger it can be seen that the share of Centurion Bank of Punjab has increased in the year 2005-06 marginally but in 2006-07 it has shown good increment.
- Therefore, it can be seen that the merger has brought the market share synergy for the banks by which the bank increased its share in the total market.
- The bigger size of the bank increased the advances of the bank by combining the current markets of the banks. It also helps the bank to capture bigger accounts which cannot be captured by the small bank because of insufficient fund.
- The ability to tap bigger market of advances also depends upon the deposits of the banks because more the deposit more will be the capacity of the bank to provide the fund. The increased size of the bank increased the deposit of the company which also helped the company to tap the new market.

Cost of Fund

The major item in the expenses of any bank is the interest paid by the bank to raise the fund. This fund consists of deposits and borrowings. The banking business is the business of accepting deposit and advancing the loans. To analyze the interest paid by the bank (which is also called as the financial expenses) the cost of fund has been calculated. For the pre-merger period combined interest, deposits and borrowings of Bank of Punjab and the Centurion bank have been considered and the cost of fund has been arrived at, which is then compared with the cost of fund of Centurion Bank of Punjab for the post-merger period.

The important observations are as follows:

- Graph 6 shows a decreasing trend throughout the period.
- In the above calculation of cost of fund two things have been considered, one is the deposit and the other is borrowings. The rate of interest on deposits has been decreasing over the years and in the year 2006-07 it has increased.
- The deposit borrowings have also been considered in the calculation of cost of fund. Due to the financial efficiency shown by the bank in borrowing, the cost of fund has gone down.

Administrative Expenses as a Percentage of Total Income

Administrative expenses do not form significant portion in the total expense of Centurion Bank of Punjab. Even then this ratio has been calculated to know whether any synergy is created during the merger process. For calculation of administrative expenses as a percentage of total income ratio, the weighted average of Bank of Punjab and Centurion bank has been taken for the pre-merger period.

The important observations are as follows:

- Graph 7 shows that the administrative expenses as a percentage of total income has increased for the pre-merger period and then it declined for the post-merger period.
- It can also be seen that in the year of merger, i.e., 2005-06 the administrative expenses as a percentage of total income has declined sharply.
- The merger was the only significant event in this year therefore the decline in above ratio can be attributed to the merger.
- This ratio can be analyzed in detail in the cross-sector analysis.

From the above analysis, it can be concluded that the merger of Bank of Punjab with Centurion Bank has made a positive impact on the value of the resulting company Centurion Bank of Punjab. The value of Centurion Bank has increased post merger and it continued to increase in further years. This can also be seen in book value comparison of the company before and after the merger process.

SUMMARY

- Corporate restructuring attained through mergers, tender offers, joint ventures, divestitures and spin-offs have many theories involved to justify the activities. These theories are: efficiency theories, information and signaling theory, agency problems and managerialism, free cash flow hypothesis, market power, taxes and redistribution.
- The efficiency theories emphasize on the fact that merger and other such forms of asset redeployment have potential for social benefits. These involve improving on the present performance of the management and achieving synergies. It includes the differential managerial efficiency, inefficient management, synergy, pure diversification, strategic realignment to changing environments and undervaluation theories.

- Other theories of mergers include information and signaling, agency problems, managerialism, free cash flow, market power, taxes and redistribution.
- Free cash flow hypothesis comes as a rescue to the agency costs involved in a takeover activity. The hypothesis states that the free cash flow must be paid to the shareholders if the firm has to remain efficient and intends to maximize its share price.
- The effects of tax can also be an important determinant of mergers though they do not play a very significant role. Carry over of the net operating losses, stepped-up asset basis, and the substitution of capital gains for the ordinary income are some of the tax motivations for mergers.

Appendix A

Implications Under the Income Tax Act, 1961

The incentive of carrying forward losses under the Income Tax (IT) Act has also led to sick undertakings merging with healthy undertakings. As a consequence, the profits of the healthy units are adjusted against the losses of the sick units.

Definition of Amalgamation

According to Section 2(1B) of the Income Tax Act, 1961 (hereinafter referred to as the Act), amalgamation in relation to companies means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that:

i. All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of amalgamation;

ii. All the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of amalgamation; and

iii. Shareholders holding not less than 3/4th in value of the shares in amalgamating company or companies (other than shares held therein immediately before the amalgamation or by a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of distribution of such property to the other company after the winding up of first mentioned company.

Tax Concessions

If any amalgamation takes place within the meaning of Section 2(1B) of the Act, the following tax concession shall be available:

i. Tax concession to amalgamating company.

ii. Tax concession to shareholders of the amalgamating company.

iii. Tax concession to amalgamated company.

i. **Tax Concession to Amalgamating Company:** Capital Gains tax not attracted: According to Section 47(vi) where there is a transfer of any capital asset in the scheme of amalgamation, by an amalgamating company to the amalgamated company, such transfer will not be regarded as a transfer for the purpose of capital gain provided the amalgamated company, to whom such assets have been transferred, is an Indian company.

ii. **Tax Concessions to the Shareholders of an Amalgamating Company Section 47(vii):** Whereas shareholder of an amalgamating company transfers his shares, in a scheme or amalgamation, such transaction will not be regarded as a transfer for capital gain purposes, if following conditions are satisfied:

    - The transfer of shares is made in consideration of the allotment to him of any share or shares in the amalgamated company, and
    - The amalgamated company is an Indian company:
        - Cost of acquisition of such shares of the amalgamated company are later on transferred.
        - The cost of acquisition of such shares of the amalgamated company shall be the cost or acquisition of the shares in the amalgamating company. Further, for computing the period of holding of such shares, the period for which such shares were held in the amalgamating company shall also be included.

iii. **Tax Concessions to the Amalgamated Company:** The amalgamated company shall be eligible for tax concessions only if the following two conditions are satisfied:

- The amalgamation satisfies all the three conditions laid down in Section 2(1B), and
- The amalgamated company is an Indian company.

If the above conditions are satisfied the amalgamated company shall be eligible for following tax concessions.

a. **Expenditure on Scientific Research Section 35(5):** Where an amalgamating company transfers any asset represented by capital expenditure on the scientific research to the amalgamated Indian company in a scheme of amalgamation, the provisions of Section 35 which were applicable to the amalgamating company shall become applicable to the amalgamated company consequently:

   - Unabsorbed capital expenditure on scientific research of the amalgamating company will be allowed to be carried forward and set off in the hands of the amalgamated company.
   - If such asset ceases to be used in a previous year for scientific research related to the business of amalgamated company and is sold by the amalgamated company without having being used for other purposes, the sales price, to the extent of the cost of the asset shall be treated as business income of other amalgamated company. The excess of the sale price over the cost of the asset shall be subject to the provisions of the capital gains.

b. **Expenditure on Acquisition of Patent Rights or Copy Rights Section 35A(6):** Where the patent or copyrights acquired by the amalgamating company is transferred to any amalgamated Indian company, the provisions of Section 35A which were applicable to the amalgamating company shall become applicable in the same manner to the amalgamated company consequently:

   - The expenditure on patents copyrights not yet written off shall be allowed to the amalgamated company in the same number or balance installments.
   - Where such rights are later on sold by the amalgamated company, the treatment of the deficiency/surplus will be same as would have been in the case of the amalgamating company.

     However, if such expenditure is incurred by the amalgamating company after 31-3-1998, deduction under Section 35A is not allowed, as such expenditure will be eligible for depreciation as intangible asset. In this case, provisions of depreciation shall apply.

c. **Expenditure of know how Section 35AB(3):** With effect from assessment year 2000-01, where there is a transfer of an undertaking under a scheme of amalgamation, the amalgamated company shall be entitled to claim deduction under Section 35AB in respect of such undertaking to the same extent and in respect of the residual period as it would have been allowable to the amalgamating company, had amalgamation not taken place.

   However, if such expenditure is incurred by the amalgamating company after 31-3-1998, deduction under Section 35AB is not allowed, as such expenditure will be eligible for depreciation as intangible asset. In this case provisions of depreciation shall apply.

d. **Treatment of Preliminary Expenses Section 35D(5):** Where an amalgamating company merges in a scheme of amalgamation with the amalgamated company, the amount of preliminary expenses of the amalgamating company, which are not yet written off, shall be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.

e. **Amortization of Expenditure in Case of Amalgamation Section 35DD:** Where an assessee, being an Indian company, incurs any expenditure, on or after the 1st day of April, 1999, wholly and exclusively for the purposes of amalgamation or demerger of an undertaking, the assessee shall be allowed a deduction of an amount equal to one-fifth of such expenditure for each of the five successive previous years beginning with the previous year in which the amalgamation or demerger takes place.

f. **Treatment of Capital Expenditure on Family Planning Section 36(1)(ix):** Where the asset representing the capital expenditure on family planning is transferred by the amalgamating company to the Indian amalgamated company, in a scheme of amalgamation, the provisions of Section 36(a)(ix) to the amalgamating company shall become applicable in the same manner, the amalgamated company. Consequently,

   - Such transfer shall not be regarded as transfer by the amalgamating company;
   - The capital expenditure on family planning not yet written off shall be allowable to the amalgamated company in the same number of balance installments;
   - Where such assets are sold by amalgamated company, the treatment of the deficiency/surplus will be same as would have been in the case of amalgamating company.

g. **Treatment of Bad Debts Section 36(1)(vii):** Where due to amalgamation, the debts of amalgamating company have been taken over by the amalgamated company and subsequently such debt or part of the debt becomes bad, such bad debt will be allowed a deduction to the amalgamated company.

h. **Deduction Available under Section 80-1A or 80-1B:** Where an undertaking which is entitled to deduction under Section 80-1A/80-1B is transferred in the scheme of amalgamation before the expiry of the period of deduction under Section 80-1A or 80-1B then,

   - No deduction under Section 80-1A or 80-1B shall be available to the amalgamating company for the previous year in which amalgamation takes place, and
   - The provisions of Section 80-1A or 80-1B shall apply to the amalgamated company in such manner in which they would have applied to the amalgamating company.

i. **Carry Forward and set off of Business Losses and Unabsorbed Depreciation of the Amalgamating Company:** Under the new provisions of Section 72A of the Act, the amalgamated company is entitled to carry forward the unabsorbed depreciation and brought forward loss of the amalgamating company provided the following conditions are fulfilled:

- The amalgamation should be of a company owning an industrial undertaking, ship or a hotel.
- The amalgamated company holds at least 3/4th of the book value of fixed assets of the amalgamating company for a continuous period of 5 years from the date of amalgamation.
- The amalgamated company continuous the business of the amalgamating company for period of 5 years from the date of amalgamation.
- The amalgamated company fulfills such other conditions, as may be prescribed to ensure that revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purposes.
- It may be noted that in case of amalgamation, the amalgamated company gets a fresh lease of 8 years to carry forward and set-off the brought forward loss and unabsorbed depreciation for the amalgamating company.

Appendix B

Strategic Intent in Recent M&A Activity among Indian Firms: A Study[1]

Research Methodology

This research focuses on analyzing the motives of M&A in Indian firms. Data on the intent behind M&A of both acquiring firms and target firms were derived from the statements made by the firms in popular and business media (print and internet sources) in the case of 30 recent M&A deals involving at least one Indian firm. Walter and Barney used rank-order data from M&A intermediaries (advisors) to analyze the relative importance of various managerial motives for different M&A types – vertical, horizontal, concentric, and conglomerate. Grant Thornton, in a survey of Indian managers, observed that the top motives for Indian M&A activity were to improve revenues and profitability; and faster growth in scale and quicker time to market.

We content analyze the statements made by the top management of the firms involved in the media to analyze the intents, as it is believed that being publicly listed firms, the firm management will be measured in making forward-looking statements, and, therefore, the intents discussed should truly reflect the real managerial motives. Content analysis is defined as 'a research technique for making replicable and valid inferences from data according to their context'. Content analysis usually is done at two levels – manifest content – where the material is coded into words or letters in written material, audio, or visual material; and latent content – where the underlying or hidden meaning is inferred from sentences/paragraphs contained in letters, documents, or press releases. Brooks and Ritchie used a review of press releases to study merger motives in the US and Canadian trucking industry, and evolve a typology of M&A specific to the trucking industry. Comtois, Denis, and Langley content analyzed the press reports on the five hospital mergers in Canada to seek rational, institutional, and political discourses on M&A. Kabanoff and Daly and Daly, Pounder and Kabanoff used content analysis of organizational documents (annual reports and other documents) and presidents' letters to shareholders respectively, to study espoused values of organizations. Since we are interested in understanding the motives of the organizations as 'they say it', we used content analysis of press releases by the firm's top management. Recent, large deals were chosen (deals done after the year 2001; deal size of at least Rs.250 mn), involving at least one Indian firm – a firm either listed on at least one Indian stock exchange or majority owned by resident Indians.

Analysis of Intents

Based on the public announcements about the intents of the mergers by the top management in newspapers, business magazines, and other news agencies, the intents of the 60 acquirer and target firms have been summarized.

Propositions

On the basis of the remarks of the top management of the 60 firms studied, about the intents and post-acquisition strategies, we have grouped a number of deals together and developed a few propositions. Since these propositions are not mutually exclusive, there are overlaps of companies under different propositions. These propositions can be tested later (after at least three to five financial years) to ascertain whether the respective firms have achieved the said intents.

Intent behind Horizontal Acquisitions

Intents of Market Leaders: Consistent with the market power or monopoly theory, firms with industry leadership typically use horizontal mergers as a vehicle for strengthening their market leadership position. In fragmented industries,

1 Sarangapani A, and Mamatha T, "Strategic Mergers and Acquisitions in Indian Firms: A Study", *Icfai Reader*, Hyderabad, June, 2008.

horizontal mergers offer firms with an efficient method of gaining top-line growth, and, therefore, market leadership. The acquisition of an aluminum forgings unit strengthens Bharat Forge Limited (BFL) and CDP Bharat Forge's leadership position in the commercial vehicle and passenger car markets. In a statement, B N Kalyani, CMD of BFL, said: 'The CDP AT acquisition is an important part of Bharat Forge's long-term business strategy. The acquisition marks the entry of the company into the aluminium auto component business.'Commenting on the acquisition of the Daewoo commercial vehicle unit, Ravi Kant, Executive Director (Commercial Vehicles Business Unit) of Tata Motors, said, 'The complementary product range of the two companies and strengths in product development and international marketing will open new opportunities for both companies.'The acquisition of Balaji is in line with STAR's strategy of increasing content production in India. Balaji is the largest content production company in India, producing shows in various languages, including Hindi, Telugu, Tamil and Kannada. Its television productions regularly top the ratings charts in the country. Trevira has a capacity of 130,000 tons per annum of polyester fiber and yarn, and with its acquisition by Reliance and its expansions under way in India, the combined total polyester fiber and filament yarn capacity of Reliance will exceed 1.8 million tons, making Reliance the largest polyester fiber and yarns producer in the world.

Proposition 1a: Horizontal Acquisitions by Market Leaders are Likely to Result in Strengthening the Market Power.

Intents of Other Profitable Companies

Complementing proposition 1, profitable (and/or cash-rich) firms which are not market leaders use horizontal mergers to gain market leadership through complementing their products and services with that of the acquired firm. Growth in top-line in such cases is typically a result of leveraging complementary capabilities across the firms to exploit growth opportunities – either introducing new products/services or entering new markets. Such advantages are referred to as competitor interrelationships where there are no overall efficiency gains, but transfer of wealth from one set of firms to another. M&M executive vice-president Anjanikumar Choudhari said, "Low-cost manufacturing base in China and M&M's design skills will give us excellent possibilities to develop overseas business in the US and other markets. M&M's joint venture with Jiangling Motor will also give advantage for exporting tractors to the US, eastern parts of Europe and Australia."

If we look into the deal of Jindal Iron and Steel Company (JISCO) acquiring SISCOL, sources say that Coimbatore-based SISCOL has a capacity of three lakh Tonnes Per Annum (TPA) of steel and JISCO is looking to double the capacity of the integrated steel plant to six lakh TPA with a focus on manufacturing value-added products.

Announcing Zee's takeover of ETC, Sandeep Goyal, Group Broadcasting CEO of Zee Telefilms, said, "This strategic acquisition is another step in Zee's plan to achieve world leadership in key content segments serving the South Asian diaspora. It puts us in an extremely competitive position in the Music and Punjabi segments and is a foundation for building more value-creation opportunities."

"In the oil sector, competition is what we are trying to ensure and that can come about only when there is competition between public and private sector companies," Union Minister for Petroleum and Natural Gas, Murli Deora said. "IOC needed access to more retail outlets immediately and bid aggressively for IBP Co. Ltd., with the aim of preparing itself for a competitive scenario with the dismantling of APM from April 1 this year." There was excess refining capacity with IOC, but it lacked enough retail outlets to market the petro products. By acquiring IBP, IOC will have control over 1,500 retail petrol stations owned by the former, which will immediately make IOC a competitive player vis-à-vis other private companies in the post-Administered Pricing Mechanism scenario.

Reliance acquired IPCL by outbidding its rival bidders IOC and the Nirma group. By being at the helm of affairs at IPCL, the Ambanis will now be able to control at least two-thirds of the total Indian market for all kinds of petrochemical products. More significantly, the new conglomerate will be able to control as much as 70-90% of the market for specific products such as propylene, polypropylene, mono-ethyl glycol, poly-butadiene rubber, poly-vinyl chloride, di-methyl terphthalate and Low and High Density Polypropylene (LDPE and HDPE).

One official source, revealed that Hutchison Essar, which is what the new company could be called after the merger of Essar with Hutch, would easily become the second largest cellular company after Airtel with 12 circles under its belt. The combined subscriber base of the two service providers was then four million, but they hoped to take it to five million within a year of their merger. The new company could also enter circles where neither of them was present at the moment.

Similarly, Patni wanted to enter the telecom industry IT services by acquiring Cymbals Corporation. "Patni currently does not have a telecom practice and hence this will enable it to rapidly initiate its telecom business," said Apurva Shah, an analyst at brokerage ASK-Raymond James. Patni's Chairman and CEO Narendra K Patni said, "We've been watching the telecom market for a while. There's some major synergy in this deal; we did not have a telecom presence, and now we can offer our services within a strong vertical market where we can already bring a real worldwide presence."

If we look into Kishore Chhabria acquiring control of the Herbertsons brands, it is clear that Chhabria was eyeing the possibility of getting market leadership. While Herbertsons owns the country's largest selling whisky brand, Bagpiper, its 100% subsidiary, BDA Distillery, owns the Officer's Choice brand.

The acquisition of Larsen and Toubro (L&T)'s cement division UltraTech Cemco by Grasim Industries was the biggest in India's corporate history. The deal is expected to enable Grasim to 'enjoy pricing power' which reflects the oligopolistic tendencies in the Indian cement industry. The acquisition resulted in Grasim emerging as a dominant player in the industry. The deal was valued at Rs. 22 bn. With the acquisition of UltraTech, Grasim now becomes the world's seventh largest cement producer with a combined capacity of 31 million tons. Horizontal mergers are undertaken by firms (which are not market leaders) to gain market share through either leveraging complementary capabilities or exploit new product-market opportunities.

Proposition 1b: Horizontal Acquisitions by Profitable/Cash-rich Firms Which are Not Market Leaders are likely to Provide them Market Leadership through Complementary Products and Services.

Intents of Loss-Making Companies

Loss-making firms exit the industry through a sell-off to another management (typically in the same industry) which can manage the business more efficiently. If we look into the JISCO-SISCOL deal, the main intention on the part of SISCOL was to get rid of losses as well as to grow faster.

On selling off Parry's to Lotte Confectionery, M V Subbiah, Chairman of Parry's Confectionery, explained that in a changed market environment, the group found it difficult to pump in money continuously to build and sustain the confectionery brands and hence decided to exit the business.

Managements of loss-making firms also use sell-offs to get rid of those assets that bleed the firm of cash/resources and write-off the accumulated losses. Such sell-offs result in the acquisition of the loss-making unit by another firm that can provide the firm with the required resources and tap the right opportunities for growth. After India Cement inked a deal with Zuari Cements to sell its entire

94.69% stake in Sri Vishnu Cement, its Vice-Chairman and Managing Director N Srinivasan told presspersons that the sale would improve India Cements' liquidity. India Cements, which got an enterprise value of Rs.3.85 bn for its stake in Sri Vishnu Cement, will use the money to retire some of its high cost debt and then restructure its debt portfolio.

Official sources of Hughes Telecom (HTIL) said, "as consideration for the acquisition of 71.43 crore [714.3 million] equity shares of HTIL, Tata Teleservice Limited [TTSL] will issue 71.43 crore redeemable non-cumulative convertible preference shares (RPS) of TTSL in favor of the HTIL sponsors. Separately, HTIL will be restructuring the debt owed by HTIL to Hughes Network Systems (HNS). Part of the debt owed by HTIL to HNS will be rescheduled as long-term debt. Also, HNS will partially transfer its HTIL receivables to TTSL in exchange for RPSs and warrants of TTSL."

Proposition 2: Sell-offs by Loss-making Firms to More Efficient Management is Likely to Result in Wiping Out Accumulated Losses.

Intents of Indian Companies Selling off to MNCs

Indian firms that sell off to MNCs typically do so to gain the advantage of the deep pockets of the MNCs to fuel their aggressive growth opportunities. Commenting on the deal with eBay, Bazee.com Chairman and co-CEO Avnish Bajaj said, 'Our partnership with eBay validates Bazee.com's business model and position in the industry. Our local expertise combined with eBay's global perspective will allow us to take e-commerce in India to the next level.'

Similarly, due to the merger with IBM, Daksh e-Service will get continuous jobs from IBM, enabling it to grow faster and become the number one outsourcing company in India. Jobsahead.com can now leverage on the wider employer-related database available with Monster Worldwide. With Avaya getting the nod to acquire 25.1% of Tata Telecom, the Tata group company can now import and distribute telecom solutions and equipment and offer specialized after-sales services.

Max India Joint Managing Director B Anantharaman said, "The proposed investment by Warburg Pincus acknowledges the strong business fundamentals of the Max Group as it builds the country's top quartile private life insurance business and an integrated healthcare delivery business in the National Capital Region. The equity infusion by Warburg Pincus in Max Healthcare will help meet the long-term funding needs of this capital intensive business."

Balaji Telefilms was assured of a broadcasting channel from its acquiring company Star Broadcasting. Jeetendra Kapoor, Chairman of Balaji Telefilms Limited, said, "We are excited about having Star as an investor in the company. We believe that the investment made in the company will assist in achieving a higher level of growth and in the process generate significant value for all the stakeholders."

Commenting on the Matrix Lab and India New Bridge deal, officials of Matrix Lab expressed their belief that the preferential issue had given Matrix access to a cash chest, which was partly to be deployed in repaying long-term debt. This should translate into a saving in interest expenditure, boosting the bottom line to that extent. Further, the excess cash could also be used by Matrix to make acquisitions.

Proposition 3a: Domestic Firms' Sell-off to MNCs May Help Gain Market Entry.

Proposition 3b: Domestic Firms' Sell-off to MNCs May Help Generate Cash to Fuel their Growth Opportunities.

Market Entry Strategy

MNCs use acquisition of domestic companies as an effective market entry strategy. Through M&A, MNCs not only get access to the domestic market, they also gain significant local capabilities to create and deliver their products and services. IBM India General Manager Abraham Thomas said, “India is one of the fastest-growing economies in the world, and an important marketplace for IBM. This investment [acquisition of Daksh e-Service] is indicative of our commitment to supporting our clients in this region and leveraging local capabilities to extend our leadership position in the rapidly-growing business transformation services marketplace.”Commenting on the NatSteel deal, B Muthuraman, Managing Director of Tata Steel, said, ‘The acquisition of the steel business of NatSteel is an important step in Tata Steel’s plans to build a global business. NatSteel’s business provides Tata Steel access to key Asian steel markets, including China.’Commenting on the transfer of Trevira, Subodh Sapra, President of Polyester Sector, in Reliance Industries, said, ‘It’s a win-win situation for both the companies. Reliance gets a foothold in Europe while Trevira will benefit from the resources of the world’s largest integrated polyester producer.’ On the FLAG acquisition issue, Reliance said FLAG’s global fiber optic network would complement Reliance’s next generation digital network in India and enable Reliance to serve its customers worldwide more effectively by offering end-to-end solutions. FLAG is in the business of providing bandwidth through its undersea cable network. It owns and operates a global telecom network comprising over 50,000 km of undersea fiber optic cable that spans four continents and connects the key regions of Asia, Europe, the West Asia and the US. Through its network, FLAG offers a variety of telecom products and services to its customers consisting of major telecom carriers, Internet service providers, and other bandwidth intensive users such as broadcasters.

Lotte Confectionery has over 500 products, which are manufactured at its five plants in Korea and exported to 70 countries. Outside Korea, Lotte Confectionery has plants in China, Vietnam and the Philippines. With its latest acquisition of 60.39% stake in Parry’s Confectionery, India, will be added to the Korean company’s production map.

Commenting on the Blue Dart acquisition, Bryan Jamison, DHL’s Regional Director, South East Asia and Indian Sub-Continent, told reporters at a news conference: “India is of strategic importance for us. It has tremendous growth opportunities.” According to company chairman and CEO Narendra Patni, the deal with Cymbals Corporations, affords Patni entry into a new market for its global outsourcing services without having to spend time and money on building expertise in a new area, while affording customers of both companies new services without any disruption in their current offerings.

Similarly, the purchase of New Delhi-based Jobsahead.com, which had sales of Rs.150 mn for the year ended March 31, will help New York-based Monster become the biggest job-search site in India, with a database of more than 2.5 million online resumes.

Proposition 4: Market Entry May be a Dominant Motive for MNC Firms Acquiring Domestic Firms.

Premium Paid for Acquisitions

MNCs acquiring domestic companies typically tend to pay a higher premium for the acquisitions. This is based on the premise that market entry is very valuable, especially in emerging markets like India, where building assets; resources and capabilities from scratch to achieve a significant market position can be very expensive, risky and time-consuming.

In our sample we looked into all the deals where multinational companies have acquired Indian companies. In all the cases the offer value is higher than the turnover of the target company. IBM paid $160 mn for Daksh e-Service, when the total turnover of the company was only $40 mn. Monster Worldwide paid Rs.400 mn for Jobsahead.com, when the latter’s total turnover was only Rs.150 mn. Similarly, eBay paid Rs.2.25 bn for Bazee.com, while the acquired company’s turnover was only Rs.150 mn. DHL paid Rs.7.30 bn to acquire Blue Dart when the turnover of

Blue Dart was only Rs.3.55 bn. Star paid Balaji Telefilms Rs.2.73 bn where the turnover was only Rs.1.78 bn. Similarly, AFK Sistema, a Russian conglomerate paid a whopping $450 mn to acquire a 49% stake in Aircel Cellular. We calculated price Paid to Turnover Ratio (P/TO) for 18 deals for which data are available. In the case of deals where multinational companies are acquiring Indian companies, this ratio varies between 1.5 and 15; while when Indian companies are the acquirers, the ratio varies between 0.1 and 1.2. As we can see from Table 1 (a t-test calculated for 5% significance level), there is a significant difference in the P/TO ratio at 5.17% confidence level between multinational and Indian deals. The lower significance level may be attributed to very small sample size.

Table 1: T-test Comparing Offer Values of MNCs and Domestic Acquirers

T-test: Two-Sample Assuming Unequal Variances

	Variable 1	Variable 2
Mean	0.553655641	4.771142026
Variance	0.13649419	26.94157194
Observations	12	6
Hypothesized Mean Difference	0	
Df	5	
t-Stat	–1.987780735	
P(T<=t) one-tail	0.051771608	
t-Critical one-tail	2.015048372	
P(T<=t) two-tail	0.103543216	
t-Critical two-tail	2.570581835	

Proposition 5: Multinational Companies May Offer Higher Premiums for Acquiring Domestic Targets than Domestic Acquirers.

Achieving Synergies

Leveraging synergies are often quoted as the intent for M&A activity. In order for firms to leverage synergy through M&A, we propose that strategic intents of the acquirers and the targets should be complementary. For instance, if a target firm that is pursuing a strategy of growth through large investments in building assets and capabilities for the long-term is acquired by a firm that intends to restructure the target with a view of freeing the excess assets, it is less likely that synergies will be leveraged. ‘As part of Zee Network, ETC will have tremendous opportunities to build on synergies,’ said Jagjit Singh Kohli, Promoter and Managing Director of ETC. “Zee’s international presence provides ETC a window to global audiences, which hitherto was not available.” As a result of this transaction, the companies believe there will be improved content offerings, which will drive viewership and subscriber fees. Zee will bring its strength in sales and marketing to the Punjabi and music channel and provide a global platform for ETC content, especially for the Gurbani rights.

The acquisition of Hindustan Zinc Limited (HZL) by Sterlite, according to sources, will help Sterlite emerge as a dominant player, best positioned to play the ‘volume game’ in the zinc and lead marketplace. Key research outfits have also forecast that aided by a steady improvement in demand from end-user segments and consolidation at the international level, the long-term prices of zinc and lead are likely to settle at $1,000-1,100 per ton (compared to the current price of $755) and $570-630 (current price of $435) per ton respectively over a two to three-year time-frame. As the domestic supplies continue to fall short of demand, Sterile may be in a position to expand production capacities of Hindustan Zinc to capitalize on this demand-supply gap in the domestic market. Thus, the potential of HZL under the Sterlite management appears quite strong, although it may manifest itself only in the long run.

Commenting on the STAR-Balaji deal, Michelle Guthrie, CEO of STAR, said, "We are thrilled to acquire a stake in Balaji, with whom we enjoy a productive and rewarding relationship. Balaji, under the continuing management and leadership of the Kapoors and with its unique pool of creative talent, has become one of the most important companies in the evolving and increasingly competitive media arena in India. As Star continues to expand its services and offer more choices to viewers, we see enormous strategic benefits from strengthening our relationship with Balaji."

On the subject of the Tata Steel-NatSteel deal, President of NatSteel Oo Soon Hee said, "With this transaction, NatSteel Asia will be well-positioned to weather the volatilities in the steel industry because it will be part of a much larger, fully-integrated steel group with extensive resources." As part of Tata Steel, NatSteel Asia will be able to benefit from a much larger footprint in the steel industry as well as have access to significant resources, enabling us to further expand within Asia. B Muthuraman, Managing Director of Tata Steel, said, "I believe that the acquisition will prove to be a good strategic fit and create value for Tata Steel shareholders."

Commenting on the VSNL-Tyco deal, Tata Industries Managing Director Kishor Chaukar said, "The price that VSNL has paid is a fraction of Tyco's total cable assets. It is a unique global network, with assets of almost $2.5 bn. VSNL was short on bandwidth, Information and technology. With this deal no one will be able to beat us. The deal gives immense flexibility to VSNL in terms of connectivity." Tyco's cables had a data transfer capacity of 10-15 terabits. Of this, the unlit capacity of the fiber was ten times the operational capacity being used. The Tyco cable had 100 clients, which included some of the world's largest data carriers.

Commenting on the acquisition of Global Trust Bank (GTB), B D Narang, Chairman and Managing Director of Oriental Bank of Commerce (OBC), said, "We have a good presence in the northern part of the country while southern region has not been tapped that much. With GTB coming into our fold we will have a strong presence in the southern market."

With the acquisition of UltraTech, Grasim achieved a combined capacity of 31 million tons. The value synergy is estimated to be around Rs.1 bn per annum. The Birlas were aiming at a 15% Return on Capital Employed (ROCE) for UltraTech Cemco. However, it will take about two to three years for UltraTech to provide a competitive return to its shareholders.

Besides making it the largest polyester fiber and yarns capacity in the world, Reliance's acquisition of Trevira gives it a strong footprint in Europe and places it in a position to cater to all market segments of polyester fibers and filament yarns worldwide. Trevira's knowledge base developed over a period of time will be complementary to Reliance's existing R&D facility, the Reliance Technology Center. Reliance's strength in the integration and management of large-scale manufacturing facilities will provide operational advantage to Trevira. The Trevira brand and products will now have access through the established Reliance sales network to India, one of the fastest-growing textiles markets in the world. The synergy will provide comprehensive and innovative solutions for apparel and non-apparel applications of polyester to customers' worldwide.

For Tata Motors, DWCV is synergic because the Korean company makes commercial vehicles in the 200-400 brake horsepower (bhp) range, while Tata trucks stop short of 200 bhp.

Proposition 6: The More the Complementarity of Intent between Acquirers and Targets, the More the Synergy is Likely to be Leveraged.

Implications for Practice

The M&A intents proposed here will provide a yardstick to the prospective acquiring firms to benchmark their intents with those of similar types of acquisitions done before. This study will also help firms in deciding the types of firms to acquire, in order to achieve specific strategic objectives. Apart from this, the cases described will come in handy for practicing managers to understand the intents of other Indian firms in their industry, which were involved in the recent deals discussed. This article not only studies the intent of the acquirers (as is most commonly done), but also focuses on the complementarity of intent between the acquirers and the target firms. The study of the target firms' intents will greatly help acquiring firm managers in their post-merger integration efforts.

Chapter 6

Sell-offs and Divestitures

After reading this chapter, you will be conversant with:

- Factors Involved in Divestment Decisions
- Explanation and Rationale for Gains to Sell-offs
- Divestitures
- Spin-offs
- Equity Carve-outs
- Decision Process: Divestiture and the Spin-off

Many corporations, mostly large and highly diversified organizations, are persistently evaluating various ways in which the shareholders' position could be enhanced. These activities are referred to as restructuring activities. The restructuring activity may take the form of either expanding the business or exiting from the business.

This chapter deals with the shareholders' wealth and effects of several forms of corporate restructuring and with strategies that allow the firm to maximize shareholders' value by redeploying assets through contraction and downsizing of the parent corporation.

Divestitures, spin offs, equity carve outs, split ups and split offs are the commonly used strategies to exit businesses and to deploy corporate assets by returning cash or non-cash assets through a special dividend to shareholders.

FACTORS INVOLVED IN DIVESTMENT DECISIONS

A number of factors play a role in making divestment decisions and are grouped under three general categories:

i. Opportunistic,

ii. Planned, and

iii. Forced.

Opportunistic considerations are totally optional and are to be implemented in a reactive manner. Taking the example of profit motivation, consider a successfully operating division that receives an unsolicited cash bid from a suitor, which would translate into an extraordinary profit. While there may be no immediate use for the cash, the profits to be obtained from selling off this division are such that management cannot be in a good conscience to turn down the offer. The profit motivation under opportunistic consideration is slightly different from profit motivation under planned considerations in column 2. Under the scenario of planned consideration, a company may have a profitable, well run division, but may go in for divestment to raise the necessary capital to invest in something new, or out of concern about the division's long-term future. While profit motivation is the same in both the instances, different circumstances lead to the divestiture decision.

Another example to highlight the differences in considerations under these categories is shown in column 2, the planned sell-off scenario, when the seller recovers some capital. This consideration refers to a faltering situation in which, as a result of an ongoing portfolio review, the division is sold off in time to "recover some capital". On the other hand, in the forced scenario, under column 3, the extent of capital recovered would generally be much less since a forced liquidation of assets is most likely to occur only after much erosion of assets.

Some amount of overlap does take place between the three basic scenarios that trigger or motivate a divestiture. Likewise, there is interchangeability among the individual factors.

These factors are divided into five categories:

i. Economic,

ii. Psychological,

iii. Operational,

iv. Strategic, and

v. Governmental or legislative.

Many of the subjects under these categories overlap.

Table 1

Categories	Opportunistic (1)	Planned (2)	Forced (3)
Economic		Never be a factor at any investment level	Continual failure to meet goals
	Tax considerations	Tax considerations	Tax considerations
		Shrinking margins	
	Better alternative use of capital	Better alternative use of capital	
	Profit motivation	Profit motivation	
		Marginally profitable	
		Recover some capital	Recover some capital
		Unprofitable division	Unprofitable division
		Liquidity problems	Liquidity problems
Psychological		Eliminate psychological effect of a loser Bad apple theory	
Operational		Lack of intercompany synergy	
		Labor considerations	Labor considerations
		Competitive reasons	Competitive reasons
		Management deficiencies	
		Concentration of management efforts	Concentration of management efforts
		Eliminate inefficiencies	
Strategic		Change in corporate goals	
		Change in corporate image	
		Technological reasons	Technological reasons
	Poor business fit	Poor business fit	Poor business fit
		Market saturation	
	Takeover defense	Takeover defense	Takeover defense
Governmental		Government-directed divestitures	Government-directed divestitures
Note: Some considerations may fall under more than one category. For example, shrinking margins and better alternative use of capital may also be strategic considerations.			

Source: Robert Lawrence Kuhn – Mergers, Acquisitions, and Leveraged Buyouts.

ECONOMIC

Never be a Factor at any Investment Level

Many times, the market in which the company is dealing is too narrow. It becomes impossible for the management to realize an adequate return regardless of the dollars and corporate muscle put into the particular division. This kind of situation arises where the company is faced with impossible goals of achieving market share in the face of competition that is either too well-entrenched, tough, or numerous to make any investment worthwhile. The RCA Corporation faced this situation when it abandoned its mainframe computer business after attempting to compete directly with IBM.

Continual Failure to Meet Goals

The continual failure by a division to meet quarterly or yearly projections serves as an excellent rationale for divesting. Continual losses or continual shortfall arising due to overestimating the potential of the company can prove expensive to any company.

Tax Considerations

Tax considerations may serve as a justification for divestment. A company can often take advantage of changes in the tax laws by selling a division or a product line at an opportune time, and derive benefits from losses incurred or other benefits allowed by the existing tax laws. Since, tax laws are continually changing, divestment can be considered as an opportunity that can quickly be lost by a change in law. For example, when Net Operating Losses (NOLs) could be easily sold and utilized by the acquirer, many companies taking advantage of this temporary tax benefit sold off their loss-plagued divisions.

Shrinking Margins

Often by the primary reason for a divestiture is reduced profit margin. Examples of companies that have run large divestiture programs because of shrinking margins are G.D Searle and American Can. Even though the divestment programs for both these companies were part of their strategic plans, the short-term reason for initiating the divestment was the continual reduction in profit margins of the divisions that were sold.

Better Alternate use of Capital

This factor serves as a combined economic and strategic reason for considering divestment. A large number of companies in corporate America have begun divestment programs in order to make better use of their capital. Companies that have reinvested proceeds into other areas of existing businesses or into new acquisitions through divestment programs have been extremely satisfied.

Profits

Lack of profits is the most noted and visible reason for corporations to initiate divestment programs. Marginally profitable divisions or those divisions whose financial performance is not in line with financial performance of other divisions in the company are sure targets for divestment. Unless serving some strategic purpose, such as a research and development unit, divisions that continue to be unprofitable and incur losses year after year should certainly be divested. A corporation’s existence is dependent on its stockholders’ satisfaction and the best way to satisfy stockholders is to perform well and produce generous profits. The prime candidates for divestiture should be the divisions and product lines that erode profit and, which cannot be restructured and reshaped so as to give a substantial and acceptable return on investment in alliance with the corporation’s goals.

PSYCHOLOGICAL

Eliminate Psychological Effect of a Loser

No one likes to be associated with a loser. It is psychologically very depressing to be working for or to be associated with a loss-making company, which has very little future ahead. Every management should try to avoid having a losing company over a long-term since the effects of a loser can be as contagious as the effects of a winner. It is best to sell off a losing company if it cannot be fixed.

Bad Apple Theory

Just as one rotten apple spoils the entire basket, losers, have a way of creating other losers. The faster a company gets rid of a loss-making division, the better it would be for all its other divisions. Losers should be quickly eliminated before they can effect the morale of the management teams at the other profitable divisions of the company.

OPERATIONAL

Lack of Intercompany Synergy

Product lines or divisions acquired or set up to add synergy to the company's other divisions, but failed to do so, are prime targets for sell-offs. If management is unable to consolidate operations to increase profitability, then liquidation or divestment is an alternative.

Labor Consideration

Often companies are divested because of unusual labor situations, which might consist of labor unrest in a particular plant, lack of adequately skilled labor pool, or outside economic and political factors causing shortage of labor at competitive prices. Divestiture can be considered as an alternative, if moving or consolidating the operation cannot remedy the situation.

Competitive Reasons

Competition forms the basis of a capitalistic system. However, when competition is intense, and is of so large and effective nature, that it becomes impossible to compete with, withdrawing from a market can be accomplished by divesting an ongoing division. The management of International Harvester, for example, due to its involvement in several markets where the competition was too intense, larger and more able to compete in terms of productivity, research and development, and new facilities, the management of preferred to sell off one of its fundamental old businesses to a larger, more financially capable company instead of remaining in these market segment as an ineffective also ran.

Management Deficiencies

A company's inability to put together the right management team to run a division reflects the management's lack of ability to recruit, hire, and even provide internally proper management to run its companies, and if the situation exists and cannot be corrected, divestitures should be considered.

Concentration of Management Efforts

It is necessary to focus the management's efforts where they will be most productive for the company. When one or several divisions of a company are losing money and the management has to concentrate its efforts on trying to turn around the losers, it is better that the problem divisions are divested quickly so that the management has ample time to return to its normal and important functions of promoting the solid and strategically important units of the company.

Eliminate Inefficiencies

Many companies operate marginal divisions indefinitely till these units encounter significant losses. However, marginally profitable units tend to get caught in the trap wherein the management starves them for growth capital. In course of time, these units become more inefficient and less competitive and ultimately begin to lose important money. It is essential to spot these trends early and to try to sell these units before they become big losers and begin gathering significant downward momentum. If divestiture can be accomplished within a reasonable time frame, not only are future losses eliminated, but the sale of the unit helps inject more capital into the corporate treasury than would have been obtained if the sell-off was delayed too long. These situations occur commonly in vertically integrated firms, where various operations can no longer be conducted efficiently. An excellent example of this kind of situation is that of Ford Motor Corporation's divestiture of its basic steel operations.

STRATEGIC

Change in Corporate Goals

This is the most common reason for companies to begin divestment programs. A company's motivation to divest itself of bad divisions, or any division, is often masked by the statement that the corporation is changing its strategic goals and wishes to divest one or several of its divisions. For example, several years ago Gould Inc. in its efforts to get out of the electrical equipment and equipment-support business and upgrade technologically into the electronics business, divested all of its technologically mundane divisions over several years and used the funds obtained to acquire companies in the electronics business, thereby moving several steps up the technological ladder. In initiating a divestment program as a result of a change in corporate strategy, the key to the divestments is not only getting out of unwanted businesses, but estimating and projecting capital that would be raised by selling off these divisions and how much this capital would assist in either acquiring or starting up new ventures that are more in line with the newly stated corporate strategic goals.

Change in Corporate Image

Some companies feel that in order to effect a "new" image, in addition to the change in corporate goals, certain divisions must be divested. The divestments rather than pertaining to segments that are failing, or even segments that have limited long-term potential, might involve businesses in areas that are not to the liking of management. For example, Gulf & Western which was involved in total restructuring, utilized divestiture of several of its large divisions to move out of mundane manufacturing areas and become more visible in the fast-moving, aggressive financial and entertainment business.

Technological Reasons

Many companies undertake divestment programs to technologically upgrade operations. For example, Litton Industries undertakes a continual year-to-year upgrading of its companies, regardless of profitability, to maximize the potential of growth in higher technological areas. On the other hand, companies downgrade technologically when they are unable to adapt to the fast-moving nature of technologically oriented business. Many companies have used divestment strategies to withdraw from the high tech areas and retreat to their core business. Warner Communications, with the sale of its Atari division, provides an excellent example of this kind of divestment strategy.

Poor Business Fit

Often divisions make no sense at all strategically and fail to fit with other divisions of the company. As a result, many a times the new management of the acquiring companies that inherit these businesses, take the course of divesting quickly. For example, Western Union Telegraph Co.'s newly appointed chairman quickly divested off E.F Johnson Company, due to its failure to fit in Western Union's core business.

Market Saturation

A division or a product line in which the investment required to maintain market share exceeds the cash it generates is a perfect candidate for divestiture. This situation is simply a case of a cash cow turning into a dog.

Takeover Defense

Divestment serves as a classic takeover defense mechanism and has been used successfully to thwart many of the takeover bids. A typical maneuver of this kind involves the sale of a "Crown Jewel" to deter an aggressive takeover player from going ahead with its plans. For example, this tactic was successfully used by Brunswick Corporation in its sale of its medical division, the best operating division of the company, to American Home Products in order to thwart an unsolicited takeover attempt by Whitaker Corporation. Shortly after this event, Whitaker Corporation withdrew its takeover bid for the company.

GOVERNMENTAL

Government Directed Divestitures

Government-directed divestitures often occur as a result of major mergers or acquisitions where the merger of two like companies gives rise to anti-trust problems. In order to avoid antitrust litigation by the government, companies either voluntarily divest certain divisions or are directed to do so. The rush of oil combinations taking place over the last few years has resulted in major oil companies selling off large parts of their merged companies. For example, the Gulf/Standard Oil of California and Texaco/Getty transactions involve government-directed divestitures.

Companies are hence forced to evaluate operations that go against government-enacted environmental laws and practices. And in many cases, companies either decide to sell a plant, switch to an alternate method of operation, or shut down the offending operation in order to meet government regulations.

Box 1: India's Privatization Hopes get Boost on IPO Success

The massive investor response to the Indian government's public offer to lower its stake in half a dozen state-run firms is likely to bolster the privatization program, say analysts.

Experts say the overwhelming response to Initial Public Offerings (IPOs) of some of the blue-chip public sector firms ahead of the parliament elections is also likely to bring in the much needed funds to the deficit-prone government.

In the last three weeks, the government offered most of its shares in four state-owned companies – Indian Petrochemical Corp Ltd. (IPCL), Dredging Corp, Computer Maintenance Corp (CMC) and oil retailer IBP. In addition, it also put on the block 10 percent of its equity in profit-making energy giants Oil and Natural Gas Corporation (ONGC) and Gas Authority of India Ltd (GAIL).

The sale of government equity in five state-run companies has already raised a whopping Rs.37 billion ($805 million). And the auction to sell 10 percent through the public offer route in ONGC, the country's largest company by market capitalization, is likely to rake in Rs.110 billion ($2.5 billion), making it the country's biggest-ever public offering. The government plans to raise a total of Rs.150 billion ($3.3 billion) through the connective public offerings to meet its budgetary target of privatization proceeds and rein in the spiraling fiscal deficit to below five percent.

Investors bid for 11 times the number of shares on offer for CMC; Dredging Corp was oversubscribed 6.5 times, Indian Petrochemicals nearly five times, IBP more than twice, and blue-chip GAIL eight times. "The sale of government equity in these firms was based on the idea of distributing public wealth among the public itself. I think this will have an impact on future privatization cases as well," said Srinivasan. Disinvestment Minister Arun Shourie has, however, said that both strategic sales and public offer routes for selling government equity in state-owned companies can co-exist.

Source: Economictimes.Indiatimes.com

While a fairly comprehensive listing of the factors to be considered while making divestment plans has been given above, there are other factors as well that can have a direct bearing on divestment strategy. These factors may include outside pressure from stockholders, the economic conditions at any given time, and political considerations. These additional macro considerations in addition to any combination of the factors described above should be reviewed before the divestment decision is made.

Box 2: Strategic PSU Sell-offs Back on Centre's Reforms Agenda
The central government has brought disinvestment through the strategic route back on its agenda. It has shortlisted five loss-making public sector companies where it plans to induct strategic investors. The companies that selected are Hindustan Salts, HMT Bearings, Richardson & Cruddas, Tungabhadra Steel Products and Central Inland Water Transport Corporation. The Board for Reconstruction of Public Sector Enterprises (BRPSE) is currently preparing a blueprint for reviving these companies. The government plans to invite strategic investment in four loss-making companies, currently under the review of BRSPE.

Source: http://www.financialexpress.com/news/strategic-psu-sell-offs back on Center's Reforms a genda/191295/#

EXPLANATION AND RATIONALE FOR GAINS TO SELL-OFFS

Some of the main reasons why firms are forced to divest are: efficiency gains and refocus, information effects, wealth transfers and tax reasons.

EFFICIENCY GAINS AND REFOCUS

While Mergers and Acquisitions lead to synergy, divestures can result in reverse synergy. A particular business may be more valuable to someone for generating cash flows and that someone will be paying a higher price for the business than its present value. Divestiture is also taken to enable a company to make certain strategic changes.

The competitive advantage that a company has may change over time due to changing market conditions, and as a result, a company may have to divest a particular business. In some cases, the past diversification programs of a company may have lost value, making it necessary for the company to refocus its core competencies. A divestiture helps a company to refocus on its core competencies.

INFORMATION EFFECTS

The information that a divestiture conveys to investors is another reason for divestiture. If the information given by management is not known to investors, the announcement of divestiture can be seen as a change in investment strategy or in operating efficiency. This may be taken in a positive sense and boost share price. However, if the divestiture announcement is perceived as the firms' attempt to dispose off a marketable subsidiary to deal with adversities in other businesses. it will send a wrong signal to investors. Whether the divestiture is seen as a good or a bad signal depends on the circumstances.

WEALTH TRANSFERS

Divestiture results in the transfer of wealth from debtholders to stockholders. This transfer takes place when a company divests a particular division and distributes the resulting proceeds of the sale among, stockholders. As a result of this transaction there is less likelihood of repayment and it will have lesser value. If the total value of the firm remains unchanged, its equity value is expected to rise.

Box 3: Motives for Divestures in India
A recent survey reveals the following motives for divestitures in India: – Focusing on core businesses for the divesting firm (For example, sale of TOMCO by the Tatas). – Declining profitability of business(es) in which the firm is operating. – Getting rid of unprofitable businesses (For example, sale of ITC Classic by ITC). – Raising the funds for other activities. (For example, divestment of 10% stake in Power Grid Corporation, Power Finance Corporation by the government). To reduce the fiscal deficit, the government may go for divestment.

TAX REASONS

As in the case of mergers, divestitures also provide a considerable tax advantage. When a company is losing money and is unable to use a tax-loss carry forward, it is better to divest wholly or in part to realize a tax benefit. When there is increased leverage due to restructuring, a firm can have a tax shield advantage due to interest payments being tax deductible.

DIVESTITURES

DEFINITION

A divestiture is the sale of portion of the firm to an outside party generally resulting in cash infusion to the parent. They are generally the least complex of the exit restructuring activities to understand. Most of the sell offs are simply divestitures. The most common form of divestiture involves sale of a division of the parent company to another firm. The process is a form of contraction for the selling company and a means of expansion for the purchasing corporation.

Box 4: Divestiture of Punjab Tractors Ltd.
It's 10 a.m. on 25 July, 2003. An air of nervous excitement hangs over the committee room on the sixth floor of the Punjab government's secretariat in Chandigarh. The deadline to submit the final bids for Punjab Tractors (PTL) is expiring in half an hour. Ever since the Punjab State Industrial Development Corporation (PSIDC) hawked its entire 23.49% stake in PTL eight months ago, 11 suitors including the who's who of India's tractor industry and three foreign private equity investors expressed interest in buying out PTL. Today is the day to state their price. The entire top brass of the Punjab government's disinvestment team is waiting in anticipation. PTL's profile as Punjab's biggest disinvestment project has even prompted the Chief Minister Amarinder Singh, to take part in the bid opening ceremony later in the evening. But as if the suitors forgot they had a date with destiny just two representatives walk into the committee room – one from London-based private equity firm CDC Group Plc and the second, India's largest tractor manufacturer Mahindra & Mahindra (M&M). In the evening, even Amarinder Singh who flies in specially from Delhi for the bid opening ceremony, is disappointed with the outcome. When the bid opened at 4 p.m., CDC was the sole bidder in the race. As it turned out, the M&M representative was merely posturing. He carried three sealed envelopes titled: 'commercial bid', 'financial bid' and 'technical bid'. But inside the envelopes were letters withdrawing M&M's entry. Soon after, Punjab's core committee on disinvestment, chaired by Amarinder Singh himself, accepted CDC's Rs.218.39-crore bid (at Rs.153 per share; BSE closing price on 25 July: Rs.158.40) for PTL. This is the most peculiar case of disinvestment in corporate India. Typically, the government decides whether it prefers divesting in favor of one strategic player or among a host of shareholders. In the case of the former, it makes the company attractive enough for a strategic investor to enter into a block purchase (like in IBP which went to Indian Oil Corporation). In the latter, it goes for a public issue like in the case of Maruti Udyog. PTL's case turned out to be curious. The government decided to sell the stake to a single, strategic buyer, yet it made little effort to make the company attractive for any tractor manufacturer. Eventually, not one tractor-maker bid and PTL went to a financial investor (CDC), who will finally sell it to a third party for a profit. The point being raised is: PSIDC could have made that profit itself if it had made the disinvestment process competitive enough. So why did it not stall the sale? Even the Punjab government, which could have withdrawn citing lack of competition, opted not to pull out.

Source: www.businessworldindia.com

SPIN-OFFS

It is a transaction in which a company distributes to its own shareholders on a *pro-rata* basis all of the shares it owns in a subsidiary. Hence a spin-off results in the creation of a new public company with the same proportional equity ownership as the parent company.

Spin-off has emerged as a popular form of corporate downsizing in the nineties. A new legal entity is created to takeover the operations of a particular division or unit of the company. The shares of the new unit are distributed on a pro rata basis among the existing shareholders. In other words, the shareholding in the new company at the time of spin-off will reflect the shareholding pattern of the parent company. The shares of the new company are listed and traded separately on the stock exchanges, thus providing an exit route for the investors. Spin-off does not result in cash inflow to the parent company.

Box 5: Kale Sets up Arm for Customized Software

KALE Consultants Ltd., has announced the launch of its subsidiary Synetairos Technologies Ltd., a spin-off of its generic software and professional services business. This move was aimed at providing greater focus and flexibility to the growing software services business.

The new company will focus on generic customized software solutions and professional services. Synetairos will continue servicing customers like Standard Chartered Bank and EDS. Synetairos will work in conjunction with the other group companies of Kale Consultants and Cognosys Software. The synergies from the various divisions will be brought together to provide value to the end customer.

Kale, which has about 550 professionals, provides software products and outsourced services to the travel and transportation industry having 35 plus customers in 30 countries. Its solutions suite includes products for accounting, reconciliation, cargo operations, online travel booking and fare distribution and decision support systems.

Source: The Hindu Business Line, 8th May, 2004.

Spin-offs are often tax-free to the parent company and to the shareholders receiving stock in the spin-off. In addition, a spin-off can be an effective method for minimizing the execution risk of a divestiture, whether due to third-party negotiations or to market conditions. Spin-offs also have smaller underwriting discounts and fees than transactions such as carve-outs. Moreover, the shareholders of the parent company receive a direct benefit by obtaining the stock of the spun-off subsidiary, as opposed to the less direct benefits of the parent company receiving the proceeds of a negotiated sale.

Box 6: GAIL to Spins-off Marketing Arm According to Regulation of Industry

GAIL India will be a gas transmission company, while GAIL Gas (GGL) will carry out marketing business. GAIL India, the state owned natural gas company, will split its marketing business into a separate company from April 1,2009 in accordance with guidelines outlined by the petroleum regulator. While GAIL India will continue to be a gas transmission company and will construct cross-country pipelines to transport gas, GAIL Gas (GGL) will carry out marketing business.

The company, GAIL, will be listed on Indian browser as soon as possible and the company has already separated the transportation and the marketing businesses. Both the companies will be legally separated and all allied businesses such as petrochemicals and telecom will remain under GAIL India.

The separated company, GGL, will take over marketing activities like the city gas projects and this entity will also distribute and market CNG for vehicles, piped natural gas for domestic or industrial use. It will distribute auto LPG in both markets, India as well as abroad. The company has also planned to set up retail CNG and LNG outlets across the country. Presently, one more state-owned enterprise Indraprsatha Gas is in this business for competitive market.

According to the policy guidelines issued by the Petroleum and Natural Gas Regulatory Board, GAIL had to split its gas transportation business from the marketing and the trading business. The policy was drawn to prevent unfair competition that resulted from the ability of integrated companies like GAIL to cross-subsidise its activities. Reliance has also separated its gas transmission and marketing businesses to comply with the regulatory requirements.

Source: http://www.vccircle.com/500/news/gail-to-spin-off-marketing-arm-and-list-in-bourses.

In the US spin-offs have become increasingly popular in the last decade, with firms seeking to divest a part of their businesses. Most of these spin-offs involve a *pro rata* distribution of shares in a wholly owned subsidiary to the shareholders of the firm, in the form of a dividend. After the distribution, both the parent and the subsidiary initially share the same shareholder base, even though the operations and management of the two entities are now separate and independent of each other. Another important feature of a spin-off that sets it apart from other types of corporate divestitures is that it does not provide the parent with any cash infusion.

Recently, there has been a noticeable trend towards two-step spin off transactions, where parent firms first sell up to 20% of the shares in the subsidiary in an initial public offering, followed shortly by a distribution of the remaining shares to its shareholders. The 20% limit is usually observed in the first step in order to preserve the tax-free status of the transaction. Why firms choose to pursue a two-step spin-off instead of a 100% pure spin-off is unclear. Previous research generally focuses on pure spin-offs, so this question has yet to be addressed. A possible reason for a two-step spin-off is to avoid the dip in the stock price that the spun-off subsidiary usually experiences in the first few months following the distribution. This initial stock price decline is usually associated with the portfolio rebalancing activities of large institutional investors who may not wish to hold the shares of the subsidiary given away by the parent in a spin-off transaction.

For example, the manager of an index fund may be required to sell the shares of the spun-off subsidiary if that subsidiary does not form part of the index. In a two-step spin-off, the minority carve-out enables the parent firm to create an orderly market for the new issue, so as to avoid flooding the market with a large number of shares, as in the case of a pure spin-off (Lamont and Thaler, 2000). Also, since the carve-out takes the form of an IPO, investment banks are often committed to help support and market the new issue – a feature that is also conspicuously absent in a pure spin-off transaction. When the second step of the spin-off takes place, the market is then better positioned to support the portfolio rebalancing activities highlighted above.

There is a wealth of research on the effects of spin-offs on both parent and subsidiary firms. Early research efforts focused mainly on the changes in parent company share prices at the time of the spin-off announcement. In a study of 6 major spin-offs in the 1970s, Kudla and McInish (1983) showed a positive market reaction in the parents' stock 15 to 40 weeks before the distribution took place – an indication that the market correctly predicted the spin-off well ahead of the actual event. This result has been supported by many other studies for periods that date back as early as 1963 to 1981.

Cusatis, Miles and Woolridge (1993) were among the first researchers to focus on the performance of the subsidiary post-spin-off. They examined 815 spin-offs from 1965 to 1988 and found significantly positive abnormal returns for the spun-off subsidiary, the parent and the spin-off-parent combination for a period of up to three years after the spin-off announcement date. They also found that the abnormal returns were attributable to increased takeover activity, which was not fully anticipated by the market at the time of the spin-off announcement. Hence, they concluded that earlier event studies underestimated the value created by spin-offs.

A 1997 study done by J.P Morgan provided evidence that the positive stockholder wealth effects continued well into the 1990s. Also, it was found that smaller spin-offs (with an initial market capitalization of less than $200 million) significantly outperformed their larger counterparts. J.P Morgan attributed this to underpricing by the market, which was in turn due to the lack of knowledge on the part of investors.

An interesting phenomenon reflected in the graphs showing the post-distribution stock returns of the spun-off subsidiary, but not investigated by J.P Morgan, is the initial decline in returns experienced by the spin-offs in approximately the first 30 trading days after the distribution. Thereafter, the downward trend is reversed and returns become positive three months after the spin-off date. This pricing anomaly, however, had already been picked up by the press and documented by other researchers such as Brown and Brooke (1993) and Abarbanell, Bushee and Raedy (1998). Brown and Brooke reported price declines of approximately 4% in spun-off subsidiaries that coincided with substantial reductions in institutional holdings in these firms, and concluded that the sudden and substantial sell-off of subsidiary shares by institutional investors as part of their portfolio rebalancing activities explained the downward pressures on price and consequently returns.

Likewise, Abarbanell *et al.*, found empirical evidence supporting the initial decline in the stock returns of the spun-off subsidiary. In a study of 179 spin-offs between 1980 and 1996, they noted that the overall returns to subsidiaries were significantly negative within 10 trading days of the distribution date, and this was consistent with a decrease in mean level of institutional ownership. In fact, a negative abnormal return of – 4.12% was observed for a 35-day trading period (similar to the finding by Brown and Brooke) and it took another 25 trading days for this trend to completely reverse. However, Abarbanell *et al.,* did not find any reliable evidence that led them to conclude that this decline was associated with institutional sell-offs.

Tax Consideration

Spin-offs consist of multiple spin offs not taxable to shareholders. To avoid ordinary income taxes the parent and the subsidiary must have been engaged in business for 5 years prior to the spin-off. The subsidiary should be at least 80% owned by the parent. And parent has to distribute the shares in the subsidiary without a prearranged plan for these securities to be resold.

Treatment of Warrants and Convertibles Securities

When the parent company has issued the warrants and the securities the conversion ratio may have to be adjusted. The spin-off may cause the common stock in the parent company to be less valuable if the deal is structured for the gain through the distribution of the proceeds in the form of special dividend. Warrant and security holders may not participate in this gain. The stock price of the parent company may fall because it will be less likely that the price will rise high to enable the securities to be converted. If this is the case, the conversion prices may not need to be adjusted as part of the terms of the deal.

Employee Stock Option Plans

Employee’s shares are held under an employee stock option plan. The number of the shares obtained also need to be adjusted after the spin-off. The adjustment is designed to leave the market value of the shares that could be obtained after the spin-off at the same level. The main goal is to maintain the market value of the shares that may be obtained through the conversion of the employee stock options.

It has grown its popularity since 1992. Its growth was partly fueled by investors’ preferences to release the internal values in the company’s stock prices.

DISADVANTAGES OF SPIN-OFFS

- There will be considerable selling pressure from institutions and index funds immediately after the spin-off. This will have a downward pressure on the stock price in the short-term.
- As shares are distributed primarily to existing shareholders, spin-off lack liquidity.
- From the disposition proceeds the parent does not get anything.
- The parent company does not gain monetarily through the spin-off.
- A spin-off is often perceived as a method for get rid of a sub-par asset by the parent.
- The new company formed by the spin-off has to incur expenses for issuing new shares.
- Servicing the shareholders will lead to duplication of the activities in parent and the spun-off company.

EQUITY CARVE-OUTS

An Equity Carve-out (ECO) is a partial public offering of a wholly owned subsidiary. Unlike spin-offs, ECOs generate a capital infusion because the parent offers shares in the subsidiary to the public through an IPO, although it usually retains a controlling interest in the subsidiary. Like spin-offs, ECOs have become increasingly popular in the last several years.

An equity carve-out involves conversion of an existing division or unit into a wholly owned subsidiary. A part of the stake in this subsidiary is sold to outsiders. The parent company may or may not retain controlling stake in the new entity. The shares of the subsidiary are listed and traded separately on the stock exchange. Equity carve-outs result in a positive cash flow to the parent company. An equity carve-out is different from a spin-off because of the induction of outsiders as new shareholders in the firm. Secondly equity carve-outs require higher levels of disclosure and are more expensive to implement.

The potential benefits of equity carve-out include:

"Pure Play" Investment Opportunity: Pure plays have been in much demand by investors in recent years. An ECO, especially for a subsidiary that is not involved in the parent's primary business or industry, increases the subsidiary's visibility as well as analyst and investor awareness. This enhances its overall value. Investors also like ECO pure plays because separating the parent and subsidiary minimizes cross-subsidies and other potentially inefficient uses of capital.

Management Scorecard and Rewards: Management is evaluated on a daily basis through the company's stock price. This immediate, visible scorecard can boost performance by spurring managers to make timely strategic decisions and concentrate on the factors that contribute to better shareholder value. Correspondingly, managers are also more likely to be rewarded for improved results.

Capital Market Access: An ECO typically improves access to capital markets for both the parent and the subsidiary.

PROCESS OF EQUITY CARVE-OUT

A typical carve-out scenario in the US begins with the parent publicly announcing its intention to offer securities in a subsidiary or division through an ECO. Since an ECO is a type of IPO, companies must file an S-1 registration statement with the SEC. Registration requires three years of audited income statements, two years of audited balance sheets, and five years of selected historic financial data. The ensuing process – including the preparation of financial and registration statements, SEC review, responses, and amendments, and offering marketing –

normally takes up to six months. Once the SEC reviews and declares it effective, the parent can sell the offering, either listing the spin-off on an exchange or providing for trading over the counter.

Either the parent or the carve-out (or both) can receive the IPO proceeds. If the subsidiary sells the shares, the IPO represents a primary offering. Over 70 percent of the companies in the researchers' sample reported handling the ECO in this manner. If the parent sells the shares (known as secondary shares), it must recognize the difference between the IPO proceeds and its basis as a gain or loss for tax purposes. If the subsidiary sells the shares in the IPO, neither the parent nor the carve-out incurs a tax liability. When the ECO sells the shares, it often uses some of the proceeds to repay loans to the parent or pay a special dividend. A relatively small number of ECOs are handled as joint offerings of the parent and subsidiary.

A study has found that 50 percent of the ECOs used for the proceedings of primary offerings to repay loans to the parent, 30 percent to be retained, and 20 percent pay to creditors. In secondary offerings, 50 percent of the parents ECOs retain the proceeds, while 50 percent pay to creditors. The research indicates that the initial stock market reaction to an ECO announcement is more favorable if the subsidiary retains the funds.

After the IPO, all transactions between the parent and the subsidiary must be conducted on an arm's-length basis and disclosed in the registration statement. The parent typically continues to perform certain corporate services, such as investor relations, legal and tax services, human resources, data processing, and banking services, on a contractual basis.

CHARACTERISTICS OF ECO CANDIDATE

Strong potential ECO candidates have some or all of the following characteristics:

Strong Growth Prospects: If the subsidiary is in an industry with better growth prospects than the parent, it will likely sell at a higher price/earnings multiple once it has been partially carved out of the parent.

Independent Borrowing Capacity: A subsidiary that has achieved the size, asset base, earnings and growth potential, and identity of an independent company will be able to generate additional financing sources and borrowing capacity after the carve-out.

Unique Corporate Culture: Subsidiaries whose corporate culture differs from that of the parent may be good ECO candidates because the carve-out can offer management the freedom to run the company as an independent entity. Companies that require entrepreneurial cultures for success can especially benefit from this transaction.

Special Industry Characteristics: Subsidiaries with unusual characteristics are often better suited to decentralized management decision-making, which may allow management to respond more quickly to changes in technology, competition, and regulation.

Management Performance, Retention, and Rewards: Subsidiaries that compete in industries where management retention is an issue and targeted reward systems are required can benefit from an ECO.

AFTER THE EQUITY CARVE-OUT

While analyzing a sample of ECOs, researchers found important increases in sales, operating income before depreciation, total assets, and capital expenditures. However, they believe these improvements owe less to newly gained efficiencies than to the carve-out's growth after going public. This is because the relative growth rates were not positive or statistically significant.

Box 7: ECOs in Action – The Story of Thermo Electron
No company illustrates the benefits of ECOs better than the Boston-based Thermo Electron. TE was a $200 million maker of energy and environmental equipment in 1982 when CEO George Hatsopoulos envisioned using ECOs to build and grow high-tech businesses. The purpose of ECOs at TE was twofold: to raise the capital for new ventures and to motivate managers to take appropriate risks.
Today, TE and its subsidiaries make everything from power plants to artificial hearts through 22 different companies created by ECOs. TE's ECOs, which trade on the American Stock Exchange, include diverse businesses such as ThermoLase (hair and skin removal), Thermo Fibertek (recycled fiber and de-inking), Thermo Power (propane gas engines), Thermo Instrument (detection devices for air pollution and toxic substances), and Thermo Medics (explosives detection and biomedical devices).
TE's ECO model involves using the parent firm, through its Coleman Research division, as a technology core from which it develops new products. As technology application enters the product development stage, TE involves venture capitalists to provide seed capital and market credibility before selling a minority stake to investors through an IPO.
TE uses three criteria for an ECO: (1) opportunities for growth, (2) a strong management team, and (3) attractive IPO prices. While TE maintains a majority stake in each company, it hands over day-to-day control to the entrepreneurs behind the new companies, along with the capital from the IPO and plenty of common share options. TE supplies its carve-outs with human resources, banking, legal, tax, and other services for a flat 1 percent of revenues.
Thermomedics, one of TE's equity carve-outs, is a good example of the company's strategy. In 1983, TE sold 14 percent of Thermomedics for $6 million. Thermomedics, in turn, sold 40 percent of its heart pump division in 1989 to investors for $15 million as Thermo Cardiosystems. By 1996, Thermo Cardiosystems had an FDA-approved heart pump and nearly $100 million in revenues. Its stock price rose from a split-adjusted price of $2.27 to $41.50.
Since TE initiated its so-called "spin-out" strategy in 1982, the TE portfolio of companies has produced a compounded growth rate (in earnings) of nearly 30 percent per year. The average annual stock return for the group is in excess of 25 percent.

Source: www.fci.org.

Note that ECOs, like spin-offs, are subject to a great deal of takeover activity. In the sample, 50% of the ECOs were acquired within three years. An analysis of returns for these companies suggests that ECOs that are taken over perform better than average, while those that are not perform worse than average. Nonetheless, even the latter outperform, on average, in other types of firms. Overall, it is clear that ECOs earn significantly positive abnormal stock returns for up to three years after the carve-out. Parents, on the other hand, earn negative stock returns.

As with spin-offs, these higher-than-normal stock returns are associated with better operating performance and corporate restructuring activity. As a restructuring device, ECOs clearly seem to lead to better operating performance (on average) and greater increases in shareholder value.

In a study of equity carve-outs by J.P Morgan, it was found that carve-out firms in which the parent firm announced that a spin-off would follow at a later date, outperformed the market by 11% for a period of 18 months after the initial public offering, while carve-out firms without spin-off announcements under performed the market by 3%. Equity carve outs involve the sale of an equity interest in a subsidiary to outsiders. This sale may not necessarily leave the parent in control of the subsidiary. Post carve-out, the partially divested subsidiary is operated and managed as a separate firm.

DISADVANTAGES OF EQUITY CARVE-OUTS

The biggest disadvantage of carve-outs is the scope for conflict between the two companies as operation level conflict occurs because of the creation of a new group of financial stakeholders by the mangers of the carved-out company. The requirements of these stakeholders differ from those of the original stakeholders. This conflict can hinder the performance of both firms. The stock performance of a company that has carved out 70 to 100 percent is better than that of a company that has carved-out less than 70 percent. This indicates that lack of separation between the two entities prevents the carved-out entity from reaching its potential.

Split-off

In a split-off, a new company is created to takeover the operations of an existing division or unit. A portion of the shares of the parent company are exchanged for the shares of the new company. In other words, a section of the shareholders will be allotted shares in the new company by redeeming their existing shares. The logic of split-off is that the equity base of the parent company should be reduced reflecting the downsizing of the firm. Hence the shareholding of the new entity does not reflect the shareholding of the parent firm. Just as in spin-off, a split-off does not result in any cash inflow to the parent company.

Split-up

Split-up results in the complete break up of a company into two or more new companies. All the division or units are converted into separate companies and the parent firm ceases to exist. The shares of the new companies are distributed among the existing shareholders of the firm.

The term "split-up" is defined as the division of a company into two or more publicly traded comparatively substantial entities through one or more transactions.

Box 8: Saudi Plans to Split-up State Electric Company
According to a *Dow Jones* report, Pakistan's government intends to break up state-owned Pakistan Telecommunications Co. Ltd., (PTCL) into at least three separate companies in order to increase competition as they deregulate the sector. Analysts believe that these actions will prevent the creation of a private monopoly after privatization. However, the privatization process could now be delayed as PTCL's restructuring into separate local, international long distance and mobile operations could take over two years. Hafeez Shaikh, Pakistan's Minister for Privatization and Investment, who heads the restructuring committee, says splitting up PTCL before its sale is an important element of the government's plans to increase telecom competition and prevent a single private company from monopolising the deregulated telecom market. The government owns 88% of PTCL. The government plans to sell as much as 26% of PTCL, raising around US$ 1 billion, according to estimates. Through voting rights on the shares, the new buyer will have management control. PTCL's restructuring comes at a time when numerous foreign telecom companies are reportedly looking to invest in Pakistan. Singapore Telecommunications, or SingTel, last week named PTCL as a possible investment target, while Egypt's Orascom, Saudi Oger and the Menara Telecom Consortium, have also expressed their interest. While it decides whether to bid for PTCL, SingTel has also expressed an interest in buying a mobile phone license in Pakistan. The advisers for PTCL's sale don't want the government to break-up PTCL. But Shaikh insists the restructuring plan will be aggressively pursued, starting with those operations that are the easiest to sell off, such as PTCL's U-fone mobile subsidiary.

Source: www.reuters.com.

DECISION PROCESS: DIVESTITURE AND THE SPIN-OFF

FINANCIAL ISSUES OF DIVESTITURES

Many corporations review the business portfolio to determine operations that fit their core strategies. The firm's desire to achieve more focused business portfolio can result in operations becoming strategically redundant. The decision to sell or retain the business depends on the comparison of the after tax value of the business with the after tax proceeds from the sale of the business.

The following steps have to be considered to decide whether to sell or retain the business:

i. **Calculating after Tax Cash Flows:** To decide if the business is worth selling or not, the parent must first estimate after tax cash flows of the business. To do so, the company needs the inter-company sales and the cost of services.

   Inter company sales represent operating unit revenue generated by selling products or services to another unit. The parent may value these operations using the transfer prices, which may be some market prices. If the transfer prices do not reflect the current market prices then the intercompany revenue may depend on the transfer prices being higher or lower than actual market prices.

   The cost of services reflects the legal, treasury, and audit services provided by the parent company. To reflect these factors the cash flows of the business may be adjusted for services provided by the parent at more or less of what the business has to pay for them. Operating profits may be reduced by the amount of subsidies and increased by what the business would have to pay if it purchased comparable services offered outside the parent firm.

ii. **Estimating the Discount Rate:** Once the after tax standalone cash flow over a discount rate is determined, it reflects the risk characteristics of the industry in which the business competes.

iii. **Estimating the After Tax Market Value of the Business:** The discount rate is used to determine the market value of the projected after the tax cash flows of the business. The valuation is based on the cash flows that have been adjusted for inter company revenues and services provided to the operating unit by the parent firm.

iv. **Estimating the Value of the Business to the Parent:** The after tax Equity Value (EV) of the business as part of the parent is estimated by subtracting the market value of the business liabilities from its Market Value (MV) as a standalone operation.

   $EV = MV - L.$

Deciding to Sell

The decision to sell or retain the business is made by comparing the EV with after tax Sale Value (SV) of the business. The decision can be summarized as follows:

If $SV > EV$ divest

If $SV < EV$ retain

Timing: Timing often has a great influence on the decisions to sell a business. It should also reflect the financial environment. Selling when the business is high and the stock prices are rising and interest rates are low will fetch a high price for the unit.

Formulation of a Restructuring Plan

A restructuring or reorganization plan must be formulated and agreement between the parent and the subsidiary may be negotiated. Planning is necessary in case of a spin-off which provides a relationship between the parent and the subsidiary. The plan covers the details like disposition of the assets of the subsidiary. If the subsidiary is to keep the assets while the others are to be transferred to the parent company the plan may provide a detailed breakdown of the asset disposition. Other issues like the retention of employees and the funding of the pension and health care liabilities should also be addressed.

Approval of the Plan by Shareholders

The approval of the plan depends on the significance of the division of the transaction and the state laws. For a spin off of a major division of the parent company, stockholders' approval may be required. The plan is submitted to the stockholders at their meeting which may be a normally scheduled shareholders meeting called to consider only this issue. A proxy statement requesting approval of the spin-off is also sent to the stockholders. And the other issues related to the meeting will be addressed in the materials submitted to them.

Registration of the Shares

Shares issued in a spin-off must be registered with the Securities and the Exchange Commission as part of the normal registration. A prospectus, which is part of the registration statement, must be produced. It must be distributed to the shareholders who receive stock in the spun-off entity.

Completion of the Deal

After the completion of these preliminary steps, the deal may be consummated. Consideration is exchanged and the division is separated from the parent company according to the prearranged timetable.

ASSEMBLING THE DIVESTITURE TEAM

Divestment of a business requires a team of functional experts under the direction of an experienced project manager. The first and foremost action that is to be taken after reaching the decision to divest pertains to the selection of the project manager. Along with general management skills, the project manager must also be knowledgeable in the tasks and techniques necessary to bring about a successful divestiture. People possessing these types of skills usually reside in the corporate development function. Corporations devoid of a formal corporate development activity may find qualified divestiture managers within the financial, legal or corporate planning departments. The appointment of an internal project manager and core team is absolutely critical even in those instances where an investment banker or some other intermediary is engaged by the corporation to assist in the divestiture.

Assembling the core team is the first task of the project manager. The composition of the core team will vary depending on the specific nature of the divestiture and generally includes someone who is extremely knowledgeable about the business being sold and from the corporate financial function. Where practical, close association of a member of the corporate legal staff with the activities of the core team from the very beginning of the project will facilitate preparation of the offering memorandum, the negotiations and writing of the letter of intent and definitive purchase agreement. The core team will also need assistance from time to time during the project from other functional areas of the corporation, which may include the tax department, human resources, corporate communications, and the corporate controller.

After having assembled the core team, the project manager should formulate a definitive project plan and obtain approval of the intended approach from the corporate management. The project plan should include:

i. Identification of the core team and supplementary internal resources that are required.

ii. Specific tasks and responsibilities of each project participant.

iii. Identification of outside resources required, such as investment bankers, their specific tasks, and anticipated costs for their services.

iv. Timetable for each major phase of the project.

v. An overall budget of the project.

The decision regarding the use of outside resources is a critical element in assembling the project team and preparation of the project plan. Some corporations may not possess the resources and talent internally to effect a successful divestiture and, therefore, turn to investment bankers, outside law firms, or other intermediaries for professional assistance. This decision of the corporation is perfectly appropriate because selling a business is a highly specialized activity, and investment bankers, in addition to providing the necessary professional expertise that may be lacking in a selling corporation, can be particularly helpful in a number of other areas important to a successful divestiture. These are:

i. Identification of potential purchases.

ii. Approaching potential buyers on an anonymous basis.

iii. Assisting in the structuring of the deal.

iv. Assisting in the negotiating process.

The process of engaging outside resources requires careful planning and execution. Both investment bankers as well as outside law firms receive substantial compensation for their services.

PREPARING THE DIVESTITURE

No two divestitures are exactly alike and one of the foremost tasks of the project team is to determine precisely what is to be sold. While some divestitures involve the sale of assets, others involve sale of legal corporate entities. When determining specifically what is to be sold, tax, legal as well as business implications are required to be considered from both the buyer's and seller's perspective.

A number of other issues, in addition to the form of the transaction, are to be considered in preparing the divestiture. Divestitures involving stand alone businesses that have no ongoing relationship with the selling corporation after the sale are the cleanest divestitures. Divestitures, however, often involve some sort of continuing business relationship. The selling corporation may be the supplier of products and/or services to the business being sold, which are critical to the future success of the business. The purchaser will, therefore, expect to negotiate some sort of a service agreement as part of the transaction. In other words, there may exist marketing or distribution dependencies between the selling corporation and the business being divested. Further, the purchaser would prefer to develop operationally viable and economically feasible agency agreements as a part of the transaction. It is, therefore, essential to carefully analyze these types of interdependencies at the very outset of the divestiture project. Major problems can often arise in the successful completion of the divestiture due to failure to understand these interdependencies and to prepare for their resolution as part of the overall transaction. The least that can happen is that discovery of critical interdependencies late in the negotiating process can seriously impact the selling price or deal structure, and may cause the buyer to relinquish the deal.

The resolution of management and human resources issues is another important matter to be considered in preparing the divestiture, and may affect the nature, timing, and valuation of the business. If key members of the management or if staff expertise are valuable assets critical to the future success of the business, these people should be retained and motivated to assure a successful sale. It is necessary to understand and address the needs and desires of these people early in the divestiture process. Special compensation and employment contracts are useful tools to be considered in some instances in order to assure management and staff cooperation in the divestiture process. The manner in which employees are handled has a role to play in deciding the price a buyer is willing to pay for the business and the net value of the deal to the seller.

Most of the effort in preparing the divestiture goes into gathering data and information necessary to present the business to prospective purchasers. Several purposes are served by this data-gathering exercise, such as:

- It enables the selling corporation to make some policy-type decisions.
- It forms the basis on which the initial selling document or offering memorandum is developed.
- It serves as the foundation for business reviews to be held with serious prospective buyers later in the selling process.

Thus, as a result of preparing a business for sale, the project team, often, ends up knowing more about the business being sold than either the management of the business or the selling corporation. In other words, successful divestitures depend upon careful preparation and intimate knowledge of the business being sold.

In preparing a divestiture, it may be helpful to review the requirements of types of data and information in the context of a typical offering memorandum. Although the preparation of a formal offering memorandum is not required for all divestitures, the data and information necessary to initiate the selling process tend to be the same. The type of selling process decides whether or not to prepare a formal offering memorandum. A formal offering memorandum is essential if the business being sold is to be offered, to a number of potential buyers, either sequentially or on a competitive bidding basis. The formality of an offering memorandum may not be necessary if the selling corporation is highly confident of knowing the buyer and that the deal will be done with that one party; however, the prospective buyer has to be provided with the same level of information.

The offering memorandum must provide sufficient details to the prospective buyers to ascertain their genuine interest in acquiring the business. It should be accurate in every respect. Errors or misstatements about the business can cause serious difficulties in consummating the transaction and may cause discussions to be terminated completely. The offering memorandum should emphasize the strengths of the business and, where possible, position these in alliance with the strategies or potential strategies of prospective buyers.

CONTENTS OF THE OFFERING MEMORANDUM

i. ***Executive Summary:*** It constitutes one of the most important parts of the document and is the key selling chapter of the document. It should emphasize the strengths and advantages of the business in addition to summarizing the business' key points, specifically including what is for sale and the reasons for sale of the business.

ii. ***Buyer Procedure:*** The rules as specified by the selling corporation are given, which indicate whether competitive bidding or some other process is being used. Dates for indications of serious interest and for initial bid submission are specified. Apart from stipulating when and where detailed business reviews will be held, it also sets the date for submission of final bids. In addition to describing the method of payment that the seller would accept, and outlining both acceptable and unacceptable deal structures, it also specifically indicates the persons in the selling corporations whom the prospective purchases are authorized to contact.

iii. ***Background:*** The business is introduced by means of historical perspective and highlights key evolutionary events till date.

The key elements of this section include history of the business; date of founding or acquisition; past and present strategic objectives; background as to why the business is being sold; background of key officers and employees, etc.

iv. ***The Market:*** A comprehensive picture of the industry in which the business is participating is provided in this chapter. It also provides information that emphasizes the strengths of the business being sold. The following types of data and information are used for this purpose:

- Market size, major products/services, historic growth rates.
- Industry's current position in its lifecycle.
- Product/service life cycle position.
- Projected growth rate of market and major segments.
- Customer concentration.
- Market share of business being sold and market saturation.
- Major competitors and their market shares.
- Market strengths and weaknesses.
- Domestic and international factors, etc.

v. ***Products/Services:*** Prospective buyers find the following types of information helpful in describing the products/services of the business being sold:

- Quality objectives.
- Pricing policies and schedules.
- Technical specifications of the product/service.
- Operating and/or production processes, etc.

vi. ***Facilities and Fixed Assets:*** There should be separate exhibits made to show the specific facilities and fixed assets that are to be included as part of the sale. The facilities and fixed assets should be categorized in terms of owned or leased, by location, and by key activities. This part includes an analysis of adequacy of both facilities and equipment for future growth, and contractual obligations are also indicated.

vii. ***Systems and Operations:*** A detailed description of the business systems and operations are included. A distinction of those systems and operations capabilities included as part of the sale and those not included in the sale is made. The section also addresses adequacy of the systems and operations, included as part of the sale, for both current and future production and delivery of products/services.

viii. ***Organization, Management and Personnel:*** Apart from describing the key human resource elements of the transaction process, this section also states who among the management and/or personnel are believed to be critical to the business, lists the numbers and employee categories to be made available, and describes all employee benefits.

ix. ***Key Financial Information:*** Sufficient financial information will be expected to be received by prospective purchasers to enable them to make a preliminary judgement regarding their interest in acquiring the business. Generally, financial history of the business pertaining to the last 5 years is provided and is shown in pro forma terms so as to reflect accurately the specific nature of the business being sold. Items such as intercompany charges for services that the selling corporation no longer intends to provide, overhead allocations from the selling corporation, and federal and state taxes, are often omitted from the profit-and-loss statement. Prospective purchasers are advised of these adjustments and instructed to insert their own estimates regarding these expenses while valuing the business. The balance sheet, also, is similarly adjusted to reflect specifically what is being sold.

    The types of data and information that might be included are balance sheet and income statement for the past five years; revenues analysis (by product/service, seasonality factors, and sales policies); expense analysis (by business segment, by product/service, fixed vs variable cost, etc); and, other specific financial items (loans, receivables analysis, prepaid expenses and deferred charges, and purchase contracts).

x. ***Valuing the Business:*** There are several valuation techniques available, one or more of which, can be utilized by the prospective purchasers in determining their offering price for the business. A similar analysis should be conducted by the divestiture team which will serve a number of purposes such as:

    - Provide the selling corporation an estimate of the market value of the business.
    - Assist in identification of prospective buyers.
    - Assist in comparing values of different offers in cases where more than one offer is received.
    - Provide foundation for price negotiation later in the selling process.

    A few of the basic valuation techniques that might be used are book value, comparables, discounted cash flow (net present value), payback, and replacement cost method.

The valuation methodologies must be modified to reflect the special circumstances of each prospective purchaser such as considerations of market forces, competition, effect of the acquisition on the buyer's base business, etc.

The outcome of activities pertaining to the valuation and pricing of a business are thus influenced by business, market, financial, and other assumptions. The seller's knowledge and understanding of these with regard to specific purchasers decides the success of a divestiture.

THE SELLING PROCESS

The four key elements that constitute the selling process are: (i) identification of prospective buyers, (ii) selection of the type of selling process to be utilized, (iii) business reviews, and (iv) negotiation of the transaction and closing the deal.

Identifying Potential Buyers

Identification of potential buyers by the project team initiates the selling process. All activities prior to this step such as the divestment decision, organization of the project team, and preliminary work in preparing the divestiture, have been internal to the selling corporation. The external process begins with the identification of the potential buyers.

The decision to engage or not to engage an investment banker or some other intermediary to identify prospective buyers is considered or reconsidered at this stage in the divestiture process. The decision to use an intermediary depends on the selling corporation's experience with divestitures, confidence it has in its divestiture team, and the in-house knowledge it has regarding potentially interested buyers. Investment bankers, similarly, can help in the identification of prospective buyers by knowing the types of businesses their clients and their competitors are seeking to acquire, and by having the capability to identify potential acquirers who have not been active in the market, but for whom a particular business may be a good strategic fit. Investment bankers can also qualify potential leads anonymously since usually the selling corporations do not like the prospect of having the business they are divesting characterized as having been widely "shopped".

Potential buyers, in general, can be categorized into direct competitors, companies in similar types of businesses, buyers who want to broaden their product lines, buyers looking for operational economies of scale, suppliers and customers, and others such as companies seeking diversification, holding companies, investment groups, and venture capitalists.

Selecting the Selling Process

There are, basically, four different methods of selling a business, each having its own advantages and disadvantages. The selection of the selling process depends on the nature of the business being sold and the objectives of the selling corporation. The four methods are given as under:

i. ***Competitive Bidding:*** This process helps produce the highest bidder and the best deal structure for the selling corporation, if correctly managed. The process of competitive bidding is most effective when 5 to 10 potential buyers have been identified and when the potential buyer list contains diverse strategic objectives.

   Disadvantages of utilizing competitive bidding include the unlikely possibility of an unsuccessful sale that can adversely affect the value and near term viability of the business. Customers as well as the employees view it as a lack of commitment to the business on the part of the selling corporation. Competitors stand to gain significant advantage in such a circumstance. If a competitor has been a potential buyer, it gains significant knowledge about the business, which it can use against the business in the marketplace. Divestitures usually fail due to poor initial planning of the divestiture or due to a badly managed selling process.

ii. ***Sequential Selling:*** This method involves establishing a priority list of potential buyers after the identification of prospective purchasers. The selling corporation offers the business to what it believes to be the most likely potential buyer and, if unsuccessful, moves down the pre-established priority list. If successful with the very first potential buyer, this process is obviously a much easier process to manage than competitive bidding. However, there is no market frame of reference available for the price and deal structure that is negotiated and the seller can never know if a better deal could have been struck with someone else. This is an acceptable selling method, if the primary objective is to get out of business with secondary importance being attached to the price and deal structure. However, if the pre-established priority list itself is faulty, it requires the business to be offered to a number of prospective buyers, in sequence, giving the business an image of having been widely "shopped" and rejected. This seriously impairs the potential value of the business.

iii. ***One Buyer:*** If, in the process of identifying potential buyers, only one prospective purchaser can be identified, the seller is left with little negotiating leverage. The resulting transaction is hence not likely to meet all of the seller's objectives. In cases where there is a known anxious buyer, the seller should ascertain the value that this buyer sees in the business, and should try and identify other buyers who might see the same value as well. If successful in doing so, a one-buyer divestiture might be transformed into a competitive bidding transaction thereby resulting in significantly better price and terms than could have been possible in a one-buyer transaction.

iv. ***Going Public:*** Divestiture of a business through an initial public offering is completely different from selling it through a private transaction. In order to go public, the entity to be sold must have an established history of profits and growth or a proprietary product or service on which a public market price can be based. Also, there should be existing favorable market conditions in terms of appetite for initial public offerings. When considering the divestiture of a business through an initial public offering, even the most sophisticated selling corporations require the assistance of investment bankers.

Business Reviews

In the competitive bidding type of selling process, business reviews are held only for serious prospective buyers after receipt of initial bids and clarifying discussions. In a sequential sale, the business review is held only for the prospective buyer enjoying top most priority and only when discussions are terminated with that buyer, the process is started all over again with the buyer who figures next on the priority list. Similar is the case with one-buyer transaction, however, if the discussions terminate, the selling corporation has only two options – either to keep the business or to turn the transaction into a competitive bidding deal by identifying other buyers who can be shown the same value in the business as was seen by the initial one buyer.

Business reviews generally last for one or two days during which prospective buyers are given detailed presentations on all aspects of the business, and are also, often, given the opportunity to visit the company's facilities.

The primary objective of business reviews is to provide sufficient information to prospective purchasers, which is necessary for the preparation of firm offers for the business. In case of competitive bidding, business reviews enable prospective purchasers to refine their initial bid after the review. In case of sequential selling, business reviews either reinforce the interest of the priority purchaser, thus increasing the probability of consummating the transaction, or lessen the interest, causing the selling corporation to move on to the next potential purchaser on the priority list. In a one-buyer type of selling process, business reviews tend to blend with the negotiating process since both the parties are aware of the fact that there is only one potential buyer. Information exchange, therefore, invariably includes discussions about the deal structure and the purchase price.

Negotiating and Closing the Transaction

A diverse set of skills and very thorough preparation is required for negotiating and closing a divestiture transaction. Facts and information alone are not sufficient for the purpose. A good negotiator knows when to be tough and when to be flexible on a specific point. The objective of good negotiators is to maximize price and optimize the deal structure.

a. **Preparing for Negotiations:** Prior to initiating negotiations, the negotiating team should identify all the major points that are to be discussed and should evaluate these in the context of the overall objective of the divestiture. The team should prepare the opening position, preferred position, fallback position and the deal breakers for each point in the negotiation.

   Before beginning the negotiations, a role-play of the forthcoming negotiations will facilitate identifying the weaknesses in the positions established for each point and enable the members of the negotiating team to polish their roles.

b. **Conducting the Negotiations:** There are several steps involved in actual negotiations. The first step deals with reaching an agreement in principle. This process may result in a term sheet, which is used as a basis for negotiation and preparation of the definitive purchase agreement or may simply result in the parties agreeing to sign a formal agreement in principle once all major points pertaining to the negotiation are believed to be resolved.

c. **Due Diligence Examinations:** After having reached a consensus and documenting an agreement on the major points of the transaction, the purchaser expects to conduct a due diligence examination of appropriate books, records, and facilities of the business to verify the financial statement and other information. Any kind of misrepresentation, if discovered by the purchaser, can void the agreement or cause renegotiations of the price and deal structure.

d. **The Purchase Agreement:** The next step involves the preparation of the definitive purchase agreement and any supplementary agreements that may be required. The process involves numerous drafts and revisions prior to the closing. Preparation of agreements and the closing documents is greatly facilitated if the divestiture is planned well by the selling corporation and both the parties in good faith negotiate the business issues.

e. **Closing the Transaction:** Usually, closing of a transaction involves signing of agreements, exchanging of the proceeds of the transaction, and may be a glass of champagne to celebrate the success of the deal. It is however essential to observe caution. To quote Yogi Berra, "It ain't over 'til it's over". Simply speaking, a seller can never relax until the documents are signed and proceeds change hands. A high level of confidence after reaching an agreement in principle is a sure signal for disaster. A feeling of comfort about the last draft of the purchase agreement can result in great disappointment, and if there is insufficient attention to detail while preparing the closing documents, it can lead to deferred closing of the deal, or worse, no closing at all.

SUMMARY

- Sell-offs and divestitures are an integral part of corporate restructuring. Large companies with diversified business interests may divest some of their businesses to focus on a few core businesses. Firms can sell assets of an entire company or of some business unit, such as a subsidiary, a smaller business unit or a product line.
- Divestitures are undertaken for two reasons: the assets are worth more as part of the buyer's organization than as part of the seller's; and or the assets are actively interfering with other profitable operations of the seller. The other reasons for the divestitures are efficiency gains and refocus, information effects, wealth transfers and tax reasons.
- A divestiture is a sale of portion of the firm to an outside party. The sale finalized is usually in cash, marketable securities, or combination of both.
- An equity carve out is the variation of the divestiture that involves the sale of the equity interest in a subsidiary to outsiders. In this, a new entity is created with stockholders that may be different from that of the parent selling company.
- Spin-off involves a creation of a new legal entity. New shares are issued but they are distributed to the existing stockholders on pro rata basis.
- In split-offs, some of the stockholders in the parent company are given shares in a subsidiary. In split-ups the entire firm is broken-up into a series of spin offs. As a result, the parent company no longer exits.

Chapter 7

Modalities of Payment – Tax Implications

After reading this chapter, you will be conversant with:

- The Forms of Financing
- Theories of the Method of Payment on Abnormal Returns
- Junk Bonds
- Post-Merger Financial Leverage
- Tax Implications
- Accounting for Mergers and Acquisitions
- Methods of Accounting for Amalgamation

Of all the aspects of the merger, acquisition or a buyout process, the most important is the aspect of financing. Nothing comes for free. It takes money to buy a company and the money must come from somewhere. Usually, all transactions are paid either in the form of cash or stock. These basic modes of payment exist within a more complex sources of funding and various other issues like the following:

- If the deal is funded by stock, will the stock come from existing shares or from an initial public offering or a private placement? Will a venture capital firm be involved in the deal, and if yes, will it have control over the company's operations?
- If, the deal is funded by cash from where will the cash be generated – internally from the profits or will it be borrowed? What will be the source if it is borrowed – a traditional commercial bank or a finance company or a leasing or insurance company?

The method of payment used in the merger or an acquisition influences the returns to the stockholders of both the bidder and the target firms. The financing of a merger and acquisition transaction can be evaluated on two levels: tactical, i.e., how to get the deal done and strategic, i.e., how to live with it. The tactical considerations of financing a merger include the speed with which an acquisition can be carried out, the attractiveness of the form of payment to the seller, the coercive nature of an offer etc. The strategic issues with respect to the buyer include the optimal capital structure, the tax implications, the future access to capital, financial flexibility, market timing, etc.

CASH CONSIDERATION

Cash is the choice of currency from the tactical point of view. Using cash as a mode of financing can be advantageous because of the following reasons:

- ***Speed:*** From the buyer's point of view, the main advantage of using cash whether to purchase shares in the open market or through a tender offer, is speed. It helps to minimize the time that competing purchasers or a reluctant target will take to react.
- ***Liquidity:*** From the seller's perspective, cash is generally preferable to shares because it is more liquid.

The possible disadvantages of cash consideration from the sellers point of view is that they will not be able to defer recognition of gain for tax purposes and will not be able to have continuing equity interest in the combined company.

THE FORMS OF FINANCING

Usually, the general sources of quick cash to finance a tender offer or open market purchase operation are:

i. Commercial banks,

ii. Private placement market, and

iii. Investment banks (which provide bridge loans).

i. **Commercial Banks:** The terms of a bank loan will depend on the creditworthiness of the borrower besides taking into account the pro-forma effect of the acquisition and the structure of the acquisition transaction. Generally, the term loans of commercial banks will be senior to any other acquisition financing. In the event of a tender offer, they are always secured by the stock to be purchased. These loans have a floating interest rate at some spread over an index like the US federal rate or the LIBOR or the PLR. They have a maturity of more than seven years and an average life of not more than four or five years. In certain cases, these loans have highly restrictive covenants with respect to additional debt issuance and the payment of dividends.

ii. **Private Placement Market:** Drexel Burnham Lambert Inc. developed a means of quickly tapping a segment of the private placement market for acquisition financing. This method of financing is also termed as Junk Bond Financing and is explained in greater detail later in the chapter.

iii. **Investment Bank Bridge Loans:** With an intention to compete with Drexel's approach of junk bond financing, a number of investment banks which did not have a proper background, have begun to use their own capital to provide the balance of funds needed to complete a tender offer. These loans are termed "bridge loans" and are intended to provide interim financing. Their terms are designed to induce the borrower to obtain permanent financing as quickly as possible. In the USA, it is generally observed that a bridge loan has a maturity of 180 days. Its interest rate would be at prime plus 500 basis points for the first six months, increasing to prime plus 700 basis points if the maturity is extended. The bridge loan would be subordinate to any bank debt, and its covenants designed accordingly. The borrower usually pays a fee of around two percent on the funds drawn.

The bridge loans, particularly used in leveraged buyouts are very risky and in such cases the loans taken by firms are often very large relative to even a well capitalized investment bank's net worth. Since most of the investment banks are themselves highly leveraged, their financial performance is very susceptible to their cost of funds. This limits the size of the bridge loan market, since excessive exposure of this nature by an investment bank could lead to a downgrade in credit rating and a corresponding increase in its cost of borrowed funds.

COMMON STOCK

The tactical and strategic considerations of using common stock to gain control of a target company are directly opposite to those of cash consideration. The common stock may be issued to the shareholders of the target company through an exchange offer or by means of a statutory merger. Both of these are time consuming. The issuance of common stock to gain control of a target company is not only a lengthy process increasing the vulnerability to competing offers and to defensive measures by the target but it may also give the acquirer's shareholders an opportunity to take hold of the transaction with which they are unhappy.

The relative Price-Earnings ratios (P/E ratios) of the two firms are an important consideration, when a company is considering using the common shares to finance a merger. For a firm having a high P/E ratio, ordinary shares represent an ideal method for financing mergers and acquisitions. In the same way, the ordinary shares are more advantageous for both companies when the firm to be acquired has low P/E ratio.

Advantages of Common Stock Issuance

Common stock has several advantages from a strategic point of view. The stock for stock exchange ratio can in certain circumstances, qualify for the pooling of interest method of accounting and thereby avoid the creation of goodwill. In such a case if the P/E ratio of acquirer is more than the P/E multiple paid to the acquirer, the merged firm's P/E will increase as a result of the transaction.

Illustration 1

The following data is available for two firms A and T:

	Firm A	Firm T
Earnings after taxes	Rs.1,40,000	Rs.37,500
Number of shares outstanding	20,000	7,500
Earnings per share	Rs.7	Rs.5
P/E ratio	10	8
Market price	Rs.70	Rs.40

Firm A intends to acquire firm T and offered one share for every 1.5 shares of T Ltd. Assume that Firm A expects to have the same earnings and P/E ratios after the merger as before (no synergy effect), show the extent of gain accruing to the shareholders of both the companies as a result of the merger. Are the shareholders better off or worse off than they were before the merger?

Solution

Exchange ratio = 1/1.5 = 0.67

Number of shares issued to shareholders of T = 0.67 x 7,500 = 5,000

Earnings per share after the merger = (Rs.1,40,000 + 37,500) / (20,000 + 7,500)

= Rs.7.1

Market price after the merger = Rs.7.1 x 10 = 71

Total market value = Rs.71 x 25,000 = Rs.17,75,000

i. **Gain from the Merger:**

Post merger market value of the firm		Rs.17,75,000
Less: Pre-merger market value		
Firm A (20,000 x Rs.70)	Rs.14,00,000	
Firm T (7,500 x Rs.40)	3,00,000	17,00,000
Gain from the merger		75,000

ii. **Apportionment of the Gain:**

	Post-merger	Pre-merger	Difference
Shareholders of Firm A	14,20,000 (20,000 x 71)	14,00,000 (20,000 x 70)	20,000
Shareholders of Firm T	3,55,000 (5,000 x 71)	3,00,000 (7,500 x 40)	55,000

Thus the shareholders are better off after the merger.

CONVERTIBLE PREFERRED STOCK

In the early 1980s, when the common stock prices were generally depreciating and the junk bond market had not yet developed into a major source of acquisition financing, a convertible preferred stock was often used as an acquisition consideration. It is similar to coercive two tier front end loaded acquisitions as roughly half of the target's shares were purchased in a cash offer, with the lower value convertible preferred stock issued in a second step. It is a hybrid between a non-convertible subordinated fixed income security and common stock. Acquirers intending to issue common stock but are concerned about the current stock price may prefer a convertible security.

The use of convertible preferred stock as a mode of financing today has decreased due to the emergence of the poison pills as an effective defense against unsolicited two tier front end loaded offers. In addition, the availability of junk bonds as an effective tool of financing has eliminated the need to use these securities.

DEFERRED PAY SECURITIES

A deferred pay security is a debt or preferred stock instrument which pays no cash interest or dividends for a specified period of time, typically two to five years, after which cash interest or dividends are paid at a predetermined fixed rate until maturity. These securities are often used in highly leveraged acquisitions to:

i. Reduce the cash debt service burden on the acquirer in the early years after the transaction, and

ii. To make it easier for the acquirer to raise more senior funds from banks and other lenders.

CONTINGENCY PAYMENTS

In certain negotiated acquisitions, the parties to the transactions agree that a business combination would be beneficial. However, they cannot agree on one particular price due to the differences of opinion as to the target's financial prospects. In such a situation, a contingency payment referred to as "earn-out" may be used to bridge the gap between the bid and ask. The acquirer agrees to make future payment to the target only when the target company achieves certain financial objectives. In this way, both the parties share in the financial risk that arise due to their respective views as to whether or not the target company's prospects will be realized.

The contingency payments are mostly found in private companies, particularly when the target company is a family owned and run business. The earn-out serves two purposes: (i) it enables to arrive at the deal, and (ii) it places golden handcuffs on the owner manager of the target company. If the owner of the target company is critical to the success of the firm the acquirer ensures that he is given proper incentive to motivate him to stay back and work hard for the company. The buyer can tie a portion of the selling price to the target company's performance over an extended period of time instead of arranging for a long-term contract because the liquidity might affect the manager's motivation.

The earn-out formulas, particularly those which extend over a number of years, must be carefully constructed to ensure that,

- the buyer retains sufficient flexibility with respect to the overall disposition of investment,
- the seller is not encouraged to manage the business in a less than optimal way from the buyer's perspective, and
- both the buyer and the seller are treated fairly.

In recent years, contingency payments are also being used in the acquisition of the troubled public companies.

Box 1: Infosys Acquires a Australian Company in an Earn-out Deal
The CEOs of Indian hi-tech companies were in the mood for shopping overseas during the quarter ended December 2003. They spent over $172 million in either fully acquiring – or picking up significant equity stakes in – foreign companies during the period. Infosys Technologies' acquisition of the Australia-based IT services company Expert Information Services Pty Ltd for about $22.9 million was the second largest deal. The deal includes an up-front cash payment and an "earn-out" payable based on achievement of certain financial targets. The deal represented the most significant acquisition by Infosys, which has been criticised for not being aggressive enough on the acquisitions front compared to its peers like Wipro.

Source: The Hindu Business Line, 14th January, 2004.

There are however, certain problems of this mode of payment. Some of them are: (i) the target firm must be capable of being operated as an independent business entity so that its contribution to the total projects may be determined, (ii) there must be a freedom of operation to the management of the newly acquired firm, and (iii) there must be willing co-operation to work towards the success and growth of the target firm on the part of the management of the acquiring firm, realizing that only by this way the two firms will gain from the merger.

There are various types of the deferred payment plan in trend. One of the most frequently used plan for this purpose is the base-period earnout. As per this plan, the shareholders of the target firm receive additional shares for a specified number of future years, if the firm is able to improve its earnings vis-á-vis the earnings of the base period (the earnings of the previous year before the acquisition). The amount which has to be paid in the future years is given as:

(Excess earnings x P/E ratio)/(Share price of acquiring firm)

Illustration 2

Firm X has purchased firm Y. Firm Y had the base year earnings as Rs.2,00,000. At the time of the merger its shareholders received initial payment of 50,000 shares of the firm X. The market value of the firm X's share is Rs.25 per share and the P/E ratio is 8. The projected post merger earnings of firm Y for the next three years are Rs.2,36,000, Rs.2,85,000 and Rs.3,10,000. Assume that there are no changes in the share price and the P/E ratio of firm X. Determine the number of shares required to be issued to the shareholders of company during these years.

Solution

Year 1: (36,000 x 8) / 25 = 11,250

Year 2: (85,000 x 8) / 25 = 27,200

Year 3: (1,10,000 x 8) / 25 = 35,200

Thus, the shareholders of firm Y will receive 73,650 shares

(i.e., 11,250 + 27,200 + 35,200) in the subsequent three years.

THEORIES OF THE METHOD OF PAYMENT ON ABNORMAL RETURNS

The method of payment considers a number of alternative theories to explain their results. Some of the main theories are: (i) Taxes, (ii) Information effects, and (iii) Signaling.

i. **Taxes:** A stock for stock exchange enables the target shareholders to avoid paying taxes at the time of the takeover. However, when equity is sold in the exchange transaction the target shareholders will then have to pay capital gains tax. Hence, the tax is delayed when it is a stock payment. Moreover, the tax paid will be at the capital gains tax rate, which is less than an ordinary income tax rate. The deferral of tax, benefits the shareholders of the target. When cash is used as a method of payment, the capital gain tax has to be paid immediately by the shareholders of the target. To offset this tax disadvantage, the premiums in cash payments generally are very high.

ii. **Information Effects:** When equity is used it gives the information that the bidder considers its equity to be overvalued. This results in negative returns to the bidders. However, since the market will see through this information, it should have no effect on the returns to the target. Target usually has much higher returns when cash is used than when there is a stock exchange.

iii. **Signaling:** The use of cash flows as a method of payment is a positive signal in many ways. For the bidder, it signals that the cash flows from its existing assets will be large. If this signaling effect exists and if internal financing as opposed to external financing is used, then it gives a positive signal. It gives a signal about the ability to exploit investment opportunities possessed by the target or created by synergy effects. The cash payment may also signal the bidder may possess certain private information about the profitability of the takeover.

The use of equity has opposite effects. It gives negative signal about the prospects of the bidder. It also gives a negative signal for the takeover, i.e., the capacity of the internal financing of both the firms combined may not be sufficient to internalize the investment opportunities. Hence, bidders who use stock as the method of payment will experience negative abnormal returns. Targets should gain but the gain is not as much as when cash is used and the gains from the takeover are shared by the bidder and the target.

VARIOUS THEORIES

Many different theories explaining the various payment alternatives in M&A transactions have been developed in the literature. Among these, the financing methods chosen in M&A deals have been identified as being of practical importance. Some of these theories are:

Asymmetric Information Proposition

Myers and Majluf (1984) developed and used a framework based on the existence of asymmetric information to understand the various financing alternatives in M&A transactions. The Asymmetric Information Theory says that there exists asymmetric information between the management and market participants. As a result, different payment methods in M&A transactions may signal different types of valuable information to the investors.

According to Myers and Majluf (1984), in a world of asymmetric information, the bidding firms' alternative payment methods in an acquisition announcement deliver different information about the bidders. For instance, when stock for stock exchange is announced to be used as the payment method, it signals that the bidder's existing assets are overvalued. On the other hand, if *cash* used as the medium of exchange, it signals that the assets of the bidder are, generally undervalued. Accordingly, the market participants take the cash offer as the good news and a share exchange as bad news concerning the value of the bidding firm's assets.

The adverse selection and Nash Bargaining Equilibrium theories were used by Hansen (1987) to explore the importance of the asymmetric information proposition in the M&A financing market. The results of Hansen demonstrate that the bidders would prefer a share exchange under the hypothesis of the target firm's asset overvaluation, thus it can benefit the bidders through sharing the overvaluation with target firms.

Another researcher, Travlos (1987) finds that share exchange as the means of payment usually results in significant losses to the shareholders of bidding firms. This result confirms his hypothesis that share exchange delivers negative information for the valuation of bidding firm's assets. Fishman (1989) runs a model of pre–emptive bidding to exam the asymmetric information hypothesis. His studies indicate that cash offers in M&A deals convey positive information about the valuation of the bidder's asset. In this regard, the management of the target is more likely to reject a share exchange or potential competitors (if there exists more than one bidder in a contested bid) are more successfully deterred by cash offer as compared with share exchange.

Conversely, Cornett and De (1991) in their findings obtained a different result about the relation between bidder's choice in acquisition finance and its returns in inter-state bank mergers compared with non-bank mergers. They examined 132 inter-state bank mergers in the USA, which took place in the period of 1982-86 and found that the abnormal returns to the shareholders of bidding firms are positive and significant at the 1% level for cash, share and the combination of the two methods. These findings are contrary to the findings of other researchers and also appear to be inconsistent with the proposition of asymmetric information. According to the authors, the first issue revealed by the study is that there might be less severe effect with the assets of banking firms than those of non-banking firms with regard to overvaluation or undervaluation and information asymmetry. This means that the information asymmetry does not play an important role in banking undertakings as those of non-banking. The other is that share-exchange financing may suggest a positive signal that the bidding banks possess the accuracy of asset management practice since, according to various regulatory rules, an inter-state bank merger requires approval by these regulatory bodies, the announcement of the merger by bidding bank, therefore, indicates that it has met kinds of relevant requirements. In this context, share exchange in bank mergers signals positive information about the bidders.

Using asymmetric information theory in explaining the payment methods in M&A deals implies that shareholders can be indifferent to the means of payment used in a complete market. However, the capital market does hold the feature of information asymmetry. The relevant internal information of both parties – the bidder and target is, therefore, released through the particular forms of payment methods used in the deal.

Taxation Implication Proposition

The method of payment can also be linked with the condition of taxation when a particular form of payment is used. Any capital gains must be realized immediately for tax purposes. Therefore, cash offer in M&As could, theoretically, result in higher premiums when compared with share exchange. In other words, due to the existence of different tax treatments, the acquirer must pay a higher acquisition price in the case of cash offer to offset the tax burden of the target shareholders. The various studies reveal the following:

- Wansley, Lane and Yang (1983) use the market model to examine the influence of payment alternatives on target firms' Cumulative Average Abnormal Returns (CAARs). For the 41 working days examined after the acquisition announcement, they find that the target CAARs are 33.54%, 17.47%, and 11.77%, when financed by cash, share and the combination of the two, respectively. The huge difference between the returns in cash offer and share exchange is because of the taxation implication theory. According to them, the substantially higher returns to target shareholders when financed by cash offer indicate that the acquirers need to pay the additional tax burden for the targets under such a circumstance. In this respect, a share exchange financing will defer the tax consequences until the share is eventually sold.
- Huang and Walking (1987) obtained the same results as the previous studies in terms of target firm's post-acquisition performance. Through a study of 204 pairs of mergers in the period of 1977-82, they find that the CAARs for cash offer, share exchange and the combination of cash and share are 29.3%, 14.4%, and 23.3%, respectively. The significantly higher CAARs for cash financing is also attributed to the taxation implication theory as discussed earlier.

Managerial Ownership Proposition

The choice of financing alternatives in M&As must be related to the managerial ownership fraction of both parties – acquirer and target. Generally, the managerial ownership refers to the percentage of equity held by management and insiders in the acquiring and target firms. The greater the management's share of acquiring or target firms, the greater is the possibility of using cash for financing. This is because in M&A deals the managers of both parties offer (or accept) cash as the medium of exchange to prevent weakening of their existing control after the acquisition.

The relationship between the choice of payment methods and the managerial ownership of acquiring firms as examined by Stulz (1988) says that the larger the fraction of the ownership held by the acquiring firms, the less likely an acquisition is financed by using share exchange. Under such a situation, the bidder's management will be reluctant to offer share as the payment medium in order not to weaken its original control after the acquisition. Stulz also finds that if the fraction of managerial control of voting rights of the target firm is high, the likelihood of a hostile takeover is low since the target with a higher fraction of ownership will want more rights before the deal is completed.

Amihud, Lev and Travlos (1990) used a sample of 209 US acquisitions which happened during 1981-83 to inspect whether there is any relationship between insider ownership and financing methods. They find that in cash financing deals the top five officers and directors of the firm hold about 11% of the company's shares, while for the share financing, there are less than 7% held by them. This result indicates that managers with relatively higher share holdings in their firms prefer financing acquisitions with use of cash to share. In their explanation, they indicate that the reason for the use of cash rather than share financing by the acquiring firms is that managers do not want to increase the risk of losing control after the acquisitions.

Ghosh and Ruland (1998) recently has also confirmed the phenomenon concerning the positive relationship between the acquirer's managerial ownership and cash financing. They examined a sample of 212 successful US acquisitions for the period 1981-88. They categorized the entire sample into three categories – (i) offer by cash, (ii) share, and (iii) the combination of cash and share. The study clearly revealed that, with share exchange financing, the target firms' average managerial ownership is significantly higher; while with cash financing, the acquirers' managerial ownership is relatively high. Their findings suggest that the acquirer firms usually prefer cash financing for acquisitions rather than share financing, when their managerial ownership is relatively high. On the other hand, the target firm prefers to be financed by shares if the management of the target still intends to hold voting influence in the merged firm.

The Growth Opportunity Proposition

The alternatives for payment methods used in M&A deals, also depend upon the acquiring firm's growth opportunities to a certain extent. Martin (1996), who attempts to explore the relationship between the means of exchange used in M&A transactions and the firm's growth opportunities has conducted a detailed study.

Initially, Martin examined a sample data of 846 US acquisitions for the period from 1979 to 1988 by applying the traditional market model to calculate the mean values of data variables which are grouped by the three payment methods. The findings show that the CAARs obtained from using variables such as institutional ownership of ordinary shares and some other leading economic indicators are not statistically different at 10% level. This result suggests that the medium of exchange in acquisitions is not significantly affected by these variables.

Furthermore, Martin employs multinomial logit regression analysis to examine the growth opportunity proposition in acquisition financing. He uses Tobin's q-ratio, the ratio of the market value of a company's debt and equity to the current replacement cost of its assets, to measure the firm's growth opportunity. It is often thought that firms have an incentive to invest when q is greater than 1, and they will stop their investment when q is less than 1. The results show that the coefficients on q are positive and highly significant in his model, which is regressed by testing the relationship between growth opportunity and share financing. The findings, therefore, have confirmed his proposition that acquiring firms with greater growth opportunities are more likely to use share exchange as the payment method in acquisitions. This is because acquiring firms would need more cash (if available) under such situations to satisfy their growth opportunities.

The Relative Size Proposition

According to some researchers bigger the size of the target firm, the more the likelihood of acquirer to use share financing in M&A deals. Some studies have however, rejected this hypothesis.

Grullon, Michaely and Swary (1997), examined 146 US bank mergers for the period between 1981 and 1990 by applying a multinomial logit model to investigate the determinants of payment methods. The variables to be tested in a logit regression include the capital position of the merged banks, the relative size of targets, and the return on equity of both parties. They found that the stock for stock exchange or a combination of share and cash financing is more likely to be used in mergers where targets have high capital adequacy relative to the bidders as indicated by higher log odds ratio of share-to-cash and the combination-to-cash which are 2.12% and 1.87%, respectively. With regard to the relative size effects on the choice of payment methods, they found that the bigger the relative size of the target to the acquirer, the more likely the merger is financed by share or the combination but not cash only. These results have confirmed their hypothesis that the relative size of the target to the acquirer is positively related to the choice of share financing in M&A deals.

However, the results of Martin's (1996) illustrate that the relative size of the target, which is measured by the ratio of the amount paid for the acquisition to the sum of the market value of equity as of 20 trading days just before the announcement date and the amount paid for the acquisition, is not significant at the 5% level in any of his regressions. He illustrates that the target's relative size does not differ significantly between the methods of payment used in acquisitions. This result suggests that there is no clear and close association between relative size and acquisition financing in mergers and acquisitions.

A study by Ghosh and Ruland (1998) present the same results as Martin's (1996), regarding the relationship between the relative size and the choice of acquisition financing. Similar to Martin (1996), Ghosh and Ruland also analyze the impact of relative size as well as other factors on the likelihood of a particular payment method used in acquisitions. Their findings show that the target's relative size does not differ significantly for the payment alternatives in their logit model. According to them, when target size is relatively large compared with the acquirer's, the target management would prefer negotiating for share financing in order to maintain their interest and influence in the combined company. Meanwhile, the acquiring firm's managers prefer paying cash in order not to dilute their existing ownership in the firm. The payment alternatives are, hence, offset by the two different motivations between the counterparts. As a result, there is no clear sign indicating the linkage between the relative size of the two parties and payment methods chosen in M&A transactions.

Business Cycle Proposition

Martin (1996) in his study mentioned above also attempted to investigate the impact of business cycle conditions on the methods of payment used in acquisitions. The business cycle variables in his study include changes in the Standard and Poor's 500, index changes in Moody's BAA bond yield, changes in the index of 11 leading economic indicators and changes in industrial production. The results of his logit regression analysis show that only the variable of Standard and Poor's 500 is consistently significant with predicted positive sign, with regard to share financing. As for the other variables studied in the model, they are all not in line with the predicted signs in terms of their relationship with acquisition financing. Therefore, according to the results obtained by Martin, the good performance in overall stock market gives rise to share financing more preferably.

As we have seen, there is much literature on the issue of payment methods in corporate acquisitions. However, nearly all of the previous research focused mainly on the USA and the UK takeovers. All these theories of acquisition financing present some propositions in terms of the payment methods. Some of them appear to have been confirmed while the others are far from being conclusive.

Closely related to the topic of method of payment is the new development that occurred in the recent years – the use of high yield bonds in the merger and acquisition activity.

JUNK BONDS

The junk bond market and the use of junk bonds as a financing tool for mergers and acquisitions and Leveraged Buyouts (LBOs) was a very important aspect in the fourth merger wave. Prior to the 1980s, the fixed income investors such as the pension funds and insurance companies were generally unwilling to buy risky bonds, so it was almost impossible for the companies to raise capital in the public bond markets. In the late 1970s Michael Milken of the investment banking firm Drexel Burnham Lambert, began to convince institutional investors of the merits of purchasing risky debt after historical studies that showed that risky bonds yielded more than enough to compensate for their risk. This lead to the birth of "junk bond", a high risk, high yield bond issued to finance a leveraged buyout, a merger, or a troubled company. The emergence of junk bonds as an important type of debt is an example of how the investment banking industry adjusts to and facilitates new developments in the capital markets. The availability of very large amounts of capital through the junk bond market made the participation of many people who would have otherwise never considered participating as possible. The access to such large amounts of capital also made even the largest and the most established firms potentially vulnerable to a takeover by much smaller firms.

A high yield, or "junk", bond is a bond issued by a company that is considered to be a higher credit risk. The credit rating of a high yield bond is considered "speculative" grade or below "investment grade". This means that the chance of default with high yield bonds is higher than with other bonds. They are usually rated 'Ba' or lower by Moody's or 'BB' or lower by Standard and Poor. Their higher credit risk means that "junk" bond yields are higher than bonds of better credit quality. The portfolios of high yield bonds have higher returns than other bond portfolios, suggesting that the higher yields more than compensate for their additional default risk.

A well-established proposition in corporate finance is the direct relationship between the risk and return. All factors remaining constant, investors generally demand higher return for the higher risk taken. If firms sell junk bonds they must also offer high returns. This higher return in the risk premium is designed to compensate for the risks associated with junk bonds – default risk and liquidity risk. The risk of paying the interest and the principle is the default risk. Liquidity risk is that the bonds may not be as liquid as other assets.

ADVANTAGES TO INDIVIDUAL INVESTORS

i. **Greater Potential Returns:** The returns associated with junk bonds are greater as compared to other debt instruments. In the US, the junk bonds have outperformed government bonds for 17 years.

ii. **Lesser Sensitivity to Variations in Interest Rates:** The return from the junk bonds is less vulnerable to the changes in the interest rates.

iii. **Diversified Investments and Better Returns:** A buyer may purchase a diversified portfolio of junk bonds that will have lower risk because of diversification.

REASONS FOR GROWTH IN JUNK BONDS

The junk bond market witnessed dramatic and rapid growth due to several reasons:

i. The losing of popularity of privately placed bonds, i.e., the bonds, which are sold to a small group of investors. Restrictive covenants associated with the indenture contract and inconsistency in the contracts for the bonds making sales in the secondary market difficult lead to the losing of their popularity. Restrictive covenants in the indenture limited the actions that the issuing firm could take in the course of business activities. Inconsistency in the contract means that the market had limited liquidity, which is another risk factor which makes private placement of low-grade/high yield bonds difficult to market. This declining popularity of the privately placed market created an opportunity to publicly issue these bonds and hence led to the development of the junk bond market.

ii. Existence of an active market maker (an entity that serves as an agent of liquidity in facilitating sales between buyers and sellers) like Drexel Burnham Lambert also aided in the development of the junk bond market.

iii. The belief in investors that the risk associated with investments in junk bonds was not as high as what they believed earlier was another factor that led to the development of the junk bond market. Academic research and promotion of this financing vehicle by interested parties such as Drexel Lambert changed the perceptions.

iv. Expansion of the field of mergers and acquisitions is yet another factor. As the targets of mergers and acquisitions as well as leveraged buyouts increased, the demand for capital to fund these purchases grew. In the absence of other forms of financing some investors had to rely on the junk bond market.

Box 2: History of Junk Bonds
Junk bonds or high yield bonds have been prevalent for decades. However, their use as a financing tool for mergers and LBOs has been recent. Junk bonds had many different names in the past. Initially they were called low grade bonds. In the 1930s and 1940s they were called "fallen angels". In the 1960s the lower grade debt issued to finance conglomerate acquisitions was referred to as "Chinese Paper". The name "Junk Bonds" originated in a conversation between Meshulam Riklis, CEO of Rapid American Corporation and Michael Milkan the former head of Drexel Burnham Lambert an investment bank. The phenomenal growth of the junk bond market was impressive, but controversial. In 1989, Drexel Burnham Lambert was forced into bankruptcy, and Michael Milken the junk bond king (who earned $500 million two years earlier) was arrested. These events led to the collapse of the junk bond market in the early 1990s. However, since then the junk bond market has recovered and today it forms an important form of corporate financing.

Source: Patrick A. Gaughan – Mergers, Acquisitions and Corporate Restructurings.

JUNK BOND TAKEOVER PROCESS

Generally, a takeover process of junk bonds takes place in the following steps:

i. The acquirer establishes a shell corporation as a subsidiary which serves as a vehicle for the target's takeover.

ii. The shell corporation makes a tender offer to the target firm. This offer is conditional to the arrangement of financing. This depends on the investment bank's confident letter that it can raise the requisite finance.

iii. Commitments from investors willing to buy the junk bonds (which will be issued at a later date) are taken by the investment bank. Investors receive a guaranteed amount of money or commitment fee for their commitment to provide funds. This fee is usually not refundable even if the takeover is canceled.

iv. The investment bank also arranges for bridge finance providing the necessary capital to complete the deal. The bridge finance will be refinanced after the sale of the junk bonds issued by the shell corporation. The investment bank has the advantage of choosing the most appropriate time for the issue of the junk bonds. The recent and the future junk bond offerings, recent performance of the junk bond market and the current level of interest rates are the factors considered to decide on the appropriate time.

v. Bonds are then sold and the cash is used to buy the tendered stock. The purchase of 51% of the target's outstanding shares gives the acquirer the controlling interest in the target firm.

vi. If it is a two-tier offer, the second set of the junk bond issues are made to sell the remaining shares.

vii. Once the target firm is owned, various measures are taken to reduce the amount of debt. Sometimes the target's assets are sold to retire the debt used in the takeover. This is why many heavily leveraged takeovers and LBOs have been referred as bust-up takeovers.

This takeover process mentioned above was common in the mid 1980s but this activity became rare towards the late 1980s because it was very difficult to find the buyers for junk bonds. However, when the junk bond market recovered in the

1990s this process became more practicable. However, in these days, takeovers financed with junk bonds are not very common though the pace of mergers picked up strongly in the mid 1990s.

BANK LOAN FINANCING VERSUS JUNK BOND FINANCING

After reading the concept of junk bonds, one might wonder why junk bond financing is used by firms when various other forms of financing like bank borrowings are present. This can be explained thus,

i. Small firms do have the option of bank borrowings but their size and lesser credit standing do not make them attractive candidates to the bank loans of the magnitude that was often necessary in the takeover. Banks usually look for low debt equity ratios and stringent financial measures.

ii. A junk bond investor is not as demanding as banks because he is better able to lower his risk through diversification. A buyer purchases a diversified portfolio of junk bonds that will have lower risk because of diversification. The limited amount of capital available with banks does not permit them to maintain a well diversified portfolio as they lend to the limited number of borrowers.

iii. The bank loan financing terms are generally inferior to the junk bond financing. Junk bonds may have a term of 10-20 years but bank loans typically have a term of 7 years.

iv. Junk bonds sometimes have call options that allow the issuer to retire the issue more quickly if possible.

v. The growth of the junk bond market has strengthened the credibility of small companies as raiders. Before the junk bond market grew, the small companies were not considered as serious raiders since they did not have access to bank financing as larger and more creditworthy companies do.

POST-MERGER FINANCIAL LEVERAGE

From the preceding discussion, one can analyze that mergers and takeovers are more and more being financed with increased use of leverage. Researchers have found that interest payments of the acquired firms usually increased after the merger, which implied that there was an increase in the leverage. Let us see how the increased use of debt affects the value of the firm.

In the public corporation, debt is one way to reduce problems that arise by placing management powers with corporate executives and directors subject to control only by the shareholders (equity). If the shareholders each hold only a relatively small percentage of the stock, it is rarely in the interest of any single shareholder to spend the resources necessary to do something about poor management. The result is what seems to be a separation of ownership and control.

A high debt/equity ratio is one set of contracts that replaces the market for control and fiduciary duties to ensure that managers act in the interests of investors. This form of governance places the equity in the hands of a coherent control group that often includes incumbent management, and it replaces the rest of the equity contracts with debt contracts. And, as noted above, debt holders impose rules and restrictions on management through an indenture and the availability of remedies for breach.

In short, a high debt/equity ratio can play a positive role in the governance of some firms. It is simply one of many different combinations of contract terms as many as there are different companies with different business needs. Whether a heavy debt structure is cheaper and more effective for an individual firm depends, of course, on the relative costs to that firm of such a structure.

Debt is simply one way of allocating cash to corporate investors. Debt, even heavy debt, does not itself fundamentally change a firm's business or weaken its operations. In fact, by reducing management's opportunity for inefficiency, increased leverage may make the firm more efficient. Among other things, managers have less scope to involve the firm in costly new projects. Thus, although a more highly leveraged firm (which, by definition, maintains a small equity cushion) is more susceptible to economic shocks than one with a lower percentage of debt, to the extent that heavy debt increases efficiency. Shocks from inappropriate managerial decisions are less likely to occur in the highly leveraged firm. Even, if heavy leverage does increase the likelihood of insolvency, the costs of insolvency are themselves limited.

Even the purchasing bondholders are not injured. The strong presence in the bond market of sophisticated players, including mutual and pension funds, ensures that the bond contracts are carefully drafted to protect investors and that they are priced so that their yield reflects their risk.

Also, it is a myth that increased debt in these transactions adversely affects existing creditors. If, indeed, leverage improves the efficiency of the post-buyout firm, there is reason to believe that existing creditors could be benefited rather than losing. It is, in short, a mistake to focus on the size of the equity cushion or the coverage ratio, because these protections can be wasted by inefficient management.

It is said that employees, creditors, communities, and others are injured by leverage because the transactions increase the risk of insolvency. As discussed above, there is no need to be concerned about costly collapse resulting from a high debt/equity ratio. Beyond this, there are extra safeguards built into leveraged transactions. They can be structured to minimize the danger of insolvency. One technique, which was used in the RJR-Nabisco buyout, is to finance the buyout partly with an instrument called exchangeable preferred stock. This security provides for dividends, which can be omitted without triggering insolvency. Later, when the firm proves that it can comfortably pay interest on its debt, the managers can exchange the preferred stock for more debt.

TAX IMPLICATIONS

Taxes are an important consideration in almost all the transactions. The transactions may be non-taxable or entirely or partially taxable.

i. **Taxable Transactions:** A transaction is considered to be taxable if it involves the purchase of stock or assets for cash, notes or some other non-equity consideration.

   If the transaction involves the purchase of the assets, the target company's basis of tax is increased or "stepped up" to their fair market value which is equal to the purchase price paid by the acquirer. The additional depreciation and amortization reduces the tax liability of the combined company. The buyer generally pays a purchase premium to compensate the additional tax, which the target shareholders might incur. Buyers usually do this only if the present value of the tax savings resulting from the step-up of the target's assets is greater than the increase in the purchase price required to compensate the target's shareholders for the increase in their tax liability.

ii. **Tax-free Transactions:** A transaction is taxable if the target company's shareholders receive something other than the acquirer's stock and non-taxable if they receive the acquirer's stock. The transactions may be partially taxable if the shareholders of the target receive some non-equity consideration, such as cash or debt, in addition to the acquirer's stock. Tax-free transactions are those in which the target shareholders have a continuing direct or indirect interest in the acquired firm. If the transaction is a tax free transaction then the acquiring company can transfer or carry over the target company's tax basis to its own financial statements. There is no increase or step-up in assets to fair market value in a tax-free transaction.

The implications arising with respect to income tax for Indian compaies is given under the Income Tax Act, 1961. These guidelines are explained in detail in chapter XVI 'Regulatory Control'.

Table 1: Key Characteristics of Taxable versus Tax-free Transactions (As Applicable to Western Corporates)

Taxable Transactions	Tax-free Transactions
Purchase of stock for cash, notes or other non-equity consideration:	Exchange of acquirer's stock for target's stock/all the target's assets:
Acquiring firm:	Acquiring firm:
i. Stepped up basis for acquired assets.	i. Net operating loss carryover.
ii. Loss of net operating losses and tax credits.	ii. Tax credit carryover.
Target firm:	Target firm:
i. Immediate recognition of gain by target shareholders. ii. Recapture of tax credits and excess depreciation.	i. Deferred taxable gains for shareholders.

Source: Donald DePamphilis Mergers – Acquisitions and Other Restructuring Activities.

ACCOUNTING FOR MERGERS AND ACQUISITIONS

MEANING OF AMALGAMATION AND RECONSTRUCTION

The term Amalgamation has not been defined by the Companies Act, 1956. However, from several legal decisions, the definition of Amalgamation can be inferred. Amalgamation is blending of two or more existing undertakings into one undertaking, or transfer of two or more undertakings to an existing undertaking. That is two or more companies are combined into one, by merger or by one taking over other. Amalgamation contemplates not only the case where two companies are joined to form a new company but also the absorption and blending of one by the other. Thus, amalgamation includes absorption.

Reconstruction is a scheme of compromise or arrangement entered into by a company with its members and creditor with a view to reconstituting its financial structure. It is a process by which the assets and liabilities of a company are revalued, the losses suffered by the company are written off by a deduction of the paid-up value of shares and or varying the rights attached to different classes of shares and compounding with the creditors. Reconstruction may be external or internal. Internal reconstruction is effected without the company being liquidated. External Reconstruction on the other hand, is brought about by liquidating the company. In this case, the business of the company is transferred to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company. External Reconstruction is in fact covered under the category of amalgamation in the nature of merger.

Section 494 of the Companies Act facilitates amalgamation, absorption and external reconstitution.

TYPES OF AMALGAMATION

Accounting Standard 14 issued by the Institute of Chartered Accountants of India deals with Accounting for Amalgamations. The Accounting Standard recognizes two types of amalgamation:

a. Amalgamation in the nature of merger.

b. Amalgamation in the nature of purchase.

AMALGAMATION IN THE NATURE OF MERGER

In this type of amalgamation, there is genuine pooling of not merely the assets and liabilities of the amalgamated companies but also of the shareholders interest and the business of the companies.

The basic conditions to be satisfied by these types of amalgamations are as follows:

a. All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

b. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by the virtue of the amalgamation.

c. The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

d. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

e. No adjustment is intended to be made to the book value of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to insure uniformity of accounting policies.

AMALGAMATION IN THE NATURE OF PURCHASE

Amalgamations in the nature of purchase are those amalgamations where one company is acquired by the other company and, as a consequence, the shareholders of the transferor company normally do not have a proportionate share in the equity of the transferee company or where the business of the transferor company is not intended to be continued. That is amalgamations which do not satisfy any one or more of the conditions specified in (a) to (e) above are known as amalgamations in the nature of purchase.

Illustration 3

AX Ltd. and BX Ltd. amalgamated on and from 1st January, 20x5. A new Company ABX Ltd. was formed to takeover the businesses of the existing companies.

Balance Sheet as on 31-12-20X4

Liabilities	AX Ltd. Rs.'000	BX Ltd. Rs.'000	Assets	AX Ltd. Rs.'000	BX Ltd. Rs.'000
Share Capital-Equity Shares of Rs.10 each	60,00	70,00	Sundry Fixed Assets	85,00	75,00
			Investment	10,50	5,50
General Reserve	15,00	20,00	Stock	12,50	27,50
P & L A/c.	10,00	5,00	Debtors	18,00	40,00
Investment Allowance			Cash & Bank	4,50	4,00
Reserve	5,00	1,00			
Export Profit Reserve	50	1,00			
12% Debentures	30,00	40,00			
Sundry Creditors	10,00	15,00			
	130,50	152,00		130,50	152,00

ABX Ltd. issued requisite number of shares to discharge the claims of the equity shareholders of the transferor companies.

Prepare a note showing purchase consideration and discharge thereof and draft the Balance Sheet of ABX Ltd.

Solution

Assumption: Amalgamation is in the nature of merger.

Working Notes:

1. Purchase Consideration

Assets taken over		AX Ltd. Rs.'000		BX Ltd. Rs.'000
Sundry Fixed Assets		85,00		75,00
Investments		10,50		5,50
Stock		12,50		27,50
Debtors		18,00		40,00
Cash and Bank		4,50		4,00
		130,50		152,00
Less: Sundry Liabilities				
12% Debentures	30,00		40,00	
Sundry Creditors	10,00	40,00	15,00	55,00
Net Assets taken over		90,50		97,00
Less: Reserves and Surplus:				
General Reserve	15,00		20,00	
P & L A/c.	10,00		5,00	
Investment Allowance Reserve	5,00		1,00	
Export Profit Reserve	50		1,00	
		30,50		27,00
Purchase Consideration		60,00		70,00

Discharge of Purchase Consideration:	AX Ltd. Rs.'000	BX Ltd. Rs.'000
$130,00 \times \frac{90,50}{187,50} = 6,27,500$ Equity shares of Rs.10 each	62,75	
$130,00 \times \frac{97,00}{187,50} = 6,72,500$ Equity shares of Rs.10 each		67,25

Balance Sheet of ABX Ltd. as on 1.1.20X5

Liabilities	Amount Rs.'000	Assets	Amount Rs.'000
Share Capital		Sundry Fixed Assets	160,00
Equity shares of Rs.10 each	130,00	Investments	16,00
General Reserve	35,00	Stock	40,00
P & L A/c	15,00	Debtors	58,00
Investment Allowance Reserve	6,00	Cash and Bank	8,50
Export Profit Reserve	1,50		
12% Debentures	70,00		
(Assumed that new debentures were issued in exchange of the old series)			
Sundry Creditors	25,00		
	282,50		282,50

The total purchase consideration is to be discharged by ABX Ltd., in such a way that the rights of the shareholders of AX Ltd. and BX Ltd. remain unaltered in the future profits of ABX Ltd.

Assumption: Amalgamation is in the nature of purchase.

Balance Sheet of ABX Ltd. as on 1.1.20X5

Liabilities	Amount Rs.'000	Assets	Amount Rs.'000
Share Capital			
Equity shares of Rs.10 each	187,50	Sundry Fixed Assets	160,00
Investment Allowance Reserve	6,00	Investments	16,00
Export Project Reserve	1,50	Stock	40,00
12% Debentures	70,00	Debtors	58,00
Sundry Creditors	25,00	Cash & Bank	8,50
		Amalgamation Adjustment Account	7,50
	290,00		290,00

Note:

1. Shares are issued by ABX Ltd. on the basis of net assets acquired of AX Ltd. and BX Ltd. Hence there is no goodwill.
2. **Discharge of Purchase Consideration:**

	AX Ltd. Rs.'000	BX Ltd. Rs.'000
9,05 Equity Shares of Rs.10 each	90,50	
9,70 Equity Shares of Rs.10 each		97,00

3. The statutory reserves of AX Ltd. and BX Ltd. are shown in the balance sheet of ABX Ltd. with a corresponding debit in Amalgamation Adjustment Account. (Investment allowance Reserve + Export project reserve).

Purchase Consideration

Purchase consideration means the price payable by the transferee company to the transferor company for the net assets taken over.

Para 3(g) of AS-14 issued by ICAI defines the term consideration as, 'the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.' In case of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the market value of the assets or in the absence of market value the net book value of the assets should be considered as fair value.

Calculation of Purchase Consideration

There are basically four methods of calculating purchase consideration.

a. **Lump Sum Method:** It is the simplest method. In this method the purchase consideration is a specified fixed amount.

b. **Net Asset Method:** Under this method, the consideration is ascertained by adding the agreed values of all the assets taken over by the transferee company and deducting therefrom the agreed values of all the liabilities taken over by the transferee company. In the absence of the agreed values, the book values of the assets and liabilities will be taken for the purpose of calculation of purchase consideration. Fictitious assets such as preliminary expenses, debit balance of profit and loss account etc. are not taken over.

   Purchase consideration = Assets taken over at agreed value

   Less: Liabilities taken over at agreed value.

Illustration 4

Given below Balance Sheet of X Ltd. as on 31st March, 20X5 on the same date the assets and liabilities are taken over by Y Ltd.

Balance Sheet of X Ltd. as on 31.03.20X5

Liabilities	Rs.'000	Assets	Rs.'000
Share Capital	25,00	Plant & Machinery	15,00
General Reserve	5,00	Furniture	5,00
12% Debentures	10,00	Stock	15,00
Sundry Creditors	5,00	Debtors	5,00
		Cash	3,00
		Preliminary Expenses	2,00
	45,00		45,00

Y Ltd. agreed to takeover the assets and liabilities of X Ltd. at current values:

Plant and Machinery	20% depreciation
Furniture	10% depreciation
Stock	+20% revaluation
Debtors	10% discount

Calculate Purchase Consideration.

Solution

Value of Assets taken over by Y Ltd.

		Rs.'000
Plant & Machinery (15,00 – 3,00)		12,00
Furniture (5 – 0.50)		4,50
Stock (15 + 3)		18,00
Debtors (5 – 0.50)		4,50
Cash		3,00
		42,00
Less: Sundry liabilities taken over		
12% Debentures	10	
Sundry Creditors	5	
		15,00
Purchase Consideration		27,00

c. **Net Payment Method:** Under this method, the purchase consideration is arrived at by adding up the cash paid and the agreed values of the shares and debentures allotted by the transferee company to equity and preference shareholders of transferor company.

Purchase consideration = Consideration for equity shareholders
+ Consideration for preference shareholders

Example 1

A Ltd. agrees to pay Rs.1,00,000 in cash and allot to B Ltd. 2,000 12% Debentures of Rs.100 each fully paid at par and 50,000 equity shares of Rs.10 each fully paid at an agreed value of Rs.20 per share, for the business taken over from B Ltd. The consideration will be ascertained as follows:

Form	Rs.
Cash	1,00,000
12% Debentures	2,00,000
Equity Shares	10,00,000
Purchase Consideration	13,00,000

d. **Intrinsic Value Method:** Under this method, purchase consideration is calculated on the basis of the agreed value of shares or intrinsic value per share of the transferor company. If the purchase consideration is to be discharged by issue of equity shares of the transferee company, the number of shares to be allotted is arrived at by dividing the total consideration by the agreed value of one share of the transferee company.

METHODS OF ACCOUNTING FOR AMALGAMATION

There are two methods of accounting for amalgamations:

i. The Pooling of Interests Method; and

ii. The Purchase Method.

i. **The Pooling of Interest Method:** This method is used in case of amalgamation in the nature of Merger. Under this method, the transferee company takes over the assets, liabilities and reserves of the transferor at their existing carrying amounts unless any adjustment is required to follow a uniform set of accounting policies. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in general reserves. Thus neither goodwill nor capital reserves arises in case of amalgamation in the nature of merger.

ii. **The Purchase Method:** Under this method, the assets and liabilities of the transferor company should be incorporated either at their existing carrying amounts or by allocating the purchase consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair value at the date of amalgamation. Only statutory reserves of the transferor company should be incorporated in the financial statements of the transferee company by way of the following entry:

Amalgamation Adjustment A/c Dr.
To Statutory Reserves A/c

The Amalgamation Adjustment Account is disclosed as a part of Miscellaneous Expenditure or other similar category in the balance sheet of the transferee company. When the identity of the specific statutory reserve is no longer required to be maintained, the above entry should be reversed.

Any excess of the amount of purchase consideration over the acquired assets of the transferor company should be recognized as goodwill arising on amalgamation in the financial statements of the transferee company. Such goodwill should be amortized to income on a systematic basis over its useful life. However, the amortization period should not exceed five years unless a somewhat longer period can be justified.

JOURNAL ENTRIES IN THE BOOKS OF TRANSFEROR

1. For transferring the assets to the Realization Account:

Realization Account Dr.
To Various Assets (individually) account

Note: All the assets except bank and cash balances should be transferred to the Realization Account at book value irrespective of whether the transferee company has taken over the assets or not. Cash and Bank balances should be transferred only if they are taken over by the transferee company. Profit and Loss Account (Dr) and expenses not written off are not transferred to the Realization Account. If there is a provision against an asset, such an asset is transferred to the Realization Account at gross figure. The related provision is transferred to the realization by means of a separate entry.

2. Transfer of all liabilities taken over by the transferee company to the Realization Account at book figure:

   Sundry Creditors a/c Dr.
   Bills Payable a/c Dr.
   To Realization a/c

   Note: In case of any fund or reserve only that portion of the fund or reserve which denotes liability should be transferred to the realization account i.e., workmen compensation fund etc.

3. For the Purchase Consideration

   Transferee Company a/c Dr.
   To Realization a/c

4. For the discharge of Purchase Consideration

Bank a/c		Dr	with cash received.
Equity shares in purchasing Co.	a/c	Dr.	with agreed value of equity shares in purchasing company.
Debentures in purchasing Co.	a/c	Dr.	with agreed value of debentures in purchasing company.
To Transferee Company	a/c		with total consideration.

5. If any asset is not taken over by the transferee company and otherwise disposed off:

   Bank Account Dr. with the amount
   To Realization Account realized.

6. Expenses of realization should be dealt with according to the circumstances of each case:

   – If the transferor company bears the expenses:

     Realization account Dr.
     To Cash account

   – If the expenses are to be borne by the transferee company one of the following methods may be adopted:

     i. Ignore it in the books of transferor company.

     ii. If the expenses of liquidation are paid by the transferor company first, to be reimbursed by the transferee company later:

        On payment of expenses by the transferor company

        a. Transferee Company a/c Dr.
           To Cash a/c

        b. Cash a/c Dr.
           To Transferor Company a/c

     iii. If purchasing company included the amount of expenses in the purchase consideration:

        On payment of expenses by the transferor company

        a. Realization a/c Dr.
           To Bank a/c

           (with the amount of expenses)

        b. Transferee Company a/c Dr.
           To Realization a/c

           (with the amount of expenses recoverable)

7. For the discharge of liabilities not taken over by the transferee company.

   Liabilities a/c Dr.
   To Bank account

   The difference, if any, between the book value and the amount paid should be transferred to the realization account.

8. For transfer of Preference share capital to the preference shareholders:

   a. If the preference shareholders are paid more than the credit balance of preference share capital.

      Preference share capital a/c Dr.
      Realization account Dr. With excess amount payable if any
      To Preference Shareholders a/c Total amount payable

   b. If the preference shareholders have agreed to accept less than the credit balance of preference share capital.

      Preference Share Capital a/c Dr.
      To Preference Shareholders a/c
      To Realization a/c

9. For Transfer of Equity Share Capital:

   Equity Share Capital a/c Dr.
   To Equity Shareholders a/c

10. Transfer of accumulated profits and reserves to the equity shareholders account:

    Capital Reserve a/c Dr.
    General Reserve a/c Dr.
    Share Premium a/c Dr.
    Profit and Loss a/c (cr) Dr.
    To Equity Shareholders a/c

11. For transfer of items under the heading miscellaneous expenditure:

    Equity Shareholders a/c Dr.
    To Preliminary expenses a/c
    To Profit & Loss a/c (Dr)
    To Discount on issue of shares a/c
    To Underwriting commission a/c

12. For transfer of profit or loss from the realization account:

    a. If realization account shows profit

       Realization account Dr.
       To Equity Shareholders Account

    b. If realization account shows loss

       Equity shareholders account Dr.
       To Realization account

13. For the balance payable to equity shareholders:

    Equity shareholders account Dr.
    To Bank account

ENTRIES IN THE BOOKS OF TRANSFEREE COMPANY

(A) **In Case the Amalgamation is in the Nature of Purchase:**

1. Business Purchase Account Dr.
   To Liquidators of Transferors Company
2. Various Assets (excluding Goodwill) taken Dr. With agreed values
   *Goodwill a/c Dr. Balancing figure
   To Various Liabilities taken over a/c With agreed values
   To Business Purchase account With purchase consideration
   To *Capital Reserve a/c Balancing figure

* If in the above mentioned entry, the total credits exceed the total debits, such an excess is treated as Goodwill. On the other hand, if the total debits exceed the total credits such an excess is treated as capital reserve.

3. To record the Statutory Reserves of the transferor company:

    Amalgamation Adjustment a/c Dr.

    To Statutory Reserves a/c

4. For discharge of Purchase Consideration:

    Liquidator of Transferor Company a/c Dr.

    To Bank a/c

    To Equity share capital a/c

    To Preference share capital a/c

    To Debenture a/c

    Note: If the allotment of shares is made at premium, the amount of premium should be credited. On the other hand if the shares or debentures are issued at discount, the discount on issue of shares or debentures should be debited.

5. If the transferee company bears the expenses of liquidation of the transferor company

    Goodwill or Capital Reserve a/c Dr.

    To Bank a/c

(B) **In Case the Amalgamation is in the Nature of Merger:**

(Entries in the books of Transferee company)

1. Same entry as in case of purchase

2. Various assets taken over a/c Dr.

    To Various Liabilities taken over a/c

    To Different Reserves of Transferor Company a/c

    To Business Purchase Account a/c

Note: While passing the above mentioned entry the difference between the amount of consideration payable by the transferee company to the transferor company and the amount of share capital of the transferor company is adjusted in the General Reserve.

All the other entries are same as in case of merger.

Illustration 5

On 31st March, 20X5 the balance sheet of A Ltd. stood as follows:

Liabilities	Rs.	Assets	Rs.
Share Capital		Plant & Machinery	5,00,000
70,000 equity shares of Rs.10 each fully paid-up	7,00,000	Furniture & Fixtures	40,000
		Stock	4,50,000
General Reserve	3,30,000	Debtors	1,00,000
P & L Account	80,000	Cash at bank	1,80,000
Creditors	1,60,000		
	12,70,000		12,70,000

On this date, A Ltd. took over the business of B Ltd. for Rs.5,00,000 payable in the form of its equity shares of Rs.10 each at par, the balance sheet of B Ltd. being as follows:

Liabilities	Rs.	Assets	Rs.
Share Capital		Furniture & Fittings	60,000
60,000 equity shares of Rs.10 each fully paid-up	6,00,000	Stock	4,00,000
		Debtors	1,00,000
Creditors	1,00,000	Cash at bank	40,000
		P & L Account	1,00,000
	7,00,000		7,00,000

You are **required** to:

i. Pass journal entries and prepare important ledger accounts in the books of B Ltd.

ii. Show journal entries for the purchase of business in the books of A Ltd. and draw A Ltd.'s Balance sheet after the takeover.

Solution

Books of B Limited Journal

	Particulars	Dr. Rs.	Cr. Rs.
20X5 Mar. 31	Realization Account Dr.	6,00,000	
	To Furniture & Fittings a/c		60,000
	To Stock a/c		4,00,000
	To Debtors a/c		1,00,000
	To Cash at Bank a/c		40,000
	(Transfer of all the other assets to realization account)		
,,	Creditors a/c Dr.	1,00,000	
	To Realization a/c		1,00,000
	(Transfer of creditors to realization account)		
,,	A Ltd. account Dr.	5,00,000	
	To Realization a/c		5,00,000
	(For the amount of consideration receivable from A Ltd.)		
,,	Shares in A Ltd. a/c Dr.	5,00,000	
	To A Ltd. account		5,00,000
	(For allotment of equity shares in discharge of purchase consideration)		
,,	Equity Share Capital a/c Dr.	6,00,000	
	To Equity Shareholders a/c		6,00,000
	(Transfer of equity share capital to equity shareholders a/c)		
	Equity Shareholders Account Dr.	1,00,000	
	To Profit & Loss Account		1,00,000
	(Transfer of debit balance of profit & loss a/c to equity shareholders)		
	Equity Shareholders A/c Dr.	5,00,000	
	To Shares in A Ltd. a/c		5,00,000
	(Shares in A Ltd. allotted to equity shareholders)		

Ledger Realization Account

Dr. Cr.

	Rs.		Rs.
To Furniture & Fittings	60,000	By Creditors	1,00,000
To Stock	4,00,000	By A Ltd.	5,00,000
To Debtors	1,00,000		
To Cash at Bank	40,000		
	6,00,000		6,00,000

Equity Shareholders Account

	Rs.		Rs.
To Profit & Loss A/c	1,00,000	By Equity Share Capital	6,00,000
To Shares in A Ltd.	5,00,000		
	6,00,000		6,00,000

A Limited

	Rs.		Rs.
To Realization account	5,00,000	By Shares in A Ltd.	5,00,000

Shares in A Ltd.

To A Ltd.	5,00,000	By Equity Shareholders	5,00,000

Books of A Limited Journal

Particulars		Dr. Rs.	Cr. Rs.
Business Purchase Account	Dr.	5,00,000	
To Liquidators of B Ltd.			5,00,000
(Consideration payable to B Ltd.)			
Furniture & Fittings a/c	Dr.	60,000	
Stock account	Dr.	4,00,000	
Debtors account	Dr.	1,00,000	
Cash at bank account	Dr.	40,000	
To Creditors account			1,00,000
To Business purchase account			5,00,000
(For the assets and liabilities taken over)			
Liquidators of B Ltd. a/c	Dr.	5,00,000	
To Equity Share Capital account			5,00,000
(Allotment of equity shares to liquidators of B Ltd.)			

Balance Sheet of A Ltd. as on 31.3.20X5

Liabilities	Rs.	Assets	Rs.
Share Capital:		**Fixed Assets:**	
Authorized, Issued and Subscribed:		Plant & Machinery	5,00,000
		Furniture & Fittings	1,00,000
1,20,000 shares of Rs.10 each fully paid	12,00,000	Stock	8,50,000
		Debtors	2,00,000
Reserves & Surplus:		Cash at bank	2,20,000
General Reserve	3,30,000		
Profit & Loss Account	80,000		
Creditors	2,60,000		
	18,70,000		18,70,000

Illustration 6

The following is the Balance Sheet of Vidyut Ltd. as on 31st March, 20X5.

Liabilities	Rs.	Assets		Rs.
Equity Share Capital	10,00,000	Goodwill		2,00,000
General Reserve	1,00,000	Land & Buildings		2,00,000
Workmen's accident compensation reserve	60,000	Plant & Machinery		4,50,000
		Patents & Trademarks		20,000
Profit & Loss Account	60,000	Stock		2,00,000
Sundry Creditors	1,60,000	Sundry Debtors	1,80,000	
		Less: Provision for bad debts	12,000	
				1,68,000
		Cash at Bank		1,22,000
		Preliminary expenses		20,000
	13,80,000			13,80,000

The company is acquired by Deep Ltd. which pays Rs.15,00,000 in all – Rs.12,00,000, fully paid shares of Rs.10 each and the balance in cash. There was a contingent liability under the Workmen's Compensation Act. The claim was not taken over, Deep Ltd. and Vidyut Ltd. had to pay ultimately a sum of Rs.20,000 against the claim. The Balance Sheet of Deep Ltd. on 31st March, 20X5 is as follows:

Liabilities	Rs.	Assets	Rs.
Share Capital:		Goodwill	2,00,000
2,00,000 equity shares of Rs.10 each	20,00,000	Land & Buildings	6,00,000
		Plant & Machinery	8,00,000
General Reserve	2,00,000	Stock	5,00,000
Profit & Loss account	1,00,000	Sundry Debtors	3,00,000
13% Debentures	3,50,000	Cash at Bank	4,50,000
Sundry Creditors	2,00,000		
	28,50,000		28,50,000

The expenses of liquidation of Vidyut Ltd. came to Rs.10,000. Pass journal entries to close the books of Vidyut Ltd. and show the important ledger accounts. Give journal entries in the books of Deep Ltd. and redraft Deep's Balance Sheet after the absorption is completed.

Solution

Books of Vidyut Limited Journal

Particulars		Rs.	Rs.
Realization account	Dr.	13,72,000	
To Goodwill a/c			2,00,000
To Land & Buildings a/c			2,00,000
To Plant & Machinery a/c			4,50,000
To Patent & Trademarks a/c			20,000
To Stock a/c			2,00,000
To Sundry Debtors a/c			1,80,000
To Cash at Bank a/c			1,22,000
(Transfer of various assets and liabilities to realization a/c)			
Sundry creditors account	Dr.	1,60,000	
Provision for bad debts account	Dr.	12,000	
To Realization account			1,72,000
(Transfer of creditors and provision for bad debts to Realization a/c)			
Deep Ltd. account	Dr.	15,00,000	
To Realization account			15,00,000
(Amount receivable from Deep Ltd.)			
Shares in Deep Ltd. account	Dr.	12,00,000	
Bank account	Dr.	3,00,000	
To Deep Ltd. account			15,00,000
(Receipt of cash and shares in Deep Ltd. in settlement of consideration)			
Realization Account	Dr.	10,000	
To Cash Account			10,000
(Expenses of liquidation paid)			

Particulars		Rs.	Rs.
Workmen's Compensation Reserve account	Dr.	20,000	
To Bank account			20,000
(The claim for compensation for accident paid)			
Equity Share Capital A/c	Dr.	10,00,000	
To Equity Shareholders Account			10,00,000
(Transfer of equity share capital to equity shareholders)			
General Reserve account	Dr.	1,00,000	
Workmen's accident compensation reserve account	Dr.	40,000	
Profit and Loss Account	Dr.	60,000	
To Equity Shareholders a/c			2,00,000
(Transfer of general reserve profit and loss account and the balance in the workmen's compensation reserve after meeting the claim of accident)			
Realization Account	Dr.	2,90,000	
To Equity Shareholders Account			2,90,000
(Transfer of profit on realization to equity shareholders account)			
Equity shareholders account	Dr.	20,000	
To Preliminary expenses a/c			20,000
(Transfer of preliminary expenses account to equity shareholders a/c)			
Equity Shareholders Account	Dr.	14,70,000	
To Equity shares in Deep Ltd. a/c			12,00,000
To Bank Account			2,70,000
(Being equity shares issued and cash paid in full settlement of a/c)			

Realization Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Goodwill	2,00,000	By Sundry Creditors	1,60,000
To Land & Buildings	2,00,000	By Provision for bad debts	12,000
To Plant & Machinery	4,50,000		
To Patents & Trademark	20,000	By Deep Ltd.	15,00,000
To Stock	2,00,000		
To Sundry Debtors	1,80,000		
To Cash at Bank	1,22,000		
To Bank (expenses)	10,000		
To Equity Shareholders	2,90,000		
	16,72,000		16,72,000

Deep Limited Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Realization A/c	15,00,000	By Shares in Deep Ltd.	12,00,000
		By Bank account	3,00,000
	15,00,000		15,00,000

Cash Book

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/fd	1,22,000	By Realization A/c	1,22,000
To Deep Ltd.	3,00,000	By Realization a/c	10,000
		By Workmen's Accident Compensation Reserve	20,000
		By Equity shareholders a/c	2,70,000
	3,00,000		3,00,000

Equity Shareholders Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Preliminary Expenses	20,000	By Equity Share Capital	10,00,000
To Equity Shares in Deep Ltd.	12,00,000	By General Reserve	1,00,000
To Bank Account	2,70,000	By Workmen's Accident Compensation Reserve	40,000
		By Profit & Loss a/c	60,000
		By Realization Account	2,90,000
	14,90,000		14,90,000

Books of Deep Ltd. Journal

Particulars		Rs.	Rs.
Business Purchase Account	Dr.	15,00,000	
To Liquidators of Vidyut a/c			15,00,000
(Being the purchase consideration payable)			
Land and Buildings a/c	Dr.	2,00,000	
Plant and Machinery a/c	Dr.	4,50,000	
Patents and Trademarks a/c	Dr.	20,000	
Stock account	Dr.	2,00,000	
Sundry Debtors account	Dr.	1,80,000	
Bank account	Dr.	1,22,000	
Goodwill account	Dr.	5,00,000	
To Sundry Creditors a/c			1,60,000
To Provision for Bad Debts a/c			12,000
To Business Purchase account			15,00,000
(Being the various assets and liabilities taken over goodwill being the result of excess of cost of acquisition over the net assets)			
Liquidators of Vidyut Ltd. a/c	Dr.	15,00,000	
To Equity Share Capital account			12,00,000
To Bank account			3,00,000
(Allotment of equity shares and payment of cash in satisfaction of the purchase consideration)			

Balance Sheet of Deep Limited as on 31-3-20X5

Liabilities	Rs.	Assets		Rs.
Share Capital		Fixed Assets		
Issued & Subscribed:		Goodwill		7,00,000
3,20,000 equity shares of Rs.10 each	32,00,000	Land and Building		8,00,000
		Plant and Machinery		12,50,000
General Reserve	2,00,000	Patents & Trademarks		20,000
Profit & Loss A/c	1,00,000	Stock		7,00,000
13% Debentures	3,50,000	Sundry Debtors	4,80,000	
Sundry Creditors	3,60,000	Less: Provision for bad debts	12,000	
				4,68,000
		Cash at Bank		2,72,000
	42,10,000			42,10,000

Calculation of purchase consideration at the intrinsic value of shares.

Illustration 7

The following are the Balance Sheets of A Ltd. and B Ltd. as on 31st March, 20X5.

	A Ltd. (Rs.)	B Ltd. (Rs.)		A Ltd. (Rs.)	B Ltd. (Rs.)
Share Capital –			Goodwill	20,000	–
5,000 Shares of Rs.100 each	5,00,000	–	Other Fixed Assets	8,30,000	16,00,000
80,000 Shares of Rs.10 each	–	8,00,000	Investments	1,70,000	–
Capital Reserve	1,00,000	–	Current Assets	6,90,000	16,80,000
General Reserve	3,60,000	10,00,000			
Secured Loans	–	4,00,000			
Unsecured Loans	2,20,000	–			
Creditors	4,20,000	4,60,000			
Provision for Tax	1,10,000	5,20,000			
Proposed Dividend	–	1,00,000			
	17,10,000	32,80,000		17,10,000	32,80,000

A Ltd. was absorbed by B Ltd. with effect from 31st March, 20X5.

For the purpose of absorption, the Goodwill of A Ltd. was considered valueless. A Ltd. had arrears of depreciation amounting to Rs.40,000.

The shareholders of A Ltd. are allotted, in full satisfaction of their claims, shares in B Ltd. in the same proportion as the respective intrinsic value of the shares of the two companies bear to each other.

Close the books of A Ltd. by preparing the necessary ledger accounts and pass journal entries in the books of B Ltd. regarding absorption of A Ltd.'s business.

Solution

		A Ltd.		B Ltd.
Intrinsic values of shares:				
Fixed Assets		7,90,000		16,00,000
Investments		1,70,000		—
Current Assets		6,90,000		16,80,000
		16,50,000		32,80,000
Less: Liabilities				
Secured Loans			4,00,000	
Unsecured Loans	2,20,000			
Creditors	4,20,000		4,60,000	
Provision for Tax	1,10,000		5,20,000	
Proposed Dividend	—	7,50,000	1,00,000	14,80,000
Total Intrinsic Values		9,00,000		18,00,000
Value of one share	$\frac{9,00,000}{5,000}$ = Rs.180		$\frac{18,00,000}{80,000}$ = Rs.22.50	

Books of A Ltd. Realization Account

Dr. Cr.

	Rs.		Rs.
To Goodwill	20,000	By Unsecured Loans	2,20,000
To Other Fixed Assets	8,30,000	By Creditors	4,20,000
To Investments	1,20,000	By Provision for Tax	1,10,000
To Current Assets	6,90,000	By B Ltd. (Purchase Consideration)	9,00,000
		By Sundry Shareholders Account (Loss)	60,000
	17,10,000		17,10,000

B Ltd.

	Rs.		Rs.
To Realization a/c	9,00,000	By Shares in B Ltd.	9,00,000

Shares in B Ltd.

	Rs.		Rs.
To B Ltd.	9,00,000	By Sundry Shareholders Account	9,00,000

Sundry Shareholders Account

Particulars	Rs.		Rs.
To Realization Account – Loss	60,000	By Share Capital Account	5,00,000
To Shares in B Ltd.	9,00,000	By Capital Reserve	1,00,000
		By General Reserve	3,60,000
	9,60,000		9,60,000

Books of B Ltd. Journal

Particulars		Dr. Rs.	Cr. Rs.
Business Purchase Account	Dr.	9,00,000	
To Liquidator of A Ltd.			9,00,000
Amount payable to liquidator of A Ltd. for the business purchased			
Fixed Assets a/c	Dr.	7,90,000	
Investments a/c	Dr.	1,70,000	
Current Assets a/c	Dr.	6,90,000	
To Unsecured Loans a/c			2,20,000
To Creditors a/c			4,20,000
To Provision for Tax a/c			1,10,000
To Business Purchase Account			9,00,000
Incorporation of assets and liabilities taken from A Ltd.			
Liquidator of A Ltd. a/c	Dr.	9,00,000	
To Share Capital Account			4,00,000
To Share Premium Account			5,00,000
Allotment of 40,000 shares of Rs.10 each at a premium of Rs.12.50 per share in discharge of purchase consideration.			

INTER COMPANY OWINGS

At the time of Amalgamation, inter company owings should be eliminated. If the purchasing company owes an amount to the vendor company or vice versa, the amount is included in the debtors of one company and creditors of the other company. The following adjustment entry is passed to eliminate the inter company-owings.

Sundry Creditors account Dr.
To Sundry Debtors account

The entry should be made after the usual amalgamation entries have been passed in the books of purchasing company.

Similar problem arises when at the time of amalgamation or absorption, the vendor company holds bills receivable accepted by the purchasing company or vice versa. After amalgamation or absorption, such bills receivable should be eliminated from the books of purchasing company by means of the following entry.

Bills Payable account Dr.
To Bills Receivable account

Similarly, if the purchasing company has an investments certain debentures issued by the vendor company or vice versa, the same have to be eliminated from the books of purchasing company at the time of amalgamation or absorption by means of the following entry.

Debentures account Dr. (par value)
To Investments in
Debentures account (cost)

If debentures are acquired as investments at above or below par, while passing the entry for cancellation of investment and debentures in the books of purchasing company, the difference between cost of investment and par value of debentures canceled should be adjusted in goodwill or capital reserve resulting on acquisition of business.

Unrealized Profit on Stock

Purchase and sale transactions between vendor company and the purchasing company give rise to the problem of unrealized profit included in the unsold stock. For example, if P Co. has sold some goods to S Co. at a profit of 20% on cost, and a part of goods purchased remains as stock with S Co. Subsequently, when P Co.

acquires the business of S Co. the unsold stock of S Co. will become the stock of P Co. The value of stock shown in the balance sheet of P Co. After absorption will comprise of the unsold stock of P Co., and S Co., valued at cost. The unsold stock of S Co., includes the profit element of P Co., (20% above cost) which needs to be eliminated. The following entry is passed to eliminate the unrealized profit.

Goodwill Account (or Capital Reserve a/c) Dr.

To Stock Account

The accounting treatment is the same when the goods are sold by the vendor company to the purchasing company, and the unsold stock remains with the purchasing company.

Illustration 8

The following are the balance sheets of Pavan Ltd. and Pankaj Ltd. as at 31st March, 20X5.

	Pavan Rs.	Pankaj Rs.		Pavan Rs.	Pankaj Rs.
Share Capital	9,00,000	3,00,000	Plant	6,40,000	–
Reserves	2,80,000	70,000	Furniture	75,000	25,000
Bills Payable	40,000	20,000	Stock	3,05,000	2,70,000
Sundry Creditors	1,00,000	70,000	Debtors	1,55,000	60,000
			Cash at Bank	1,15,000	70,000
			Bills Receivable	30,000	35,000
	13,20,000	4,60,000		13,20,000	4,60,000

Pavan Ltd. takes over the business of Pankaj Ltd. for Rs.4,00,000 payable in the form of equity shares allotted at par. Included in the Bills Payable of Pavan Ltd. are bills amounting to Rs.30,000 accepted in favor of Pankaj Ltd. for goods purchased; Pankaj Ltd. charging profit @ 25% on cost. On the date of absorption, goods purchased from Pankaj Ltd. of the invoice price of Rs.10,000 still remain unsold in the stock of Pavan Ltd. and of the above mentioned bills of Rs.30,000, bills for Rs.5,000 only still remain in Pankaj Ltd.'s hands, the rest having been endorsed in favor of creditors or got discounted with bank. Expenses of liquidation of Pankaj Ltd. Rs.8,000 were met by Pavan Ltd.

Prepare Realization Account and the account of Pavan Ltd.'s ledger and pass journal entries in the books of Pavan Ltd. Also draw Pavan's balance sheet immediately after absorption.

Solution

Dr. **Realization Account** Cr.

	Rs.		Rs.
To Furniture	25,000	By Bills Payable	20,000
To Stock	2,70,000	By Sundry Creditors	70,000
To Debtors	60,000	By Pavan Ltd.	4,00,000
To Cash at Bank	70,000		
To Bills Receivable	35,000		
To Equity Shareholders	30,000		
	4,90,000		4,90,000

Dr. **Equity Shareholders Account** Cr.

	Rs.		Rs.
To Equity Shares in Pavan Ltd.	4,00,000	By Equity Share Capital	3,00,000
		By Reserves account	70,000
		By Realization account	30,000
	4,00,000		4,00,000

Books of Pavan Limited Journal

		Dr. Rs.	Cr. Rs.
Business Purchase Account	Dr.	4,00,000	
To Liquidators of Pankaj Ltd.			4,00,000
(The consideration payable to liquidators of Pankaj Ltd. for business purchased)			
Furniture account	Dr.	25,000	
Stock account	Dr.	2,70,000	
Debtors account	Dr.	60,000	
Cash at Bank account	Dr.	70,000	
Bills Receivable account	Dr.	35,000	
Goodwill account	Dr.	30,000	
To Bills Payable account			20,000
To Sundry Creditors			70,000
To Business Purchase a/c			4,00,000
(Assets and Liabilities taken over from Pankaj Ltd. The balancing figure being the goodwill)			
Liquidators of Pankaj Ltd. a/c	Dr.	4,00,000	
To Equity Share Capital account			4,00,000
(Being equity shares allotted at par in discharge of the consideration)			
Bills Payable account	Dr.	5,000	
To Bills Receivable account			5,000
(Cancelation of inter company owings in the form of bills)			
Goodwill Account	Dr.	2,000	
To Stock account			2,000
(Being unrealized profit eliminated from unsold stock)			
Goodwill Account	Dr.	8,000	
To Bank account			8,000
(Being expenses of liquidation of Pankaj Ltd. paid)			

Balance Sheet of Pavan Ltd. as on 31.3.20X5

Liabilities	Rs.	Assets	Rs.
Share Capital		**Fixed Assets:**	
Authorized, Issued and Subscribed Equity Share Capital	13,00,000	Goodwill	40,000
		Plant	6,40,000
		Furniture	1,00,000
(Of the above shares Rs.4,00,000 have been allotted to vendors without payment being received in cash)		Current assets, loans and advances	
		A) Current assets	
		Stock	5,73,000
Reserves & Surplus:	2,80,000	Debtors	2,15,000
Reserves		Cash at bank	1,77,000
Current Liabilities & Provisions		B) Loans & Advances:	
A) Current Liabilities		Bills Receivable	60,000
Bills Payable	55,000		
Sundry Creditors	1,70,000		
B) Provisions			
Provision	—		
	18,05,000		18,05,000

INTER COMPANY HOLDINGS

Inter company holdings are the investments made by the,

a. Purchasing company in the shares of selling company; or

b. Selling company in the shares of purchasing company; or

c. By both the companies in shares of each other.

Shares Held by the Purchasing Company in the Selling Company

When the Purchasing Co. holds shares in the vendor company, it has acquired ownership of the assets of the company to the extent of the investment. Therefore, the purchase price it has to pay is limited to the amount payable to outside shareholders. That is it need not pay any purchase price for that part of the assets which belongs to it. For example, if P Ltd. acquires business of S Ltd. on a valuation of Rs.2,00,000 and if P Ltd. is already holding 20% equity shares in S Ltd., the purchase consideration taken as Rs.1,60,000 as Rs.40,000 already belongs to P Ltd.

The cost of shares to P Ltd. is not relevant for this purpose. But while recording the acquisition entries the account representating cost of shares acquired should be credited. (at cost to the purchasing company) and then only Goodwill or Capital Reserve should be ascertained.

The vendor can treat the matter in either of the two ways:

i. The purchase consideration may be computed only for outsiders and the Realization account credited and purchasing company is debited accordingly. In this case, the paid-up value of the shares held by the purchasing company should be debited to the share capital account and credited to the realization account.

ii. The purchase consideration may be computed ignoring the fact that some shares are held by the purchasing company. Proportionate amount due to the purchasing company for shares held by it should be debited to the shareholders account and credited to the account of the purchasing company.

Illustration 9

The abridged balance sheet of Sun Ltd. as at 31st March, 20X5 was as follows:

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets	13,00,000
2,00,000 equity shares of Rs.10 each	20,00,000	Current Assets	9,80,000
		Profit & Loss account	70,000
Current Liabilities	3,50,000		
	23,50,000		23,50,000

On the above mentioned Moon Ltd. absorbed the business of Sun Ltd. at balance sheet values. Winding up costs of Rs.9,000 were borne by Moon Ltd. The summarized balance sheet of Moon Ltd. at that date stood as follows:

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	32,20,000
3,00,000 equity shares of Rs.10 each	30,00,000	Investments in 50,000 equity shares of Sun Ltd.	4,75,000
General Reserve	10,00,000		
Current Liabilities	19,45,000	Current Assets	22,50,000
	59,45,000		59,45,000

Moon Ltd. discharged the consideration by allotment to Sun Ltd. 1,00,000 fully paid-up shares of Rs.10 each at an agreed value of Rs.12 each and by payment of cash for the balance. Moon Ltd. had sufficient cash at bank for payment to liquidators of Sun Ltd.

Show important ledger accounts in the books of Sun Ltd. pass journal entries in the books of Moon Ltd. and draw Moon's balance sheet immediately after the absorption.

Solution

Calculation of Purchase Consideration

Fixed assets	13,00,000
Current assets	9,80,000
	22,80,000
Less: Sundry creditors	3,50,000
	19,30,000

However, 50,000 shares out of 2,00,000 shares of Sun Ltd. is already with Moon Ltd. It means 25% business has already been paid for.

The amount to be paid now

= 19,30,000 × 25/100 = Rs.14,47,500

Books of Sun Ltd. Realization Account

Particulars	Rs.		Rs.
To Fixed Assets	13,00,000	By Current Liabilities	3,50,000
To Current Assets	9,80,000	By Moon Ltd.	14,47,500
To Shareholders Account	17,500	By Equity Share Capital	5,00,000
	22,97,500		22,97,500

Moon Ltd.

To Realization account	14,47,500	By Shares in Moon Ltd.	12,00,000
		By Bank account	2,47,500
	14,47,500		14,47,500

Equity Shares in Moon Ltd.

To Moon Ltd.	12,00,000	By Equity Shareholders	12,00,000

Equity Shareholders Account

To P & L account	70,000	By Share Capital	15,00,000
To Bank account	2,47,500	By Realization a/c	17,500
To Equity Shares in Moon Ltd.	12,00,000		
	15,17,000		15,17,000

Books of Moon Ltd. Journal

Particulars		Debit (Rs.)	Credit (Rs.)
Business Purchase account	Dr.	14,47,500	
To Liquidators of Sun Ltd.			14,47,500
(Amount payable to liquidators of Sun Ltd. for the business taken over)			
Fixed Assets account	Dr.	13,00,000	
Current Assets a/c	Dr.	9,80,000	
To Current Liabilities a/c			3,50,000
To Business Purchase a/c			14,47,500
To Investments in equity shares of Moon Ltd. a/c			4,75,000
To Capital Reserve a/c			7,500
(Assets and liabilities of Sun Ltd. taken over, cancellation of shares of vendor company, on take over and the resultant capital profit on acquisition credited to capital reserve)			

Particulars		Debit (Rs.)	Credit (Rs.)
Liquidators of Sun Ltd.	Dr.	14,47,500	
To Equity Share Capital a/c			10,00,000
To Share Premium account			2,00,000
To Bank a/c			2,47,500
(Allotment of equity shares of Rs.10 each at a premium of Rs.2 per share and payment of cash to liquidators of Sun Ltd. in discharge of consideration)			
Capital Reserve a/c	Dr.	7,500	
Goodwill a/c	Dr.	1,500	
To Bank a/c			9,000
(Payment of winding up expenses of Sun Ltd. resulting in goodwill of Rs.1,500 after exhausting capital reserve of Rs.7,500)			

Balance Sheet of Moon Ltd. as on 31st March, 20X5

Liabilities	Rs.	Assets	Rs.
Share Capital		**Fixed Assets**	
Issued & Subscribed		Goodwill	1,500
4,00,000 equity shares of Rs.10 each	40,00,000	Other Fixed Assets	45,10,000
Share Premium	2,00,000	Current Assets	29,83,500
General Reserve	10,00,000	Loans & Advances	—
Current Liabilities	22,95,000		
Provisions	—		
	74,95,000		74,95,000

Current Assets

	Rs.		Rs.
To Balance B/fd	22,60,000	By Liquidators of Sun Ltd.	2,47,500
To Business Purchase	9,80,000	By Capital Reserve	7,500
		By Goodwill	1,500
		By Balance c/d	29,83,500
	32,40,000		32,40,000

Shares Held by the Vendor Company in the Purchasing Company

It is illegal under the Companies Act to acquire one's own shares. When the assets of the vendor company are taken over by the purchasing company, the latter company cannot takeover the shares in it held by the former. For example, S Ltd. holds 100 shares in P Ltd. P Ltd. acquires the business of S Ltd. allotting 2 shares for every 3 shares held in S Ltd., and the total number of shares in S Ltd. is 1,500. In all the shareholders of S Ltd. will get 1,000 shares (1,500 x 2/3). Since S Ltd. already has got 100 shares in P Ltd. it will get only 900 additional shares from that company.

While closing the books of the vendor company, it would be proper to revalue the shares already held by it in the purchasing company, debiting or crediting the realization account as the case may be. The account representing the shares should not be transferred to the realization account.

Illustration 10

P Ltd. takes over the business of V Ltd. for Rs.16,00,000 on 31st March, 20X5 on which date the balance sheets of the two companies stand as follows:

P Ltd. Account Dr. Cr.

	Rs.		Rs.
Equity shares of Rs.10 each fully paid	36,00,000	Good Will	2,00,000
General Reserve	8,50,000	Other Fixed Assets	28,00,000
Current Liabilities	10,50,000	Other Current Assets	20,00,000
	55,00,000		55,00,000

V Ltd. Account

Dr. Cr.

	Rs.		Rs.
Equity Shares of Rs.10 each, fully paid	20,00,000	Fixed Assets	12,00,000
		2,500 shares in P. Ltd. (at cost)	30,000
Current Liabilities	3,00,000	Cash at Bank	10,000
		Other Current Assets	8,60,000
		Profit and Loss Account	2,00,000
	23,00,000		23,00,000

The consideration is to be discharged by a cash payment of Rs.1,00,000 and allotment of sufficient number of fully paid equity shares in P Ltd. of the face value of Rs.10 each valued at Rs.12.50 each. Expenses of winding up Rs.10,000 are borne by P Ltd.

You are required to:

i. Prepare important ledger accounts and pass journal entries in the books of V Ltd.

ii. Pass journal entries in the books of P Ltd.

iii. Draw P Ltd.'s balance sheet immediately following absorption.

Solution

The consideration to be discharged in the form of shares	=	Rs.16,00,000 – Rs.1,00,000
	=	Rs.15,00,000
Agreed value of one share of P Ltd.	=	Rs.12.50
Hence the number of shares to be allotted	=	15,00,000 x 2/25 = 1,20,000
Shares already held by V Ltd.	=	2,500
Hence the number of shares now to be allotted	=	1,20,000 – 2,500 = 1,17,500
Agreed value of 1,17,500 shares	=	1,17,500 x Rs.12.50
	=	Rs.14,68,750
Adding Rs.1,00,000 of cash to be paid, entries are to be passed with Rs.14,68,750 + Rs.1,00,000	=	Rs.15,68,750

Books of V Ltd.

Realization Account

Dr. Cr.

	Rs.		Rs.
To Fixed Assets	12,00,000	By Current Liabilities	3,00,000
To Cash at Bank	10,000	By P Ltd. (Reduced purchase consideration)	15,68,750
To Other current assets	8,60,000	By Shares in P. Ltd.	1,250
		By Sundry Shareholders Account (loss)	2,00,000
	20,70,000		20,70,000

P Ltd. Account

	Rs.		Rs.
To Realization Account	15,68,750	By Bank	1,00,000
		By Shares in P Ltd.	14,68,750
	15,68,750		15,68,750

Dr. **Shares in P Ltd. Account** Cr.

	Rs.		Rs.
To Balance b/fd	30,000	By Sundry Shareholders Account (distribution)	15,00,000
To Realization Account (profit on revaluation)	1,250		
To P Ltd.	14,68,750		
	15,00,000		15,00,000

Cash Book (Bank Columns)

	Rs.		Rs.
To Balance b/fd	10,000	By Realization Account - transfer	10,000
To P Ltd.	1,00,000	By Sundry Shareholders	1,00,000

Sundry Shareholders Account

	Rs.		Rs.
To Profit & Loss Account	2,00,000	By Equity Share Capital	20,00,000
To Realization Account (loss)	2,00,000		
To Bank	1,00,000		
To Shares in P Ltd.	15,00,000		
	20,00,000		20,00,000

Journal

Particulars	Rs.	Rs.
Realization Account Dr. To Fixed Assets a/c To Cash at Bank a/c To Other Current Assets a/c Transfer of all the assets (except shares in P Ltd.) to Realization Account on winding up of the company.	20,70,000	 12,00,000 10,000 8,60,000
Current Liabilities a/c Dr. To Realization Account Current Liabilities transferred to Realization Account as they are being taken over by P Ltd.	3,00,000	 3,00,000
P Ltd. a/c Dr. To Realization Account Current Liabilities transferred to realization Account as they are being taken over by P Ltd.	15,68,750	15,68,750
Bank a/c Dr Shares in P Ltd. a/c Dr. To P Ltd a/c Cash and value of 1,17,500 shares received from P Ltd. in discharge of the consideration	1,00,000 14,68,750	 15,68,750
Shares in P Ltd. a/c Dr. To Realization Account Appreciation in the value of 2,500 shares (now valued at Rs.12.50 each) credited to realization Account	1,250	 1,250

Particulars		Rs.	Rs.
Equity Share Capital Account	Dr.	20,00,000	
To Sundry Shareholders Account			20,00,000
Transfer of Equity Share Capital Account to Sundry Shareholders Account			
Sundry Shareholders Account	Dr.	4,00,000	
To Profit & Loss Account			2,00,000
To Realization Account			2,00,000
Transfer of Profit & Loss Account and loss on Realization to Sundry Shareholders Account.			
Sundry Shareholders Account	Dr.	16,00,000	
To Bank a/c			1,00,000
To Shares in P Ltd. a/c			15,00,000
Distribution of cash and shares in P Ltd. among sundry shareholders to satisfy their claim			

Books of P Ltd. Journal

Particulars		Rs.	Rs.
Business Purchase Account	Dr.	15,68,750	
To Liquidator of V Ltd a/c			15,68,750
Amount Payable to liquidator of V Ltd.			
Fixed Assets a/c	Dr.	12,00,000	
Cash at Bank a/c	Dr.	10,000	
Other Current Assets a/c	Dr.	8,60,000	
To Current Liabilities a/c			3,00,000
To Business Purchase Account			15,68,750
To Capital Reserve a/c			2,01,250
Assets and liabilities taken over from V Ltd. and capital profit resulting from takeover.			
Liquidator of V. Ltd a/c	Dr.	15,68,750	
To Bank a/c			1,00,000
To Equity Share Capital a/c			11,75,000
To Share Premium a/c			2,93,750
Payment of cash and allotment of 1,17,500 equity shares of Rs.10 each at a premium of Rs.2.50 per share to liquidator of V Ltd. in discharge of purchase consideration.			
Capital reserve a/c	Dr.	10,000	
To Bank a/c			10,000
Cost of winding up of V Ltd. being paid-up resulting in the reduction of capital reserve on acquisition of business.			

Balance Sheet of P Ltd. as at 31st March, 20X5

Liabilities	Rs.	Assets	Rs.
Share Capital		**Fixed Assets**	
Authorized, Issued & Subscribed: 4,77,500 Equity Shares of Rs.10 each fully paid (Of the above shares, 1,17,500 shares have been allotted to vendors pursuant to a contract without payment being received in cash)	47,75,000	Goodwill	2,00,000
		Other Fixed Assets	40,00,000
		Current Assets, Loans and Advances	
		(A) Current Assets	
		Cash at Bank	4,00,000
		Other Current Assets	28,60,000
Reserves and Surplus		(B) Loans and Advances	Nil
Capital Reserve	1,91,250		
Share Premium	2,93,750		
General Reserve	8,50,000		
Current Liabilities and Provisions			
A. Current Liabilities	13,50,000		
B. Provisions	Nil		
	74,60,000		74,60,000

Shares held by both Companies in One Another

The important problem in this case is calculation of purchase consideration. When the purchase consideration is calculated on the basis of net assets or intrinsic value method the computation is made algebraically since the value of net assets of one company influences the net assets of the other.

Illustration 11

Following are the summarized balance sheets of two companies, P Ltd. and N Ltd. as on 31st March, 20X5

	P Ltd. Rs.	N Ltd. Rs.		P Ltd. Rs.	N Ltd. Rs.
Share Capital: (Shares of Rs.10 each)	5,00,000	1,80,000	Shares in P Ltd (10,000)		1,00,000
Reserves	1,45,000	–	Shares in N Ltd. (4,500)	30,000	–
Debentures	–	2,00,000	Debentures in N Ltd.	1,00,000	–
Trade Creditors	3,00,000	2,00,000	Sundry Assets	8,15,000	4,60,000
			P&L A/c	–	20,000
	9,45,000	5,80,000		9,45,000	5,80,000

The two companies agreed that P should takeover N Ltd. The debentureholders in N Ltd. agreed to convert the debentures into 14% Redeemable Preference Shares of Rs.100 each. Prior to the absorption, P Ltd. declared a dividend of 20% – the dividend had not yet been paid. Shareholders in N Ltd. were to receive shares in P Ltd. on the basis of the intrinsic value of the shares. The sundry assets of N Ltd. had to be written up by Rs.40,000 and those of P Ltd. reduced by Rs.15,000.

Draw up the Balance Sheet of P Ltd. after the absorption is completed.

Solution

Balance Sheet of P Ltd. as on March 31, 20X5

Liabilities	Rs.	Assets	Rs.
Share Capital		Sundry Assets	13,00,000
Equity: 55,563 fully paid shares of Rs.10 each	5,55,630		
14% Redeemable Preference shares of Rs.100 each	1,00,000		
	6,55,630		
(Of the above 5,563 equity shares and all the preference shares have been issued for consideration other than cash.)			
Share Premium	6,453		
Reserves – Capital	12,917		
– General	45,000		
Trade Creditors	5,00,000		
Dividend Payable	80,000		
	13,00,000		13,00,000

Working Notes:

i. **Intrinsic value (without taking into account shares held)**	P Ltd. Rs.	N Ltd. Rs.
Sundry Assets as valued	8,00,000	5,00,000
Debentures in N Ltd.	1,00,000	
Add: Dividend Receivable from P Ltd.	—	20,000
	9,00,000	5,20,000
Less: Liabilities and Dividend Payable	4,00,000	4,00,000
Total Rs.6,20,000	5,00,000	1,20,000

ii. **Division of Rs.6,20,000 between P Ltd. and N Ltd.:**

Let p stand for the share of P Ltd. and n for that of N Ltd.

Then:

p = 5,00,000 + 1/4n
n = 1,20,000 + 1/5p
= 1,20,000 + /5(5,00,000 + 1/4n)

substituting the value of p

= 1,20,000 + 1,00,000 + 1/20 n

= 2,20,000 + 1/20n

20n = 44,00,000 + n

19n = 44,00,000

n = 2,31,579
p = 5,00,000 + 1/4 x 3,21,579

= 5,57,895

iii. **Intrinsic value of one share of P Ltd.**

5,57,895/50,000 = 11.16

iv. **Amount to be paid to outsiders in N Ltd.**

Rs.1,73,684

v. **Number of Shares in P Ltd. to be issued 15,563,**

i.e. 1,73,684 = 11.16

Shares already with N Ltd. 10,000

Additional shares to be issued 15,563

Amount: Share Capital @ Rs.10 Rs.55,630

Share Premium @ Rs.1.16 Rs.6,453

vi. **P Ltd. will not convert Own Debentures in N Ltd. into Preference Shares**

		Rs.	Rs.
vii.	**Goodwill/Capital Reserve**		
	Assets taken over from N Ltd.		5,00,000
	Add: Cancellation of Dividend Payable		20,000
			5,20,000
	Less: Intrinsic value of shares held in N Ltd.	57,895	
	2,31,579 x ¼		
	Liabilities taken	4,00,000	
	over Intrinsic value of 5,563 shares now issued	62,083	5,19,978
	Capital Profit		22
viii.	**Capital Reserve:**		
	Intrinsic Value of 4,500 shares in N Ltd.		57,895
	Purchase Price		30,000
			27,895
	Add: Capital Profit as in (vii) above		22
			27,917
	Less: Loss on revaluation of assets		15,000
			12,917

Illustration 12

The followings are the balance sheets of BOP Ltd and CB Ltd as on 31st March, 20X5.

Liabilities	BOP Ltd. Rs.	CB Ltd. Rs.	Assets	BOP Ltd. Rs.	CB Ltd. Rs.
Share Capital			Land & Buildings	500,000	1,000,000
Equity share capital			Furniture	300,000	500,000
Rs.10 each	500,000		Plant	500,000	1,000,000
Re.1 each		1,000,000	Stock	100,000	300,000
Preference share capital (Rs.10 each)	300,000	500,000	Debtors	60,000	80,000
General reserve	150,000	400,000	Cash& Bank	40,000	20,000
Profit & loss A/C	100,000	300,000			
12% Debentures	200,000	400,000			
Current Liabilities	250,000	300,000			
	1,500,000	2,900,000		1,500,000	2,900,000

BOP Ltd. was absorbed by CB Ltd. with effect from 31st March, 20X5.

The purchase consideration is fixed as follows:

- CB Ltd. offers Rs.3 in cash and 8 equity shares of Re.1 each for every 1 equity share held in BOP Ltd. @ a premium of 20%. The preference shareholders of BOP Ltd., will get same number shares in CB ltd. The debenture holders of BOP Ltd. will be paid with new debenture of CB Ltd. @10% premium.

- CB Ltd. takes all assets and liabilities at their book value. CB Ltd. issued 1,00,000 share of Re.1 @ at a premium of 20 per cent to the public.
- Journalize all these transactions in the books of BOP Ltd. & show the new balance sheet of CB Ltd. after absorption.

Solution

Journal Entries in the Books of BOP Ltd.

Particulars		Rs.	Rs.
Realization a/c	Dr.	1,500,000	
To Land & Building a/c			500,000
To Furniture a/c			300,000
To Plant a/c			500,000
To Stock a/c			100,000
To Debtors a/c			60,000
To Cash & Bank a/c			40,000
(Transfer of all the assets to realization a/c)			
12% Debentures a/c	Dr.	200,000	
Current liabilities a/c	Dr.	250,000	
To Realization a/c			450,000
(All liabilities are transferred to realization a/c)			
CB Ltd. a/c	Dr.	930,000	
To Realization a/c			930,000
(Being purchase consideration due)			
Cash a/c	Dr.	150,000	
Equity shares in CB Ltd. a/c	Dr.	480,000	
Preference shares in CB Ltd.	Dr.	300,000	
To CB Ltd. a/c			930,000
(Being purchases consideration received)			
Equity share capital a/c	Dr.	500,000	
General reserve a/c	Dr.	150,000	
Profit & loss a/c	Dr.	100,000	
To Equity shareholders a/c			750,000
(Shareholders found are transferred)			
Preference share capital a/c	Dr.	300,000	
To Preference share holders a/c			300,000
(Transfer of share capital to shareholders a/c)			
Equity share holders a/c	Dr.	120,000	
To Realization a/c			120,000
(Being loss in realization a/c is transferred)			
Equity share holders a/c	Dr.	630,000	
To Cash a/c			150,000
To Equity shares in CB Ltd. a/c			480,000
(Being equity shareholders are paid)			
Preference shareholders a/c	Dr.	300,000	
To Preference shares in CB Ltd. a/c			300,000
(Being preference shareholders are paid)			

Balance sheet in the books of CB Ltd. after absorption:

Balance Sheet of CB Ltd. as on 1-4-20X5

Liabilities	Rs.	Assets	Rs.
Share Capital			
Equity share capital (Re.1 each)	1,500,000	Land & Buildings	1,500,000
Preference share capital	800,000	Furniture	800,000
Share premium	100,000	Plant	1,500,000
Capital Reserve	100,000	Stock	400,000
General reserve	400,000	Debtors	140,000
Profit &loss A/C	300,000	Cash & Bank	30,000
12% Debentures	620,000		
Current Liabilities	550,000		
	4,370,000		4,370,000

Working Notes:

1. **Computation of Purchase Consideration (Net Payments Method)**

	Particulars	Rs.
1.	***Payments to Equity shareholders***	
	In the form of cash (50,000 x 3)	1,50,000
	In the form of shares (50,000 x 8 x120/100)	4,80,000
	Payments to Preference shareholders	
	In the form of shares	3,00,000
	Total purchase consideration	9,30,000
2.	***Computation of amount of capital reserve***	
	Total agreed value of assets taken	15,00,000
	(–) agreed value of liabilities	4,50,000
	Net assets value	10,50,000
	(–) purchase consideration	9,30,000
	Capital reserve	1,20,000
	(–) Goodwill on payment of debentures	20,000
	Amount of capital reserve	1,00,000

SUMMARY

- A study of the methods of payments being used to effect payment under mergers revealed that there are significant differences in the returns to stakeholders of the bidder and target firm depending on the payment mode used. Target shareholders will have higher abnormal returns when paid in cash than by stock offers. Bidder returns are also higher when payment is done by cash. It is also well established that between the management resistance and the method of payment, it is the method of payment that was found to influence the returns more significantly. Various theories go in to explain the effect of the method of payment.

- According to the theory of taxes, since the taxable gains of the target shareholder is deferred infinitely in case of a stock-for-stock exchange and that of the cash transaction are paid immediately, cash offers must therefore be higher as a token of compensation.
- Another reasoning for higher cash pay outs is the scope offered by the asset write-ups in terms of future tax-shelters under depreciation to the acquiring firm. The information and signaling hypothesis also set the explanation for the cash offers giving higher returns.
- The junk bond market and the use of the junk bonds as a financing tool for mergers and acquisitions and Leveraged Buyouts (LBOs) is a very important aspect. Junk bonds either not rated or rated below investment grade. The growth of the junk bond market has strengthened the credibility of small companies as raiders.
- There are two methods for accounting for Mergers and Acquisitions: (i) Purchase Method, and (ii) Pooling of interest method.

Chapter 8

Joint Ventures

After reading this chapter, you will be conversant with:

- Strategic Alliances
- Joint Ventures
- Rationale behind Joint Ventures
- Key Issues in a Joint Venture
- Managing International Joint Ventures
- Reasons for Failure of Joint Ventures

In today's fast changing competitive world many firms particularly large and diversified organizations are constantly reviewing various ways to increase the shareholder value by changing the composition of their assets, equity, liabilities and operations. Business alliances or strategic partnerships represent an attractive alternative to mergers and acquisitions. Business alliances take the form of a variety of different legal structures.

The alternative to M&A is 'strategic partnership' wherein two or more firms develop a relationship that combines their resources, capabilities and core competencies for certain business purposes. This chapter explores the potential of various means to maximize shareholder's value without resorting to mergers and acquisitions. There are four major types of strategic partnerships: (i) Strategic alliances, (ii) Long-term contracts, (iii) Equity partnerships, and (iv) Joint ventures.

STRATEGIC ALLIANCES

In this form of strategic partnership, two or more companies jointly share resources, capabilities, or distinctive competencies to achieve some business goals. These alliances may be aimed at global market dominance within a product category. While the partners cooperate within the boundaries of the alliance relationship, they often severely compete in other parts of their business operations. Each firm remains a distinct entity, separate from its strategic alliance partner.

EXAMPLES OF SOME RECENT STRATEGIC ALLIANCES

Wipro Infotech – IBM

Wipro Infotech was started in 1980. It is one of the leading companies in IT services, solutions and products. To bring in a comprehensive suite of IT products, solutions and services, it formed strategic relationships with some of the world's best technology companies. Some of the strategic alliances are with world famous IBM and Sun Microsystems.

IBM is the world's largest information technology company, with more than 85 years of leadership in helping businesses with innovations. IBM creates, develops and manufactures the industry's most advanced information technologies, including computer systems, software, networking systems, storage devices and microelectronics. Its revenue for the year 2008 was $103.6 billion.

Wipro Infotech formed a strategic alliance with International Business Machines (IBM). Accordingly, Wipro Infotech integrates IBM products for customer solutions in India and complements IBM's service delivery in Asia Pacific region. This alliance enables Wipro to further enhance its proposition to its customers by offering a wide range of services and solutions based on IBM platforms. Through this alliance, Wipro delivers comprehensive IT solutions on the Lotus Suite and IBM WebSphere platforms. Wipro's expertise on these platforms is centralized in the form of best practices at the IBM Center of Excellence.

Wipro – SunOne

Sun Microsystems provides a complete portfolio of affordable, interoperable, and open software systems designed to help organizations maximize the utilization and efficiency of their IT infrastructure. It includes advanced software like Java. Wipro Infotech formed a strategic alliance with SunOne. Through this alliance, Wipro Infotech brings all the components required to set up next generation Internet infrastructure. The SunONE platform employs open standards at every level of integration, enabling enterprises to create innovative services that leverage advanced communication and Internet technologies. Some products on the offer include the SunONE portal server, messaging server, calendar server, proxy server, web server and directory server. These SunONE products offer always-on services that also offer the convenience and control of a single mailbox, phone number, address book and calendar.

Mahindra & Mahindra – Yueda Yancheng Tractor Company

In farm equipment sector, Mahindra & Mahindra (M&M) occupied leader position in manufacturing and marketing of tractors. To extent its operations globally, it had committed a joint venture with china based Yueda Yancheng Tractor Company. The joint venture firm, Mahindra Yueda Yancheng Tractor Company will have a capacity to produce 38,000 tractors with 125 HP capacity. This joint venture helps to capture the growing demand by the company. The combined domestic and export sales of tractors in China has grown from about 56,000 tractors in calendar year 2003 to 2,22,000 tractors in 2008, posting a combined annual growth rate of 32 per cent. In this joint venture firm, M&M contributed 51 per cent share capital through its subsidiary, Mahindra Overseas Investment Company (Mauritius) Ltd.

SAS India – Datamatics Technologies Ltd.

In Business Intelligence industry, SAS India is a leading company, which provides services in the areas of risk-management, competitive financial analysis, and warranty analysis in manufacturing industry.

Datamatics Technologies Limited is an Information Technology and BPO services center in India. It provides business process outsourcing solutions and specializes in providing services in the areas of Accounting, Claims, Payroll, Tax forms and Content Management. Its consulting practices service offerings include Document Management & Workflow, and Data Warehousing & Business Intelligence Solutions.

SAS India has entered into a strategic technology alliance with Datamatics Technologies Ltd. (DTL). This aims at bringing together the technology and solution synergies to address the Business Intelligence needs of the Banking Financial Services Insurance (BFSI) and manufacturing sectors.

Reliance Industries Limited and DuPont Polyester Technologies

Reliance Industries Limited (RIL) is the largest company in Reliance Group and the largest petrochemical firm in private heads in India. The company’s major products have wide applications in agriculture, clothing, consumer goods, and electronics. Its petrochemicals, including benzene, polypropylene, and Polyvinyl Chloride (PVC), are used in packaging, pipes, kitchenware, and furniture. Reliance is also engaged in polyester R&D. Reliance has built a “state-of-the-art” Research and Technology Center (RTC) at Patalganga, near Mumbai.

DuPont is one of the oldest companies providing innovative products to the markets all over the world. In 2002, it celebrated its 200th year of scientific achievement and innovation. It provides products and services that improve the lives of people everywhere. Based in Wilmington, Del., DuPont delivers science-based solutions for markets that make a difference in people’s lives in the areas of food and nutrition, health care, apparel, home and construction, electronics, and transportation. DPT is the technology development and licensing arm of DuPont Textiles & Interiors (DTI).

RIL has formed a strategic alliance with DTI to jointly explore new areas of research opportunity. The alliance will benefit polyester consumers worldwide, by accelerating the delivery of new polyester products and processes to the global marketplace in a cost-effective manner employing both pilot scale and commercial scale manufacturing facilities at Patalganga and other Reliance polyester manufacturing sites.

DIFFERENT TYPES OF STRATEGIC ALLIANCES

Some of the more common types of alliances include: (i) Partnering with Supplier, (ii) Pooled Purchasing, (iii) Partnering with Distributors, and (iv) Franchising and Licensing Contracts.

i. **Partnering with Suppliers:** Alliances are formed between a firm and its suppliers to boost quality, reduce cost and increase speed by establishing long-term relationships. This partnering enables a supplier to develop the desired parts or services at a specified level of quality or cost.

ii. **Pooled Purchasing:** It is the alliance between firms for purchasing identical products by combining separate purchasing volumes to increase their leverage on suppliers.

iii. **Partnering with Distributors:** These are alliances between a company and one or more distributors to provide access to new markets (domestic/foreign), or strengthen a position in existing markets.

Box 1: Partnership between SanDisk Corporation (India) and HCL Infosystems

The company SanDisk Corporation (India) has tied-up with HCL Infosystems to distribute SanDisk's wide range of mobile phone memory cards in the Indian market.

SanDisk has adopted this strategy to increase its market share and revenues as Indian consumers are increasingly becoming reliant on their mobile phones and are using them to enjoy and share more content.

"SanDisk Corporation (India) will be able to capture a significant market in this segment as the growth in mobile phone market is growing rapidly. SanDisk will increase its distribution capacity with this decision".

This partnership underlines the synergy with the mobile distribution capabilities of HCL and SanDisk's exciting offering for mobile phones. With this partnership, both the companies have a wider reach in one of the largest mobile markets in the world. Presently, SanDisk's offering for mobile phones includes mobile memory cards (microSD(HC) and M2) with capacities ranging from 2 GB to 16 GB and also MobileMate USB readers (SDHC compatible) which provides the users with a complete and versatile solution for transferring music, video, photos and other files between their mobile memory cards and computers. With a high capacity memory card in their mobile phone slots, consumers can do more with their mobile devices - be it storing more music, listening to more songs and/or saving more videos, photos, maps, ringtones and games. For example, an 8GB mobile memory card can store 1,000 songs, 1,200 photos and 21 hours of video.

Source: http://www.blonnet.com/blnus/15201210.htm

iv. **Franchising and Licensing Contracts:** Alliances are formed to provide long-term business assistance or to offer access to a new technology or product through:

- R&D partnerships and research consortia with other private companies.
- Alliances between the company and government agencies or universities.

WHY DO COMPANIES FORM STRATEGIC ALLIANCES?

The following are the several reasons that compel/encourage companies to form strategic alliances:

i. **Globalization of Demand and Supply**

- Major markets have come up in Europe, Japan, and in newly industrialized countries in Asia and Latin America.
- Uniform demand for same products because of increasing equivalency of literacy rates, higher mobility of people, and mass media communications.
- Trends in achieving economies of scale by focusing on production of components or end products in the same location.
- Trends in shifting production facilities from one place to another to exploit differentials in resource costs and wages.

ii. **Rapid Change in Technology**

- Growing technological equality among countries.
- The level of technology needed to compete in the industry often exceeds the financial or technical capabilities of the individual companies.

iii. **Pressures on Individual Companies**

- Pressure to increase/protect market share of the firm by expanding into new domestic/foreign markets.
- Pressure to manufacture products beyond the existing technological capabilities of the firm.
- Pressure to accelerate product development and bring technology to the market quickly.
- Pressure to decrease the cost of products and boost product quality and usefulness to the consumers.

iv. **Other Reasons**

- To focus on the firm's core competencies and outsource other functions. A core competency is a key competitive advantage of the firm.
- To gain access to complementary human, physical and financial resources.
- To gain access to technical expertise, cheap manpower, manufacturing capabilities, raw materials and finances.
- To gain access to new domestic and foreign markets.
- To access established distribution channels to preclude market entry barriers.
- To direct limited capital investment funds to the areas that the firm does best.

LONG-TERM CONTRACTS

In this form of strategic partnership, two or more firms enter a legal contract for a specific business purpose. Long-term contracts are common between a buyer and a supplier. Many strategists consider long-term contracts more flexible and less inhibiting than vertical integration. It is usually easier to walk out from an unsatisfactory long-term contract than a joint venture.

JOINT VENTURES

In a joint venture, two or more firms join their hands to form a separate, independent organization for strategic purposes. Such partnerships are typically focused on a specific market objective. As part of the joint venture agreement, ownership, operational responsibilities, and financial rewards and risks are allocated to each participant. Each partner in the joint venture retains its own corporate identity and independence. Joint ventures may run from a few months to a few years, and often involve a cross-border relationship called as "cross-border joint ventures".

- The joint venture entity is manned by a separate management team.
- The joint venture may own its assets independently from its parent firms.
- Partner firms play an active role in the joint venture's strategic decisions.
- The joint venture is the vehicle of choice for international market entry in countries which do not permit wholly owned subsidiaries.

A GLANCE AT SOME IMPORTANT JOINT VENTURES IN THE RECENT PAST

Idea Cellular Limited

Idea Cellular Limited is a three-way joint venture involving the Aditya Birla Group, the Tatas and AT&T Wireless of the US. Idea is a leading cellular operator, with a subscriber base of over 4.5 million across the country. It has its operations in the states of Maharashtra (excluding Mumbai), Goa, Gujarat, Andhra Pradesh, Madhya Pradesh, Chattisgarh, Uttar Pradesh (West), Uttaranchal, Haryana, Kerala and Delhi (inclusive of NCR).

LG-DOW Polycarbonate Limited

LG-DOW Polycarbonate Limited is a 50:50 joint venture between LG Corporation and The Dow Chemical Company, the leading chemical companies in Asia and the world, respectively. LG-DOW combines the strength and capabilities of its parent companies with the logistics flexibility to meet customer demands in Asia for CALIBRE™ polycarbonate resin. Based in Korea, this joint venture has close proximity to China and other growing markets in Northeast Asia.

HCL – NEC

On June 3, 2005, NEC Corporation, Japan, and HCL Technologies Limited (HCL), India announced a joint venture to provide offshore led software engineering solutions in embedded software, hardware design, network security, R&D, high performance computing and mobile technology to NEC and its subsidiaries. In this joint venture, NEC will have 51% stake while HCL will have the remaining 49% will be held by HCL.

ONGC Mittal Energy Service Ltd. (OMESL)

On 23rd July 2005, India's state-run Oil and Natural Gas Corporation (ONGC) and Britain-based Mittal group signed on an agreement to set up OMESL as a joint venture. It will work in trading and shipping of Oil and Gas. In this venture, while ONGC will hold 49.98 percent equity, the Mittal Steel Company would hold 48.02 percent stake and Financial institutions would hold the remaining 2 percent stake.

Videocon with Korean Companies

Videocon International is looking at forming a financial collaboration with two Korean companies, Daehung Electronics and Teravision Corporation, for the manufacture of electrical capacitators. The new company where Videocon and Daehung will hold 40 percent, each, and Teravision Corporation 20 percent will be called Daehung Electronics India.

Bharti and Changi

Telecom major Bharti Enterprises announced the formation of a 50:50 joint venture with Singapore's Changi airport to bid for the development and management of the Delhi and Mumbai airports.

Ashok Leyland and IOC

Ashok Leyland and Indian Oil Corporation (IOC) have joined hands to offer freight management services across the country. The venture will be driven by Ashok Leyland's newly floated subsidiary, Ashley. A tripartite agreement among Ashok Leyland, Ashley and IOC is to be signed for the purpose. The venture will offer its services to small fleet owners.

IL&FS and Punj Lloyd

Consolidated Toll Network of India (CTNL), a wholly-owned arm of Infrastructure Leasing & Financial Services (IL&FS) and Punj Lloyd have decided to enter into a 50:50 venture for developing a Rs.200 crore road project at Thiruvananthapuram in Kerala. CTNL and Punj Lloyd will be investing Rs. 25 crore each as equity in the joint venture

CHARACTERISTICS OF JOINT VENTURES AS PER CONTRACT LAW

As per the contract law, joint ventures are often described as possessing the following characteristics:

- Contribution by partners of money, property, knowledge, efforts, skill or other asset(s) to the common project.
- Joint property interest in the subject matter of the venture.
- Right of mutual control or management of the enterprise.
- Expectation of profit or presence of adventure.
- Right to share the profit.
- Usual limitation of the objective to single undertaking or ad hoc enterprises.

HOW STRATEGIC ALLIANCE DIFFERS FROM JOINT VENTURE

A strategic alliance is simply a business-to-business collaboration where two or more corporates share resources, capabilities or distinctive competencies to achieve some business purpose. These alliances are formed for joint marketing, joint sales or distribution, joint production, design collaboration, technology licensing and research and development. A strategic alliance is a more flexible concept than a joint venture and refers to numerous arrangements between firms whereby they work jointly for varying periods of time to accomplish a specific business goal. The central idea behind this type of alliance is to minimize risk while maximizing the leverage.

On the other hand, in a joint venture, two or more organizations set-up a separate, independent organization for strategic purposes. Such partnerships are normally focused on a specific market objective. They may continue for few months/years and often involve a cross-border relationship. One firm may buy a percentage of the stock in the other partner but not a controlling share. An organizational entity usually is not created with a strategic alliance, whereas it often is in a joint venture.

RATIONALE BEHIND JOINT VENTURES

Joint ventures are generally not formed as a result of one firm making a passive investment in another. Fund alone does not form the basis of a successful joint venture. The basis of this union can include several other factors such as:

POOLING OF COMPLEMENTARY RESOURCES

With the formation of joint ventures, firms can share each other's resources such as technology, production facilities, inventories, distribution channels, etc.

It enables companies involved to keep the pace with the fast changing business environment. With resources of all the partners being pooled, they can have access to sufficient resources that will help them to innovate in all spheres such as technology, product quality, etc.

ACCESS TO RAW MATERIALS

Joint ventures help companies to gain access to the raw materials available in the new place, i.e., the place where the other partner carries its business/production functions. It enables companies to mitigate the risks like scarcity of raw material, irregularity in raw material supply, etc.

ACCESS TO NEW MARKETS

Accessing new markets is often a costly affair involving huge outlays in terms of upfront marketing costs such as advertising, promotion, warehousing, and distribution expenses. With the formation of joint ventures, companies can use the other partners' marketing/distribution channels and hence can reduce the marketing costs to a significant extent. This also helps companies to gain access to new markets (partners' markets) that in turn boosts the overall sales performance.

DIVERSIFICATION OF RISKS

Cost of rolling out new products can be very high in terms of development and manufacturing costs. By sharing these costs with other partners, the capital sum that any single partner has at risk is reduced. Further, risk may be minimized by reducing the chance or probability of taking poor business decisions by allying with those who have access to better information or proprietary knowledge. Risk of missing lucrative business opportunities can also be minimized by having access to ample resources required to exploit apparent opportunities at the right time.

ECONOMIES OF SCALE

A joint venture can produce economies of scale, take advantage of complementary assets or specialized skills and acquire new technological or managerial capabilities. Sometimes separate operations may be economically wasteful.

COST REDUCTION

'Cost reduction' is also one of the basic rationale behind joint ventures. Cost reduction through joint ventures may come about in many ways such as purchaser-supplier relationships and combining/sharing facilities in joint manufacturing operations.

i. **Purchaser-Supplier Relationships:** Companies across the globe, starting from retailers to computer hardware manufacturers are increasingly building relationships with providers of 'logistic' services. These alliances usually cover both transportation and warehousing services and utilize a single provider for these services. This helps the companies to reduce their transportation and warehousing costs to a significant extent.

ii. **Joint Manufacturing:** Firms may also opt to combine their manufacturing operations in a single facility with the potential to meet the production needs of all parties involved in the venture. By setting up a large facility, firms can mutually benefit from lower production costs resulting from spreading fixed cost over larger volume of production units. Companies can obtain identical benefits by closing their production facilities and meeting their production needs by purchasing at favorable prices from other parties with substantial unutilized capacity.

TAX SHELTER

Though tax considerations should never push up the transaction of a joint venture, failure to recognize their different implications can have adverse financial consequences for all the partners involved. The key tax concerns of the joint venture partners will be to avoid the recognition of taxable gains on the formation of the joint venture and to lessen taxes imposed on the distribution of their incomes.

EQUITY PARTNERSHIPS

This partnership involves a company's purchase of stocks (mostly 5-10%) in another company or a two-way exchange of stock by the two companies. The minority investor may also have an option to buy a larger stake. Sometimes, it is often referred to as a partnership because of the exchange of equity ownerships. But, in the legal sense, it is considered as a partnership. These partnerships are usually formed in market alliances, purchaser-supplier relationships, technology advancements and in circumstances where a larger company makes an investment in a smaller company to ensure its continued financial viability. Companies form these partnerships when there is a necessity to have a close strategic relationship (long-term), to prevent a competitor from making an alliance or acquisition, or as a 'lead-up' to an expected merger or acquisition.

Memorandum of Collaborations and Memorandum of Understandings [MOC and MOU]

Box 2

Indian Oil Corporation's Overseas entered into MOC

- With Marubeni Corporation, Japan in the areas of refining, petrochemicals, power and pipelines.
- With Petronas, Malaysia, for petrochemicals, refining, blending, LNG, training, R&D opportunities and LPG import.

Indian Oil Corporation's Overseas entered into

- MOU with Premier Oil Pacific Ltd., for development and production projects in Northeastern states of India.
- MOU with ELF, ANTAR, France for manufacture and marketing of fuel additives and R&D assistance.
- MOC with Enbridge International Inc., Alberta, Canada to explore methods and avenues of cooperation in pipeline design, construction management, operation & maintenance techniques, software development, training and consultancy in India and abroad.
- MOU with Petronas Carigali for development/production projects.
- MOU with Pertamina, Indonesia for collaboration in hydrocarbon sector.
- MOU between Government of India and Government of Mauritius for Indian Oil Corporation's entry into downstream petroleum sector in Mauritius.
- MOU with Ceylon Petroleum Corporation Indian Oil Corporation's entry into downstream petroleum sector in Sri Lanka.

Indian Oil Corporation's Inland MOC

- Entered into MOC EIL for "Products upgrading project in Tehran & Tabriz refineries of NIOEC, Iran".
- Entered into MOC between Indian Oil Corporation and L&T for collaborating new onshore/offshore projects, facilities and retrofitting/modernization of existing onshore/offshore plants for crude oil/gas (NG, LPG and LNG etc.) exploration, drilling, processing, production, transportation and distribution. Also for collaborating pipeline projects, operation and maintenance, petrochemicals projects, training & consultancy, etc.

Indian Oil Corporation's Inland MOU

- Entered into MOU with GAIL for marketing for transfer of LPG through pipeline from Kandla/Jamnagar to Loni.
- MOU with NTPC for petrofuel-based power projects.
- MOU with Indo Rama Synthetics Ltd. for supply of PTA from the proposed PX/PTA plant at Panipat.
- Joint Statement of Intent with Hindustan Lever for supply of LAB from the proposed LAB plant at Gujarat refinery.
- MOU with National Iranian Company in May, 2003 for cooperation in Hydrocarbon Sector.
- MOU with GAIL in May, 2004 for development of City Gas Distribution Project in Agra, Lucknow & Barielly.
- MOU with Government of Andhra Pradesh in January 2001 for development of LNG Project in Andhra Pradesh this is under extension following its expiry in July 2004.
- MOU between IndianOil and HPCL to pursue the projects in the areas of E&P, refining, sharing of infrastructure in grass root or expansion projects in refinery, petrochemicals, LNG, consultancy services, etc.

Source: www.blonnet.com.

KEY ISSUES IN A JOINT VENTURE

Key issues to be considered in the joint venture agreement are given below:

i. **Management Issues**

- The agreement should be clear in terms of arrangements for managing the joint venture company.
- Clear assignment of responsibilities to all the full-time directors.
- Board of Directors should have a higher representation of the majority shareholder; chairman should be nominated by the majority shareholder.

ii. **Financing Issues**

- Provision for funds on a regular basis.
- Meeting day-to-day funds (working capital needs).
- Losses incurred by the joint venture.
- Expansion and development cost.
- Proportion of contribution of the partners vis-à-vis the original investment.
- Issues related to the inability of the minority partner to subscribe to future expansion costs.

iii. **Issues Regarding Transfer of Shares**

- Degree to which the participation of the partners is transferable in terms of shareholding.
- Issues related to pre-emptive rights in case of transfer of shares to a third-party.
- Transfer of shares if the joint venture winds up in case one of the parties intends to sell the whole shares.
- Intra-group transfer issues.
- Price of shares in case of transfer.
- Issues related to naming the joint venture in case of change in shareholding pattern.
- Issues relating to transfer of shares in case one of the parties turns out to be insolvent.
- Transfer of shares if one of the partners becomes liable for breach of the joint venture agreement.

iv. **Issues Related to Termination**

- Recognizing situations in which the joint venture is automatically terminated or cases where one of the partners is entitled to terminate the joint venture.
- Preparation/arrangements for termination.

v. **Contingency Issues**

- Alternation in government regulations and policies.
- Changes in competition scenario and market forces.
- Requirement of more funds.

vi. **Commercial Issues**

- Limitation and scope of activity/geographical location and spread, offices under consideration, operation of office activities, profit centers, etc.
- Rights of exports and imports.

PARTNER SELECTION FOR THE JOINT VENTURE

Some of the important factors that should be kept in mind while selecting a partner are:

- The firm in search for a partner must meet a number of potential companies and discuss the plans with them.
- The firm should prepare a list of criteria for evaluation of these partners – this could include both tangible and intangible factors. In addition, weightage must be given to each parameter.
- Local consultants can be contacted; their inputs or suggestions may help to select the right partner.
- Proper identification of both short-term and medium-term goals of the company vis-à-vis that of the future/potential partner.
- Both the participants in the joint venture should bring near-equal strengths; and both should gain from the deal.

With regards the partner contribution towards the joint venture, some of the important factors that have a say on the operation of the joint venture are given in the following table:

Table 1

Success	Failure
• Understanding • Transparency • Shared objectives • Faith or trust • Foresightedness • Professional thinking	• Contradictory views or perceptions of the domestic office and foreign office (cross-border joint ventures) • More than two partners • Change of top-level management/owners on the either side • Lack of proper communication

ADVANTAGES AND DISADVANTAGES OF JOINT VENTURES

The advantages from entering a joint venture include:

- Achieving economies of scale in some aspects of marketing or the procuring of production inputs;
- Flexibility in obtaining capital for expansion and other purposes;
- Guaranteed market for the output;
- Guaranteed source of supply for raw material;
- Achieving a greater degree of quality and quantity control;

- Maintaining a steady buyer;
- Achieving stronger bargaining power;
- Spreading market risk between the cooperative and the corporation; and
- Sharing in growth and profits of a branded product.

The disadvantages from entering into a joint venture are:

i. Loss of effective management control, and

ii. May lead to exchange of competitive-sensitive information.

MANAGING INTERNATIONAL JOINT VENTURES

Though international joint ventures are more risky, they are also potentially most rewarding. International joint ventures, unmistakably, not only help the participants to boost their earnings but also increase organizational learning and help gain access to new markets. In addition, they become the basis for new partnerships and collaborations in the future.

With the waves of globalization on the rise and with the convergence of new technologies and regulatory and institutional changes during the past thirty years, markets the world over have created new opportunities for international collaboration between companies. The growth of international joint ventures has intensely affected international business. It is now vital to the quest of competitive advantage. But, international joint ventures remain difficult to handle, in part because of the difficulty of matching goals and objectives of firms situated/headquartered in two or more nations.

WHAT IS AN INTERNATIONAL JOINT VENTURE?

A joint venture is known as international if at least one of the partners is headquartered outside the country of operation, or if the venture has active presence in more than one country. Thus, put simply, an international joint venture can be defined as, "inter-company alliance over an international economic space and time for the achievement of mutually agreed business goals."

According to the above definition, a number of integrative relationships between companies such as M&As, subcontracting agreements, licensing and franchising, etc. are not considered as international joint ventures. On the other hand, strategic networks, strategic alliances and other strategic unions that satisfy the conditions of the definition qualify for international joint ventures.

Box 3: An International Joint Venture: IFFCO's Joint Venture with Legend International Holdings Inc of Australia

The price of Phosphoric acid is touching the roof in the past one year and the price of the product has increased at the rate of 250% in the international market. Since India has imported the item at an average price of $566.25 per ton in financial year 2007-08. However, the negotiated price for the year 2008-09 had settled at $ 1985 per ton.

After analyzing the scenario, IFFCO has set up a joint venture with Legend International Holdings Inc of Australia. It would mine rock phosphate at Lady Annie project in Queensland and would supply three million tons of rock phosphate to IFFCO annually. The price at which the subsidiary would sell rock phosphate to IFFCO would be negotiated on a fair and equitable basis for both companies based on international market prices applicable for the Indian market with an appropriate discount. Rock phosphate is the main raw material for phosphoric acid, which in turn is the main raw material for the multinutrient fertilizer Di-Ammunium Phosphate (DAP).

India is currently facing shortage of phosphate fertilizer and prices have also gone up manifold in the last one year due to supply constraints and other factors like increased use of biofuels in different countries. The total project cost is around $800 million. The possible modes of financing and joint venture options for the capital cost are currently under discussion between IFFCO and Legend officials.

Source: www.blonnet.com.

WHY DO COMPANIES FORM INTERNATIONAL/CROSS-BORDER JOINT VENTURES?

MNCs routinely formed joint ventures and strategic alliances to enter the markets of countries with restrictions on foreign investments. However, over the recent years, strategic alliances have been driven by rapidly changing market conditions. During the past two to three decades, the number of international joint ventures, both horizontal and vertical, has increased significantly. Increased global competition, rapid change in technology, high cost R&D, change in government policies in different nations, etc., are some of the factors that have stimulated/compelled companies to form cross-border joint ventures. According to a recent survey conducted on Danish companies, the motives for international joint venture are as follows:

- Market penetration/expansion.
- Retaining market share/position in the existing market.
- Achieving economies of scale.
- Sharing/exchanging existing technology.
- Internationalization or expansion internationally.
- Sharing Research and Development (R&D) costs.
- Develop new technology.
- Alliance to adhere to government policy.
- Alliance with competitor(s) to avoid competition.
- Forming alliance with suppliers/marketing channels.
- Product diversification.
- Diversification of risk associated with investments.
- Payback on investment.

DIMENSIONS CRITICAL TO THE SUCCESS OF INTERNATIONAL JOINT VENTURES

The difficulty in managing international joint ventures lies in their "comparatively low success rate". International joint ventures demand strategists to concentrate on four important decision-making dimensions such as:

a. Choosing the right partner.

b. Governance and control.

c. Performance.

All the four factors are important and play their own role in the success of the venture. Each of the four factors influences the other factors in the development of an international joint venture. The following paragraphs explore some of the key management decisions involved in each of the four dimensions.

Choosing the Right Partner

A company can profit from a cross-border joint venture if the partner it joins its hands with has the relevant skills to help it achieve its strategic goals. Selecting a right partner is important for it makes the deal smoother, improves strategy-environment configuration for both companies and reduces uncertainty or risk. In a broader sense, partner selection is based on two criteria:

i. Task-related criteria.

ii. Partner-related criteria.

Task-related Criteria

These are strategic competencies the company gets access to through the prospective partner. These criteria include knowledge about product, market, regulation, distribution channel, etc. Following are the task-related criteria that a company considers before it joins its hands with a cross-border partner.

- Access to local market knowledge.
- Access to links with key suppliers/borrowers.
- Accesses to marketing/distribution channels.
- Access to product-specific knowledge.
- Access to local regulatory knowledge.
- Access to technology.
- Access to finances/capital.
- Access to production techniques.
- Access to raw material and other important production inputs.

Partner-related Criteria

Partner selection criteria are the organizational features that decide the desirability of the venture. These criteria include collaborative know-how, how intimately the partner's business relates to the company's business, and the size of the partner company. Following are the partner-related criteria a company considers before it forms a joint venture with another company.

Partner-related Criteria:

- Trust between top management teams,
- Relatedness of partner business,
- Partner's goodwill and reputation,
- Partner's financial condition,
- Partner's company size,
- Past favorable experience with partner,
- Distribution capabilities,
- Partner's international exposure and experience,
- Past experience in technology application and adoption,
- Potential for new technology development,
- Partner's technological sophistication, and
- Partner's ability to negotiate with local government.

Partner selection plays a key role behind international joint venture formation. The success of international joint ventures depend on the criteria "how best is the partner the company chooses". A company's motives for constituting international joint venture will determine the type of partner it joins with, according to both task-related and partner related criteria. The criteria listed above also show the importance of the sociological dimension of international joint venture formation. Some of the most important criteria are connected with factors such as access to knowledge, status, reputation and trust.

Governance and Control

Once a partner has been chosen and a contractual agreement negotiated, focus gets shifted to the integration and governance of the joint venture. Since the contractual agreement specifies the type of relationship entered into, the choice of partner and the initial motivation have a profound effect on the governance and control of an international joint venture. As per the transaction cost perspective, intermediate asset specificity and low uncertainty may lead to a preference for hybrid forms of governance over both arm's-length transactions and internalization. Hence, international joint ventures can be regarded as an intermediate organizational form between market and hierarchy.

There too exists a relationship between levels of integration and degrees of control. Usually, the deeper the integration – as, for example, with a merger – the greater the level of control. With joint ventures, the distinction between a non-equity joint venture and an equity joint venture illustrates this relationship. A non-equity joint venture is an agreement between partners to co-operate in some way without creating a new, joint entity. On the other hand, an equity joint venture includes the set up of a newly incorporated entity in which each of the partners has an equity position. Partners in an equity joint venture usually expect representation on the board of directors and a proportional share of dividends as compensation.

The type of joint venture entered into vis-à-vis its level of integration and control, is determined by the overall objective and the partner's characteristics. To cite an example, if a firm wishes to enter a developing market such as India, China, etc., and needs access to local regulatory and cultural knowledge, then an equity joint venture might be most appropriate. It could then retain control and ensure that local knowledge is a feature of the joint venture. On the other hand, if a firm intends to sell a patented product in a developed market, then a licensing agreement might be more beneficial. The selection of governance structure along with the other two dimensions, determines the overall performance of the international joint venture.

Performance

It is quite difficult to estimate the performance of an international joint venture. It has been linked to objective financial parameters such as profitability, growth and cost status, survival, duration, instability of ownership and re-negotiation of the alliances. But, international joint ventures may not be mainly motivated by such factors. As an alternative, companies may form international joint ventures because of the above cited reasons including enhancing learning, improving strategic positions and gaining legitimacy within a larger social context. The degree to which an international joint venture achieves its aims may not always be fully reflected in objective financial measures. In reality, by measuring the performance of an international joint venture on a firmly financial basis, managers run the risk of abandoning it before it realizes its potential.

REASONS FOR FAILURE OF JOINT VENTURES

Like all the long-term contracts, joint ventures are also subject to difficulties. As time passes the circumstances surrounding the contract change and the inflexibility in the contract may not authorize the required adjustments to be made. Sometimes the participants in the contract do not spent enough time in laying out a proper program for implementing the joint venture. Some of the most common reasons for the failure of joint ventures are:

- The expected technology never developed.
- Inadequate preplanning.
- Agreements could not be reached on alternative approaches to solve the basic objectives of the joint venture.
- Managers with experience in one company refuse to share knowledge with their counterparts in the joint venture.
- Management difficulties may be compounded because of inability of parent companies to control or compromise on difficult issues.
- Cultural differences.

- Profitability of foreign operations.
- Taxability characteristics of joint venture products
- Importance of financial and other conflicts.

A FAILED JOINT VENTURE

The project was signed for the construction of a 900,000-square-foot plant on a 145-acre site at U.S. 31 and Indiana Highway 28. It started in July 2007. The plant was designed to produce energy-saving dual-clutch transmissions for Chrysler and would have created up to 1,400 jobs. When the project was announced, it was hailed as the greatest single investment ever to be made in Tipton County.

In the early stages of the project a commitment agreement dated May 3, 2007, spelt out the terms of the parties' relationship. Tipton County agreed to provide certain incentives to Getrag and Chrysler, and Chrysler and Getrag agreed to a number of obligations, including agreeing to notify Tipton County if the two automotive manufacturers were unable to reach complete agreement on the cooperative development of the project. If the two parties failed to reach complete agreement, Chrysler agreed to be responsible for reimbursing Tipton County for all the third-party costs incurred in the project.

Tipton County has filed a claim against Getrag Transmission LLC over the failed transmission plant the German company planned to operate with Chrysler LLC. The county has submitted a $14.1 million claim in the U.S. Bankruptcy Court of Southern Michigan. Barnes and Thornburg LLP Partner Michael McCrory says the filing has been made in Getrag's bankruptcy case and covers the county's costs related to the failed joint venture.

Tipton County, Indiana, has asked Chrysler, LLC, to return $5.5 million dollars in bonds the Tipton County issued to develop a transmission manufacturing plant. Officials have also asked Chrysler to honor its commitment to reimburse Tipton County at least $4.5 million for amounts owed to the third parties as a result of the project.

The requests for payment are a result of the bankruptcy of Getrag Transmission Manufacturing LLC, litigation between Getrag and Chrysler, and the apparent termination of the manufacturing facility project in Tipton County.

The request for payment comes after several months of discussions of the City and County project team, which included the Tipton County Board of Commissioners, Tipton Mayor Dan Delph, former Tipton County Commissioner Tom Dolezal, Tipton Utilities Director, Dave Reep, and the county's legal and financial advisors. Tipton County's request to Chrysler for the $4.5 million reimbursement and the return of $5.5 million in bonds has already been rejected. Officials received a rejection letter from Chrysler February 24.

Legal troubles between Chrysler and Getrag began in October 2008 when Chrysler filed a lawsuit accusing Getrag and a U.S. subsidiary of breach of contract and fraudulent misrepresentation. Getrag Transmission Manufacturing LLC canceled the Tipton project and filed for bankruptcy protection in November, leaving the partially completed building at the gateway to the community.

Before the public legal battles began, a bond purchase agreement was made on September 15, 2008, for Getrag and Chrysler so that each could receive $5.5 million in bonds issued by Tipton County based on his expenditure for the project. Those bonds were issued on September 16.

One day later, Chrysler advised Getrag that it would not provide the assurances that Getrag had requested to enable Getrag to obtain debt financing for the project. Chrysler's refusal to provide the requested assurances caused Getrag to send a "Failure Notice" advising Chrysler that Getrag could not obtain the necessary financing.

Chrysler's court papers allege that Getrag should have obtained financing no later than June 2008 and that Getrag's failure to obtain the financing breached the parties' agreements.

Neither Chrysler nor Getrag advised Tipton County before the bonds were issued that the parties were not in complete agreement on project development, that the necessary financing had not been obtained or that critical aspects of their agreements were not fulfilled or finalized.

"Their own legal papers suggest that Chrysler was aware of the lack of a complete agreement well in advance of Tipton County issuing the bonds. In those papers, Chrysler alleges there was a breach by Getrag of the terms of the parties' agreements, but Chrysler failed to notify Tipton County of those circumstances," said Ken Ziegler, Tipton County Commissioner.

More than $44 million is owed to electrical, pipe fitting and mechanical contractors who worked on the project; 116 have filed liens against both Chrysler LLC and Getrag Transmission Manufacturing LLC. Several contractors are in danger of going out of business because of the unpaid bills.

Tipton County is a predominantly rural area with a population of about 16,000 people and an unemployment rate that had increased to 10 percent at the end of 2008.

In a February 26 response letter to Chrysler, the Tipton County Board of Commissioners said: "We find Chrysler's failure to honor its obligations to the County particularly disturbing given that Chrysler is asking the citizens of Tipton and the entire nation to place continued faith in Chrysler by providing it with additional hard-earned federal income tax dollars."

Table 2: Dairy of Events

Date	Programs
February 2007	Getrag and DaimlerChrysler sign a memorandum of understanding to develop and produce dual-clutch transmissions for DCX operations in North America.
03 May 2007	Commitment Agreement spells out terms among Tipton County, Getrag and Chrysler. Chrysler and Getrag agree to notify Tipton County if the parties are ever unable to reach complete agreement on the cooperative development of the project.
13 June 2007	Permit issued for foundation construction.
18 June 2007	Official announcement that Tipton will be the site of a new $530 transmission plant to open in September 2009.
October 2007	Road improvements nearly complete.
21 December 2007	Construction is suspended over the holidays, but does not resume pending negotiations between Chrysler and Getrag Transmission Manufacturing, LLC regarding pricing and volume of transmissions to be purchased by Chrysler.
25 February 2008	Construction resumes.
15 September 2008	Bond purchase agreement signed.
16 September 2008	$11 million in bonds issued, $5.5 million to Chrysler and $5.5 million to Getrag.
17 September 2008	Chrysler advises Getrag it will not provide assurances Getrag had requested to enable Getrag to obtain debt financing for the project.
07 October 2008	Chrysler files lawsuit accusing Getrag and a U.S. subsidiary of breach of contract and fraudulent misrepresentation.
17 October 2008	Talks between Chrysler and Getrag Transmission Manufacturing, LLC shut down after Chrysler rejects the financing structure Getrag secured to build the joint venture in Tipton.
30 October 2008	Getrag Transmission Manufacturing LLC and its German affiliate file a counter suit against Chrysler to recover costs associated with the Tipton project and reimbursement of all expenses incurred by GTM LLC and its suppliers in connection with the project.
17 November 2008	Getrag Transmission Manufacturing LLC files for bankruptcy protection.
12 February 2009	Tipton County Board of Commissioners officially requests return of bonds and reimbursement from Chrysler.
24 February 2009	Tipton County Board of Commissioners receives letter from Chrysler refusing County's request.

Source: www.insideindianabusiness.com

SUMMARY

- Joint ventures represent a form of relationship between two or more business entities to achieve common strategic objectives and are being used widely by business firms. They are typically formed for special purposes for a limited duration.
- The participants of the joint venture continue to exist as separate firms with a joint venture representing a newly created business enterprise.
- A joint venture may be structured as a partnership, a corporation or any other form of organization.
- As joint ventures represent a new thrust by each participant, it is also called a strategic alliance. The main motive for joint ventures is to reduce the investment outlay required and share risks. A small firm may have a new product idea that involves high risks and requires relatively large amounts of investment capital. Another larger firm may be able to carry the financial risk and may be interested in becoming involved in a business entity that promises growth and profitability. By investing in a large number of such ventures, the larger firm has limited risk in any one while enjoying the possibility of very high financial pay-offs.
- There are several other general motives for joint ventures which can be summarized as achievement of economies of scale, supply of raw materials, sharing of technology, etc.
- Some of the reasons for failure of joint ventures may be inadequate preplanning, refusal to share knowledge or inability of parent companies to share control or compromise on difficult issues.

Chapter 9

Going Private and Leveraged Buyouts

After reading this chapter, you will be conversant with:

- 'Going Private' Transactions
- Leveraged Buyout
- Sources of LBO Financing
- Characteristics of an Ideal Leveraged Buyout Candidate
- Sources of Gains in LBOs
- Management Buyouts
- Management Buy-Ins
- Leveraged Cash Out
- LBO and Corporate Governance
- Leveraged Buyouts in India

The business and legal climate have changed dramatically in the recent years. Public companies as a whole recorded a loss in their market capitalization. The collapse in market valuations has affected the finances of being public. In particular, while a public company should still generally be able to raise capital more easily than a private company, the advantage is diminished if the company cannot easily tap the capital markets at an acceptable price.

The recent developments have affected the costs and risks of staying public. The increased costs and risks include the following:

Cost of reporting: A publicly owned company must file quarterly reports with the SEC and/or various state officials. These reports can be costly especially for very small firms.

Disclosure: Management may not like the idea of reporting operating data, because such data will then be available to competitors.

Self-dealings: The owners/managers of closely-held companies have many opportunities for self-transactions, which they may not want to disclose to the public, although legal.

Inactive market, low price: If a firm is very small, and its shares are not traded frequently, then its stock will not really be very liquid and the market price may not be truly representative of the stock's true value.

Control: Owning less than 50% of the control could lead to a loss of control for the owners/management. Against this background, two financial developments have led to the increase in the number of going private transactions. First, large pools of capital are currently available for going private transactions. Second, relatively low interest rates may permit privatizations to be financed on attractive terms with borrowed funds.

This has led to increasing number of companies 'going private' in recent times.

'GOING PRIVATE' TRANSACTIONS

The transformation of a public company into a privately held firm is called a going private transaction. In other words, it can be termed as the repurchasing of some or all of a company's outstanding stock by a private investor or sometimes by the employees. Over the past few years, transactions involving public companies turning private have grown dramatically world over. One of the significant elements in a going private transaction is justice to minority or outside shareholders thus, avoiding allegations of security fraud against the controlling shareholders. But the most important aspect of going private is from where the money would come from.

Going private requires a great deal of more financial planning than going public. Most going-private deals are structured as Leveraged Buyouts (LBOs) involving a company's management, an equity player and a lender. Let us look at leveraged buyout transactions in more detail.

METHODS FOR 'GOING PRIVATE'

A company can go private in a variety of ways, including a merger, a tender offer and a reverse stock split. A privatization typically commences when a prospective buyer approaches a public company, which may form a special committee to consider the proposal. The special committee retains legal and financial advisors and negotiates with the prospective acquirer.

i. In a going-private merger, the parties execute a merger agreement, and the company sends its stockholders a proxy statement soliciting votes on the merger. If all conditions to the merger are satisfied, the parties file certificates of merger with the relevant states and the public company merges with an entity formed by the buyer. As a result of the merger and by operation of law, the shares of the public company's stock (other than shares owned by the buyer) are converted into the right to assert appraisal rights or receive the merger consideration. The merger consideration is the cash or stock paid to the stockholders. A merger typically leaves the surviving corporation with one stockholder, a subsidiary of the buyer.

ii In a tender offer, the acquirer purchases shares directly from the public company's stockholders. The acquirer sends the stockholders a written offering document, the "offer to purchase", and a letter of transmittal, which stockholders use to tender shares. Tender offers are commonly conditioned on the buyer's holding at least 90% of each class of the company's stock following the offer. Ownership of at least 90% of the stock permits the buyer to complete a short-form merger, without a vote of stockholders or soliciting proxies. In the short-form merger, the shares that were not tendered are typically converted into the right to assert appraisal rights or receive the same consideration that was paid to the tendering stockholders. At the conclusion of the short-form merger, the company typically has one stockholder, a subsidiary of the buyer.

iii. Companies can, but rarely 'go private' through a reverse stock split. In a reverse stock split, each outstanding share is converted into a fraction of a new share, and stockholders receive certificates representing whole shares and cash in lieu of fractional shares. For example, in a 1-for-10,000 split, each stockholder who owned less than 10,000 shares would receive cash only, each stockholder who owned 10,000 shares would receive 1 new share, and each stockholder who owned more than 10,000 shares would receive 1 new share for each 10,000 shares owned and cash for the remainder of his shares. A reverse stock split is generally affected by amending the company's certificate of incorporation; this requires the company to distribute a proxy statement and permit stockholders to vote on the amendment. A 1-for-10,000 split effectively cashes out holders of less than 10,000 shares and reduces the number of stockholders.

LEVERAGED BUYOUT

The ideal mechanism to finance an acquisition or a going private transaction might be to use the cash held by the target in excess of normal working capital requirements. However, having such huge amount of liquid cash is difficult. Use of stock may be an appropriate way to minimize the initial cash outlay, but such an option is hardly ever available in a buyout by privately held firms. Venture capital funding may become very expensive financing since the firm might have to give up as much as 70% of the ownership in the acquired firm. The use of a public issue of long-term debt to finance the transaction may minimize the initial cash outlay, but it is subject to restrictions placed on how the business may be operated by the investors buying the issue. For such reasons, asset-based financing or a leveraged buyout has emerged as an attractive alternative to the use of cash, stock, or public debt issues, if the target had sufficient tangible assets to serve as security.

A leveraged buyout is a financing technique where debt is used to purchase the stock of a corporation and it frequently involves taking a public company private. It is used by a variety of entities, including the management of a corporation, or outside groups, such as other corporations, partnerships, individuals or investment groups. The leveraged buyouts are usually cash transactions in which the cash is borrowed by the acquiring firm. The target company's assets are often used as security for the loans acquired to finance the purchase. This type of lending is often called the asset based lending. Thus, capital intensive firms with asset having high collateral value can easily obtain such loans. Non-capital intensive firms (like the service industries) having high enough cash flows to service the interest payments on the debt can also obtain such loans.

HISTORY OF LBOs

LBO transactions started when entrepreneurs in the 1950s and 1960s, who were considering retirement, were often willing to sell their businesses at or below book value to the younger individuals who were willing to expand the entrepreneur's business. Such buyers only provided equity amounting to 20-25% of the purchase price and borrowed the remainder from commercial finance companies using the assets of the target firm as a security to the borrowing. Most of these leveraged transactions were of privately held, small to medium sized businesses.

Later, in the 1960s a bull market encouraged many businesses to go public rather than to get involved in highly leveraged transactions. Hence, LBO activity fell during late 1960s. But, in the 1970s in the wake of rising bankruptcies and high P/E ratios, the public excitement for new equity shares had subsided. New interest in LBOs emerged by the late 1980s. Conglomerates that were formed during the 1960s and early 1970s began to divest many of their holdings which ranged in annual sales from $5 million to more than $250 million. LBOs were very commonly used to finance these transactions.

The value and the number of LBOs increased significantly starting in the early 1980s and peaking by the end of the decade. Larger companies started to become the target of LBOs in mid 1980s. By 1980s LBOs attracted much attention but, were small compared to the mergers in terms of number and volume.

ELEMENTS OF TYPICAL LBO OPERATION

A leveraged buyout transaction takes place as follows:

- The first stage, in an LBO operation consists of raising the cash required for the buyout and devising the management incentive system. Usually around 10 percent of the cash is put up by the firm's top managers and/or the buyout specialists. Managers also receive incentive compensation in the form of stock option or warrants. Hence, the percentage of equity share on the management will be around 30%. Other outside investors provide the remaining equity.
- Approximately 50 to 60% of the required cash is raised by borrowing against the company's assets through secured bank loans. The bank loan usually is taken from different commercial banks. This portion of the debt is sometimes also taken from insurance companies, pension funds or from limited partnerships specializing in venture capital investments and leveraged buyouts. The remainder of the cash is obtained by issuing senior and junior subordinated debt in a private placement or in a public offering as high yield notes or bonds like the junk bonds.
- The second stage, of the transaction involves making the firm private. The company can be made private either in a stock purchase format where all the shares of the company are bought or in an asset purchase format, where all the assets of the company are purchased. In an asset purchase format the buying group forms a new privately held corporation. Some of the parts of the business are sold off by the new management to reduce the debt.
- In the third stage, the management tries to increase the profits and cash flows by cutting operating costs and changing marketing strategies. It may strengthen and restructure the production facilities, change product quality, product mix, customer service, pricing, improve inventory control and

accounts receivable management. It may even lay off employees and reduce the expenditure on research and development as long as these are necessary to meet the payment on the huge borrowings.

- In the fourth stage, the investor group may again take the company public if it has become stronger and the goals of the group are achieved. This process is called a reverse LBO and is achieved through a public equity offering which is referred to as a Secondary Initial Public Offering (SIPO). The purpose is to provide liquidity to the existing shareholders.

FINANCING FOR LBOs

Two general categories of debt are used in LBOs – secured and unsecured debt and they are often used together.

Secured LBO Financing or Asset Based Lending

Under the asset based lending, the borrower pledges certain assets as collateral. Asset based lenders look at the borrower's assets as their primary protection against the borrower's failure to repay. Such loans are often short-term, i.e., around 1-5 years in maturity and secured by assets that can be easily liquidated such as accounts receivable and inventory. Secured debt also called the asset based lending contains two sub-categories: senior debt and intermediate-term debt. In some small buyouts these two categories are considered one. In larger deals there may be several layers of secured debt, which vary according to the term of the debt and the types of assets used as security.

Senior Debt

Senior debt consists of loans secured by liens on particular assets of the company. The collateral which provides the risk protection required by lenders includes physical assets such as land, plant and equipment, accounts receivable and inventories. The level of the accounts receivable that the firm averages during the period of the loan is assessed, based on which the amount of loan to be lent is determined. Lenders usually will give 85% of the value of the accounts receivable and 50% of the value of the target inventories (excluding the work-in-progress).

The process of determining the collateral value of the LBO candidate's assets is sometimes called qualifying the assets. Assets that do not have collateral value such as accounts receivable that are unlikely to be collected are called the unqualified assets.

Intermediate-term Debt

The intermediate-term debt is usually subordinate to senior debt. The loan is often backed by the fixed assets such as land and plant and equipment. The collateral value of these assets is usually based on their liquidation value. A debt backed up by equipment usually has a term of six months to one year and a debt backed by real estate will have a one to two year term. Usually, the loan amount will be equal to 80% of the appraised value of equipment and 50% of the value of real estate. However, these percentages may vary depending on the area of the country and conditions of the market. The collateral value depends not on the book value of the asset but on its auction value. If the auction value i.e., the liquidation value is greater than the book value of assets, the firm's borrowing capacity is greater than what is reflected in the balance sheet.

Costs of Secured Debt

The costs of senior debt vary depending on the market conditions. Senior debt rates are often quoted in relation to other interest rates such as the prime lending rate. The prime rate is the rate which the bank charges for their best customers. It often ranges between 2 and 5 points higher than the prime rate for a quality borrower with quality assets.

Unsecured LBO Financing

Leveraged buyouts are typically financed by a combination of secured and unsecured debt. The unsecured debt also referred to as subordinated and junior subordinated debt has a secondary claim on the assets of the LBO target. Unsecured financing often consists of several layers of debt each secondary (subordinate) in liquidation to the next most senior issue. Those with the lowest level of security normally get the highest yields to compensate for their higher level of risk.

It is also often called mezzanine financing, because it has both equity and debt characteristics. It has more characteristics of a debt but, it is also like equity, because lenders receive warrants that may be converted into equity in the target. The warrant allows the holder to buy stock in the firm at a pre-determined price within a defined time period. When the warrant is exercised the share of ownership of the previous equity holders is diluted. Hence, this form of LBO financing is often used when there is no collateral. The main advantage of the mezzanine layer financing is the profit potential that is provided by either the direct equity interest or warrants or warrants convertible into equity. The added return potential offsets the lack of security that the secured debt has.

Unsecured LBOs are sometimes called cash flow LBOs because stable cash flows can also act as an important source of protection. The more regular the cash flows, the more assurance the lender has that the loan payments will be made. These deals have a more long-term focus with a maturity of around 10-15 years. On the contrary, secured LBOs might have a financing maturity of only around 1-5 years. The cash flow LBOs allows firms that are not in capital intensive industries like the service industries to be LBO candidates. Usually, lenders of an unsecured financing require a higher interest rate as well as an equity interest. The equity interest may be as low as 10% or as high as 80% of the company’s shares. If the risk is higher this percentage will be even more.

Unsecured lenders are entitled to receive the proceeds of the sale of the secured assets after the full payment has been made to the secured lenders.

In India in the absence of norms governing M&A financing, banks have gone for asset financing. For example, Deutsche bank partly financed the acquisition of 25% government holding in Videsh Sanchar Nigam Ltd. (VSNL) by the Tatas. The foreign bank undertook the buyout deal by placing debt installments with mutual funds and FIIs. The Tatas received the required funds by leveraging their own balance sheet.

PRIVATE EQUITY

Private Equity means an equity investment in an asset in which the equity is not freely tradable on public stock markets. Now-a-days, most of LBOs are financed by private equity. It also helps deals like venture capital, growth capital etc. Private equity firms maintain private funds. In India, ICICI bank is one of the equity investors. At present 800 funds are maintained by private equity firms. Private equity funds are organized as limited partnerships which are controlled by the private equity firms that act as General partners. Private Equity fund is contributed by long-term funds, like pension fund. The life of a fund often extends up to ten years, the fund will typically make between 15 and 25 separate investments with usually no single investment exceeding 10% of the total commitments. General partners are generally compensated with a management fee and interest. In India, the funds seek to invest in the commercial, residential, retail and other world-class real estate assets, both in developed and development projects, in the potentially growing cities of India. The Fund will seek to deliver a compounded internal rate of return in excess of 20-25% per annum over a seven years tenor.

Box 1: Road ahead for Private Equity

The Private Equity deals can be reduced in future in comparison with the past and the operators will be more cautious in selecting investment candidates.

However, in the past two years the deals made a record in number and size but in 2008 the deals had diminished when compared to that of the previous year. Presently, the PE players are facing great challenges to park their funds and find the good rating investment as globally credit market and are not performing well. How the situation arose has been described as follows:

i. Due to the nasty meltdown of valuations of the stocks the number and value of PE deals recorded actually fell in 2008 as the total number of private equity deals took place in 2008 was 312, with the total value of $10.59 billion. However, a total of 405 deals took place in 2007 which had been valued at $ 19.03 billion. The average deal value took a strike down to $33.93 million in the year 2008 with the comparison to $46.99 million in the year 2007. As valuations fall sharply across the board, the shrinking deal size doesn't come as a big surprise.

   But what does justify the lower deal volumes? Shouldn't lower asking prices and the credit crunch have paved the way for more PE deals? However, actually the sharp fall in equities has turned many private equity investors into the worst conditions as a big chunk of the money they had raised in the last couple of years went in as Private Investments in Public Equity. That is more than 70 per cent of the private equity money invested into Private Investments in Public Equity (PIPE) deals may explain the current tardiness in deal volumes. As per the analysis, a good majority of deals are under water and further some of them have been vanished as much as 90 per cent of their original investment.

   In the present scenario of economy, there are few more reasons which have pulled the deal volumes southwards. (a) The earnings outlook for quite a few businesses turns murky, PE players feel that investment opportunities in the market have shrunk. (b) Companies that may have lined up PE money to fund their expansion plans are wary of the deteriorating environment and they are postponing their expansion plan. (c) The PE investors such as IDFC feel that the collapse in valuations in the listed space is yet to be reflected in promoter expectations on unlisted ventures.

ii. It is worth noting that the primary reason for the problems faced by PE funds is not wrong investment decisions; it is wrong timing. Since returns on the PE investments made through PIPE deals were at the mercy of stock market cycles, the sudden reversal in the cycle took many of them by surprise. The PE industry had its own share of froth during the boom when, from just under 40 funds in 2004, the number of private equity funds rose to well above 200 in 2007. This shows that they are not bothered about the industry or company but they are in a hurry to participate and make an investment through PE.

iii. While the equity downfall may have left funds with smaller time horizons in the lurch, there aren't too many such funds. Most funds invest with over a five-year-plus time frame. Funds may also see significantly lower growth and returns than they projected at the time of investment, which in turn may stretch the holding period of their investments.

However, on that score the funds with seven year or ten year time frames may achieve better results as they have more room to maneuver and tide over the current situation.

Which have better placed…….

The challenges, therefore, may be pronounced only for those funds that were launched at the peak of the market euphoria and executed deals at sky-high valuations. The ones that showed restraint then and have plenty of cash in hand at the moment may be spoilt for choice. This may also explain why the funds that are entering the market now or the ones that did fewer PIPE deals previously may dominate the PE arena in the next couple of years.

New funds such as Morgan Stanley Private Equity Asia, which recently inked its first deal in India, or existing funds such as IDFC PE, which raised close to Rs.3,000 crore towards the fag end of 2008, or Kotak PE, which has sufficient funds left from money raised in 2007, may stand the best chance to grab quality companies at attractive valuations. And what may help them is the flagging of the primary market, once the most sought-after means of raising capital.

Ideal Industries……

Since PE money, in general, figures at the extreme right of the risk-return bar, their high-risk and high return aspiration will find a better match only in smaller and mid-sized companies.

> In terms of sector choices, the year promises to be diverse. Quite unlike in 2007 and 2008, when the real estate and IT & ITES enjoyed most of the attention, the coming year may see a broad-basing of sectors on the PE radar. Investments in sectors such as healthcare, education, consumer goods and infrastructure are expected to dominate, given their relatively strong domestic demand, even as export-oriented businesses face headwinds from recessionary trends in the US and Europe.
>
> Funds may also be seen betting increasingly on agro-based companies, given the sector's strong demand undercurrents and counter cyclical nature. Recent deals by Blackstone in Nuziveedu Seeds ($50 million) and Morgan Stanley, through their Asia fund, for a minority stake in Biotor Industries ($37.8 million) are instances.

Source: www.blonnet.com

STRUCTURING LEVERAGED BUYOUTS

The structure of the leveraged buyout is aimed at optimizing the relationship between a company's capital structure and the equity values realizable by both its current shareholders and prospective future shareholders. The current shareholders receive an acquisition value that reflects the financial capabilities of the company and its ability to assume a significant debt burden. New investors bear the risk of the ownership of the leveraged company with the expectation of receiving an outstanding return on their investment as compensation for the financial risk being assumed.

Leveraged buyouts can be divided into three categories depending on the probable mechanism for debt repayment and the realization of value to equity. They are:

Bust up LBOs

LBOs of this kind depend on the sale of assets of the acquired company to generate returns for the equity investors. This type of LBO is usually seen in acquisitions of diversified public companies where the equity markets may not fully value the various sub-entities of the company. In such cases, the acquirer seeks a relatively short-term return based upon a rapid sale of the individual parts of the firm to exploit the markets' failure to recognize the full value of a diversified business.

The finances of the bust-up transaction depend upon the values of the assets of the various individual units. The greater the value of these assets, the less equity is required to accomplish the transaction as the acquirer can subsequently sell off the various sub-entities to generate cash required to retire the debt. These forms of leveraged buyout transaction are very rare.

Cash Flow LBOs

Cash Flow LBOs is a second category of leveraged buyout which is most common in management led transactions that requires repayment of acquisition financing through the operating cash flows. Equity investors receive the returns through the replacement of debt capital with equity and also through any increase in the total market value of the company. This type of LBO is similar to the purchase of a real estate property with mortgage financing and equity. Returns are obtained when the value of the property increases with an increase in rent (operating income) and when the debt is replaced by equity as debt is retired from the income from property.

Selective Bust-up/Cash Flow LBOs (Hybrid)

The third type of leveraged transaction is a hybrid of a bust-up and cash flow techniques. It involves the purchase of a fairly diversified company and the subsequent divestiture of selected units to retire a portion of the acquisition debt. The acquirer gets the control of a smaller group of assets which are best suited for longer term leverage and have captured a premium on the assets which have been sold. The remaining assets form the operations of a cash flow leveraged buyout.

SOURCES OF LBO FINANCING

The primary sources of LBO financing are the different categories of institutional investors such as Life Insurance Companies, Pension Funds, etc. Institutional investors either fund LBOs by direct investment or fund LBOs indirectly through an LBO fund. Pools of funds are created by contributions made by various institutional investors, to invest in various LBOs. By investing in LBOs, institutional investors anticipate realization of higher returns than those available from other sources or forms of lending. Also, by pooling the funds, they could achieve broader diversification and hence can reduce the risk. Diversification is designed to limit the exposure of default to any one borrower.

Box 2: Tata Tea – Tetley Deal – Not Everyone's Cup of Tea

After a pitched battle against the MNCs in the domestic arena, not many Indian companies would have thought of going global. Devour competitor and destroy competition – the mantra that the global conglomerates had been chanting so far, had not gone down well with their Indian counterparts. But fortunately, that does not remain their (MNCs) prerogative anymore. The war-averse domestic companies are now fast shedding their inhibitions. The roles, no doubt, have changed. And, after fighting it out successfully in global commodities arena, it is time now for the global teacup.

India's corporate grant Tata Tea now has taken a plunge into global tea war. Though it was not an easy decision to make, that too when the competitor was of no less than a stature of Unilever, a global food and beverage behemoth, but then Tata Tea had little choice – shape up or be swamped. It chose the former. And, what else could have been a better vehicle than Tetley for Tata Tea to piggy back on to take on the might of global tea giants like Lever and Hillsdown. But that has not come to it easily. After a long drawn out battle first with Schroder Ventures, followed by a bitter retreat in 1995, and then with Sara Lee, Tata Tea finally tasted victory on March 10, 2000, when it finally bought out Tetley for a staggering Rs.2,135 crore (305 mn pounds sterling). Such a deal has never been heard or seen before in the Indian corporate world. What makes the deal so special is the fact that it is the first ever LBO (Leveraged Buyout) by any Indian company. In fact, this also happens to be the largest ever cross-border acquisition by any Indian company.

Leverage Buyout Structure

With a reserve of just around Rs.400 crore in its kitty, it could not have been possible for Tata Tea to go for such a gigantic acquisition on its own. Or, even bringing such a colossal debt upon its own books could have meant putting enormous pressure on the bottomlines. So, it went for Leveraged Buyout or LBO (see box on LBO).

The deal has been structured in such a way that although Tata Tea retains full control over the venture, the debt portion of the deal does not affect its balance sheet. The deal has been tied up through a leveraged buyout based on Tetley's assets so that Tata Tea's gearing is not impaired as a result of it.

Tata Tea has created a Special Purpose Vehicle (SPV) – christened as Tata Tea (Great Britain) – to acquire all the properties of Tetley. The idea of the SPV, essentially, is to ensure that Tata Tea's balance sheet does not suffer additional funding costs, while at the same time, allowing it to benefit from the acquisition of the international brand. The SPV has been capitalized at 70 mn pounds out of which Tata Tea has contributed 60 mn pounds; this includes 45 mn pounds raised recently through its GDR issue. The US subsidiary of the company, Tata Tea Inc., has contributed the balance 10 mn pounds. The SPV has leveraged the 70 mn pounds equity 3.36 times to raise a debt of 235 mn pounds to finance the deal.

The entire debt amount of 235 mn pounds comprises 4 tranches whose tenor varies from 7 to 9.5 years, with a coupon of around 11 percent, 424 basis points over the Libor. Of this, the Netherlands-based Rabobank has provided 215 mn pounds while venture capital funds Mezzanine and Schroders each has contributed 10 mn pounds.

The debt has been divided into four tranches, namely, A, B, C and D. While A, B and C are senior term loans, trench D is a revolving loan that takes the form of recurring advances and letters of credit. Of the four tranches, money from tranches A and B is meant for funding the acquisition, while tranches C and D are meant for capital expenditure and working capital requirements respectively.

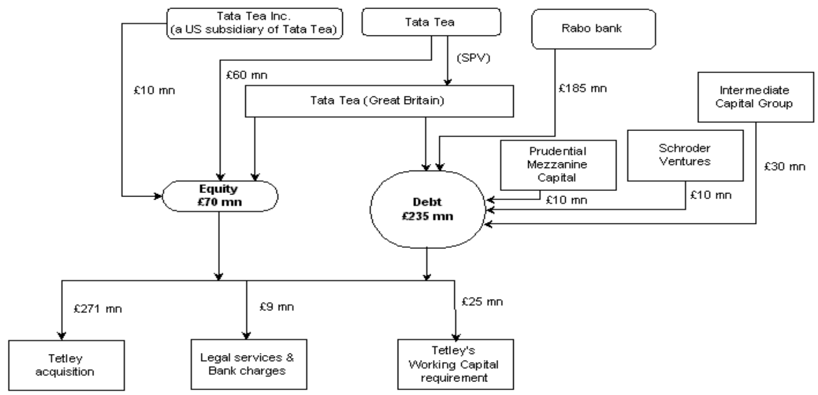
While tranche A is a 110 mn pounds loan scheduled to be retired in 2007 through semi-annual installments, tranche B is a 25 mn pounds loan which will mature in 2007 and will be paid back in two equal installments at the end of 7.5 years and 8 years respectively. Tranche C is a 10 mn pounds loan, to be matured in 2008, and will also be repaid in two equal installments at the end of

7.5 years and 8 years respectively. Tranche D is a 20 mn pounds loan, which has been made available through advances, letters of credit, overdrafts and is due to retire in 2007.

The debt has been raised against Tetley's brands and physical assets. The valuation of the deal has been done on the basis of future cash flows that the brand is expected to generate in the foreign market as well as the synergy and benefits that Tata Tea will receive.

Though the actual cost of the Tetley takeover comes to 271 mn pounds, Tata Tea has spent 9 mn pounds on legal, banking and advisory services and another 25 mn pounds for Tetley's working capital requirements and additional funding plans; thereby swelling the total acquisition cost to 305 mn pounds. Since entire securitization is based on Tetley's operations, Tata Tea's exposure is limited to the equity component only i.e., 70 mn pounds.

Figure 1: Structure of the Tata Tea's LBO Deal
A Fine Blend of Debt and Equity



Source: Amit Singh Sisodiya – 'Tata Tea – Tetley deal – Not Everyone's cup of Tea', Chartered Financial Analyst, June, 2000.

CHARACTERISTICS OF AN IDEAL LEVERAGED BUYOUT CANDIDATE

Lenders often look for certain features in a business to identify whether the business makes a good leveraged buyout candidate. Not all of the following characteristics are necessary for the completion of a leveraged buyout. However, the greater the number of these characteristics in a target company and the stronger any individual characteristic is, the more likely it is for the LBO to be successful.

EXPERIENCED MANAGEMENT TEAM

A strong management team consisting of a highly qualified chief executive officer and chief financial officer are key components to an LBO. In a leveraged situation, the company has little room for trial and error. Because of this, lenders and investors will insist on having a management team that has a long track record in the industry and knows how to meet projections with few surprises. Lenders also like to see a management team that has either been in a leveraged situation or who has had to meet projections on a consistent basis.

STRONG AND SECURE CASH FLOW

Cash flow must be sufficient enough to fund both the company's ongoing operations and to service the debt. Future cash flows based on strong and stable historical performance are most saleable to lenders. Projections that need little explanation and that replicate past performance can withstand the greatest scrutiny and will therefore produce the highest borrowing capacity. To the extent these projections are based on changes in the business, detailed assumptions with specific explanations should accompany the first set of numbers presented to lenders. Prior explanation allows the lender to follow the flow from start to finish with little guess work. This type of presentation maximizes the lender's belief that the cash flows are strong and secure and leaves a strong first impression. In addition to supportable cash flow, cash flow with a significant depreciation component is also desirable, because it can be used to pay down acquisition debt and not to pay taxes.

STRONG ASSET BASE

Because assets are used as collateral for financing, assets should have significant value relative to the purchase price of the company. Machinery and equipment that has multiple uses or that can be easily converted for alternative uses will derive a higher borrowing percentage than equipment that is highly customized. Customized equipment is difficult to sell in a downside situation and therefore has a lower borrowing value. In addition, accounts receivable and inventory that can be collected quickly or has a high liquidation value are attractive to lenders. Finished inventory and raw materials generally have higher advance rates than work-in-progress. Generally, the more commodity-like the asset is, the higher the advance rates will be.

LOW OPERATING RISK

Because the financial risk of the business is very high under an LBO, the business cannot afford to have a bad year. Therefore, those companies that have less operating risk are better LBO candidates. Companies with strong market positions can usually weather downturns in the economy and thus have less operating risk. Companies with a diversified product, customer base, or geographic market have less operating risk because the company's cash flow is less dependent on any single source of revenue. These companies are better able to withstand the obsolescence of a product, loss of a customer, or change in a region's economy. Companies that have long-term contracts with their customers or who have customers that would incur high changeover costs if they switched suppliers also have less operating risk.

LIMITED DEBT ON THE FIRM'S BALANCE SHEET

The lower the amount of debt on the firm's balance sheet relative to the collateral value of the firm's assets, the greater the borrowing capacity of the firm. If the firm's balance sheet is already burdened by significant financial leverage, it may be more difficult to finance the LBO. The already existent debt limits the borrowing capacity of the company.

EQUITY INTERESTS OF OWNERS

The equity investment of managers or outside parties who are buying the company acts as a cushion to protect lenders. The greater the cushion, the more likely it is that secured lenders will not have to liquidate their assets since the management would try its best to save the company in tough times due to their equity investment.

SEPARABLE, NON-CORE BUSINESSES

If the LBO candidate owns non-core businesses that can be sold off quickly to pay back a significant portion of the firm's post-LBO debt, the deal may be easier to finance. Deals that are dependent on the sale of most of the businesses of the firm are referred to as breakup LBOs.

OTHER FACTORS

Lenders look for many other factors depending on the business of the LBO candidate. The existence of unique or intangible factors may provide the impetus for a lender to provide financing when the lenders are indecisive of the performance of the LBO candidate. A dynamic, growing and innovative firm may provide lenders with sufficient incentives to ignore some shortcomings.

TIMING

Timing is often the most important element to take advantage of an LBO opportunity. Below are some examples of situations where timing makes a business a good buyout candidate.

COMPANIES THAT LACK STRATEGIC FIT WITH PARENT

Often larger corporations that have multiple subsidiaries have businesses that no longer fit with their strategic objectives. A common example is when a company decides to focus on the marketing end of a business and decides not to manufacture a product but rather to outsource it. This is a great opportunity for an LBO, because the buyer can usually negotiate a long-term supply agreement with the seller. This allows the buyer to purchase the business based only on the cash flows from the supply agreement, thus minimizing the purchase price. In addition, it creates the base of business necessary for the new company to grow and be competitive in the marketplace.

There are many more reasons a parent corporation might decide to exit a business, all of which might be valid for that owner. However, just because the owner wants to exit the business based on its standards, it does not mean it is a bad business to be in. Instead, it means that there may be an excellent opportunity for someone to attempt a leveraged buyout.

RETIRING OWNER SITUATIONS

One of the most common reasons for the sale of a business is that the owner wants to retire and there are no family members who want to takeover the business. Confronted with the decision to sell to a competitor, the owner often turns to the management team to see if they have an interest in purchasing the business. Selling to the management team can provide a smooth transition for the owner and minimize the interruptions to the business.

COMPANIES THAT MUST BE SOLD BECAUSE OF REGULATORS

With the continued consolidation going on in many industries, the Trade Commission is faced with the task of maintaining a competitive environment for the consumers. In many cases, the trade commission has ordered companies to divest assets in particular markets where the divesting company has too much market share. Generally, the trade commission will require the sale to be made to a qualified buyer who will continue to run a competitive business and therefore promote competition in the marketplace. This type of situation is a very good time to attempt an LBO, because there is a seller who must sell the business and who also wants to sell to the least competitive buyer as possible. Selling to another big player in the industry is usually not the seller's first choice.

SUBSIDIARIES THAT LACK THE ATTENTION OF THE PARENT COMPANY

Often smaller divisions or units of larger corporations lack the attention necessary to maximize their potential. Therefore, these divisions or units appear to be much less valuable than they really are. This is an ideal time for an LBO to be structured. With parent company management at headquarters believing that they are selling a business with little potential, the buyer can negotiate a bargain purchase, raise the necessary capital to move the business in the right direction and generate the cash flows necessary to pay-off the transaction debt. Although the parent company is usually the initiator of the transaction, management should not hesitate to ask the parent company if it is willing to sell. Management teams are the natural buyers in these situations and can usually find an equity sponsor to back their ideas.

Good LBO candidates have experienced management teams, strong and secure cash flows, a healthy asset base and low operating risk. In addition, a business is a good LBO candidate when the owner believes it is no longer fits its strategic objectives; when the owner is considering retiring or estate planning; when regulators are requiring the sale of the business; or when the business lacks the attention of its parent. Combining the characteristics of a good buyout candidate with proper timing will maximize the probability of a successful transaction.

SOURCES OF GAINS IN LBOs

The gains associated with a leveraged buyout transaction are mainly: (i) taxes, (ii) management incentives, (iii) wealth transfer effects, (iv) asymmetric information and under pricing, and (v) efficiency considerations.

TAXES

The new company formed can operate without payment of any tax for as long as five to six years. The high amount of leverage provides the benefits of interest savings. Moreover, the asset setups can provide higher asset values for depreciation expenses.

MANAGEMENT INCENTIVES AND AGENCY COST EFFECTS

Management ownership is enhanced by the leveraged buyout or the management buyout. Hence, there are more and stronger incentives for an improved performance. Some investment proposals may require disproportionate effort of managers. In such cases, the managers are given disproportionate share of the proposal’s income. The going private buyouts facilitate compensation arrangements that induce managers to undertake these proposals.

A going private transaction may eliminate certain costs incurred by managers to defend their position to potential proxy contestants and to the outside shareholders. In many buyouts the promoters retain a large stake and their desire to protect their reputation as efficient promoters give them the incentive to closely monitor post buyout management. This will decrease the information asymmetry between the managers and the shareholders. The ownership resulting from the LBO represents reunification of ownership and control, which reduce agency costs.

Finally, presence of internal cash accruals will encourage managers to use more of these cash flows for self-expenditure rather than pay them to the shareholders as dividends. However, an increase in debt through a leveraged buyout commits the cash flows to debt payments. Hence, the agency costs of the free cash flows will be decreased in the leveraged buyouts. In case of risk averse managers increased debt will put pressure on managers and gives them an incentive to perform to prevent bankruptcy since bankruptcy will cause a decline in their compensation and value of human capital. Hence, an LBO is a debt bonding activity which bonds the managers to meet newly set targets.

WEALTH TRANSFER EFFECTS

Payment of premiums in the leveraged buyout transactions represent wealth transfers to shareholders from other stakeholders like the bond holders, preferred stock holders, employees and the government. Hence, there is an increase in the value of the equity. The existing bondholders are protected by the covenants in the event of change in control, new debt issues, etc., to some extent but not completely. The new debt issue might not be subordinated to the outstanding debt and the maturity of these debts may be of shorter duration. Hence there might not be an absolute security for the outstanding debt.

ASYMMETRIC INFORMATION AND UNDERPRICING

Large premium paid in the LBO transactions indicate that the buyers or the managers have more information on the value of the firm than the public shareholders. The buyout proposal signals to the market that the future operating income will be greater than what was expected and the firm is less risky than what was perceived by the public.

EFFICIENCY CONSIDERATIONS

Under a private ownership the decision process is more efficient. Actions can be taken more promptly. Getting a new investment program started is critical for the success of a firm and it is easily achievable under a private ownership. A public firm has to disclose information that is vital and competitively sensitive to rival firms which a private firm need not.

TYPES OF LBO RISK

The risk of a leveraged buyout transaction may be a business risk and/or an interest rate risk.

Business Risk

It refers to the risk that the firm going private will not generate sufficient earnings to meet the interest payments and other current obligations of the firm. Cyclical downturn in the economy and competitive factors within the same industry such as greater price and non-price competition are some of the factors which affect the risk of the firm. Firms that have cyclical sales or firms that are in very competitive industries are not considered as good LBO candidates.

Interest Rate Risk

Risk that the interest rates will rise, increasing the firm's current obligations of interest payments is the interest rate risk. This is more important for firm that has more variable rate debt. Increase in interest rate could force a firm into bankruptcy even when it experiences greater than anticipated demand and holds non-financial costs within reasonable limits. The level of interest rates at the time of the LBO may be a guide to the probability that rates will rise in the future.

REVERSE LBO

A reverse LBO occurs when a company goes private in an LBO only to be taken public again at a later date. This may be done if the buyers who take the company believe that it is undervalued, perhaps because of poor management. They may buy the firm and introduce various changes, such as replacing senior management and other forms of restructuring. If the new management converts the company into a more profitable private enterprise, it may be able to go through the initial public process again.

LEVERAGED BUYOUTS AS WHITE KNIGHTS

Managers in target firms have used LBOs as part of an anti-takeover strategy, providing stockholders an offer that they may accept instead of the hostile bid. This phenomenon became very common in the fourth merger wave and declined with the overall slowdown in the LBO activity in the 1990s.

MANAGEMENT BUYOUTS

A management buyout is a special type of a leveraged buyout where the management decides that it wants to take its publicly traded company or a division of the company, private. Since, large sums are necessary for such transactions, the management has to usually rely on borrowing to accomplish such objectives. There should be a premium to be given above the current market price to convince the shareholders to sell their shares.

Management buyouts have been a very important aspect of a business. However, the following points should be considered by managers before going ahead with the management buyout:

- Management buyouts are very risky and can result in the managers losing their personal wealth as well as their jobs.
- When the new company becomes independent there are possibilities of problems being encountered. For example, there are chances of losing the customers if they consider the existing firm to be too risky.

On the other hand a management buyout can also be advantageous as follows:

- Though the risks are high the potential rewards are also high. The returns to the shareholders can be very high once the loans have been repaid.
- Management buyouts are less risky than starting a new firm altogether.
- Firms that have been subject to management buyouts tend to operate at a higher level of efficiency. The separation of ownership and control is effectively ended and managers and the shareholding employees have greater incentive to improve the efficiency of the firm.

MANAGEMENT BUY-INS

A management buy-in occurs when a group of outside managers buys a controlling stake in a business. Management buy-in is particularly effective when the existing management is weak and need to be replaced and when more efficient managers are able to quickly gain new responsibilities. However, employee resistance can be experienced when the new management tries to impose new ways of running the business. Another disadvantage is that the new management might concentrate on the short-term profitability at the expense of securing the company's long-term prosperity.

Illustration of a Leveraged Buyout

Jupiter Ltd., is a successful publicly traded manufacturer of consumer durables. It acquired a smaller company Venus Ltd., manufacturing glassware. However, Venus did not fit into its mould and suffered for a number of years. In the year 2001, a small group of disappointed executives of Venus began to consider a leveraged buyout. Jupiter was ready to consider the divestiture as it was never comfortable with Venus's product line. Venus had always had stable production costs and good contribution margins which consistently resulted in a strong and steady cash flow. Though, the production equipment was old it was in a good condition and its replacement cost exceeded its book value. Till the acquisition by Jupiter, Venus was always managed well and had very little debt.

The following financial information for the 2008 is available for Venus:

Revenues	–	Rs.80 lakh
EBIT	–	Rs.12 lakh
Net Income	–	Rs.7.2 lakh

After negotiations the purchase price was settled for Rs.30 lakh. Because of the high replacement cost of its assets, its strong cash flow, and its relatively unencumbered balance sheet Venus was able to take on large amount of debt. Banks supplied nearly Rs.20 lakh of the senior debt at an interest rate of 13%. This was secured by finished goods inventory, plant and equipment and was amortized over a five year period. An insurance company also provided a loan of Rs.6 lakh in the form of subordinated debt. Finally the management of the company took an equity position of Rs.4 lakh.

Estimate the value of the firm after the Leveraged buyout.

Solution

Amortization Table of Bank Loan

(In Rs.)

Year	Interest	Principal	Balance
1	2,60,000	3,08,666	16,91,334
2	2,19,873	3,48,793	13,42,541
3	1,74,530	3,94,136	9,48,405
4	1,23,293	4,45,373	5,03,032
5	65,394	5,03,032	–

* Rs.20 lakh at 13%, annual payment X

$$20{,}00{,}000 = X\ PVIFA_{(13\%,\ 5\ yrs)}$$

$$X = 20{,}00{,}000/3.517 = Rs.5{,}68{,}666$$

Amortization Table of Insurance Company Loan

(In Rs.)

Year	Interest	Principal	Balance
1	78,000	92,600	5,07,400
2	65,962	1,04,638	4,02,762
3	52,359	1,18,241	2,84,521
4	36,988	1,33,613	1,50,908
5	19,618	1,50,908	–

* Rs.6 lakh at 13%, annual payment X

$$6{,}00{,}000 = X\ PVIFA_{(13\%,\ 5yrs)}$$

$$X = 6{,}00{,}000/3.517 = Rs.1{,}70{,}600$$

The following proforma cash flow calculations are made on the basis of a number of conservative assumptions. It is assumed that there is no growth. The tax rate is assumed to be 36%. Depreciation is calculated on a straight line basis over a period of 15 years.

Cash Flows Statement

(In Rs.)

Particulars	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
EBIT	12,00,000	12,00,000	12,00,000	12,00,000	12,00,000	12,00,000
– Interest		3,38,000	2,85,835	2,26,889	1,60,280	85,012
EBT		8,62,000	9,14,165	9,73,111	10,39,720	11,14,988
– Taxes @ 36%		3,10,320	3,29,100	3,50,320	3,74,300	4,01,396
NI		5,51,680	5,85,065	6,22,791	6,65,420	7,13,592
+ Dep		2,00,000	2,00,000	2,00,000	2,00,000	2,00,000
CFBDR		7,51,680	7,85,065	8,22,791	8,65,420	9,13,592
– Principal repaid		4,01,266	4,53,431	5,12,377	5,78,986	6,53,940
Cash Flow Cushion		3,50,414	3,31,634	3,10,414	2,86,434	2, 59,652
Equity	4,00,000	9,51,680	15,36,745	21,59,536	28,24,956	35,38,548
Debt	26,00,000	21,98,734	17,45,303	12,32,926	6,53,940	–
Total Assets	30,00,000	31,50,414	32,82,048	33,92,462	34,78,896	35,38,548
% Debt	87%	70%	53%	36%	19%	0%

CFBDR – Cash Flow Before Debt Repayment.

LEVERAGED CASH OUT

It is also known as leveraged recapitalization. It is a defensive reorganization of the capital structure in which outside shareholders receive a large one time cash dividend and inside shareholders, i.e., the management receives new shares of stock instead. The cash dividend is largely financed with newly borrowed funds, leaving the firm highly leveraged and with greater proportional ownership share in the hands of management.

LEVERAGED JOINT VENTURE

We have learnt that the leveraged buyouts have become increasingly popular forms of acquisitions for management groups who intended to buy private companies, divisions of public companies, or public companies in going private transactions. It is hardly ever used as an M&A device by the publicly held corporation. However, in situations where there are volatile market conditions or where the transaction size is so huge that the acquisition is apparently expensive and unaffordable, the LBO technique can be used by public companies to make acquisitions that are otherwise not possible. The use of leveraged joint venture as an M&A technique makes this possible.

A leveraged joint venture LBO attempts, to overcome a major disadvantage of a public company using an LBO to acquire a target company. The public company, along with a passive financial partner can acquire the target business through an LBO but does not have to show the related debt on its balance sheet. It is still free to operate in the business, turn it around and ultimately purchase and consolidate the entire operation when the debt declines to a manageable level. A typical joint venture LBO is where one partner is a publicly owned corporation owning up to 50 percent of the acquired company’s voting stock and sometimes owns a large block of preferred stock as well. The other passive partner is a leverage financing buyout firm, or a investment bank, owning to the remainder of voting stock. Sometimes the management of the acquired firm may also own some of the common stock.

The acquired firm is usually managed and operated by the corporate partner. A fee for the management services is paid to the corporate partner.

LEVERAGED SELL OUT

A leveraged sell out is a transaction which enables a company to raise cash from the sale of one of its business unit. The main difference between the leveraged sell out and a leveraged buyout transactions is that the former transaction enables the seller to retain an interest in the equity of the divested business.

When a company intends to sell 50 percent or more of its holding in its subsidiary, it can enter into an agreement with a financial partner (a LBO fund or an investment bank) to restructure the subsidiary and obtain the necessary buyout financing. After the sale, both the corporate and the financial partners own 50 percent, interest in the entity.

DIVESTMENT OF PUBLIC SECTOR ENTERPRISES – INDIAN SCENARIO

Divestment of PSUs in India

In 1992, Government of India appointed a committee on disinvestments under chairmanship of Dr.Rangarajan. The committee submitted its report in 1993. The report stated that the percentage of equity to be divested could go up to 49% for industries explicitly reserved for public sector. It recommended that in exceptional cases, such as the enterprises which had a dominant market share or where separate identity had to be maintained for strategic reasons, the target ownership level could be kept at 26%, that is, disinvestment could take place to the extent of 74%. In all other cases, it has recommended 100% divestment of Government stake. However, holding of 51% or more equity by the Government was recommended only for 6 scheduled industries, namely –

i. Coal and Lignite,

ii. Mineral oil,

iii. Arms, ammunition and defence equipment,

iv. Atomic energy,

v. Radio active minerals, and

vi. Railway transport.

In March 1999, the Government approved the guidelines for strategic/non-strategic classification of PSUs for divestment. The strategic PSUs include defence related, Atomic energy related and Railway transport. All other Public Sector Enterprises were to be considered non-strategic. For the non-strategic Public Sector Enterprises, it was decided that the reduction of Government stake to 26% would not be automatic and the manner and pace of doing so would be worked out on a case-to-case basis. A decision with regard to the percentage of disinvestments, i.e., Government stake going down to less than 51% or to 26%, would be taken on the following considerations:

- Whether the industrial sector requires the presence of the public sector as a countervailing force to prevent concentration of power in private hands, and
- Whether the industrial sector requires a proper regulatory mechanism to protect the consumer interests before Public Sector Enterprises are privatized.

The Department of Disinvestment was set up in 2001. From May, 2005 it came under the Ministry of Finance and is looking after all the matters related to Disinvestment of government holding.

NATIONAL INVESTMENT FUND

The Government decided on 27th January 2005 to constitute a fund, called "National Investment Fund", into which the realizations from the sale of minority holdings of the Government in profitable PSEs would be channalized. The fund would be maintained out side the Consolidation Fund of India and would be professionally managed by selected public sector financial entities, which have the requisite experience, to provide sustainable return to the Government without affecting the corpus. The amount available from this fund is aimed at investing in social sector projects which promote Education, Health and employment and capital investment in selected profitable and revivable public sector enterprises, that yield adequate return, in order to enlarge their capital base to finance expansion/diversification.

During 2003-04, the total amount realized from the divestment was Rs.15,547 crore. The main deals were sale of 27.5% equity in Maruti Udyog Ltd, 72% equity sale in Jessop & co, 18.92% in Hindustan Zinc Ltd, 9.2% in ICI Ltd, 26% in IBP Ltd, 28.945% in Indian Petrochemicals Corporation Ltd, and a sale of 9.96% equity in ONGC.

During 2004-05, the Government realized a sum of Rs.2,765 crore, out of which the major receipt of Rs.2,684 crore was from the sale of Rs.43.29 crore equity shares of Rs.10 each of National Thermal Power Corporation Ltd., (NTPC) out of Government holding. A sum of Rs.64.81 crore was realized from the sale of shares to employees of IPCL.

The following table indicates the actual disinvestment from 1991-92 till date, the methodologies adopted for such disinvestment and the extent of disinvestment in different PSUs:

Table 1

Year	No. of transactions in which equity sold	Target receipt (Rs. in Crore)	Actual receipts (Rs. in Crore)	Methodology
1991-92	47	2,500	3,037.74	Minority shares sold in Dec. 1991 and Feb 1992 by auction method in bundles of "very good", "good" and "average" companies.
1992-93	29	2,500	1,912.42	Shares sold separately for each company by auction method.
1993-94	–	3,500	0.00	Equity of 6 companies sold by open auction but proceeds received in 94-95.
1994-95	17	4000	4,843.10	Sale through auction method, in which NRIs and other persons legally permitted to buy, hold or sell equity, were allowed to participate.
1995-96	5	7000	168.48	Equities of 4 companies auctioned.
1996-97	1	5000	379.67	GDR (VSNL) in international market.
1997-98	1	4800	910.00	GDR (MTNL) in international market.
1998-99	5	5,000	5,371.11	GDR (VSNL) / Domestic offerings with the participation of FIIs (CONCOR, GAIL). Cross purchase by 3 Oil sector companies, i.e., GAIL, ONGC & IOC.
1999-00	5	10,000	1,860.14	GDR–GAIL, VSNL-domestic issue, BALCO restructuring, MFIL's strategic sale and others.
2000-01	5	10,000	1,871.26	Strategic sale of BALCO, LJMC; Takeover - KRL (CRL), CPCL (MRL), BRPL.
2001-02 #	8	12,000	5,632.25	Strategic sale of CMC – 51%, HTL –74%, VSNL – 25%, IBP – 33.58%, PPL – 74%, and sale of hotel properties of ITDC & HCI; receipt from surplus cash reserves from STC and MMTC.
2002-03 #	8	12,000	3,347.98	Strategic sale: HZL (26%), IPCL (25%), HCI, ITDC, Maruti: control premium from renunciation of rights issue, Put Option - MFIL (26%), Shares to employees in HZL, CMC and VSNL.
2003-04	2	14,500	15,547.41	Jessop & Co. Ltd. (72% Strategic Sale), HZL (18.92% Call Option), through Public Offer-Maruti (27.5%), ICI Ltd. (9.2%), IBP (26%), IPCL (28.945%), CMC (26.25%), DCI (20%), GAIL (10.%) and ONGC (9.96%).
2004-05	3	4,000	2,764.87	NTPC (5.25% Offer for Sale), IPCL (5% to Employees) and ONGC (0.01%).
Total		96,800	47,646.43	

Source: http://www.divest.nic.in/performance.htm

Table 2: Realization through Strategic Sale during 1999-2000 to 2004-05

Sr. No	Name	Percentage of Government Equity Sold	Realization Rs. in crore	Profit/Loss Making during the Year of Disinvestment
1 a.	Modern Food Industries (India) Ltd., (MFIL)	74	105.45	Loss Making
1b.	(MFIL) Phase II	25.995	44.07	
2.	Bharat Aluminium Co. Ltd.	51	826.92^	Profit Making
3a.	CMC Ltd.	51	152	Profit Making
3b	CMC Ltd. @		6.07	

Sr. No	Name	Percentage of Government Equity Sold	Realization Rs. in crore	Profit/Loss Making during the Year of Disinvestment
4.	HTL.	74	55	Profit Making
5.	Lagan Jute Machinery Corporation	74	2.53	Loss Making
	ITDC-19 HOTELS			
6.	Hotel Agra Ashok	89.97	3.61	Loss Making
7	Hotel Bodhgaya Ashok	89.97	1.81	Loss Making
8.	Hotel Hassan Ashok	89.97	2.27	Loss Making
9.	TBABR Mamallapuram	89.97	6.13	Loss Making
10.	Hotel Madurai Ashok	89.97	4.97	Loss Making
11.	Hotel Ashok Bangalore	89.97	39.41	Loss Making
12.	Qutab Hotel, New Delhi	89.97	34.46	Loss Making
13.	Lodhi Hotel, New Delhi	89.97	71.93	Loss Making
14.	LVPH, Udaipur	89.97	6.77	Loss Making
15.	Hotel Manali Ashok	89.97	3.65	Loss Making
16.	KABR, Kovalam	89.97	40.39	Loss Making
17.	Hotel Aurangabad Ashok	89.97	16.50	Loss Making
18.	Hotel Airport Ashok, Kolkata	89.97	19.39	Loss Making
19.	Hotel Khajuraho Ashok	89.97	2.19	Loss Making
20.	Hotel Varanasi Ashok	89.97	8.38	Loss Making
21.	Hotel Kanishka, New Delhi	89.97	92.37	Loss Making
22.	Hotel Indraprastha , New Delhi	89.97	43.39	Loss Making
23.	Chandigarh Hotel project	89.97	17.27	Loss Making
24.	Hotel Ranjit, New Delhi	89.97	29.28	Loss Making
25.	HCI – Centaur Hotel Juhu Beach, Mumbai	100	153	Loss Making
26.	HCI-Indo Hokke Hotels Ltd, (Centaur Rajgir)	100	6.51	Profit Making
27.	HCI - Centaur Hotel Airport, Mumbai	100	83	Loss Making
28.	IBP Co Ltd.	33.58	1153.68	Profit Making
29.	Videsh Sanchar Nigam Ltd.	25	3689^	Profit Making
30.	Paradeep Phosphates Ltd.	74	151.70	Loss Making
31a.	Hindustan Zinc Ltd.	26	445	Profit Making
31b.	Hindustan Zinc Ltd. @		6.19	
32.	Maruti Udyog Ltd.	4.2	1000	Profit Making
33.	Indian Petrochemicals Corporation Ltd.	26	1490.84	Profit Making
34.	State Trading Corporation of India		40	
35.	MMTC Ltd.		60	
36.	Jessop & Co Ltd.	72	18.18	Loss Making
Grand Total			10,257.19	
@ Disinvestment in favor of employees. ^ include dividend.				

Source http://www.divest.nic.in/performance.htm

LBO AND CORPORATE GOVERNANCE

In India, while attempting to put forward principles of best practice in British Corporate Governance, the Cadbury Committee studied LBOs, venture capital firms and relational investing (Warren Buffet) as different possible models for best practices. Since LBOs are mainly seen as mere financial transactions, their effect on governance is often ignored. But, the fact is finance and governance are closely related. Equity (corporate governance) is a matter of constant negotiation. Debt and equity are not only two different types of financial claims but represent alternative approaches to check corporate performance and direct management governance. Equity and debt are opposite ends of a range of potential governance management. Debt is inflexible but leads to a simple and low cost administration while equity is flexible and adoptive but complex and costly. The ideal form of governance depends on the nature of the assets to be managed, the transaction stream which these assets support and the growth opportunities. A leveraged buyout (LBO) is one form of governance that is suitable for a wide cross section of business. It represents a young and still growing organizational form in a market-determined economy.

LEVERAGED BUYOUTS IN INDIA

Traditionally, public sector banks have stayed away from M&A financing because there are no clear guidelines for this. However, Leveraged buyout financing is likely to emerge in India against the backdrop of the government's divestment program. Till a couple of years ago, banks were reluctant to sponsor any Leveraged Buyout (LBO). But, as the divestments accelerated, most banks have come forward to fund the acquisitions. Now banks have realized that funding an acquisition of a running company is safer than funding a new company. Unlike the foreign practice of funding based on the acquiree balance sheet, in India, banks fund acquisitions relying on the acquirer's balance sheet and the cash flows that the company can receive after the acquisition. The recent exemptions on the utilization of the foreign reserves raised in the form of External Commercial Borrowings (ECBs), American Depository Receipts (ADRs) and Global Depository Receipts (GDRs) have created a new channel of funds for the companies going for acquisition. One instance of a leveraged buyout by an Indian company with international funds is Tata Tea's £ 271mn acquisition of Tetley.

Due to the determined drive to big-ticket divestments from Arun Shourie, most banks are now open to the funding acquisitions, at least funding for the PSUs being disinvested. Although so far the interest is only in PSU disinvestment bankers say that the experience gained here could pave the way for creating a formal system of financing takeovers even in the private sector. The move by the RBI that loans for acquisitions of divested PSUs will not come under the 5% cap on exposure to loans against shares has encouraged banks to provide loans for acquisitions. Among the domestic players, ICICI has been the first to do such deals and has funded Sterlite and Piramal in their acquisitions.

Lenders have to evaluate whether the cash flows that accrue to the acquirer after the purchases are enough to repay the debt raised for the takeover. The cash flows could arise out of forward integration of the acquired company or by way of dividend. All this requires heavy financial structuring. For this reason, the target company's cash flows, debt profile, shareholding pattern, etc., are to be understood properly. Hence, LBOs can be selectively be used in PSUs, which have low leverages in their capital structure.

SUMMARY

- Going private refers to the act of a public corporation transforming itself into a privately held firm. The term is used in various ways. In some cases, it may refer to the controlling shareholders squeezing out the minority shareholders. Going private can take place through Leverage Buyout (LBO), a frequent form of corporate restructuring.
- An LBO is an acquisition that is financed largely by borrowing of all the stocks or assets of a public limited company by a small group of investors. Specialists or investment bankers who arrange the deal generally sponsor the buying group. Debt financing represents 50 percent or more of the purchase price and is secured by the assets of the acquired firm.
- An LBO operation is generally carried out in four stages. The first stage, involves raising the required cash for the buyouts and devising a management incentive system. In the second stage, the organizing sponsor group buys all the outstanding shares of the company and takes it private. The group may even purchase all the assets of the company and form a new privately held corporation. The third stage, involves the new corporation cutting down of operating costs and changing the marketing strategies to increase the profits and cash flows. The fourth stage, is the stage when the investor group has to decide if the company is to be taken public if the company emerges strong and the goals have been achieved. Such a procedure is referred to as a reverse LBO. It is affected through public equity offering, better known as Secondary Initial Public Offering (SIPO). Such a conversion creates liquidity for the existing stockholders.
- A variant of going private is the unit Management Buy-Out (MBO). In a unit MBO, a purchasing group led by an executive from the parent company acquires a division or a subsidiary of a public corporation.
- An LBO or an MBO can be used as an anti-takeover method against an unwanted takeover. And sometimes they stimulate competing bids once announced.

Chapter 10

ESOPs and MLPs

After reading this chapter, you will be conversant with:

- Types of Pension Plans
- ESOPs: The Underlying Philosophy
- History of ESOPs in the US
- Types of ESOPs
- Mechanics of ESOPs
- ESOPs and Corporate Performance
- Role of ESOPs in Mergers and Acquisitions
- ESOP Practices in India – An Overview
- Master Limited Partnerships

The Employee Stock Options Plan (ESOP) has become the new buzzword in the corporate sector. From cash-poor start-ups in the Silicon Valley to old-line manufacturing and service firms, an increasing number of companies are offering stock options not only to their senior executives but to other employees as well, all in the hope of enticing and retaining the intellectual capital within the organization by creating a feel of ownership.

ESOPs are nothing but “contribution employee benefit pension plans”. These plans may receive stock or cash to buy employer’s stock. ESOPs may also provide for the employee contribution besides the employers’. To better appreciate the relevance and potency of ESOPs as a tool of HRD, we first need to recall what we understand by pension plans.

TYPES OF PENSION PLANS

There are three major types of pension plans such as (i) defined benefit plans, (ii) defined contribution plans, and hybrid and cash balance plans.

i. **Defined Benefit Plans:** Government workers in the US quite often avail this facility. Under this plan, an employer agrees to pay employees specific benefits upon their retirement. It may be a fixed sum per month or a specific percentage of previous year’s salary/several years’ salary, according to a predetermined formula.

ii. **Defined Contribution Plans:** In a defined contribution plans, employers make a substantial and recurring contribution rather than a specific benefit. The employees’ benefits depend on the investment performance of the benefit fund that is managed by a group that oversees the investment of the funds. Since the employees’ benefits under these plans depend on the performance of the funds, these plans are riskier for the employees. The factor of risk gets compounded with the absence employer’s guarantee for the performance of funds. Money Purchased Pension Plans, Profit Sharing Plans etc., are some of the examples of defined contribution plans available in the US market.

iii. **Hybrid and Cash Balance Plans:** The hybrid plan is the combination of the features of defined benefit and defined contribution plan. Generally, the defined benefit plans are treated for tax, accounting, and regulatory purposes and simultaneously with defined benefit plans, investment risk is largely borne by the plan sponsor. The defined contribution plan has described the benefits in terms of a notional account balance, and is usually paid as cash balances upon termination of employment. The Hybrid and cash Balance Plans make more portable than traditional defined benefit plans and however, it may be more attractive to a highly mobile workforce. A distinctive hybrid design is the Cash Balance Plan. Under this plan, the employee’s notional account balance grows by some defined rate of interest and annual employer contribution.

    In the US, conversions from traditional to hybrid plan designs have been controversial. Upon conversion, plan sponsors are required to retrospectively calculate employee account balances, and if the employee’s actual vested benefit under the old design is more than the account balance, the employee enters a period of wear away. During this period, the employee would be eligible to receive the already accrued benefit under the old formula, but all future benefits are accrued under the new plan design. Eventually, the accrued benefit under the new design exceeds the grand fathered amount under the old design. To the participant, however, it appears as if there is a period where no new benefits are accrued. Hybrid designs also usually eliminate the more liberal early retirement provisions of traditional pensions.

In the context of Mergers and Acquisitions, employee stock ownership plans have evolved as tools for facilitating the transactions in two main ways: (i) as a financing vehicle for the acquisition of companies, including through LBOs, and (ii) as an anti-takeover defense.

ESOPs: THE UNDERLYING PHILOSOPHY

In markets like the USA, ESOPs are seen as an important HRD (Human Resources Development) tool. In India, the idea is just beginning to catch up. An ESOP is another incentive or compensation tool for a company.

The rationale is that stock options generate a sense of ownership among employees. Stock options tend to develop an entrepreneurial spirit among top executives since they own stock and an appreciation in stock prices, if the company does well will add to their wealth. ESOPs help in aligning individual goals with corporate goals. ESOPs also help companies to retain staff, attract talent, motivate employees by enabling them to share the long-term growth of the company.

The basic purpose of the employee stock option plan is to ensure employee retention. In an industry where switching loyalties is as common as changing one's outfit, this option would give an incentive to employees to hold on at least until their stocks mature. If stock-holding employees decide to leave the organization before the maturity period, they would stand to lose their benefits under the plan.

ESOPs are a very good method of giving part-ownership to employees. Stock options are also a mechanism by which the firm can synergize the personal goals of the employees with those of the organization. This is because an employee with a stock option has a personal interest in seeing the price of the stock increase and, therefore, has an incentive to be more productive to improve the firm's bottom line.

The Employees Stock Option Plan (ESOP) is widely recognized as an effective means of improving corporate performance, by enabling employees to participate in the creation and sharing of the wealth they help create in an organization. The ESOP confers on an employee the right to buy shares at a predetermined price to be exercised at a predetermined time. During this intervening time, i.e., from the date of vesting of the right to buy shares till the actual exercise of option to buy the shares, an employee just by working would add value to the organization.

An employee also stands to gain. Stock options have advantages over other forms of compensation like profit sharing. There is an implied justice in a stock option that is apparent to the employee. This is so because the owner or promoters of the company are also rewarded in exactly the same way.

Also, should the board decide to increase the employees' salary by, say, 40%, it will directly burden the profits of the company. By issuing ESOPs, the company is able to retain its employees as well as build long-term wealth.

INDUSTRY SEGMENTS AND PREDOMINANCE OF ESOPS

Companies in the software or pharmaceutical industries are likely to go in for ESOPs. Basically, options work in industries where intellectual capital is precious and attrition levels are high. In knowledge industries like software and financial services, for instance, the benefits of ESOPs have converted companies like Infosys Technologies, NIIT and Aptech into front rank players in the global markets several years ago. But now, dozens of companies in other sectors – from services to engineering, from automobiles to consumer goods are embracing ESOPs too.

In software industries, ESOP can be a very strong motivation to retain high quality professionals. A few software companies in India have introduced this scheme and have seen the benefits.

Box 1: Amendment of Regulations for Esops to Nominee-Directors by SEBI
Directors nominated by financial institutions are now eligible for employee stock options (Esops), provided the director and nominating institutions sign an agreement on this and a copy of it is given to the company.
The Securities and Exchange Board of India (Sebi) made this amendment after it received several cases after a grey area in the regulation led to institutions forbidding nominee-directors from receiving Esops.
However, the joy of the nominee-directors could be short-lived as sources in Life Insurance Corporation (LIC) and General Insurance Corporation (GIC), which have a substantial shareholding in many large Indian companies, said they would not allow nominee-directors to accept Esops since they were government-owned bodies.
However, no government institution will allow nominee-directors to take Esops.
Before the amendment to the Sebi (Employee Stock Option Scheme and Employee Stock Purchase Scheme) guidelines, 1999, Esops were meant for whole-time directors, employees and officers of an organisation. Exempt categories were promoters or directors with over 10 percent holding in the company.
In the Year 2008, there was a two-month face-off between LIC and GIC and their nominee directors, B P Deshmukh and Kranti Sinha, on the board of Larsen and Toubro (L&T) after the nominee-directors refused to return shares allotted to them by the construction major in spite of directions by both the institutions that its nominees should not accept any Esops. Sinha and Deshmukh held 20,000 and 30,000 L&T shares, the market price of which was Rs.3.5 crore and Rs.5 crore, respectively at the time.
The two financial institutions moved the Bombay High Court to bar their nominee directors from dealing in these shares. Both directors lost their jobs on the L&T board. The matter was later settled out of court after the former directors returned their employee stock option shares to the company. After this, all financial institutions that hold equity stakes in various companies had written to them asking them not to issue Esops to their representatives to avoid a similar situation.

Source: www.business_standard.

HISTORY OF ESOPs IN THE US

ESOPs have their roots in the USA. During the 1920s when the stock market was rising and Americans owned stock the employee stock option plan was very popular in the United States. The stock market crash of 1929 followed by the economic slowdown caused the stockholdings of employees to decline dramatically. With the decline in the value of the firm's stock, employees were not willing to take shares in the company as compensation, due to the added risk that this form of compensation brought.

The past, present and future play a crucial role in the evolution of the ESOP. Its humble beginning is no indication of its current or future state. It is, and always will be, simple in principle but inherently complex in application.

The earliest sign of anything remotely similar to an ESOP was in 1926. The stock bonus plan was authorized in the same Internal Revenue Code that authorized the profit sharing plan. Some of the more famous stock bonus plans include the Sears Plan, which was adopted in the late 1920s, the J C Penney Plan and the Proctor and Gamble Plan. In fact, stock bonus plans were not very popular until the 1950s and the 1960s and were used primarily by public companies that already had a readymade public market for their stock.

The ESOPs gained significance first in 1956. At this time, a revenue ruling was made that authorized stock bonus plans to borrow money to purchase company stock. Previously, the critical difference between a stock bonus plan and an ESOP had been that an ESOP had the power to leverage; that is, to borrow money to purchase company stock. A stock bonus plan, on the other hand, did not have the authority or the power to borrow money; it could only purchase stock on an annual basis. In 1956, for the first time, an Internal Revenue Service Ruling allowed stock bonus plans to borrow funds to purchase company stock. With this ruling the first ESOP was adopted and operated in the form known today.

The first recognizable case was Peninsula Newspapers. In this case, two owners wanted to sell their company to the employees rather than see their company bought by a large newspaper chain. They approached Louis Kelso, a San Francisco attorney, to assist the employees in obtaining loans since the bank had refused their loan request. In reviewing the matter with the company, Kelso discovered that the company had several profit sharing plans with $250,000 worth of trust assets. He realized that this could be the down payment towards the purchase. The employees again approached the bank. This time the bank approved a loan, but instead of letting the employees borrow the money, the bank let the trust borrow the money. The trust then purchased the company stock from the two owners. All the employees who were also participants in the plan were now the owners of the company.

Each year following, the company made tax deductible contributions to the plan which was used to repay the loan. The loan was originally designed as a 20-year loan. However, since the repayment was made with tax deductible dollars, the company paid off the loan in only eight and one-half years.

This was the first IRS qualified ESOP. Again, the qualification of the ESOP rested entirely upon one revenue ruling. There was no statutory authority for ESOPs then and each ESOP designed between 1956 and 1974 had to be “hand-carried” through the IRS.

There were very few ESOPs installed between 1956 and 1968, due to lack of statutory authorization. In 1968, there were less than two dozen ESOPs installed throughout the country. From 1968 to 1971, the interest in ESOPs began to grow, primarily because of new interest generated by the publication of Kelso’s book, Two Factor Economics. By 1971, there was sufficient interest and Kelso established a separate firm to specialize exclusively in ESOPs. His firm was established as an investment banking firm and contributed to the increased public awareness of ESOPs. Between 1971 and 1974, approximately 50 plans per year were installed throughout the United States.

In 1974, the Employee Retirement Income Security Act (ERISA) was being considered by Congress. The Act originated as an attempt to regulate the Central States Teamsters’ Pension Plan that had been subject to abuse. However, in its final form, the Act regulated everything from savings plans to profit sharing and pension plans.

In the same year, significant actions regarding ESOPs came up in the Senate. The Senate, at that time, had two bills: the Senate Labor Committee Bill and the Finance Committee Bill. Both bills were based upon the provisions in the 1969 Charitable Foundation Act and the 1969 Tax Reform Act. That is, there was a series of prohibited transactions and a series of exemptions from prohibited transactions. Accordingly, there was an exemption for loans to purchase company stock. There was also a prohibition against purchasing or borrowing stock from a party-in-interest. However, an exemption existed in the private foundation provisions and in ERISA for borrowing money from a party-in-interest. No one in the Senate realized that this inadvertently protected ESOPs.

After considering both bills, they were assigned to a Conference Committee comprising members of the Senate Finance Committee and the Senate Labor Committee. Since only one or two senators were even aware of ESOPs, the Conference Committee saw no need for the exemption and deleted the exemption that protected ESOPs. The Senate passed the Bill and sent it to the House Ways and Means Committee. As a result, the bill was passed by the House, making ESOPs prohibited transactions.

Consequently, Kelso began immediate work in rewriting the exemption and redefining the ESOP. He, in turn, had filed a memorandum with the House Ways and Means Committee that addressed these considerations. Most members of the House did not realize that ESOPs even existed, let alone realize that legislation would be needed to protect them. Once they understood the problem, most of them readily endorsed the ESOP concept.

In the Senate, the ESOP concept was expressly endorsed and whole heartedly supported by Senator Russell Long, D-La. Senator Long, Chairman of the Senate Finance Committee, was in a unique position to appreciate the many aspects of ESOPs. At the time of this legislation in 1974, Senator Long was grappling with several problems. He was in charge of the Penn Central Railroad Reorganization and he also commissioned a study to determine the capital needs of the nation.

During 1974, there was high inflation, high interest rates and banks were rationing credit. As a result, the Dow Jones Industrial Average was in the 500s, there was no venture capital and there were no mergers or acquisitions. Small businesses could not even borrow money from their banks. The Penn Central was in bankruptcy and was asking the Congress for a $15 billion subsidy. Added to this, the British economy was in a depression, and the entire work force in Britain was on a three-day work week due to the presence of various union strikes. Because of these circumstances, Senator Long immediately endorsed the ESOP for the following reasons:

- ESOPs reduce the tax burden for smaller companies.
- ESOPs reduce inflation by encouraging employees to take less pay in return for more equity.
- ESOPs are an incentive for employees to become more productive.
- ESOPs generate capital.
- ESOPs reduce unionization and the frequency of strikes.

Accordingly, he sponsored the legislation that became law on September 2, 1974 the Employee Retirement Income Security Act (ERISA). He also sponsored ESOP legislation in the Railroad Reorganization Act. This legislation proves that, to the maximum extent possible, should Congress give federal subsidy to private industry, i.e., Penn Central Railroad, this financing should be provided through an ESOP, to the maximum extent possible. By doing so, a broader ownership of capital would be created, the employees would be less likely to engage in striking and featherbedding, and the probability of having the money repaid would be enhanced.

In 1976, 1978 and 1982, there was additional ESOP legislation. These bills made technical corrections that improved and enhanced the abilities and the advantages of ESOPs. The Retirement Equity Act of 1984, signed into law by President Reagan on August 24, 1984, contains the most dramatic tax benefits for ESOPs ever enacted. It is evident by this Act that Congress intended to encourage and promote the ESOP concept by providing special tax incentives for companies that adopt them. The most dramatic provision of the 1984 law is the tax free rollover provision contained in Section 1042 of the IRS Code. Under this provision, a taxpayer may defer paying the capital gains tax on certain securities sold to an ESOP if he reinvests the proceeds in qualified securities within 12 months of the date of sale. Further enhancements included an interest exclusion, a dividend deduction and an estate tax assumption. Together, these strengthened and encouraged the implementation of ESOPs.

However, in the Tax Reform Act of 1986, Congress unexpectedly questioned the practicality of all ESOPs. Their future existence was at stake. After much debate, but little action, ESOPs remained basically unchanged. Since then, the popularity of ESOPs has grown, and it is unlikely that Congress will drastically change or eliminate ESOPs in the future.

The enactment of tax laws in 1974 set a stage for the eventual development of the leveraged ESOPs. The law allowed a qualified retirement plan to borrow for the purpose of purchasing stock. However, till the 1980s the tax benefits and other advantages of ESOPs were not explored and so the ESOP activity was not very significant.

ESOPs became very attractive by the end of 1980s. The improved tax incentives that were enacted in the Tax Reform Act of 1984 and the use of ESOPs as an anti-takeover defense led to this popularity of the ESOPs.

The following table show the growth in the number of ESOP plans from 1975 to 2008. The number of ESOPs has been gradually rising over this period and the use of ESOPs as a financing vehicle for leveraged buyouts has varied.

Table 1: ESOP Plans

Year	Number of Plans
1975	1601
1976	2331
1977	3137
1978	4028
1979	4551
1980	5009
1981	5680
1982	6082
1983	6456
1984	6904
1985	7402
1986	8046
1987	8514
1988	8862
1989	9385
1990	9870
1991	9888
1992	9762
1993	9226
1994	9670
1995	10170
1996	10670
1997	11100
1998	11400
1999	11500
2000	11500
2001	11,200
2002	11,000
2003	10,300
2004	10,000
2005	10,200
2006	10,600
2007	11,000
2008	11,400

Source: National Center for Employee Ownership.

Usually, employees in the USA are known to acquire interest in their employer company's stock in three common ways:

i. **Company Stock Under 401(k):** Often, public companies will allow employees to purchase stock within their 401(k), sometimes at a discounted rate. This stock is usually portable, and can be transferred in-kind to a Rollover IRA or redeemed into a taxable Brokerage Account.

ii. **Stock Purchased through Employer Company:** Public companies sometimes allow employees to purchase company stock directly from the company. One type of plan is an Employee Stock Purchase Plan, which gives an employee the right to purchase company stock, sometimes at a predetermined discount from the fair market price. This stock can usually be transferred in kind to a Brokerage Account.

iii. **Employee Stock Options:** As incentives, many public companies give certain employees the right to purchase stock at a predetermined price, even if the fair market value of the stock has increased from that option's grant price. Often, companies will require the allotted employee the options to hold for a period of time before being exercised. This is called the vesting period. When the allotted employee leaves a company, the company's plan may give him/her a limited amount of time to exercise vested unexercised options (usually 90 days). Shares acquired previously through exercise of options can, of course, be retained by the employee and can be transferred in kind into a Brokerage Account.

An ESOP ("Employee Stock, Option Plan") is a qualified plan designed to invest primarily in the employer's securities and thus gives the participants in the ESOP an ownership interest in their employer. An ESOP may also be leveraged and deal with related parties to acquire the employer's securities. This would be prohibited under other types of qualified plans. As a result, an ESOP may serve as a financing vehicle for the employer. The Tax Reform Act of 1984, of the USA which forms a part of Deficit Reduction Act of 1984 ("DEFRA"), and the Tax Reform Act of 1986, present the most important legislative breakthroughs in the history of ESOPs. These Acts not only provide substantial incentives for institutions making loans to ESOPs and employers maintaining ESOPs, but also includes significant federal income and estate tax planning opportunities.

Employee Stock Options are the right to purchase a given number of shares of company stock at the non-tradable "strike" price. An employee can exercise a vested in-the-money option but cannot sell the option to an investor. An implication of this is that both the employee's valuation of the option and the timing of the exercise decision are affected by the employee's risk tolerance. An employee with a significant amount of wealth tied-up in company stock options has a strong interest in diversifying the risk from movements in the value of the company stock. With traded stock options, the employee could simply sell some options in the market to another investor, an action that transfers but does not diminish the options' underlying value. With employee stock options, the employee would have to exercise the options in order to diversify his risk. This creates an incentive for the early exercise of the options, which reduces their overall value because the employee forgoes the remaining option value. Huddart and Lang (1996), show that workers tend to exercise employee stock options soon after their vesting dates, and that this early exercise sacrifices roughly half of the value implied by the Black-Scholes pricing methodology (which is designed to price a traded stock option). Employee stock options differ from traded stock options in two other key ways. As we observed, employee stock options are subject to vesting requirements and tend to have a significant time period until expiration. A variety of vesting schedules are used in practice, with the majority of plans incorporating vesting over two to five years. In addition, an employee must exercise any vested in-the-money options prior to leaving the firm; any non-vested or out-of-the-money options must be forfeited upon termination of employment. This restriction creates an additional reason for early exercise of these options.

The best way to understand stock options is through an example. Let's say a company grants its CEO 20,000 stock options, which can be exercised at any time after one year and up to ten years following the grant date. The strike price equals the current stock price of $50. If the stock price appreciates by ten percent a year, the stock will sell for $129.69 after ten years. Assuming the CEO exercises his/her options on the expiration date, he/she will be able to purchase $2,593,742 worth of stock ($129.69 x 20,000 shares) at a cost of only $1,000,000 ($50 x 20,000 shares). If he/she turns around and sells the stock, perhaps back to the company, he/she will make a clear gain of $1,593,742.

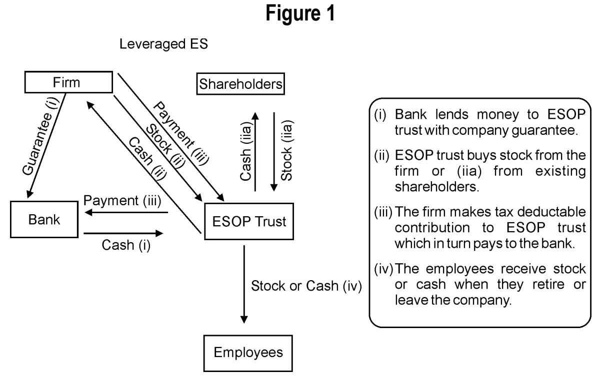
TYPES OF ESOPs

Employee stock ownership plans can be divided into two categories – leveraged stock ownership plans and unleveraged stock ownership plans.

i. **Leveraged:** In a leveraged ESOP, companies borrow to purchase their own shares and then make a contribution to the ESOP that is used to pay the principal and interest on the loan. Leveraged ESOPs are of more interest as a vehicle for Leveraged Buy-outs (LBOs).

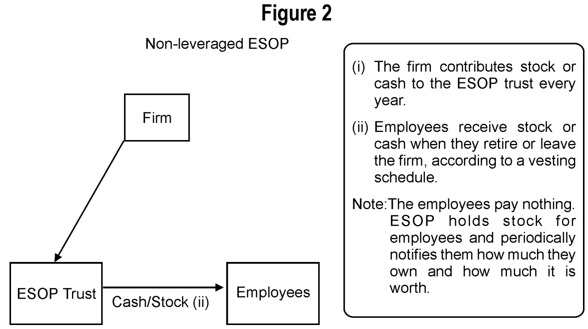
   In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust and this enables to amortize the loan on schedule; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP. If the leveraging is meant to provide new capital for expansion or capital improvements, the company will use the cash to buy new shares of stock in the company. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares. If the leveraging is being used to divest a division the ESOP will buy the shares of a newly created shell company, which will in turn purchase the division and its assets. ESOP financing can also be used to make acquisitions, buy back publicly – traded stock, or for any other corporate purpose.

Figure 1



ii. **Unleveraged ESOPs:** On the other hand, unleveraged ESOPs do not borrow.

Figure 2



iii. **Leverageable ESOPs:** It is an authorized ESOP which does not require borrowing the funds; and the plan for the documents for non-leveraged ESOPs do not provide for borrowing.

iv. **Tax Credit ESOPs:** In addition to the regular investment credit in existence an additional investment credit of 1% is also earned by a contribution of that amount to an ESOP. These plans were called as Tax Reduction Act ESOPs or TRASOPs. Further, 0.5% credit was added in 1976 to companies which contributed same amounts as their employees to the TRASOPs.

Such plans are called as pay roll based ESOPs or PAYSOPs.

Employee Risk and ESOP

By accepting part of their compensation in the form of stock in the employer corporation, workers take on an increased risk. If the company fails, employees will lose not only their regular source of income but perhaps the value of their pension as well. This occurred in January 1990 in the USA when the South Bend Lathe company was forced to file for bankruptcy.

Corporations may offset the risk by contributing convertible preferred shares instead of shares of common stock. Shares are convertible in common stock to be eligible for the plan. Preferred shares have a higher priority than common stock in bankruptcy. If the value of the firm is increasing the employees will be able to participate in this growth by converting to shares of common stock.

It is important to bear in mind that many successful proponents of ESOPs disagree with this assessment of the risks of ESOPs when this is combined with the fact that most ESOPs have higher contribution rates than other defined contribution plans.

ESOPs: MODUS OPERANDI

Most ESOPs act out of a Trust or through a Board of Directors; this is a direct transfer of shares in the employee’s name from the company. In the case of a Trust, the company commits itself to transfer a certain amount of shares. It is like a kitty where a one-time preferential issue of warrants is stored.

In place of actual stock options, companies can also offer phantom stock options, which grant stock appreciation rights. The recipients in such schemes receive a cash payment equivalent to the rise in the values of their respective notional stocks without actual transfer of shares in their names.

Pricing

In India, stock options must be priced according to the same rules that govern the issue of preference shares. That is, the option price must be at the current market price (the average of the weekly high and low during the six months preceding the date of approval of the scheme by shareholders). Issuing the shares at a discount to market price is not permissible.

The price at which one should grant shares under ESOP has invited much debate. At one level, the price should be determined by the employer’s objectives. If it is past performance that one is rewarding, then employees should be able to buy their shares at a sizeable discount to the market price so that their gains are immediate. That, of course, will hit the bottom line of an employer.

On the other hand, the more profit – friendly alternative is best applied when one is using ESOP to spur future performance. Then, the grant price could well be the same as that of scrip’s current market price, with the incentives being available only if the recipients can take the company to greater heights on the bourses.

Payment Mechanics

Since the mechanics of ESOPs involves offering employees the opportunity to buy their company's shares, these shares have to be made available in the first place. The source: either a fresh issue of equity, or buying back one's shares from the stock market with the intention of issuing them to employees. Both have a cost.

The second option will mean using the firm's reserves to bankroll the repurchase. And the first will carry a two-fold cost: lower earnings, thanks to a higher equity-base.

And the cost involved in offering the shares at a discount. As a leading analyst in the Industry points out: "A discounted issue implies an opportunity-loss since the same shares could have been issued at the marketprice or even higher."

Let us now turn to how the cost will show up on employer's books. The SEBI guidelines specify that the difference between the price at which your employees can exercise their options and the market-price-on-the-date on which the option is granted-must be taken as an expenditure on employer's Profit & Loss Account although there is no actual cash-outflow. The only saving grace is – this can be spread out over the entire period during which the scheme is in play instead of taking the blow in one year.

The impact can be considerable. In 1998-99, its ESOP gobbled $16.55 million (Rs.69.51 crore) out of Infosys' net profits of $32.21 million (Rs.135.28 crore) in the US GAAP guidelines – compliant version of its results. This implies that a company must be profitable before it can think of an ESOP. Which will, for instance, prevent a start-up or a new company from attracting top talent with the lure of stock options.

An analyst says "Perhaps SEBI is trying to follow the US GAAP accounting practices, but this will hit new companies". But then, that's precisely the reason that the ESOP cannot be unleashed blindly. Sums another analyst "Companies must bear the cost in some form or the other. This will impose the necessary financial discipline on them."

Identification of the Recipients

If a company wants to make all its employees richer a general disbursal can be opted, with a short lock-in period so that the payback period is tangible. For instance, at the Bangalore-based Aditi Technologies, all 300 employees are stock-option holders, with ESOPs being an intrinsic part of the compensation-package. In fact, the straightforward stock-purchase scheme could be the ideal solution since it creates instantaneous ownership. The focus is on rewarding a track record, but not on promising incentives for future performance.

If, like a growing number of the peers, a company wants to use ESOPs as a tool for rewarding the best, stringent qualification standards need to be set. This may create a rift between the haves and the have-nots. But then, the company only wants to reward and motivate the best people. A simple solution is to make either length of service or seniority – or both, the criteria for granting ESOPs which will automatically narrow the number of recipients.

For many companies, ESOPs are, actually, an obvious carrot for employees to do better in future. At one level, since the market is the ultimate arbitrator of performance, the price it puts on the company's scrip will help determine the value of every employee's stockholding. But is the offer an identical number of shares to each or does it vary according to their past and potential contribution? That is where picking the right parameter of performance comes in. Judging from the precedents set by the US corporations, the primary choice is between absolute and relative indicators: improvement in sales, profits, or share-prices, either in absolute terms or relative to those of rivals. In addition, specific targets could be set for different individuals.

One has to take into account the criticality and the market value of both the position and the individual when picking whom to reward with ESOPs. Smart strategists classify their people in two ways: those who, both as individuals and by virtue of the roles they play, are critical to a company's competitive advantage, and those who are substitutable head-and-body players. The differentiation is needed because it is best to use ESOPs only for the first category.

Box 2: ESOPs – All Your Queries and Answers
Will the employees own the stock?
Not when the company grants the stock option, since there is usually a period before the option can be exercised. After this period, if it is worthwhile to exercise the option, the stock becomes the employee's, to be retained or sold as he sees fit.
Can it be transferred, gifted or bequeathed to another person?
Once the option is vested, you can do as you please. So, it can be transferred, gifted or bequeathed to anybody.
What if the employee quits before the lock-in period expires?
If you quit before the lock-in period, you will be given the options that have been vested in you during the period that you worked with the company. Again, the options can be exercised only at the time specified in them.

Source: www.projectshub.com

ESOPs AND CORPORATE PERFORMANCE

Some proponents of ESOPs challenge that they are beneficial to a corporation because they help finance capital expenditure and facilitate improvements in labor productivity. Employee Stock Ownership Plan may take a greater interest in their performance. With sufficient incentives, workers may be less resistant to productivity enhancement changes such as mechanization or more efficient work procedures.

In 2000, Douglas Kruse and Joseph Blasi of Rutgers University analyzed all the ESOPs set-up between 1988 and 1994 for which data were available. They then matched these companies to comparable non-ESOP companies and looked at the sales and employment data for the paired companies for three years prior to a company setting up an ESOP to the period three years after. They found that when they indexed out for the performance of the competitor companies, the ESOP companies grew 2.3% to 2.4% faster after setting up their plan than would have been expected otherwise. That seemed to give strong evidence that ESOPs do make a significant and positive contribution to corporate performance.

Impressive as these findings are, they do not indicate what it was about employee ownership that causes the improved performance or whether the improved performance is accounted for by just a subset of ESOP companies with particular characteristics.

The answer to whether employee ownership motivates employees seems to answer whether ownership improves corporate performance. Not so. In most companies, labor costs are under 30-40% of total costs. Motivation on its own, presumably, makes employees work harder. When managers are asked about how much more work they think they could hope to get from more motivated employees, based on an eight-hour day. "Fifteen minutes" is the typical response.

While a 1% improvement can be a lot of money, it is not what distinguishes the really successful companies from the mediocre ones. The star performers are those that react to their environment in creative, innovative ways, providing better value to their customers than competitors. How is that achieved? Through processing information and acting on it intelligently. In most companies, information gathering is limited to a group of managers. The generation of ideas is similarly limited. So is decision-making. The assumption is that only these people have the talent, and perhaps motivation, to carry-out these tasks.

In fact, no one has more daily contact with customers than employees at the front end office, at least in most companies. No one is closer to the day-to-day process of making the product or providing the service than the employees. And, employees often do have useful ideas they could share with the management.

Thus, for a company to use employee ownership effectively, it needs to do more than motivate people to work harder at what, after all, may not be the most efficient or effective thing to do. Instead, it must enlist employee ideas and information to find the best ways to do the most important things. To do that, companies need to get employees involved. Managers should seek their opinions. Employee task forces, *ad hoc* and permanent, should be established to solve problems. Quality circles and employee involvement teams can be set-up. Individual jobs can be enhanced with limited supervision suggestion systems can be implemented. This may all seem like common sense, and it is. Though, it is not very common practice in most companies, however, Data indicate that this practice is becoming common in employee ownership companies. In a 1987 General Accounting Office Report, about one-third of all ESOP firms had some degree of employee participation. By 1993, a study of Ohio firms by the Northeast Ohio Employee Ownership Center and Kent State University found that about 60% of the companies now had active employee involvement programs, such as autonomous work teams, total quality management, or similar programs. The incidence of participation roughly doubled after the initiation of an ownership plan. These participative firms, the GAO reported, showed a strong improvement in productivity when they combined their ESOPs with participative management practices.

In a study by the National Center for Employee Ownership published in the September/October 1987, Harvard Business Review, it was found that participative ESOP firms grew 8% to 11% faster with their plans than they would have without them. In both the NCEO and GAO studies, no other factors had any influence on the relationship between ownership and performance. Three other recent studies confirmed both the direction and magnitude of these findings. Only participation can translate the motivation of ownership into the reality of a fatter bottom line. However, participation is not enough on its own, as hundreds of studies have shown. One reason is that few participation programs last more than five years in conventional companies.

The structure of participation varies from company to company, but basically boils down to employees forming groups to share information, generate ideas, and make recommendations. At United Airlines, for instance, employee task teams were formed soon after the employees purchased the company. Over the ensuing two years, the teams took apart every aspect of the business, making recommendations for often substantial changes. The teams were appointed to include a broad cross section of employees, but anyone could volunteer to join them. The ideas helped generate hundreds of millions of dollars in cost savings and new revenues.

Stone Construction Equipment Company in Honeoye, New York is yet another good example. It set-up an ESOP in the late 1970s with little impact. Then, the company hired a new president, Bob Fien, who started a participative management program. Eventually, all employees were trained in “just-in-time” management and were organized into work cells that scheduled and controlled their own workflow and offered considerable input into the design and organization of their jobs.

At Springfield Remanufacturing in Springfield, Missouri, employee owners are taught to read detailed financial and production data. Meeting in work groups, they go over the numbers; then figure out ways to improve them. Employees are sometimes given 90-page financial statements to digest. Springfield's stock went from 10 cents a share when it started its ESOP in 1983 to $21.00 in 1994. Employment increased to over 500.

Other approaches include employee advisory committees to management, eliminating levels of supervision while giving non-management employees more authority, meetings between management and randomly selected groups of employees, suggestion boxes, and anything else companies can imagine to get people involved in.

This "high-involvement" management style has, of course, become conventional wisdom, if still considered an unconventional practice, at many companies.

Is ownership really essential to make it work? There are no conclusive data on this, but there is good reason to believe that ownership, if not essential, is at least highly desirable. First, ownership is a cumulative benefit. Each additional year, an employee has more and more at stake in how well the company performs. It is not unusual in mature plans for the appreciation in share value and employer contributions to add up to 30% to 50% or more of pay in a year. In profit sharing or gainsharing, both of which are paid periodically and almost always amount to a small portion of total compensation, the benefit always remains relatively minor. Second, ownership has a stronger emotive appeal. People may be very proud to say they are owners; a few would brag to friends to be profit-sharers. Finally, only ownership encourages people to think about all aspects of a business, not just short-term profits or some efficiency measure. This is especially important in companies moving towards open-book management systems.

Box 3: Why do some Firms give Stock Options to all Employees?

The use of Employee Stock Option Plan is becoming more and more popular in recent years as an organized plan for employees of a company to buy shares of its stock. In different studies, generally, there are three possible benefits to the firm that are explained as a reason for issuing stock option to employees. The first reason is to provide the incentives to the employees as it overcomes the agency problem and motivates the employees to do best in the firm's interest. Second reason is the option may bring on sorting as different employees have different beliefs regarding the company's future. It attracts the optimistic employees to invest and help the form to reduce the compensation cost. Third reason that is usually cited for this practice is retention of employees. The research paper tries to find the justification for this practice and consider all the three mentioned above potential economic justifications. The research paper concludes the fact that sorting and retention of employees is the main motive behind this move while the data rejects the incentive-based explanation for ESOP.

The data which is used in the analysis has been collected from the three distinct sources. First data source is a survey conducted in year 2008 by the National Center Employee Ownership (NCEO), which provides detailed information regarding salary and option packages offered to middle-level executives. The second data source is pilot Survey conducted by the Bureau of Labor Statistics (BLS) in 1999, which provides fairly detailed information regarding option grants. For third source of data, the researchers randomly chose one thousand publicly traded firms that filed both annual reports and proxy statements with Securities and Exchange Commission (SEC). It helps to gather the information about the number of options granted to employees in 1999. Two indicator variables have been generated to capture the breadth of establishment level stock option grant. First indicator is that they set "Any Option" equal to one for any establishment that granted any stock options to any non-owners' in 1999. Second indicator variable is intended to mimic the NCEO measure of broad based stock option grants.

Models Used and Empirical Implications

The research use several models that may help to explain the point that why firms elect to issue options to a broad group of employees. To develop the incentives based justification for use of equity in compensation, linear contracting agency model is used which yields the standard comparative statistics of agency theory. From this exercise it is concluded that the provision of incentives does not appear to be a very reasonable one as an explanation for option based pay. To consider the possibility that firms used option based compensation to induce workers to sort into the most efficient employment matches the models developed by Lezear is used but this model fails to explain that why firms give stock options to very low level workers also. So a variant of this model is used. After analyzing the data the results suggest that the sorting model is the least contributing factor in explaining why some firms offer stock options to lower level employees. However, this model suggests two additional points that if employees' expectations about firms equity returns change, firms option granting behavior should change as well and second, even if firms do not care directly about employee optimism they may use options to attract optimistic employees if optimism is correlated with other characteristics the employer does value.

Third possible justification of grant of ESOP is that these options may help firms to retain employees as they increase the cost to employees departing the firm but the question arise that why firms do not simply defer cash payments if retention is the aim. Oyer points out that if labor market condition is positively correlated with firms share price, then options serve to index deferred compensation to employees outside options.

Besides these three explanations, the researcher also recounts some other factors like financing constraints, favorable accounting treatment, options as explicit contract and calibrations.

Cash Compensation as an Alternative to Stock Options

Beside cash compensation as an alternative to stock option, the firms can offer other reward-based-on-firms-performance like profit sharing and stock but it seems to be an ineffective device because in the sample used, most of the firms are unprofitable. And it is also found that despite demanding compensation or risk the optimistic employees may be willing to accept a large reduction in cash compensation to warrant using options as compensations.

On the basis of above facts the researcher concludes that neither the accounting treatment of option grants, cash constrains nor any of the models examined in the paper can be the single determinant for explaining the use of broad based stock option plans. But it suggests that sorting or retention may be first order determinant of a typical firms decision to adopt a broad based stock option plan.

Source: Surabhi Agarwal – 'Why Do Some Firms Give Stock Options to All Employees' Portfolio Organizer, February, 2003.

ROLE OF ESOPs IN MERGERS AND ACQUISITIONS

Till now we have seen how ESOPs are used as a HR tool to generate a sense of ownership among employees, as an effective means of improving corporate performance, and as an incentive to improve the productivity of the firm. Now we will look at how ESOPs are increasingly being used in raising capital in leveraged buy-outs and divestitures and also as an anti-takeover defense.

ESOPS AS A FINANCING TOOL

Equity financing can be obtained from within the company if the firm is willing to share some ownership control with the employees of the company. An ESOP plan enables employees to purchase shares of stock in the company by paying cash or by agreeing to deductions from salary or benefits. The employees become part owners of the business and the firm in turn has additional funds for other business purposes. In addition, the company also can contribute to the ESOP by either making an annual cash contribution to the plan for the purchase of company securities or by directly contributing stock to the plan. In both ways, the company's contribution results in the cash price of the stock being returned to the company. The company gets a tax deduction for the ESOP contribution while effectively retaining the cash.

ESOPs can also be used as leverage for borrowing additional funds for the business. An ESOP can borrow funds from lenders in order to purchase additional securities in the employer's business. Alternatively, the employer can borrow from a lender and re-lend the funds to the ESOP. The ESOP would then purchase company stock with the cash. In both the situations, the employer ends up with the cash price of the stock. ESOPs can be used in this manner for large stock purchases when funding is necessary to finance mergers, acquisitions or buy-outs.

However, the use of ESOPs as a financing tool has its own disadvantages. ESOP as a financing tool may not be prudent for many startup and existing small businesses because implementing an ESOP is very expensive and time-consuming.

In addition, participants in the ESOP plan who terminate employment may demand distribution of stock itself, rather than simply the stock's cash value. A closely held business may not want former employees to own stock in the company or to be able to vote as shareholders. Besides, if the trustees of the ESOP are also the business' owners, they may occasionally face a conflict of interest between their duties to act in the best interests of the ESOP and their duties as directors and/or officers of the company. For example, if a takeover offer was tendered, the ESOP might profit from the takeover, but company management might oppose the possible change.

We will now see the use of ESOP financing over other forms of financing like equity and debt in the form of a numerical example.

A firm is trying to expand its business and requires a capital of Rs.2,50,000. The shareholders capital is Rs.1,50,000 and it seeks to raise the additional capital required i.e., Rs.1,00,000. It can do this through three options.

Option I – Conventional Equity Financing

By selling 10,000 shares at Rs.10 per share. Assume that during first year the operating income of the firm is Rs.20,000 and is expected to grow at 20% every year for 4 years. The tax rate applicable to the firm is 36%.

(In Rs.)

	0	1	2	3	4
Operating Income		20,000	24,000	28,800	34,560
Less: Interest		–	–	–	
Income before Tax		20,000	24,000	28,800	34,560
Income Tax @ 36%		7,200	8,640	10,368	12,441.6
Net Income		12,800	15,360	18,432	22,118.4
Cumulative Net Income			28,160	46,592	68,710.4
Shareholders Capital	1,50,000				
	1,00,000				
	2,50,000	2,62,800	2,90,960	3,37,552	4,06,262.4
Cumulative Taxes Paid		7,200	15,840	26,208	38,649.60

Here, the original number of shares was 15,000. The new total is 25,000. Hence, the percent ownership of the original shareholders will be 15,000/25,000 = 60%.

Hence, the ownership in the income is 4,06,262 x 60% = Rs.2,43,756 approximately.

Option II – Long-term Debt

By raising long-term debt of Rs.1,00,000. The debt is to be paid off in four years by paying Rs.17,500; Rs.22,500, Rs.32,500 and Rs.37,500 respectively at the end of each year in the first four years. The interest is assumed to be 10% on the balance at the beginning of the year.

(In Rs.)

	0	1	2	3	4
Operating Income		20,000	24,000	28,800	34,560
Less: Interest		1,000	825	600	325
Income before tax		19,000	23,175	28,200	34,235
Income tax @ 36%		6,840	8,343	10,152	12,324.6
Net Income		12,160	14,832	18,048	21,910
Cumulative net income		12,160	26,992	45,040	66,950
Repayment principal on debt		17,500	22,500	27,500	32,500
Capitalization					
Long-term debt	1,00,000	82,500	60,000	32,500	
Shareholder's equity	1,50,000	1,62,160	1,76,992	1,95,040	2,16,950
Total capital	1,50,000	2,44,660	2,36,992	2,27,540	2,16,950

Here, there is no dilution of equity ownership. However, because of the repayment of the debt and the interest on debt, the total capital is about 1,80,000 less than under the conventional equity financing. But the taxes are reduced and the ownership is higher.

Option III – ESOP Financing

Establish an ESOP trust which will borrow Rs.1,00,000 and use the money to buy 10,000 shares in the sponsorer firm. The resulting financial patterns can be shown as:

(In Rs.)

	0	1	2	3	4
Operating Income		20,000	24,000	28,800	34,560
ESOP contribution interest		1000	825	600	325
ESOP contribution Principal		17,500	22,500	27,500	32,500
Income before taxes		1,500	675	700	1,735
Income tax @ 36%		540	243	252	624.6
Net income (Books)		960	432	448	1,110
Net income (Actual)		18,460	22,932	27,948	33,610
Cumulative net income		18,460	41,392	69,342	1,02,952
Capitalization					
Long-term debt	1,00,000	82,500	60,000	32,500	
Shareholders equity	1,50,000	1,68,460	2,09,852	2,79,194	3,82,146
ESOP obligation	1,00,000	82,500	60,000	32,500	
Net equity = book value	50,000	85,960	1,49,852	2,46,694	3,82,146
Total Capital	1,50,000	168,460	2,09,852	2,79,194	3,82,146
Outstanding Shares	15,000	16,750	19,000	21,750	25,000
Share Additions		1,750	2,250	2,750	3,250
Percent Ownership	100%	89%	79%	69%	60%
ESOP Capital Cumulative Shares		1,750	4,000	6,750	10,000
ESOP % of shareholders equity owned		11%	21%	31%	40%
ESOP equity at book value (Shareholders equity x ESOP %)		18,530	44,069	86,550	15,2858
Cumulative Taxes paid		540	783	1,035	1,660

Here, we started with the operating income as in the previous two options. However, in addition to interest being a deductible expense as it was in the case of borrowing through debt, the ESOP contribution applied to principal is also a tax deductible expense. The taxable income before taxes and the income tax is the lowest among all the three options. The cumulative net income is the highest because of tax savings.

As compared to the conventional debt financing, shareholders' equity is much larger. The number of shares outstanding at the end of the year 0 is 15,000 and in each subsequent year we transfer shares on the basis of the amount that the ESOP has repaid on the principal. By the end of the fourth year an exactly same 60% original ownership remains as in the conventional equity financing. But the advantage of leveraged ESOP financing over the conventional equity financing is that if the funds raised are productive so that the value of the shares increases, a smaller number of shares will have to be transferred. Consequently, the percentage that the original shareholders own at the end of the fourth year period would be greater than 60%.

(**Note:** In all the above three options it is assumed that the shares were sold at a market price equal to the book value of Rs.10 per share.)

From the above discussion, we can say that as compared to the conventional equity financing, leveraged ESOPs financing has the benefit of transferring the shares on the basis of the future market prices which are expectantly higher. As compared with the conventional debt financing, repayment of principal is a tax deduction, and hence taxes can be saved.

Box 4: ESOPs Versus Alternative Methods of Raising Funds

Corporate Financing: Role of ESOPs

- They provide benefits midway between debt and equity financing.
- They can bring additional debt capacity to highly leveraged firms.
- Debt interest expense under leveraged ESOP had been lower than straight debt financing when interest exclusion was permitted.
- They provide market for equity financing for closely held firms.
- They are useful device for transferring ownership.
- Most leveraged ESOP funds used to buy back stock from existing shareholders.

Control of Stock

- Management continues to control ESOP.
- Employees who wish to maintain *status quo* or who do not want an outside company to take over the firm, more likely to support management when ESOPs are used as takeover defense.

Economic Dilution

- ESOPs potentially transfer shareholders' wealth to employees.
- If ESOP contribution not offset by the reduction in other payments to workers, employees gain at the expense of shareholders.
- Any borrowing by ESOP uses some debt capacity of firm.

Equity Position Dilution

- Infrequent use of ESOP loans suggests that non-tax costs of using ESOP are high.
- Large equity stake that goes to contributing employees significantly reduces equity stake to managers and buyout promoter.
- Potential advantage: Shares can be sold at higher prices over the years as ESOP contributes to higher earnings through tax advantages and improved motivations of employees.

Source: www.brenhall.com/finance center

ESOPS AND DIVESTITURES

If a subsidiary of a large corporation cannot be sold at a reasonable price or if liquidating the subsidiary would be disruptive to customers, the parent company may initiate a sale directly through an ESOP. Many corporations are now increasingly considering using Employee Stock Ownership Plans (ESOPs), as a unique cost-effective tool for facilitating divestiture.

The employers of the subsidiary can purchase the controlling interest of the subsidiary through an ESOP since they will have a huge stake in the subsidiary. Divestiture of a subsidiary through an ESOP can be done by establishing a shell corporation. The shell company will establish an ESOP and the debt capacity of the shell company and the ESOP will be used to finance the purchase of a subsidiary from the parent. The shell corporation will be responsible for the operations of the subsidiary and the ESOP holds the stock of the subsidiary. If the subsidiary is successful, income is generated. And this income is allowed for tax deductions. This will enable the subsidiary to service its debt. Here, the subsidiary's capability as an independent entity and its ability to generate sufficient income to cover its financing is very important. If the subsidiary is in a dying industry and requires a large amount of transformation then it is better to liquidate the assets of the subsidiary.

ESOPS AND LEVERAGED BUYOUTS

ESOPs are also commonly used by employees in leveraged buyouts or management buyouts to purchase the shares of the owners of privately held firms. The use of ESOPs to finance leveraged buyouts is seen mostly where the owners have most of their net worth tied-up in their firms. The mechanism is similar to a sale initiated by the owner to the employees.

ESOPS AS AN ANTI-TAKEOVER DEFENSE

Usually, firms which are potential takeover candidates create ESOPs. The ESOP trust borrows with the help of the sponsoring firm's guarantee and uses the loan proceeds to buy stock issued by the sponsoring firm. While the loan is outstanding, the ESOPs trustees retain the voting rights on the stock. Once the loan is paid off, it is generally assumed that the employees will tend to vote against bidders who they perceive as putting their jobs at risk.

Much of the rising popularity of ESOPs is related to the use of the compensation vehicle as an anti-takeover defense rather than because of its tax advantages. For a large percentage of the American corporation in Deleware where an anti-takeover law became effective, this law provided that if a bidder purchases more than 15% of a firm's stock he may not complete the takeover for three years unless:

- The bidder purchases as much as 85% of the targets shares;
- Two-thirds of the shareholders approve the acquisition; and
- The Board of Directors and the shareholders decide to exempt themselves from the provisions of the law.

ESOPs PRACTICES IN INDIA – AN OVERVIEW

The survey report, which is described in the following section, addresses to the finer aspects of ESOP Design practices in India. It would however be useful to take a macro view of the overall trends that seem to be emerging in this relatively new phenomenon in India.

Here, we have made an attempt to identify and analyze the macro trends. An attempt is made to interpret the findings with reference to sectors (IT vs Non-IT) and also within the sectors, in terms of whether companies are looking at structures unique to their requirements or is everyone following each other. We have also tried to analyze the impact of the SEBI guidelines on ESOP and benchmarked the findings versus global trends, particularly in the USA.

COVERAGE OF EMPLOYEES

There is a noticeable difference in terms of coverage, if one compares the IT and Non-IT companies. While around 43% of the IT companies have given ESOPs to more than 90% of the employees, only 17% of the Non-IT companies have done so. A related finding is that more than 75% of the Non-IT companies offer ESOPs only to the senior and middle management employees.

This is a predictable trend. We believe that apart from the willingness of the management to offer ESOPs, it is also the preference of the employees, which influences the decision about coverage. While a worker employee in a manufacturing company would prefer a cash incentive to a stock option, a fresh software developer would go for a stock option. It has to be seen how the employees in the IT sector react to the slump in the stock prices.

It is however interesting that within the IT companies, while only 23% of the large companies offer ESOPs to more than 90% of the employees, the number is as high as 60% in case of smaller companies. A significant 54% of the large IT companies offer ESOPs to less than 25% of their employees. This clearly brings out that smaller companies offer options to the junior employees also to ensure retention and attract them from larger companies. For IT sector, the Government has expanded the scope of the "Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipts Mechanism)" to cover employees of subsidiary companies of parent company, under the facility for issue of ADR/GDR linked stock options. Accordingly, Indian companies engaged in the IT Software and IT Services, would be entitled to issue ADR/GDR linked Stock Options to the permanent employees (including Indian and overseas working directors) of its subsidiary companies incorporated in India or out of India and engaged in Information Technology Software and Information Technology Services subject to the eligibility criteria and other parameters announced earlier. The Government has been considering expansion in the coverage of employees who would be entitled to the ESOPs in line with the SEBI guidelines on ESOPs which covers employees of a subsidiary company for the purposes of ESOPs.

Legal Structure

It is interesting to find that there is no uniform legal structure followed by the companies. While around 58% of the companies have preferred a direct route (Without an ESOP Trust) a significant number (42%) of companies have preferred a Trust route.

Also interestingly there is no major shift in the post 1999 (after SEBI guidelines) period. It was expected that the accounting treatment suggested by SEBI would force companies to opt for a direct route.

Term of Options

There appears to be no difference in the practices followed by IT and Non-IT companies with respect to the term of the options. More than 78% of the IT companies have a term of less than 4 years and the percentage is identical for the Non-IT companies.

It was expected that the tenure in the Non-IT companies would be longer since their attrition rates are much less than the IT sector.

If the Non-IT companies look at longer terms, they could optimize by diluting less equity without affecting the attractiveness of ESOPs.

Interestingly no remarkable difference is noticed between large and small IT companies. It was expected that small IT companies would have shorter term of options than the larger companies, to attract and retain talent. However, it does not appear to be so.

Frequency of Grants

Here, again there is similarity in the practices followed by the IT and Non-IT companies. Around 57% of the IT companies grant on a yearly basis whereas around 50% of the Non-IT companies do so.

It is expected that as a response to volatility in stock prices, more and more companies would now go for frequent grants. This would facilitate pricing the options at close to the market price.

Entitlement

Large number of companies (77%) noticeably give more weightage to individual performance when it comes to deciding the number of options granted. Less importance is given relatively to salary grade, position/title.

Here again the trends are similar in the IT and Non-IT companies.

Conditional Vesting

A significant portion (25%) of the companies provide for vesting linked to individual performance. A comparable figure in the US is around 5%. An apparent trend in the US is more towards only time based vesting because performance based vesting requires compliance with variable plan accounting.

As more and more Indian companies start following US GAAP, they are also likely to follow time-based vesting. Other US features such as performance accelerated vesting (which avoids variable plan accounting) are also likely to feature in the Indian plans.

Another interesting trend is that while in around 90% of the IT companies the vesting is time based, the figure is only 67% in the Non-IT sector. Significantly large number (33%) of Non-IT companies links the vesting to individual performance.

Vesting Schedule

Almost all the companies (98%) prefer uniform vesting schedule for all the options. It seems that companies are not looking at differentiating between say options given to senior management and junior team. We believe that options could be made more effective if the vesting schedule (both the term as well as graded schedule) is fine-tuned based on the target employee segment.

Exercise Price

This is an important factor in the design of an option. Only around 42% of the companies offer options at the fair market value. The global figure is almost 100%.

The trend is no different between the IT and Non-IT companies, except that a fair portion (17%) of the Non-IT companies offer options at a fixed price.

As ESOP practices mature in India, there shall be more and more companies offering options at the market price. Further, usage of differential exercise prices to optimize on the extent of dilution, presumably to avoid the accounting impact in all likelihood, would continue as a norm in the future too.

Provision for Facilitating Exercise

Significantly large number of companies (60%) leave it to the employees to make arrangements for financing the exercise of options. As many as 20% provide for broker-assisted cash less exercise. An equal portion (20%) provides loans to fund the exercise.

The global picture is that almost every company offers broker assisted cashless exercise of options, as a facility to employees.

It is expected that with the new (draft) insider trading guidelines more and more companies would provide for broker assisted exercise (through a designated broker). With more and more banks offering loans against shares, financing of options is also likely to surge.

Change in Control, Rights, Bonus

An alarmingly large number of companies have not addressed situations such as impact of change in control (more than 55%), Rights issue (50%) and Bonus issue (27%). It appears that these companies would leave it to the compensation committees to decide on the impact as and when such situations arise. But such changes (through takeovers, mergers and de mergers) would no longer remain as stray incidences. They shall happen every now and then. So also the occasions when companies issue Right and Bonus shares. These events have significant impact on the underlying value of the options and as such should be addressed upfront in the scheme document. It is noticeable that even larger companies (IT as well as Non-IT) have been equally ignorant about this (especially change in control) in their schemes.

Globally, companies provide for accelerated vesting in case of change in control and suitably change the number of options and the exercise price in case of Bonus issues.

Even though more than 73% companies have addressed the issue of treatment to be given on issue of bonus shares, there is no uniformity in the nature of treatment. More than 37% of the companies offer bonus options for vested as well as unvested options.

In order to be fair to the shareholders, option holders should be entitled to bonus options only on the unvested options. For the vested options, employees should exercise them to be eligible for bonus. A significant portion (22%) of the companies do not give bonus options on the unvested options. Considering that the issue of bonus shares directly influences the price of the shares and hence the value of the options, it is only fair that the option holders are offered bonus on the unvested options.

A significant proportion of companies (32%) which grant bonus options, have kept the exercise price of the bonus options as nil. This could lead to a situation where an option holder would be able to exercise the bonus options (without exercising the original options) without paying any exercise price.

It should also be noted that SEBI Guidelines require that situations such as change in control, right issues and bonus issues are addressed by the compensation committee in a fair and reasonable manner.

Response to the Slump in Stock Prices

It is no secret that after the stock market crash most of the options are under-water and no longer attractive. Interestingly, the companies have not found it necessary yet to respond to this situation. More than 92% of the companies have left their schemes untouched.

We believe that this is the first time IT companies are experiencing the phenomenon of crashing prices and under-water options. It will take some time for them to react. We are likely to witness much more on re-pricing, new schemes to swap the earlier grants, etc.

Concluding Remarks

ESOPs are yet to evolve in India. We are yet to see companies differentiating on the basis of the sector they belong to, the category of target employee, etc. While in the USA, responses are faster (more than 30% of the hi-tech companies have repriced their options), the Indian companies are taking time to react.

Box 5: ESOP Survey Highlights

- More than 60% of the companies have implemented ESOPs in 2000 (post-SEBI guidelines).
- Around 55% of the companies used the services of a consultant to design the plan.
- 35% of the companies offered options to more than 90% of the employees.
- Retention, rewarding performance and facilitating employee ownership were the major objectives of implementing ESOP.
- Around 58% of the companies used the direct route for granting options.
- More than 80% of the plans have options for a tenure of less than 4 years.
- Position, salary grade and management discretion were the three most prominent criteria for determining the grant.
- More than 87% of the plans have graded vesting.
- Options for more than 82% of the plans provide for time based vesting. Within this more than 37% of the plans provide for performance based vesting (individual and company).
- More than 97% of the plans provide for uniform vesting schedule for all participants.
- 42% of the plans offered options with an exercise price equal to market value on the date of grant.
- 60% of the companies do not provide for any specific mechanism for financing the exercise of stock options. 20% of the companies provide for broker assisted cashless exercise.
- In case of termination of an employee 68% of the plans provide for forfeiture of unvested options.
- 80% of the plans provide for forfeiture of unvested options in case of resignation.
- 55% of the plans do not address the situation arising out of change in control of the company.
- 50% of the plans do not address the situation arising out of right issues made by the company.
- More than 37% of the plans provide for bonus options for vested as well as unvested options.
- More than 92% of the companies have not responded by changing the plan in view of fall in stock prices.
- 85% of the companies do not use software to administer stock plan.
- 95% of the companies comply with the accounting practices suggested by SEBI guidelines.

Source: esopdirect.com

TAXATION

It is easy to conclude any tax scheme as illogical since there is no right way of taxation. In terms of tax policies associated with this instrument, the global practice is to tax the benefits in the hands of employee. The ever-alert Union Finance Minister, P Chidambaram now seems to have found a way to tax such wealth and that too without annoying the beneficiaries, i.e., the employees. In a smart move, the ESOPs are now proposed to be taxed but with a twist that it will be taxed as a fringe benefit which means the tax burden is on the employer. Hence, employees who already hold ESOPs are very happy to be spared the rigors of taxation. At the same time, the employers are fretting as they see their Fringe Benefit Tax (FBT) bill going up with every rupee appreciation in their stock prices. Companies may even have to think of appropriating some portions of their profits towards a reserve to meet future FBT liability. Thus, charging FBT on the ESOPs means that the employer will now have to pay a tax when its employees exercise the right to get the shares, and the employees will have to pay capital gains tax when they sell the shares.

Recommendations of SEBI on ESOPs

The Committee on ESOPs appointed by the Securities and Exchange Board of India (SEBI) has recommended splitting the difference between the sales price of the stock vested through ESOP and exercise price into two elements and treat a part of the gain as perquisite and the rest as capital gain. The new tax scheme has implemented the recommendation with one change where the collection point of the tax has been shifted to the employer instead of the employee and exempted such rewards from taxation at the hands of employee.

Table 2: Arguments – Pros and Cons of Employee Stock Options

• The holder has no taxable income until the option is exercised. The tax due then is calculated at the lower capital gains rate.	• This benefits the holders at the expense of the taxpayer.
• Giving actual shares instead will result in immediate dilution of earnings and voting control.	• The cost of the shares will then be known and recorded as an expense. Since the market value of the shares will inevitably be greater than the book value there will be a gain to the pre-existing shareholders. A falling stock price will be felt more by the holder of shares because the money to buy them has been earned and taxed. It is 'real' not just an 'opportunity' cost.
• A rising share price motivates employees to work harder and longer.	• The reverse effect can cause employees to quit.
• Stock options align the holders' interest with those of the shareholders.	
• While stock options may dilute the value held by each of a company's existing shareholders, they are of little concern to creditors, and Generally Accepted Accounting Principles (GAAP) ought to be geared toward meeting the needs and desires of creditors rather than the needs and desires of short-term stock market speculators.	• Management will be motivated to repurchase shares in the market (increasing EPS and probably share value), instead of paying dividends (because no dividends accrue to the options). Offering options to promoters gives them incentives to misrepresent the company to investors. Management can finance the constraints of the options with derivatives.
• They require no cash. For businesses that are not yet profitable and which are 'burning' cash, this is unquestionably good. More shares will dilute the losses per share.	• Currently, GAAP financial statements are from the point of view of the shareholder. Creditors most frequently have their own reporting requirements written into their contracts.

Rule under Indian Income Tax Act, 1961

The Finance Act, 2007 changed the taxation of securities issued by an employer to its employees from April 1, 2007 (assessment year 2008-2009), by levying Fringe Benefit Tax (FBT) on Employees' Stock Options (ESOP). The value of the Fringe Benefit (FB) shall be the Fair Market Value (FMV) of the security on the date on which the option vests with the employee, as reduced by the amount actually paid by, or recovered from, the employee in respect of the security or shares. FMV is to be determined as per rule 40C of the Income-tax Rules, 1962 (Rules) notified on October 23, 2007. But, rule 40C of the Rules defines the valuation norms only for listed or unlisted shares and not other securities.

The rate of FBT on the value of such FB is 30% plus surcharge and educational cess thereon. The other conditions are as follows:

- Where shares are allotted or transferred by a foreign company to the employees of its Indian subsidiary, the Indian subsidiary (not the foreign company) would be liable to pay FBT. This would entail a cash and tax burden on the Indian subsidiary.
- If shares are allotted or transferred by a foreign holding company to the employees of its Indian subsidiary and such employees are outside India at the time of allotment or transfer, then FBT would be payable by the Indian subsidiary, if such employee was based in or deputed to India at any time during the grant period (period commencing with the date of grant of the option and ending with the date of vesting of such option) irrespective of the place of location of the employee at the time of allotment or transfer of such shares. This is in alignment with the OECD view on cross-border income-tax issues arising from ESOP. Thus, employer would have to keep track of or record the movement of the employees during the grant period. Furthermore, in such cases**:** only proportionate value of FB (value of FB in proportion to the length of period of stay in India by the employee during the grant period to the length of the grant period) would be subject to FBT. This gives rise to another problem of calculation in cases, where the employee has stayed in India for only a part (few hours) of the day.
- In the hands of the employee, the cost of acquisition of shares shall be the FMV on the date of vesting of the option as reduced by the amount actually paid by, or recovered from, the employee in respect of the security or shares, even when the employer is liable to pay FBT on the proportionate value of FB discussed above.
- If shares of a foreign company, listed outside India or unlisted, are issued by an employer to an employee, the FMV would need to be determined or valued by a Category 1 Merchant Banker registered with Sebi, which would be binding on the assessing officer. But, this increases the compliance requirements and costs of an employer.
- The benefits arising from issuance of ESOP to non-employees, including non-executive directors, would not be subject to FBT, but would be taxable as per the other provisions of the Income Tax Act, 1961.
- Where shares are allotted or transferred to an employee having different or multiple vesting dates, the First-In-First-Out (FIFO) method needs to be used.
- For an employer, just as FBT is not an allowable deduction, recovery of FBT from an employee is not income subject to income-tax. Similarly, for an employee, recovery of FBT by an employer from an employee cannot be added to the cost of acquisition of the shares in the hands of the employee.

MASTER LIMITED PARTNERSHIPS

As the term indicates, Master Limited Partnerships (MLPs) are structured as conduits through which the operating results of the business are passed on to the unitholders. Limited partnerships are designed to distribute 85%-90% of their earnings and are not subject to corporate taxation. The immediate advantage of the partnership structure is the elimination of double taxation found within the traditional corporate framework. As a result, operating earnings flow directly to the unitholders in the form of cash distributions. Distributions made to each partner are taxed at each unitholder’s individual income tax rate. Income taxes paid at the individual tax rate are generally less than the taxes paid if the partnership were classified as a corporation. Although the characteristics of an MLP closely resemble a traditional limited partnership, a major difference is that MLPs may trade on a public exchange or in the over-the-counter market. The ability to trade on a public exchange or in the over-the-counter market provides a certain amount of liquidity not found in many limited partnership investments.

MLPs are limited partnerships in which the shares are traded publicly. The partnership is formed of a general partner and one or more limited partners. The general partner runs the business and shoulders unlimited liability. The limited partnership provides an investor with a direct interest in a group of assets, usually, oil and gas properties. Master limited partnership units are traded publicly like stock and thus significantly provide the investor more liquidity than ordinary limited partnerships.

The interests of the limited partnership are divided into units that are traded as shares of common stock. This tradability of the stock provides for continuity of life. A master limited partnership has all the features of a corporation. However, it is superior to a corporation in that it eliminates the double taxation in earnings. For tax purposes, the master limited partnership is not treated as a separate entity. It is treated as a partnership for which the income is treated on a *pro rata* basis to the partners. To avoid being taxed as a corporation an MLP has only two features of a corporation. (i) centralized management, and (ii) transferability. The life of the MLP is limited to generally 100 years and the general partner has unlimited liability.

Master Limited partnerships have been popular in the petroleum industry. Oil companies have distributed oil and gas assets into MLPs allowing the returns to flow directly to stockholders without double taxation.

Master Limited Partnerships are generally held by individuals as opposed to corporations, which are predominantly owned by institutional investors.

Based on their method of formation, the MLPs are classified into five different categories.

i. **Roll-up MLP:** It is formed by a combination of two or more partnerships into one publicly traded partnership.

ii. **Liquidation MLP:** It is formed by a complete liquidation of a corporation into an MLP.

iii. **Acquisition MLP:** It is formed by an offering of MLP interests to the public with the proceeds used to purchase the assets.

iv. **Roll-out MLP:** It is formed by a corporation’s contribution of operating assets in exchange for general and limited partnership interests in the MLP.

v. **Start-up MLP:** It is an MLP formed by a partnership that is initially privately held but later offers its interests to the public in order to finance internal growth.

All of the MLPs in the USA, universally provide tax advantages to unitholders through partially tax-deferred cash distributions. The amount of the distribution that is tax-deferred is treated as a return of capital, and reduces the investor’s tax basis in the investment. The amount of the distribution that is not tax-deferred is taxed at the taxpayer’s ordinary income tax rate, and when the unitholder sells the MLP, the gain will be taxed at the ordinary income tax rate. The tax-deferral feature makes MLP an attractive investment alternative to investors seeking an estate-planning vehicle. These securities are also an excellent diversification alternative to bonds, utilities, real estate investment trusts, and other high-yielding investments.

For investors looking for more than just yield, several MLPs continue to accelerate earnings and distributable cash flow growth through acquisitions and capacity expansions. Improvements of distributable cash flow have subsequently led to increasing cash distributions payable to unitholders. The result of increasing cash distributions is usually an improved yield valuation, since cash distributions drive unit prices. As cash distributions continue to increase, the unit price of an MLP should also increase, offering investors the opportunity for attractive total returns.

Generally, all of the taxable net income received by a tax-exempt investment vehicle such as an IRA, Keogh, or 401(k) plan from an MLP may be considered Unrelated Business Taxable Income (UBTI). Section 512 of the US Tax Code states that the UBTI tax liability applies if the total amount of UBTI from all partnership interests exceeds $1,000 in any taxable year. Therefore, a unitholder may be subject to income taxes in an otherwise tax-exempt retirement account. We recommend that investors consult with their tax advisor regarding any potential retirement account investing.

Since most partnerships are not alike and generally have been formed for a myriad of different reasons, investors should not focus exclusively on a partnership's yield. Common reasons for the formation of an MLP typically involve a corporation attempting to increase shareholder value or using the partnership structure as a corporate financing tool. A corporation that believes the value of its assets is not being correctly recognized by the market may decide to monetize a portion of its asset base under the MLP structure. This strategy is based on the expectation that a more favorable valuation would be rewarded by the market once the assets are separated from the corporation. As a corporate financing tool, a corporation could obtain cash on its assets in an amount equal to its fair value, without surrendering control of the assets.

Investors should attempt to determine the partnership's ability to cover its current distribution obligations and the potential for any future cash distribution increases. Trends among many MLPs have shown a greater emphasis on improving cash flow and increasing distributions payable to unitholders. Growth initiatives such as developing new markets, capacity expansions and strategic acquisitions have played key roles for MLPs seeking ways to grow distributable cash flow. Higher cash flows and distribution increases are ultimately the driving force behind higher unit valuations. Partnerships seeking to grow should provide attractive total returns.

ADVANTAGES OF AN MLP

One of the most important advantages of an MLP is its elimination of the corporate layer of taxation. In case of a corporation, the stockholders are taxed twice on their investments – once at the corporate level and once at the individual level on the distribution of dividends. However, in case of an MLP the returns to the owners flow through just as they do in other partnership firms. They are not taxed as separate business entity. Many corporations use MLPs to redistribute assets so that their returns are not subjected to double taxation. Limited partners in MLP do not have control, which is an attribute that institutions are starting to value more. Moreover, corporate shareholders are normally taxed on their MLP income as opposed to the exclusion they would qualify for if they were receiving dividends from another corporation. In addition, even institutions that are normally tax-exempt may have their income taxed. For these reasons, MLPs are not very attractive to institutions.

In the USA, in the 1980s, many corporations converted themselves to MLPs to get over the problem of double taxation. However, with the Tax Reform Act, 1987, eliminating a limited partner's right to deduct passive losses, most MLPs converted themselves back to corporate form of organizations. Today, one can find only a few businesses operating as MLPs in the US market.

TAX TREATMENT OF MLPS

IRS focused on four characteristics to distinguish between corporations and MLPs.

- Unlimited life;
- Limited liability;
- Centralized management;
- Transferability.

MLPs may have only two of four corporate characteristics to avoid being taxed as corporation – usually centralized management and transferability;

MLPs typically specify limited life of 100 years;

MLPs have limited liability for limited partners but unlimited liability for general partner or manager.

GENERAL PARTNER OF MLPS

a. General Manager (partner) of MLPs has unlimited liability.
b. Virtually autocratic power.
c. Difficult to change general partner in the absence of provable fraud.
d. Alignment of interests between general partner and public unitholders.
e. Management incentive fees.
f. Ownership of significant number of limited partnership units.

CHARACTERISTICS OF VARIOUS TYPES OF MLPS

i. **Roll-up MLPs:** Roll-up MLPs are the first type of MLPs organized. They began in oil industry by Apache Petroleum Company in 1981.

   Combine existing limited partnerships into one publicly traded partnership.

   Provide liquidity for non-traded limited partnerships.

   Nature of Roll-up:

   Before roll-up, there are a number of limited partnerships in existence.

   a. General partners enter into agreement to combine a number of previously sponsored limited partnerships; in return for their old shares, units in new MLP are issued.
   b. After MLP has been formed, there is a general partner and units which are owned by limited partners; units may trade on stock exchange or over-the-counter.

ii. **Roll-out (spin-off) MLPs:** The first roll-out MLP created by Transco Corp in 1983.

   Formed by a corporation's contribution of operating assets in exchange for general and limited partnership interests in MLP.

   Sold on a yield comparison basis.

   Nature of Roll-out:

   a. Corporation holds a number of business segments.
   b. Corporation places assets of one or more of its business segments into MLP.
   c. Avoid double taxation of corporate dividends.
   d. Establish a new value on undervalued assets.
   e. MLP transfers MLP units to corporation which in turn distributes them to its shareholders.
   f. Stockholders hold stock in corporation and own units in MLP.
   g. Corporation could sell portion or all of units to outside public.

iii. **Start-up (new issue, or acquisition) MLPs:**

Formed by a partnership that is initially privately held but offers its interests to the public in order to finance internal growth.

Nature of start-up:

a. Existing entity transfers assets to MLP.

b. Management Company may be involved that provides services to MLP and probably will be its general partner.

c. In return, management company receives certain percentage of cash flows of MLP.

d. General partner does not have to hold units in order to receive income.

SUMMARY

- ESOPs were developed to provide benefits to the employees. They may also be highly innovative. The cash flow benefits may be enhanced when the company combines the tax benefits with a reduction in outstanding contributions to other benefit programs.
- Hostile bidders as well as employee groups interested in acquiring ownership of their company may use ESOPs.
- In addition to providing benefits to the employees and defending the corporations in hostile contests, ESOPs also seem to generate positive wealth effects for shareholders. Thus, implying that there must be significant benefits that more than offset the lower probability of a takeover, when this defense is instituted.
- MLP being a new organizational form, offers investors the structure and the tax attributes of more traditional partnerships. But it differs in one key aspect where it offers investors liquidity in an organized secondary market for the trading of partnership interests.
- Thus, even the liquidity advantages of MLPs assume greater importance leading to the distinctly different investment and marketing thesis. They appeal to investors to view the units simply as another component of their equity securities portfolio rather than as a long-term method of sheltering income from taxes.

Chapter 11

International Mergers and Acquisitions

After reading this chapter, you will be conversant with:

- Theory of a Multinational Enterprise
- Motives behind International Mergers and Acquisitions
- Reasons for Failure of Mergers and Acquisitions
- Global Mergers and Acquisitions – Indian Scenario
- Tax and Regulatory Issues in Cross-border Mergers and Acquisitions

In the last decade, we have witnessed a strong trend of investment liberalization in developing and transition countries. This resulted in high cross-border Mergers and Acquisitions activity worldwide, driving the increase in Foreign Direct Investment (FDI) over the past decade and especially over the past few years. While industrialized countries account for a dominating 90 percent share of the value of world cross-border M&As, in the recent past Latin America and East Asian developing countries are also witnessing a rise in cross-border M&As.

THEORY OF A MULTINATIONAL ENTERPRISE

To better understand international mergers, acquisitions and tender offers let us first take a look at the theory of a multinational enterprise.

A firm that operates in more than one country other than import/export operations is called a multinational company. The fundamental issue in the theory of a firm is what factors determine whether the firm would use external markets to operate its business or use managerial coordination within the firm. The cost and the revenue conditions of a firm are one of the important factors which determine whether a firm should use external markets to transact its business or use only internal managerial coordination. A firm uses internal managerial coordination rather than the external market when the costs are lower or when the net productivity is higher domestically.

Cost and revenue functions play a key role in international activities relating to issues like whether the firm has to import or export or acquire license or use joint ventures rather than have a plant abroad. A multinational company does not know the foreign labor markets, foreign suppliers, or the culture and customs of foreign lands. Hence, its costs are likely to be higher and revenue productivity lower than the local firms with which it competes. In such a case a question arises as to why a company has to set-up a plant outside its country when it can produce in a much familiar domestic environment and sell abroad through an agent. In this context, they can also explore, other contractual arrangements like licensing and joint ventures.

The theory of a multinational company believes that firms operate in foreign countries because costs are lower or revenue productivity is higher than if alternative contractual arrangements are made. When firms choose to merge internationally, it implies that it will result in lower costs and higher productivity than alternative contractual means of achieving international goals.

Intangible assets are the most important factors that form the source of net revenue benefit to a multinational firm with plants in different countries. A firm may possess one or more of a number of intangible assets. The firm may be superior in technology or managerial knowledge. It may be a leader in repeated innovations. It may hold patents, trademarks or branded products. It may possess special competence in techniques, product differentiation or in continued improvement in product quality which are not available with every firm. In this context, according to Caves (1982) a leading researcher in multinational enterprise, it makes sense for such firms to come together and set-up multinational firms rather than sell the individual intangible assets in the multi-location activities. Such coming together would enable the multinational enterprise to get the right answers for issues such as: (i) Uncertainty about the quality of the product, (ii) Il-defined and expensive property rights, (iii) Low cost of supply consequently leading to a threat of customer becoming a potential competitor, and (iv) Irreversible supply of the product, making inspection impossible.

Thus, multinational companies are found to a higher degree in industries where intangibles are important. Excess capacity in the intangible assets is one of the main reasons for setting up a foreign subsidiary. Availability of excess cash is also one of the motivating factors for foreign investment. High reputation or high organizational capital firms prefer to expand worldwide by direct investment rather than by licensing. Here, the inseparable reputation of the firm is the intangible asset transferred to the foreign subsidiary.

A vertically integrated multinational company usually establishes a subsidiary in the foreign country: (i) when the switching costs are high, i.e., when it is expensive to shift the buyer-seller relationships, (ii) when the information costs are high, and (iii) when the costs of negotiating and monitoring are high etc.

Another influencing factor of international mergers is the 'tariff'. High tariffs against outside firms in a particular country result in the foreign company setting up a firm in that country. Exchange rate relationships have similar effects. A weak currency would increase the foreign direct investment in that country and a strong currency would encourage that country to invest in other countries having weaker currencies.

MOTIVES BEHIND INTERNATIONAL MERGERS AND ACQUISITIONS

Many of the motives behind international mergers and acquisitions are similar to those of purely domestic transactions, while a few are unique to the international deals. Some such motives are discussed hereunder:

GROWTH

Growth is the most general and important motive for international mergers. Merging internationally provides an immediate growth opportunity to a firm which was once operating within a single country. There are various factors which encourage a firm to merge internationally for growth. They are:

i. A firm having surplus cash flows operating in a slow growing domestic economy can invest its cash in the fast growing economy.

ii. Firms, which operate in a domestic market that is too small to accommodate the growth of the corporates or where the domestic markets are saturated, enter into foreign markets.

iii. Overseas expansion may enable medium sized firms to attain the size necessary to improve their ability to compete.

iv. Size enables firms to achieve the economies of scale necessary for effective global competition.

Box 1: Motherson Sumi to buy Europe's Visiocorp

Motherson Sumi, an auto component-maker has acquired the European company Visiocorp group at the cost Euro 25 million and also the allotment of five per cent consideration of shares with a face value of euro 1.5 million. The acquisition comprised only of assets in the form of shares without any debt and the acquired subsidiaries too had minimal debt. In the financial year 2008, Visiocorp group's turnover was Euro 660 million. Both the companies were doing the business with the help of each other for the past 13 years and now both entities have become one entity.

However, Motherson Sumi Systems Ltd has recorded a turn over of Rs.2,000 crore and this is seventh acquisition by acquiring the businesses of one of the world's largest rear view mirror producers, Visiocorp.

Visiocorp clocked a revenue over €700 million in FY 2008 and has about 17 manufacturing locations across Europe, the US, Australia and Asia. While the acquisition will be mainly funded through internal resources of Motherson Sumi, the company will also set up a special purpose vehicle for €30 million. This would be a step down subsidiary between Motherson Sumi and Samvardhana Motherson Finance Ltd in the ratio of 51:49.

The company currently enjoys 45 per cent of domestic market share in mirrors for passenger cars.

After the acquisition, the company will emerge as the largest player globally with clients such as General Motors, Hyundai, Ford, Volkswagen, Renault and BMW. Motherson Sumi group makes diverse parts like wiring harness, air compressors, metal parts and fuel pump parts, and has 12 joint venture companies.

Source: http://www.blonnet.com/2009/03/11

Technology effects mergers in two ways:

i. A technologically superior firm may make acquisitions in another country in order to exploit its technological advantage.

ii. A technologically inferior firm may make acquisition in another country to enhance its competitive position both at home and abroad.

Technological superiority can be exploited very easily without a lot of cultural interference unlike specific management functions like marketing, labor relations etc., which are environment specific and are not readily transferable to other surroundings. The acquirer may intentionally select a technologically inferior target which, because of its inferiority is losing market share and hence market value. By bringing in technology into the acquired firm, the acquirer can improve its competitive position and profitability both at home and abroad. On the other hand, the acquirer firms with surplus cash but technologically inferior can obtain the necessary technology by acquiring a firm with superior technology to remain effective as competitors on the worldwide scene.

PRODUCT ADVANTAGES

A firm that has developed a reputation for superior products in the domestic market may find acceptance from the foreign consumers as well. Hence, such firms foray into other countries to exploit the favorable market conditions of that country.

Box 2: Tata Steel – No Big Bottomline Boost

Tata Steel is buying NatSteel's steel division for a cash consideration of approximately Singapore $466 million or Rs.1,260 crore. This division did sales of Singapore $1,416 million in the year ended December, 2003, which means Tata Steel has paid just 0.33 times trailing sales.

Thus, while the acquisition will add 36 percent to Tata Steel's top line, it adds less than 5 percent to its bottomline. The Tatas would have to improve efficiencies considerably for the acquisition to impact its bottomline significantly. Analysts say that its captive iron ore supply will help lower costs for the NatSteel division.

Moreover, the low profit margin currently is not a big concern as significant synergies accrue to Tata Steel. First, it would have access to additional steel capacity of approximately 3.2 million tonne in the booming construction segment of the Asia Pacific region.

Also, NatSteel has steel manufacturing operations in five Asian countries including China, Singapore and Vietnam, which are in proximity to the ports of the west coast of America. Lower transportation costs would be an added incentive for Tata Steel to expand in the key American market.

Source: Business Standard, August 17, 2004.

GOVERNMENT POLICY

Government policies, regulations, tariffs and quotas play a great role in the merger and acquisition activity in a country and more significantly in cross-border deals. The exports of a country are particularly very vulnerable to the tariffs and quotas mainly implemented by the government with an intention to protect the domestic industry. The presence of such restrictions encourages international mergers, especially when the market which is protected is large. Restrictions on exports in a country can result in increased direct investment in countries to where the goods were supposed to be exported. Occasionally the environment and other government regulations increase the cost and also the time required to build facilities abroad. This may lead to acquisitions of companies with already existing facilities.

Changes in the government policy can make acquisitions in various countries more or less attractive. For example, the deregulation policies followed by the Government of India have encouraged many foreign companies to acquire Indian firms over the recent years.

Privatization of the insurance industry in India has lead to the formation of many joint ventures between the Indian and the foreign companies. Some of the joint ventures are:

Dabur	AVIVA
Max India	New York Life
HDFC	Standard Life
Bajaj	Allianz
Birla	Sun Life Financial Services
ICICI	Prudential
ICICI	Lombard Insurance
M A Chidambaram	Metlife
Tata	AIG
Vysya Bank	ING

RATE OF EXCHANGE

Rate of exchange is another unique factor that influences international mergers and acquisitions. The relative strength or weakness of an acquirer's currency versus the target company's currency influences.

i. The effective price paid for an acquisition.

ii. The source of financing.

iii. The cost of production of operating the acquired firm.

iv. The value of the repatriated profits to the parent company.

Further, the accounting conventions followed would also give rise to currency translation profits and losses. Thus, managing the exchange rate risk is an additional cost for doing business for a multinational firm.

POLITICAL AND ECONOMIC STABILITY

The relative political and economic stability of a particular country plays an important role in attracting foreign buyers. Political or economic instability increases the risk factor of operating in that country for the foreign buyer.

The various political considerations which play a key role in acquiring a firm in a foreign country are:

i. The frequency with which the change in the government takes place.

ii. The systematic transfer of power.

iii. The difference between the government policies of various administrations.

iv. The degree of government intervention on subsidies, tax breaks, loan guarantees, etc.

The economic factors that influence an international merger decision include:

a. The low or predictable inflation.

b. Labor relations.

c. Stability of exchange rates.

DIFFERENTIAL LABOR COSTS AND PRODUCTIVITY

The labor climate of a country influences the cost of production in that particular country. High labor costs and/or declining productivity of labor act as entry barriers in a country. Firms aiming to decrease the cost of production tend to acquire firms in countries where the labor costs are low and/or where the productivity of labor is high.

TO FOLLOW CLIENTS

Some service companies like banks move into other countries following their major clients. For instance, if the banks have enough clients in a particular country, it makes business sense to move to that country where its clients are present. Firms who establish their business abroad will have to be loyal to the banks of their home country. If the foreign bank does not have offices where its clients are located, it may lose its business to more convenient local banks.

DIVERSIFICATION

International mergers provide diversification both geographically and also by product line. When the various economies are not correlated, then international mergers reduce the earnings risk inherent in being dependent on the health of a single economy. Thus, international mergers reduce systematic risk as well as unsystematic risk.

Box 3: Exxon and Mobil Merger – The Return of Big Oil

The wheel turned full circle when the two major parts of the erstwhile oil giant Standard Oil Trust Company decided to merge in 1998. Broken apart by the trustbusters in 1911 for the yesteryears' oil behemoth Standard Oil Trust Company, it was a sort of reincarnation when the two US oil giants Exxon and Mobil decided to merge in 1998.

Merger Synopsis

Participating Companies	Exxon and Mobil
Year	1998
Transaction type	Stock Swap
Deal amount	$82 bn
New entity	Exxon Mobil Corp.
Shareholding pattern (Exxon Mobil)	Exxon shareholders – 70%
	Mobil shareholders – 30%
Annual synergies (before tax) by 2002	$3.8 billion
Significant cash flow benefits One-time impact	$3.5 billion
Ongoing annual benefit	$4+ billion
Earning's impacts positive Year one (2000)	$1.5 billion
Year three and beyond (2003+)	$2.5 billion
Merger integration costs (before tax)	$2.5 billion
Regular employee reduction	16,000

A Strategic Fit

The strengths of Mobil and Exxon complement each other well. In the exploration and production area, Mobil's and Exxon's respective strengths in West Africa, the Caspian region, Russia, South America and North America line up well, with minimal overlap. The two companies respective strengths in deepwater assets and deepwater technology also gel nicely.

In the Asia Pacific region, the combine stands a good chance, as they do not have any overlap in business operations there. Mobil has refining assets in Australia and New Zealand, where Exxon has none. But Exxon has a refinery in Thailand and in Malaysia, where Mobil has no refining presence. In Singapore, Mobil and Exxon own two of the country's four refineries, with 3,00,000 bpd and 2,20,000 bpd, capacity, respectively. While the merger could lead to some rationalization, which would potentially downsize these refineries or reduce throughput rates.

In the upstream sector, although both Mobil and Exxon have stakes in countries such as Australia, Indonesia most are in different areas. Exxon has a 50 percent share in Indonesia's Natural gas field where Mobil has 26 percent. But Exxon has a limited position in Indonesia other than that, while Mobil has a stake in the Arun LNG field. Exxon also has a big foreign equity in Malaysia's upstream sector, where Mobil has almost no presence. As per some rough estimates, Exxon Mobil would be able to save around 15-20 percent in fixed operating costs and fixed overheads. The company's exploration and production portfolio of assets compliment each other well.

In the downstream sector, Exxon Mobil's refining operations combine global scale with efficiency and match up well with others in the industry. Fuels marketing is being built on three of the best-recognized and most-trusted brands in the world – Exxon, Mobil and Esso – complemented by strong retail networks in the key established and high-growth markets. The two companies also enjoy a strategic fit in lubricants, with Exxon's strong basestock business and Mobil's leadership in finished lubricants, resulting in a pre-eminent position. The combine boasts of the most profitable petrochemical business of any integrated oil company as well as of a balanced portfolio, designed to deliver superior performance throughout the business cycle. This, to a considerable extent, addresses the issue of coping with a regime of volatile oil prices. The exploration and production portfolio of assets of the two companies complement each other well.

Source: Amit Singh Sisodiya – Exxon and Mobil Merger – The Return of Big Oil Chartered Financial Analyst, October 2000.

TO ASSURE A SOURCE OF RAW MATERIAL

It is one of the important motivating factors in a vertical merger particularly when the acquiring firm is from the domestic country which is poor in resources. Cross-border mergers are hence used to prevent the erection of barriers against import/export of raw materials.

REASONS FOR FAILURE OF MERGERS AND ACQUISITIONS

In international mergers language barriers, different working practices and lack of cultural understanding are major obstacles faced in bringing together the workforce of the two firms behind the common vision. Some of the major reasons for the failure are:

REALITY GAP

There is always a gap existing between the perception and reality. Many firms focus too much on the hard mechanics of the merger like evaluation of synergy, integration project planning, and due diligence to extract value from an acquisition. Instead managers should also concentrate more on the softer issues like selecting the right management team and resolving cultural and communication misunderstandings which are very important for the success of the merger.

CULTURE CLASH

No two companies are alike, not just in what they do, but also in how they operate at a corporate or functional level. Some firms are very different than others. Language and culture appear to be the biggest barriers to a successful completion of the deal. Hence, mergers of companies from the same country are more likely to succeed.

The type and complexity of the cultural challenge depends on the nature of integration in the merger or acquisition. If both companies are to be fully integrated, the best inherited aspects of both the organizations should be incorporated into a single new company culture focused on achieving future business growth. Where the companies are to be run as two separate entities, cultural integration is neither wise nor necessary, yet close links to ensure mutual co-operation between two separate cultures will be essential to ensure that the deal increases the shareholder value. However, in each case, cultural factors should be incorporated into all the elements of the M&A process from pre-deal planning to post-deal implementation.

The reasons why managers must recognize and act upon critical cultural issues in global mergers and acquisitions are:

Employee Retention

Differences in language, customs and organizational belief systems often create conflicts between the employees. If employee resistance after the merger is allowed to continue, the merged company might face the risk of losing most of the key human capital which is required to execute integration and attain its corporate growth objectives.

Organizational Design

Integrating people, products and processes requires forming a new organizational structure. Designing a structure that is capable of effectively serving customers and creating shareholder value requires dealing with the cultural variables like the ways of communicating, expectations of management, etc., immediately after the merger to allow the merged company's organization to drive its underlying strategy.

FORGING A NEW CORPORATE CULTURE

Merging companies from different countries can never be fully integrated if conflicting elements of their original cultures are allowed to continue. Creation of a global culture as opposed to merely supporting the existing ones is the critical success factor in international transactions. It must be the focus of all levels of management early on and should continue over the long-term period.

Box 4: Reasons for Failure of Mergers and Acquisitions

Corporate Mergers and Acquisitions (M&As) have turned into trendy globally during the last two decades. The synergistic gains from M&As may result from more efficient management, economies of scale, more profitable use of assets, exploitation of market power, the use of complementary resources, etc. Interestingly. The results of many empirical studies show that M&As fail to create value for the shareholders of acquirers. Here, the reasons for failure of merger and acquisition, and impact of merger on shareholders are explained. At the time of merger of one entity to another entity the management of acquired company interprets all the possibilities for upcoming future with the business of acquired entity, still there are some reasons that lead to failure of merger. Some of them have been discussed below:

1. **Excessive Premium:** when the acquisition has been made through bidding process where many bidders are available to bid and the highest bidder called winner. At this point of time, the winner overestimates value out of ignorance and this is called winners curse hypothesis. However, after paying excess premium then required the acquirer fails to achieve the synergies required compensating the price, the M&As fails.
2. **Lack of Research:** Merger & Acquisition needs a collection of data and information which are concerned with the company to analyze it. It requires broad and careful research. A simple ignorance with research or analyzing the data can cause the devastation of the acquirer's capital.
3. **Diversification:** The very few firms and management groups have the capability of effectively managing the diversified businesses. Distinct diversification has been associated with lower capital productivity, lower financial performance and a higher degree of variance in performance for a variety of reasons including a lack of industry or geographic knowledge. Dissimilar acquisitions, which may emerge to be very capable, may turn out to be big dissatisfaction in reality.
4. **Culture Clash:** The cultures of the companies are not compatible and compete for dominance. If the battle is drawn out, the businesses of both companies suffer while the attention is diverted to the contest. If the culture of one of the companies is totally subsumed, it may destroy a key element of its prior success.
5. **Poor Business and Strategic Fit:** Business fit can be explained when the equivalent between administrative practices, cultural practices and personnel characteristics of the goal and acquirer. It influences the ease with which two organizations can be integrated during execution. Mismatch of Business fit can be lead to failure of mergers and acquisitions. Mergers with strategic fit can develop profitability through reduction in overheads, effective utilization of facilities, the ability to raise funds at a minimal cost, and exploitation of excess cash for expanding business with higher returns. But opposite to this, many a time lack of strategic fit between two merging companies especially lack of synergies results in merger failure. Strategic fit can also include the business philosophies of the two entities and the way in which assets are utilized. For example, P&G-Gillette merger in consumer goods industry is an exceptional case of acquisition by a pioneering company to increase its product line by acquiring another pioneering company, which has been described by analysts as a perfect merger.
6. **Regulatory Delay:** The announcement of a merger is a dislocating event for the employees and other constituents of one or both companies. It is customary to have detailed plans to deal with potential problems immediately following an announcement. However, when there is a possibility of regulatory delay. The risk of substantial deterioration of the business increases as time goes on, with valuable employees and customer and supplier relationships being lost. This loss is a key consideration in evaluating whether a particular merger should be undertaken. It is necessary to include in this evaluation the relationship between the desire to limit anti-trust divestitures and the costs attributable to the delay in consummating the merger.

7. **Poorly Managed Integration and Ego Clash between Top Management:** Integration of the companies require a high quality management. Integration is very often poorly managed with little planning and design. As a result implementation fails. The key variable for success is managing the company better after the acquisition than it was managed before. Ego clash between the top management and subsequently lack of harmonization may lead to disintegration of company after merger. The dilemma is more important in cases of mergers between equals. Even good deals fail if they are poorly managed and Ego clash after the merger.
8. **Over Leverage:** Cash acquisitions frequently result in the acquirer assuming too much debt. Future interest costs consume too great a portion of the acquired company's earnings. An even more serious problem results when the acquirer resorts to cheaper short-term financing and then has difficulty refunding on a long-term basis. A well thought-out capital structure is critical for a successful merger.
9. **Boardroom Schisms:** When mergers are structured with 50/50 board representation or substantial representation from the acquiree, care must be taken to determine the compatibility of the directors following the merger. A failure to focus on this aspect of the merger can create or exacerbate a culture clash and retard or prevent integration. All too often, the continuing directors fail to meet and exchange views until after the merger is consummated.

Source: www.indianmba.com

A survey made by one of the leading Investment Banking firm KPMG about the success of cross border mergers and acquisitions across the world revealed the following:

Businesses in the UK and the US have historically conducted more cross-border deals, and hence have the advantage of having better experience. Moreover, they have an increasingly strict regulatory code regarding merger benefits, which may affect the overall success rates. The reason may also be the common mother tongue. If the employees of the two firms do not talk in the same mother tongue, while they communicate, subtle nuances may be missed or misinterpreted and this can severely disrupt the sensitive integration process. This fact of life could be better understood from the following key interpretations arrived at from a survey carried out at the merger experiences of US, UK and Europe.

US/UK Deals

- Benefit from many years of deal experience,
- Same language and culture, and
- High success rates are as expected.

UK/Europe Deals

- UK has extensive deal experience.
- Proximity between the UK and Europe means heightened cultural awareness, as compared with the more distant US.

US/Europe

- In spite of extensive deal experience, the US faces greater cultural differences and challenges in its deals with Europe.

Briefly, the survey suggests that companies entering into cross-border deals linking companies of dissimilar cultures or language need to pay particular attention to the problems of cultural integration. They must focus their efforts on the communication programs and should look at reward systems to support the changed management programs. It also seems that experience pays, as is observed in the survey that the countries which have seen extensive consolidation over the past 30 years perform significantly better than the relative newcomers.

Box: 5 Nine Steps to Prevent the Failure of Merger & Acquisitions
One: No Guiding Principles: As rudimentary as this sounds, we often see merging companies fail to develop a set of guiding principles linked to the merger's strategic intent. These principles should get at the very logic of the transaction – is the merger an absorption of one company into another or a combination designed to take the best of both? Perfection may not be possible, but these principles will assure that all decisions drive the combined entity in the same direction. In a best-of-both-companies transaction, for example, one principle might be: "Combine IT organizations by selecting the most up-to-date systems and deploying them across the combined entity."
Two: No Ground Rules: While this sounds similar to sin number one, ground rules for planning provide nuts-and-bolts guidance for how the planning teams should act as they begin to put the face of the merged entity on paper. These rules should include processes as to how decisions are to be made and how conflicts should be resolved.
Three: Not sweating the details: Its hard to believe, but detailed post-close transition plans can be lacking even when two companies are working hard and have top-level leadership closely engaged. Why? To some extent, this reflects the daunting complexity of any integration. It can also, however, reflect the culture of the companies and a resistance to detail and top-down accountability. The acquirer may be suffering from acquisition fatigue, management distraction, a reluctance to share information, or a simple unwillingness to follow a methodical decision timeline.
Four: Poor stakeholder outreach: All relevant stakeholder groups both internal and external must receive communication about the transaction, early and often. While employees (see sin number eight), customers, and regulators get the bulk of the attention, there is a long list of additional stakeholders such as communities, suppliers, and the like who also need care and feeding. Management must strive to understand how these groups view the deal and how they might react to changes such as new pricing, the elimination of vendors, and adjustments in service and personnel.
Five: overly conservative targets: Management must set aggressive targets from the start. This helps reinforce and clarify the transaction's guiding principles and strategic intent, specifically, how hard the integration teams need to push for cost savings and revenue growth. Most companies tend to focus on one or the other – but neglect to place adequate emphasis on both. Experience demonstrates that management never gets more in synergies than it requests. So, build your targets with some stretch and expect that your people will find a way to get there.
Six: Integration plan not explicitly in the financials: We have seen merging companies build detailed integration plans only to stop short of driving them into the combined entity's operating financials in a clearly identifiable manner. Institutional memory is short and the plans are often redone on the fly (see sin number nine). While the integration plan will evolve, you need to create financial benchmarks that can be tracked.
Seven: Cultural disconnect Bringing disparate groups of people together as one company takes real work and represents an effort that is often largely overlooked. Culture change management is not indulgent; it is a critical aspect of any transaction. However, simply acknowledging the issue or handing it off to specialists is not enough. Management must set a vision, align leadership around it, and hold substantive events to give employees a chance to participate. Detailed actions and well-articulated expectations of behavior connect the culture plan to the business goals.
Eight: keeping information too close. There is a natural hesitancy to share information, and current regulations put pressure on what management can tell the organization without going to public disclosure. However, absent real facts, the rumor mill will fill the void. Tell employees what you can. Also, tell them what you can't tell them at the moment, why, and when you will be able to do so.
Nine: Allowing the wrong changes to the plan. After all the hard work and despite meticulously avoiding sins one through eight, some companies still miss the mark. The popular trend toward empowered line managers and decentralization carries the risk of handing off carefully designed plans to new decision-makers who are not steeped in the balances and considerations that made the plan viable in the first place. Following handoff, every company needs clear decision rights about who can change the agreed upon plans, under what circumstances, and with what approvals.
In working to avoid the nine deadly sins listed above, one key step is selecting the right person or people to lead the program integration team and track the plan's execution. The mergers that do best tend to have such leadership. Clearly, with proper planning and attention to detail throughout the merger process – from determining strategic direction, transaction design, and post-merger integration – it is possible to avoid these sins and close a successful transaction.

Source: www.hbswk.hbs.edu.

GLOBAL MERGERS AND ACQUISITIONS – INDIAN SCENARIO

Mergers in India have led to a massive upsurge in the Indian economy. The sectors like pharmaceuticals, automotive components, beverages, industrial goods, cement, petrochemicals, telecommunications, software and financial services have experienced mergers with global companies. Some of the industrial sectors in India, which have witnessed tremendous post-merger growth are Maruti Suzuki, Tata, Videocon, etc. Some of the companies that have sought mergers with Indian companies belonged to Canada, Holland, Belgium, Italy, Sweden, Korea, Norway, Poland, Germany, Spain, and the UK.

The year 2007 can be called the year of global M&A. Tremendous amount of money flowed into India on the back of opening up of growing economy, high liquidity levels and the continued reforms introduced by the Indian Government to attract investors. In 1988, the number of takeovers was 15 which grew to 223 deals in 2007. This was a huge increase as there seemed to be a great rush to achieve global status by the Indian companies. A case in point is the acquisition of Tetley Tea by Tata Tea deal valued at £271 mn, thus making Tata Tea, the world's second largest tea company. Bharat Forge, the world's second largest producer of forgings for engines and chassis components, bought six companies in four countries Britain, Germany, Sweden and China is another merger of significance. After taking over Singapore-based firm Natsteel, Tata Steel concluded the biggest takeover of European Steel giant – Corus for £12 bn. India's largest electronics firm – Videocon acquired South Korea's debt-laden Daewoo Electronics for nearly $700 mn.

Some important M&A in India for the year 2007-08 are:

- Mahindra & Mahindra acquired 90% stake in the German company Schoneweiss.
- Tata took over Corus.
- RSM Ambit, based in Mumbai, was acquired by PricewaterhouseCoopers.
- Vodafone took over Hutchison-Essar in India.
- Vijay Mallya's United Brewery (UB Group), the world's third largest maker of spirits, acquired Whyte & Mackay (W&M Ltd.), a Scotch whisky-making company in Scotland.
- Indian drug maker Dr. Reddy's Ltd. acquired Italian generics firm Jet Generici Srl.
- JK Tyres acquired Mexican tyre company Tornel for Rs. 270 crore.
- Religare, a financial services company owned by prominent businessmen Malvinder and Shivinder Singh, bought London's oldest stockbroker Hichens, Harrison & Co.

Until up to a couple of years back, the news of Indian companies acquiring American-European entities was very rare. However, this scenario has taken a U-turn. Buoyant Indian economy, excess fund with Indian corporates, liberal government policies and dynamism in Indian businessmen have all contributed to this new trend. Indian companies are now looking at North American and European markets to spread their wings and become global players.

The top 10 acquisitions made by Indian companies worldwide are given in the Table 1.

Table 1: Top Ten Acquisitions Made by Indian Companies

Acquirer	Target Company	Country Targeted	Deal Value ($ mn)	Industry
Tata Steel	Corus Group	UK	12000	Steel
Hindalco	Novelis	Canada	5982	Aluminum
Videocon	Daewoo Electronics	Korea	729	Electronics
Dr. Reddy's Labs	Betapharm	Germany	597	Pharmaceutical
Suzlon Energy	Hansen Group	Belgium	565	Energy
HPCL	Kenya Petroleum Refinery Ltd.	Kenya	500	Oil & Gas
Ranbaxy Labs	Terapia SA	Romania	324	Pharmaceutical
Tata Steel	Natsteel	Singapore	293	Steel
Videocon	Thomson SA	France	290	Electronics
VSNL	Teleglobe	Canada	239	Telecom

Source: Business Line, Friday, March 07, 2008.

Indian outbound deals, which were valued at $0.7 bn in 00-01, increased to $4.3 bn in 2005 and further crossed the $15 bn mark in 2006. It more than doubled in 2007 to $33 bn. Indian businessmen went shopping across the globe and acquired a number of strategically significant companies. The top 10 deals themselves account for nearly $21,500 mn. This is more than double the amount involved in US companies' acquisition of Indian counterparts.

Table 2: Top Deals Involving Indian Targets

Acquirer	Target	Deal (US $ mn)
Vodafone	Hurchison Essar	10900
Hokim	Ambuja Cement	1820
Vedanta Group	Sesa Goa	1372

Source: Business Line, Friday, March 07, 2008.

AN ARRAY OF ACQUISITIONS

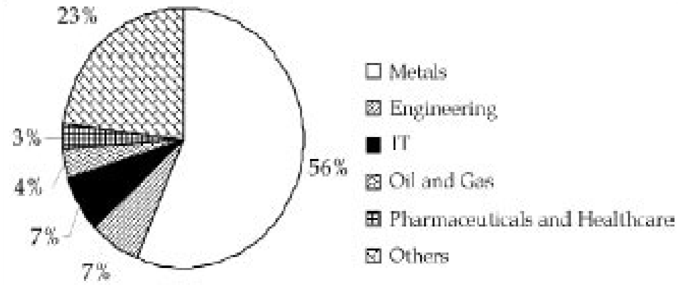
In contradiction with the past trend, where the growth was led by a few sectors, 2007 saw more variety. The telecom sector overtook the IT industry and dominated the M&A scene with a 33% share in the total deal value. The largest deal of the sector was Vodafone acquiring a 67% stake in Hutchison Essar, now Vodafone Essar, India's fourth largest telecom player. It was followed by finance with a 15%, cement and building material 7%, oil and gas 5% and metals 5%. Among the sectors, aviation, shipping and logistics accounted for 4% of the total deal value.

In all, there were 223 deals worth Rs.1,367 bn ($33 bn) registering a massive growth of 300% over the previous year (140 deals worth $8 bn). The average deal size increased from $58 mn in 2006 to $150 mn in 2007. This underlines Indian companies' readiness, enthusiasm and confidence to go global.

The metal sector occupies the lion's share in the overseas M&A deals with 56% of the total investments contributed by the Tata-Corus deal and the Hindalco-Novelis deal. Other sectors attracting large investments were engineering, information technology and, oil and gas. The largest deals in the respective sectors were: Suzlon Energy acquiring Repower Systems for $1.8 bn; Wipro Ltd. acquiring Infocrossing Inc for $557 mn; and Aban Offshore increasing its stake in Sinvest from 37% to 97% for $774 mn.

The largest deal of the year was India's steel giant, Tata Steel, acquiring Anglo-Dutch giant Corus. Another high profile, multi-billion dollar deal was by the leading copper and aluminium manufacturer Hindalco. Hindalco spent $3.33 bn to acquire Atlanta-based Novelis, a leading aluminium sheet-maker. The third largest cross-border deal of the year was Suzlon Energy acquiring Germany-based Repower for $1.8 bn.

Figure: Cross-border Deals



Source: Business Line, Friday, March 07, 2008.

The major problem arising regarding cross-border mergers and acquisitions is the conflicting legal regimes of the various jurisdictions in which the two entities are located. Consequently, the tax efficient structuring of the transaction is turning out to be the "deal-maker" or the "deal-breaker" as the case may be.

TAX AND REGULATORY ISSUES IN CROSS-BORDER MERGERS AND ACQUISITIONS

Indian corporates, much like their global counterparts, are increasingly becoming involved in cross-border mergers and acquisitions with an intention to strengthen themselves or to restructure their business and thereby enhance shareholder value. Several tax and regulatory issues need to be considered when such deals come through.

Some of the salient tax and regulatory issues that arise as a result of cross-border mergers and acquisitions are outlined below:

SITUATION 1

Swap Transaction

As a result of business considerations, Indian residents holding the entire share capital of an Indian Company (Indian Company) intend to transfer their shareholding in the Indian Company to the Foreign Company in exchange for shares of the Foreign Company thereby making the Indian Company a 100% subsidiary of the Foreign Company. This exchange is commonly termed as a 'share swap' transaction.

Tax Implications

The transfer of shares in the Indian Company in exchange of shares of the Foreign Company would imply capital gains tax for the shareholders of the Indian Company. For the purpose of computing the capital gains, the cost of acquisition of the shares in the Indian Company would have to be reduced from the consideration received by the shareholders of the Indian Company.

The capital gains arising as a result of such a swap would depend on the valuation of the shares in the Foreign Company. The consideration received would have to be computed based on the value of shares in the Foreign Company received and not on the value of shares in the Indian Company parted. In case the Foreign Company was a listed company, the market value of Foreign Company shares received could be considered as the consideration for the transfer and thereby used to compute capital gains. In the past, sister legislations like the Wealth Tax Act and the Gift Tax Act provided for valuation of shares in unlisted companies on the basis of Net Asset Value (NAV). It is a moot point whether the NAV method can be utilized for computing the sale consideration of a share of unlisted company for the capital gains purposes.

It is also relevant to note that under US regulations, such a share swap is a tax neutral transaction.

In addition to the above aspects, provisions of Section 79 of the Act also need to be considered when an Indian Company has unabsorbed losses. Section 79 of the Act restricts a closely held company, i.e., a company in which public are not substantially interested, from carrying forward and setting off its losses against future profits in case of change of more than 51% shareholding of such a closely held company. Since more than 51% shareholding of the Indian Company would change in this case it will not be allowed to carry forward its prior year's losses for set off against profits of future years. Unabsorbed tax losses are a tax shield against profits of future years and hence it would be an important criterion to be considered in business restructuring.

SITUATION 2

Merger of an Indian Company with a Foreign Company

To achieve synergy in operations and to leverage upon the character and identity of the foreign company it is proposed to merge an Indian Company with a Foreign Company.

Tax Implications

The Act contains provisions that exempt capital gains arising in the hands of the shareholder in the course of the amalgamation in a case where the amalgamated company is an Indian Company. The Indian shareholders acquiring shares in the Foreign Company is subject to capital gains tax since in this case the Foreign Company is a foreign body corporate.

Implications from Corporate Law Perspective

Any compromise or arrangement with the members of the company or with the creditors of the company needs to be approved by a High Court in terms of Sections 391 to 394 of the Companies Act, 1956. However, as per the provisions of Section 394, a *transferee company* means a company incorporated under the provisions of the Companies Act, 1956 and a *transferor company* means any body corporate within the meaning of the Companies Act, 1956 or not. In view of this, when an Indian Company (transferor company) is merged with a Foreign Company (transferee company), the Foreign Company being a foreign company would not appear to be covered by the provisions of Section 394. This issue needs to be clarified by the Company Law Board.

SITUATION 3

Reverse Merger

To achieve synergy in operations and to tap the capital market opportunities in India, it is proposed to merge a foreign company with an Indian company.

Tax Implications

Since the fixed assets of the Foreign Company would be located abroad, no tax consequences would normally arise in India on transfer of such assets to the Indian Company. Further, the Indian Company would only be issuing its shares to the shareholders of the Foreign Company; hence no taxable event would take place in India.

Implications from Corporate Law Perspective

Any compromise or arrangement with the members of the company or with the creditors of the company needs to be approved by a High Court according to

Sections 391 to 394 of the Companies Act, 1956 or not. As per the provisions of Section 394, the court *inter alia* needs to make provisions for the following:

- The transfer to the transferee company of the whole or any part of the undertaking, property or liability of any transferor company;
- The allotment or appropriation by the transferee company of any shares, debentures, policies, or other like interests in that company which, under the scheme, are to be allotted or appropriated by that company to or for any person; and
- The provision to be made for any person who, within such time and in such manner as the court directs, dissents from the compromise or arrangement.

Since the Foreign Company is not within the jurisdiction of the Indian courts, it is a moot point as to how the 'Indian courts would be in a position to ensure that these activities are carried out in accordance with the approved scheme'.

SITUATION 4

Global Merger

A Foreign Corporation (Foreign Company 1) holds controlling stake (say 51%) in an Indian Company. The Foreign Company 1 proposes to merge with another Foreign Corporation (Foreign Company 2). As a result of this merger, the investment in Indian Company is transferred from Foreign Company 1 to Foreign Company 2.

Tax Implications

The transfer of shares of an Indian company from a foreign company to another foreign company in a scheme of amalgamation is exempt from tax if 25% of the shareholders of the amalgamating foreign company continue to be shareholders of the amalgamated foreign company and the transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated.

It may be relevant to note that under US regulations, such transfers are generally tax-free.

In addition to the above, caution needs to be exercised with respect to Section 79 of the Act as discussed under scenario 1, which restricts set-off of business losses of the Indian closely held Company if shareholders holding 51% of shares of the Indian closely held Company have changed.

According to a recent Amendment to Section 79 of the Act, if the shareholding in an Indian closely held company changes even in excess of 51% as a result of the amalgamation such that 51% of the shareholders of the amalgamating foreign company continue to be shareholders of the amalgamated foreign company, the loss of Indian closely held company will still be carried forward and set-off in the next years profits.

Transaction Issues

The other relevant issues that normally arise in such transactions are treatment of goodwill and non-compete payments from the tax perspective.

Goodwill

The payment in respect of goodwill is currently taxable in the hands of the recipient as capital gains. Recently, the government has amended the Act that provides for amortization in respect of intangible assets, but the definition of the word "intangible" does not cover goodwill. Expenditure on acquiring Goodwill whether it is paid in lump sum at one time (or) installment distributed over a definite period is a capital expenditure, i.e., expenditure incurred for acquiring Goodwill is not allowed as revenue expenditure. *[Mehra Khan & Co. Vs. CIT (2001)].* The annual sum paid for the use of Goodwill is a revenue expenditure *[Vithaldas Thakordas & Co Vs. CIT (1946)].*

Non-compete Payment

In the current era of competition, one of the main business considerations for any scheme of business re-organization/merger/acquisition is the competitive edge in the market. In view of this, non-compete covenants have become a common phenomenon in such re-organization. Again, due to evolving market conditions, each arrangement for non-compete is unique.

Any sum received (or) receivable in cash or kind under an agreement for not carrying out any activity in relation to business or sharing any know-how, patent, copyright of similar nature (or) information on technique likely to assist in the manufacture or processing of goods or provision for services are taxable under Section 28 as income from business.

Exception

Non-compete payment in respect of the (i) right to manufacture, produce or process any article or thing or (ii) transfer of a right to carry on the business, are taxable in the hands of the recipient as capital gains.

Under Section 28(ii), compensation or payment due to or received by the following persons, by whether name called, is chargeable to tax under the head "profits and gains of business or profession":

a. Any person managing the whole or substantially the whole of affairs of an Indian company, at or in connection with the termination of his management or the modification of the terms and conditions thereto;

b. Any person managing the whole or substantially the whole of the affairs in India of any company, at or in connection with the termination of his office or the modification of the terms and conditions relating thereto;

c. Any person, holding an agency in India for any part of the activities relating to the business of any person, at or in connection with the termination of the agency or the modification of the terms and conditions relating thereto; and

d. Any person, for or in connection with the vesting in the Government or in any corporation owned or controlled by the Government, under any law for the time being in force, of the management of any property or business.

In view of the payer, general rule is that payment made to a rival to ward off competition in the business would constitute capital expenditure provided the object of making that payment is to derive an enduring advantage by eliminating competition over some length of time *[CIT Vs. Coal Shipment (P) ltd. (1971)]*.

REGULATORY AND PROCEDURE FOR OBTAINING GOVERNMENT APPROVAL-FIPB

As per the current Foreign Investment Policy of the government, any foreigner intending to invest in India, either in the form of acquiring shares or by acquiring business of an existing concern, is required to obtain approvals from the Foreign Investment Promotion Board (FIPB).

Under the exchange control guidelines, an Indian resident is required to obtain prior approval of the Reserve Bank of India for making any investment abroad, either by acquiring shares of the entities abroad or by acquiring the business of the foreign concerns or by establishing the presence in foreign countries.

In addition to the above, anyone intending to acquire shares of the listed Indian companies would also need to comply with the Substantial Acquisition of shares and Takeover Regulations of Securities and Exchange Board of India.

The above are just a few of the salient issues which must be considered in cross-border mergers and acquisitions. With increasing activity in this area around the globe, these issues would gain greater attention.

Procedure:
All proposals for foreign investment requiring Government approval are considered by the Foreign Investment Promotion Board (FIPB). The FIPB also grants composite approvals involving foreign investment/foreign technical collaboration.

For seeking the approval for FDI other than NRI Investments and 100% Export Oriented Units (EOUs), applications in form FC-IL should be submitted to the Department of Economic Affairs (DEA), Ministry of Finance.

Plain paper applications carrying all relevant details are also accepted. No fee is payable. The following information should form part of the proposals submitted to FIPB:

a. Whether the applicant has any existing financial/technical collaboration or trade mark agreement in India in the same field for which approval has been sought.

b. If so, details thereof and the justification for proposing the new venture/ technical collaboration (including trade marks).

c. Applications can also be submitted with Indian Missions abroad who will forward them to the Department of Economic Affairs for further processing.

d. Foreign investment proposals received in the DEA are generally placed before the Foreign Investment Promotion Board (FIPB) within 15 days of receipt. The Decision of the Government in all cases is usually conveyed within 30 days.

SUMMARY

- Of late, the economy is seeing the growth of international mergers. These international mergers share most of the similar influences and motivations with the domestic mergers. However, the threats and opportunities seen by the international mergers are unique to them.
- Firms going in for international mergers have to analyze their costs and synergies carefully. Once they decide to go for it, it can be implied that costs to be incurred in the merger activity would be justified by the increased productivity and the synergy. In case of a horizontal merger, intangibles play an important role in both domestic as well as international mergers. Similarly, in vertical integration, firms try to internalize markets for intermediate products.
- Tariff barriers and exchange rate relationships influence the international mergers more than the domestic mergers. In spite of the reduced costs and the synergies expected from the international merger, there always hangs the risk of operating in a foreign environment. This can however be reduced through proper planning and by following an incremental approach while entering a foreign market.
- The international Mergers and Acquisitions activity has been growing in the recent past and is expected to continue in the future as well.

Chapter 12

Corporate Control – Buy-back of Shares and Exchange Offers

After reading this chapter, you will be conversant with:

- The Nature of Cash Share Repurchases
- Dividend like Effects of Share Repurchases
- Basic Stock Repurchase Model
- The Theories behind Share Repurchase
- Share Repurchases as a Potentially Unique Signaling Mechanism
- Criticism of the Potential Unique Signaling Benefit of Repurchases
- The Rationale behind the Popularity of Buy-backs
- Implications for Investors
- The Indian Scenario
- Share Buy-back by DLF – A Case Study
- Concept of Exchange Offers

Managers wishing to distribute profits to their shareholders have two choices: (i) Issue dividend, or (ii) Repurchase shares. Unlike in the past when paying out dividends was the most popular way of distributing profits, share repurchases are preferred today as a way to compensate shareholders with a company's excess cash. Share repurchases enhance shareholder value in many ways.

One of the reasons that companies opt for share repurchases over dividends is that shareholders often prefer capital gains over the current income that comes in the form of dividends. Moreover, in some countries dividends are double taxed since all the profits which a company earns are taxed at the corporate level besides being taxed in the hands of the receiver. (In the Indian context, dividends are exempted from tax in the hands of the receiver.). If a company wishes to pay-out some of its profits in the form of a dividend, the shareholders also have an income tax liability. This is the reason why in recent times dividend yields of stocks are being at all-time lows and at the same time share repurchase activity is becoming extremely active.

Another reason which justifies the operations of open market repurchases is related to free cash flow. Free cash flow gives rise to conflicts between shareholders and managers when the latter have incentives to invest in projects other than those which give positive net present value. By distributing the free cash flow to shareholders, repurchases lessen these conflicts. Repurchases are an extremely reliable means of distributing free cash flow because funds are distributed immediately. Other methods of distributing free cash, such as dividends, involve an obligation to make distributions in the future. Also open market repurchases are often a more flexible and efficient means of distributing free cash flow than major leverage increasing transactions such as debt-for-equity swaps and leveraged recapitalizations.

The free cash flow hypothesis implies that firms with high levels of excess cash flow and firms with low marginal financing costs will repurchase more stock. Firms with high levels of excess cash flow are at a greater risk of over investing, and hence, derive greater benefits from distributing cash to shareholders. Firms with relatively low marginal financing costs can distribute more cash to shareholders, knowing that if they must raise external funds in the future if cash flow is lower than expected, or profitable investment opportunities are greater than expected, the funds will be relatively inexpensive.

THE NATURE OF CASH SHARE REPURCHASES

A company can repurchase its own outstanding shares in three ways: (i) in the open market, (ii) by a tender offer, or (iii) by a private negotiation.

OPEN MARKET REPURCHASES

Open Market Repurchases (OMR) refer to a company's buying back of its own shares in the open market at the prevailing market price just as any other investor might buy the company's shares, as opposed to a tender offer for share repurchase or a negotiated repurchase. Open market share repurchases take place more often than tender offers to repurchase, but they are a smaller fraction of total shares outstanding than tender shares.

The firm wishing to repurchase its shares need not announce the OMR either in advance or while it is taking place and may start, suspend, resume, and terminate the OMR whenever it desires. Generally, firms announcing an OMR will typically indicate the number of shares they intend to repurchase, but at the same time makes clear that the number of shares that it will actually repurchase will depend on the market conditions. As a result, the firm is not compelled to repurchase any shares. Because of the lack of filing and other requirements an OMR's transaction costs are lower than those of a Repurchase Tender Offer (RTO).

Box 1: Buybacks offer through Open Market: A Little Protection to Stock Prices

Little Respite

	Stock price (Rs.)		
	Maximum#	Open*	Current@
EID Parry India	160	155.7	129.8
Supreme India	125	112.2	101.1
Surana Telecom	50	28.2	18.3
Rain Commodities	307	201	71.2
Reliance Infra	1600	1300	482.9
Goldiam Intl.	85	59	11.11
Sasken Comm	260	130.5	51.6
Patni Computer	325	246.8	121

Maximum price indicated for the offer

* Date of buyback the Opening price

@ Price as on 22nd March 2009.

Presently, more and more listed companies are taking the buyback route to signal that their stocks are undervalued, buybacks completed over the last six months suggest that the strategy has done little to protect stock prices from their incessant decline.

The eight companies which have been completed buybacks through the open market over the last six months have seen their stock prices drop by 8-80 percent, from the opening day of the respective buybacks, till date.

Share Prices Plummet

From the above table we can analysis that Companies such as EID Parry India, Reliance Infrastructure, Supreme Industries and Surana Telecom which have recently closed their buyback offers and extinguished shares have witnessed sharp tumble in stock prices during and after the offer period. That the market did not take a cue from the buybacks is evident from the low average prices at which the shares were mopped up.

All the companies have bought back shares at an average price much lower than the maximum price indicated for the offer. Rain Commodities for instance bought back shares at an average price of Rs.150 as against the stated maximum price of Rs.307. Surana Telecom bought back its shares at half of the maximum price of Rs.50 a share.

The open market route adopted by most companies has been much less effective than the alternative "tender offer route" in boosting market sentiment in these stocks. Open market offers seldom provide an opportunity for retail investors to participate equitably in the offer, as shares are sold in the open market at the prevailing price.

The number of shares extinguished in the eight offers that closed range between 2 and 8 percent of the issued number of shares pre-buyback – perhaps a proportion too small to enhance per-share profits.

Source: www.blonnet.com

NEGOTIATED REPURCHASE

Negotiated repurchase involves repurchase of shares from a smaller number of shareholders who own a significant block of the company's common stock. In recent years negotiated repurchases are being used to defend against groups of shareholders who try to make large initial purchases with an intention of taking over the company by a tender offer. The management of the target arrange for a negotiated repurchase which is termed as a 'greenmail'. It may sometimes include a standstill agreement under which the investors in the company agree to sell their shares and not make any additional purchases for a specified period of time.

REPURCHASE TENDER OFFERS

In a tender offer the company usually decides the number of shares it is offering to purchase, the price at which the company would repurchase the shares and the period for which the offer would be open. The offer price is generally higher than the market price prevailing at the time of the tender offer. The number of shares offered for tender represents the total number of shares which the company intended to repurchase. If the shares tendered exceed the limit, then the company might buy all or a portion of the shares tendered in excess of the number announced. Shares are repurchased on a pro rata basis (same fraction from every tendering shareholder) if the number of shares repurchased is less than the number of shares tendered. The company also has the right to extend the time period of the offer. Usually, when fewer shares are tendered than what is targeted by the company, the length of the offer period is extended. All the shares tendered during the initial offer period are repurchased and the shares tendered during the extension period are purchased either on a pro rata basis or on the basis of the order in which the shares are offered. The tender offer generally does not permit officers and the directors of the company to tender their shares.

Box 2: Repurchase Tender: Fixed Price and Dutch Auction

Basically, the Repurchase tender offers are to be used in Fixed Price and Dutch auction. Recently two of the Indian companies Eicher Motors and Srei Equipment Fin. have adopted these procedures.

Fixed Price: The board of Eicher Motors has decided to buy-back the equity share up to 14,08,969 fully paid-up equity shares of the face value Rs.10 each from the existing shareholders of equity shares through the Tender Offer route in accordance with Section 77A of the Companies Act, 1956 at a price of Rs.691.68 per share payable in cash, for an amount aggregating up to Rs.97.46 crore.

This offer size represents up to 21.28% of the aggregate of the company's total paid-up equity capital and free reserves as on March 31, 2008. The buyback would not be more than 25% of its total paid-up equity capital as provided under section 77A of the Companies Act, 1956. In terms of buy-back Regulations, under tender offer route, the promoters have right to participate in buyback. Therefore, Mitsubishi Motors Corporation is free to participate in the proposed buy-back to the extent of their shareholding. They hold 10 lakh equity shares of the company.

Dutch Auction: The Company Srei Equipment Finance Pvt Ltd, a joint venture between Srei Infrastructure Finance Ltd. and BNP Paribas, expects to start financing medical and IT equipment projects from year 2009. As per the company expectation the medical equipment market in the country is estimated at $500 million and the IT equipment much more. The joint venture was formed with an initial net worth of Rs.800 crore and currently has an asset base of Rs.8,000 crore.

The company has conducted similar auctions in six to eight major cities if India. This is the fourth year that the auction has been conducted and the total business raked in was to the tune of Rs.1,500 crore on the previous occasions. But this year alone, expect to do Rs.1,500 crore through the nine events. The company's motto to bring together the construction equipment manufacturers on one side and contractors engaged in construction activities on the other. After which the company offer the companies finance for the equipment being presented, for which the bidding will be done Dutch style.

That is, the interest rate will start high, and be lowered until a contractor bids to buy at that interest rate and that bids for the loan are allowed by only those contractors whose due diligence qualifies them to do so.

Source: www.blonnet.com

Of all the three ways through which share repurchases is done, tender offer repurchases are usually of the largest magnitude because its impact on the market is more clearly defined and measurable. This is because the date of the repurchase, the actual dates of the repurchase activity and the repurchase price is known in advance.

Section 77 of the Companies Act governs the rule for share repurchases. According to which, private, public and listed companies can all buy-back shares. However, listed companies will have to wait for the Securities and Exchange Board of India (SEBI) Regulations. Power in articles and a special resolution are pre-requisites. Buy-back can be taken in the form of tender offers acquiring shares from shareholders on proportionate basis, purchases in open market, and purchase of odd lots. Negotiated buy-backs are not permitted in India. Without adequate safeguards and transparency, negotiated buy-backs have a serious potential for harm to shareholders' interests. At the same time, it should find a place with due protection as it is a convenient method to buy-back certain groups of shareholders. Buy-back can be out of securities premium, free reserves and prior issue.

(Refer to the Appendix-A for detailed guidelines).

DIVIDEND LIKE EFFECTS OF SHARE REPURCHASES

A share repurchase transaction can be visualized as a two part transaction in which a firm issues a dividend and causes shareholders to trade with another. In particular, a repurchase can be thought of as a transaction in which the corporation (i) compels non-selling shareholders to purchase the stock of selling shareholders at the repurchase price, and (ii) then issues a dividend equal to the amount of the repurchase.

A simple example can be used to illustrate the equivalence between a share repurchase and this two-part transaction.

Suppose that ABC Corp. has N shareholders, each of whom owns one share.

Consider a single-step stock repurchase in which ABC repurchases X shares for a price Rs.P per share. The effect of the repurchase is that (i) X shareholders have sold all of their shares for a total of Rs.XP in cash; (ii) ABC has distributed Rs.PX in cash; and (iii) the (N – X) non-selling shareholders own 100 percent of ABC.

Now consider the following two-step transaction: First, ABC causes the selling shareholders to sell their X shares to non-selling shareholders (pro rata) at the price Rs.P per share. Call this the "involuntary trading component". Second, ABC distributes a dividend of Rs.PX to the remaining (non-selling) shareholders. Call this the "dividend component".

The results of this two-step transaction are identical to those of the single-step transaction: (i) the selling shareholders end up with Rs.PX and no shares in ABC; (ii) ABC has distributed Rs.PX in cash; and (iii) the non-selling shareholders own 100 percent of ABC.

Because of this equivalence a share repurchase can be considered to be having two types of economic effects: the economic effects that flow from the dividend component of the transaction and the economic effects that flow from the involuntary trading component of the transaction. Reconceptualizing the effect of share repurchase in this way makes it clear that only differences between a dividend and a share repurchase are those that arise from the involuntary trading component of the repurchase.

Before we consider these differences, however, it will be useful to first examine the potential efficiency consequences of a dividend – and therefore, the potential efficiency consequences arising from the dividend component of a repurchase. It is to this subject that we now turn.

Dividends and share repurchases can influence the social value in two ways:

i. By reducing the cash available for corporate projects and increasing the cash available for projects outside the corporations, and

ii. By increasing leverage and thereby changing managerial incentives.

The net effect on social value can be either positive or negative. This can be explained as follows:

REALLOCATION OF CAPITAL

The first mechanism by which dividends and repurchases can effect social value is through their effect on the allocation of capital. Dividends and repurchases move funds from corporate projects to projects outside the corporation. The efficiency consequences will depend on the returns of the different projects. When a firm's projects have higher expected returns than the alternative investments available to its own shareholders, distributing cash will be wasting value. The funds could be better used in the firm.

On the other hand, when the firm's projects have lower expected returns than projects outside the firm, distributing cash is value increasing. Funds that could be better used outside of the firm are called 'excess' or 'free' cash.

ALTERING MANAGERIAL INCENTIVES BY INCREASING LEVERAGE

The second means by which a dividend and repurchase can affect social value is by changing managerial incentives. Managers' incentives are not fully associated with value maximization.

They are altered due to three reasons. First, managers do not capture the full benefit of their efforts because they own only a fraction of the equity, and thus have an incentive to work less than would be socially optimal, that is, to 'evade'. Second, to the extent managers are risk averse, they may give up the positive expected value projects with a high likelihood of failure. Finally, managers of highly leveraged firms who own a large amount of equity may have an incentive to choose high risk negative expected value projects rather than low risk positive expected value projects in order to benefit shareholders at the expense of creditors.

The reduction in total wealth that results from each of these distortions is called an 'agency cost'.

Dividends and repurchases can effect managerial incentives by increasing leverage – the debt/equity ratio of the firm – and therefore the likelihood of failure. The manner in which dividends and repurchases increase the risk of failure depends on whether the distribution is funded by new debt. If the dividend is funded with new debt, the firm is obliged to make additional interest payments, which increases the likelihood that the firm will not be able to make these payments in bad times. If the dividend is not funded with new debt, the managers will have fewer assets with which to make payments on any old debt. In either case the likelihood of failure increases. As explained below, by increasing leverage and the risk of failure, dividends and share repurchases can ease or worsen each of the three distortions described above.

Shirking or Evading

Managers have an incentive to work less and take less care than is optimal, because they enjoy 100 percent of the benefit of their "shirking", but pay (through the reduction in the value of their shares) only a small fraction of the cost of their shirking to the firm.

A cash distribution, whether in the form of a dividend or share repurchase, reduces this problem by raising the cost to the managers for evading their responsibilities. The distribution raises the cost of evading by making it more likely to lead to a crisis that could threaten managers' jobs. This should give managers an incentive to focus harder on generating revenues and cutting costs, making the corporation more efficient.

Risk Aversion

Managers tend to place a high value on keeping their jobs (and in particular the salary, power and prestige that comes with them). When the firm does poorly, managers face an increased likelihood of losing their jobs. To the extent managers value their jobs they will be reluctant to engage in projects that have a relatively high probability of failure, even if those projects are value maximizing. Because a dividend or repurchase increases the likelihood of failure, either form of cash distribution could exacerbate the problem of risk aversion by making managers even less likely to undertake value-increasing projects that happen to be risky.

Asset Substitution

Once firms have borrowed funds, they may have an incentive to choose projects that benefit shareholders at the expense of creditors even though the projects are value-wasting. The severity of this distortion increases as leverage increases. Thus, to the extent a dividend or repurchase distribution boosts leverage it may increase managers' incentives to engage in high risk value-wasting projects.

BASIC STOCK REPURCHASE MODEL

Analysts have designed the basic stock repurchase model to understand better the implications of stock repurchases and exchange offers. Some of the assumptions which are made under the model are:

i. The market is efficient, i.e., at any given time the market prices reflect all publicly available information that influences the prices of securities.

ii. There is pure competition in the markets. This means that the information is costless and is the same and received at the same time by all individuals.

iii. The individual investors are price takers and they cannot influence the outcome of a stock repurchase, i.e., there is perfect competition in the markets.

iv. The expectations of all investors regarding the various aspects of the share repurchase like the change in value caused by the repurchase, portion of shares tendered and the portion of shares purchased by the company are homogenous.

v. Investors seek to maximize their wealth only after taking into consideration the taxes and the transaction costs.

vi. The price changes are evaluated with respect to the repurchases only after adjusting for the market wide price changes.

vii. Offers are maximum limit offers. This means that when the offer is undersubscribed the firm will buy all the shares and when the offer is oversubscribed the firm will either by all or some portion of these shares on a pro rata basis.

According to the basic repurchase model,

$$P_x N_x = P_0 N_0 - P_{TP} (N_0 - Nx) + W$$

Where,

P_0 = Pre-announcement share price.

P_{TP} = The tender price.

P_X = The post-expiration share price.

N_0 = The pre-announcement number of shares outstanding.

N_X = The number of shares outstanding after repurchase.

W = The shareholder wealth effect caused by the share repurchase.

The equation states that, the value of the shares outstanding after expiration of the repurchase offer equals the value of the shares existing before the announcement of the repurchase offer less the value of the shares repurchased plus the change in the shareholder wealth associated with the repurchase offer.

Illustration 1

XYZ Ltd., a listed company in the Bombay Stock Exchange which has 50,000 outstanding shares has made an offer to repurchase 18 percent of its shares through an open market operation. The shares are being quoted at Rs.84. XYZ Ltd., offered Rs.92 for each share sold by the shareholders. 25 percent of the outstanding shares were offered by the shareholders for the buy-back.

Estimate the value of the remaining shares after the repurchase.

Solution

According to the basic stock repurchase model.

$$P_x N_x = P_0 N_0 - P_{TP} (N_0 - N_x) + W$$

Where,

P_0 = Pre-announcement share price.

P_{TP} = The tender price.

P_X = The post-expiration share price.

N_0 = The pre-announcement number of shares outstanding.

N_X = The number of shares outstanding after repurchase.

W = The shareholder wealth effect caused by the share repurchase.

$= 84 \times 50{,}000 - 92\ (50{,}000 - 37{,}500) + 0.18 \times 12{,}500$

$= 42{,}00{,}000 - 11{,}50{,}000 + 2{,}250$

= Rs.30,52,250.

Therefore, value of the shares outstanding after expiration of the repurchase offer = Rs.30,52,250.

Value per share = 30,52,250/37,500 = Rs.81.40 per share approximately.

THE THEORIES BEHIND SHARE REPURCHASE

As studied earlier there is an increase in the market price of the firm's common stock as a consequence of the share repurchase. This is because of the following reasons:

DIVIDEND OR PERSONAL TAXATION

The dividends received on the equity shares are taxed at the ordinary income tax rates whereas capital gains are taxed at lower rates. The cash received by the shareholders in a stock repurchases in excess of the acquisition price of the shareholders is taxable at the capital gains tax rate. Hence, a share repurchase enables the stockholder to substitute a lower capital gains tax for a higher ordinary personal income tax rate on the cash received.

LEVERAGE

Repurchase of stock increases the debt/equity ratio. If the repurchase is financed with cash and other marketable securities the extent to which the debt/equity ratio increases depends on the method used to calculate the leverage ratio. If the share repurchase is financed clearly by an issue of debt then the increase in the debt/equity ratio is regardless of the method of calculation used. Also the amount of tax deductible interest payments increases with the use of debt in the share repurchases exercise.

INFORMATION AND SIGNALING

The most popular explanation for stock repurchases is that they are a means by which management can convey, or signal, its view that the firm's stock is undervalued. The announcement by a company that it is going to employ a share repurchase exercise sends an information signal to the investors. An announcement of the management to buy its own shares conveys information, that it has no other profitable investments in which the funds can be utilized. It can also convey another message. When the management tries to buy its own shares at the premium above the market price, it may convey an inside information that the company is undervalued by the market.

Analysts have found that the wealth of the shareholder increases due to the above signaling effects.

Example, in 1997, Coca-Cola opted for buy-back of 8.3 percent of their equity that raised the price of the scrip by a whopping 42 percent in the New York Stock Exchange (NYSE). Several major companies that have opted for share buy-back in the recent past include Samsung, Citigroup, Mastek, Reliance Energy, Britannia, Godrej etc.

The signaling theory of share repurchases is explained in detail later in the chapter.

Box 3: Reliance Infrastructure to Buy Back Share through Open Market Window
Reliance Infrastructure, announced a buy-back of its equity shares at a maximum price of Rs.700 a premium of about 27% to Current Market Price per share. It has earmarked Rs.700 crore (US $ 143 million) for the purpose. The Reliance Infrastructure board and its shareholders have approved the share buy-back for an amount of upto Rs.700 crore, being the maximum amount that the board is authorized to deploy for this purpose, as per the provisions of the Companies Act, 1956, and prevailing Securities and Exchange Board of India regulations. As per board of the company during AGM explained that the proposed buy-back will lead to a reduction in the outstanding number of equity shares, and consequent increase in Earnings Per Share (EPS), improvement in return on net worth and other financial ratios. This will send a strong signal to the capital markets on the under-valuation of the company's stock price and the confidence of the management in future growth prospects and be a deterrent to speculative activity in the company's stock.

Source: www.economictimes.com

BOND HOLDER EXPROPRIATION

Share repurchases also result in an increase in the bond prices. Significant positive rates of return were observed for the convertible securities, which may be regarded as delayed issues of common stock. Hence, bond holder expropriation is one of the reasons for share repurchases.

WEALTH TRANSFER AMONG SHAREHOLDERS

Transfer of wealth takes place between shareholders who have tendered the shares and those who have not tendered their shares. The largest portion of the wealth effect goes to the shareholders who do not tender their shares, since they experience significant gains as the price of expiration still remains higher than the price of the stock before the announcement of the repurchase tender offer. Moreover, since no insiders (management) are allowed to participate in the offer it gives signaling information that the stock price in future will be even more favorable than at the expiration period.

DEFENSE AGAINST OUTSIDE SHAREHOLDERS

When the management of a firm feels that the firm is undervalued, it may be worried that it may be subject to a takeover bid at a relatively small premium. A large premium in the share repurchase order may convey information to the outside shareholders that the value of the share should be as high as the premium and may be perhaps even higher in the future. This could put the market on notice that if a takeover bid is to succeed, it may have to be even higher than the repurchase tender offer premium.

SHARE REPURCHASES AS A POTENTIALLY UNIQUE SIGNALING MECHANISM

According to the "signaling theory", managers who have confidential information indicating that the stock is underpriced and intend to signal that the stock is underpriced can use a share repurchase (but not a dividend) to do so. In particular, managers can convincingly signal that the stock is worth more than the repurchase price by conducting either an RTO or an OMR and committing not to tender or sell their own shares. In this section, we will explain why according to the signaling theory, managers may need to signal in such a manner and how share repurchases can uniquely enable them to do so.

NEED TO SIGNAL

Managers often have inside information about the value of the stock which is not reflected in the stock price. This information may sometimes indicate that the stock is underpriced. And the managers may wish to communicate this positive information to shareholders. The managers may consider disclosing the basis of their belief. However, disclosure of all the data may be impossible because of concerns of confidentiality or difficulty of describing the facts on which the managers' conclusions are based. The managers may consider to simply announce that the stock is underpriced. According to signaling theorists, however, there is no cost to the manager who falsely announces that the stock is underpriced. Thus, an announcement that the stock is underpriced will not convince the market. To convincingly signal underpricing, managers must act in a way that compels managers to incur substantial costs if the stock is not actually underpriced. And, these costs must be high enough so that a would-be false signaler would find the signal too costly to send.

SHARE REPURCHASES AS A SIGNAL OF UNDERPRICING

By offering to repurchase shares and committing not to sell their shares, managers, can signal that the stock is worth more than the repurchase price. This is because, as was explained, a share repurchase in effect causes non-selling shareholders to buy the shares of selling shareholders. Thus, managers buy those shares at the repurchase price. In particular, managers purchase a fraction of all the share repurchases equal to their post-repurchase proportional interest in the firm. To the extent the actual value of the shares is below the repurchase price, this transaction makes managers worse off because they overpay for those shares. Thus, the signaling theory suggests that by committing not to sell their shares managers send a credible signal that the actual value of the stock is above the repurchase price. The cost to managers of false signaling increases with the size of the repurchase and the percentage of insider ownership. Thus, the larger the repurchase amount, and the higher the percentage of insider ownership, the more credible is the signal.

For the share repurchase to be a credible signal that the stock is underpriced, managers must undertake that they will not sell any shares until the good news signaled by the repurchase is supposed to materialize. Otherwise, managers would have an incentive to conduct a share repurchase when the stock's actual value is below the repurchase price, indicating that they will not sell during the repurchase and thereby, falsely signaling good news, and then sell their shares at a high price after the signal has caused the market price to rise.

In theory, both RTOs and OMRs can be used for signaling underpricing. An RTO in which managers pledge not to tender their shares or sell them into the market after the announcement has caused the stock price to rise would signal that managers believe that the stock is worth more than the offer price (or, in the case of a Dutch auction RTO, the highest price on the offer range). There is nothing inherent in OMRs that would prevent managers from using OMRs to signal in the same manner as RTOs. For example, if the stock is trading at Rs.10 managers could announce that during a specified period the corporation will repurchase stock in the open market whenever it falls below Rs.10, that the corporation will expend upto a certain amount on the repurchase, and that the managers will not sell their shares below Rs.10 during that period. This would signal the managers' belief that the stock is worth at least Rs.10.

CRITICISM OF THE POTENTIALLY UNIQUE SIGNALING BENEFIT OF REPURCHASES

We have seen that share repurchases can, in theory, be used to signal that the stock is underpriced. However, some analysts feel that managers do not have an incentive to use repurchases to signal underpricing. According to them signaling is not the primary or even secondary motive for most Repurchase Tender Offers (RTOs) and Open Market Repurchases (OMRs). They also say that if managers had an incentive to signal underpricing the potential efficiency benefit of that signaling would be low, because there are even better means of sending the same signal.

MANAGERS' INCENTIVE TO SIGNAL

Let us first consider the managers' incentives to signal. According to the signaling theory managers benefit from using repurchases to signal underpricing. However, in practice managers have little incentive to use repurchases to signal underpricing because they can use the same inside information indicating that the stock is underpriced to profit at the expense of public shareholders. This can be explained with the help of an example:

Suppose managers know that the stock is worth Rs.15 when it is trading for Rs.10.

The signaling theory would indicate that managers conduct a Repurchase Tender Offer (RTO) at Rs.15 and pledge not to tender their shares or sell their shares within the "acceleration period" following the RTO, i.e., the time it is expected to take for the inside information indicating that the stock is worth Rs.15 to emerge on its own. The announcement of the RTO coupled with the pledge would credibly signal that the stock is worth at least Rs.15.

However, conducting an RTO at Rs.15 and holding their stock until the information indicating that the stock is worth Rs.15 emerges would provide the managers with no profits. Consider an alternative use of the same information. Managers knowing the stock is worth Rs.15 when it is trading at Rs.10 buy as much stock as they wish for their own accounts. The managers then conduct an OMR or an RTO at Rs.10 in order to indirectly buy more stock at a low price. When conducting the RTO or OMR, the managers do not commit to hold their shares because this would send an unequivocal signal that the stock is worth more than Rs.10. If such a signal were sent, public shareholders would not tender or sell their shares for Rs.10 and the managers could not profit from the repurchase. By failing to announce their tendering or selling plans, managers leave shareholders wondering whether (a) the stock is worth more than Rs.10 and the managers are attempting to buy low, or (b) the stock is worthless than Rs.10 and the managers are using the repurchase option to sell their shares back to the firm at a high price. Because of this uncertainty, some public shareholders will be willing to sell or tender their shares for Rs.10. Thus, it is not in the managers personal interest to conduct repurchases in a way that sends a credible signal of underpricing. Managers act more in a manner much more consistent with insider trading than signaling.

SHARE REPURCHASES ACTIVITY – EFFECT ON SHAREHOLDER VALUE

The very nature of share repurchases answers this basic question. Share repurchases result in decrease in the number of shares outstanding. Smaller numbers of outstanding shares not only increase the relative percentage ownership of the remaining shareholders, but also increase the percentage claim on the company's profits. In other words, buying back shares increases the Earnings Per Share (EPS) assuming that net income is stable. If a company can manage to increase earnings at the same time when it is buying back shares, the growth in EPS is compounded.

Another reason why share buy-backs tend to increase shareholder value is the equilibrium between supply and demand for any given stock. If demand remains constant and the supply (number of shares outstanding) decreases, prices in a free market tend to rise. This is simple economics.

Reducing excess cash can also have a dramatic effect on some important efficiency metrics that many investors look at. Assuming that a company's net income remains constant over time, share buy-backs also tend to increase both a company's Return On Assets (ROA) and Return On Equity (ROE). This can be expressed as,

Return On Assets = Net Income/Average Assets.

Since cash is certainly a part of any company's assets, it again makes sense that reducing assets by spending money to buy-back shares would increase the ROA, all other things remaining constant. Substituting "Equity" for "Assets" in the above equation also shows why share buy-backs tend to increase ROE with steady profits.

However, share repurchases, are not always successful. One of the worst times a company can buy-back shares is when the company's core business is in trouble. When investors start selling a stock because of deterioration in the fundamental health of a company, management is often attracted by the temporary positive effects that share buy-backs may yield. But, if the company's future fortunes are actually declining, buying back shares generally wastes the valuable cash that may be needed to help the business come out of the problem. In other words, share buy-backs done poorly can worsen a bad situation.

Another disadvantage of share repurchase is when a company has a high amount of debt. In this case, buying back shares represents nothing more than an increase in a company's leverage, not really a return of excess cash.

Box 4: Not a Silver Bullet

An Investment Banking firm declined an assignment of a company that already had a Board Authorization to move ahead with the execution of a share buy-back. Let us see the reasons:

A company is a technology firm with a publicly stated business strategy to grow through acquisition.

The buy-back would risk putting its financial strategy directly at odds with its business strategy.

Should not the cash reserves and potential debt capacity be preserved for acquisition targets? An argument for shoring up their acquisition "currency" could only be rationalized if the buy-back could increase the share price much more than the offsetting loss of cash and debt capacity.

While the share price was down significantly, operating cash flow was also down. In fact, it had negative operating cash flow as a result of generally reduced telecom sector capital spending and a nervous outlook for broadband based consumer applications. The company's share price implicitly assumed a significant rebound in operating cash flows – a future growth value that more than offset the capitalized value of negative operating cash flow. The valuation was premised on considerable growth and access to capital.

The Board had authorized opportunistic open market repurchases for five percent, may be 10 percent, of outstanding shares. A very weak signal. But even worse, the investment banking firm found record of heavy insider selling even as its share price was registering new lows. Regardless of the terms and mechanism of repurchase, it would be difficult to create any signaling value in the face of insider selling. The managers would need to borrow money and make a premium tender offer for any signal.

With a financial strategy at odds with its business strategy, a potentially inappropriate capital structure and limited cash, and negative signaling, a share buy-back would most likely be seen as a desperate attempt to shore up the share price in the face of poor operating results.

Source: Justin Pettit, 'Share Buy-backs: Where are we headed?' Chartered Financial Analyst, December 2001.

While there are always some exceptions to the rule, share buy-backs tend to enhance shareholder value when done properly. Investors will serve themselves well if they know why repurchases work and can spot the difference between what is a true return of capital to them and what is merely a fake transaction and leveraging up.

THE RATIONALE BEHIND THE POPULARITY OF BUY-BACKS

By purchasing its own stock, a company reduces the number of shares outstanding without disturbing its reported earnings, consequently increasing the company's earnings per share. But buy-backs do not create value by increasing earnings per share. Apparently a buy-back is an economic non-event. If increased earnings per share were the only rationale for buy-backs, it would have no impact on value.

Buy-backs can create value in two main ways. Firstly, the announcement of a share repurchase, its terms, and the way it is implemented all convey signals about the company's prospects and plans, even though few managers accept this publicly. Secondly, when the buy-back is financed by a debt issue, it can significantly change a company's capital structure, increasing its dependence on debt and decreasing its dependence on equity. Buy-backs can also be a tax efficient alternative to dividends. Buy-backs offer companies a shareholder-friendly way to distribute cash where investors are taxed highly on cash dividends than on capital appreciation.

Some analysts argue that much of the popularity behind share buy-backs is their relative advantage against dividends in effecting the value of executive stock options.

The rationale behind share repurchase can be summarized as follows:

i. To increase share price,

ii. To rationalize the company's capital structure,

iii. To substitute dividend pay-outs in cash with share repurchases,

vi. To prevent dilution of earnings, and

v. To deploy excess cash flows.

Box 5: No Delisting after Buy-back Likely

The Securities and Exchange Board of India (SEBI) proposed to prohibit companies that have concluded a buy-back of securities or made a preferential allotment from delisting their shares.

Further, no company can delist its shares within three years of listing its shares on any stock exchange, or when it has any convertible instruments still outstanding, the SEBI's proposed amendments to the February, 2003 delisting guidelines say.

SEBI's proposed amendments say that when the promoters do not accept the 'discovered price' in the reverse book building route for delisting, it will be presumed that they have aborted the delisting process.

As a consequence, if the public shareholding has fallen below 10 percent at the start of the bidding, the public holding will have to be brought up to 10 percent by issuing new shares, or by an offer for sale.

SEBI has clarified that in the case of voluntary delisting, the shares may be delisted from all the stock exchanges where they are listed or only from the stock exchange where they are listed, provided everyone is given an exit opportunity. Where the shares are still traded on any exchange, the company does not need to provide a separate exit opportunity.

For delisting, the company will have to obtain the approval of its shareholders by introducing a special resolution, and within one year of passing the resolution make an application to the stock exchanges. The company has to close the process of delisting within 45 days of receiving approval from the exchanges.

SEBI has reiterated that the company's promoters will have to deposit in an escrow account 100 percent of the estimated amount of consideration calculated on the basis of the floor price indicated and the number of securities required to be acquired.

SEBI has already indicated that delisting will be through the reverse book building method. Where the shares are frequently traded, the floor price for building purposes will be at the average of the weekly high and low of the closing prices for the preceding 26 weeks.

Where the securities are infrequently traded, SEBI has set out three alternatives for arriving at the floor price. The offer will have to remain open for a period of 15 days, SEBI has said.

Source: Business Standard, April 9th, 2004.

IMPLICATIONS FOR INVESTORS

To evaluate buy-backs and their implications on the investment decision investors must understand the rationale and evaluate its relative merits in each specific case. Buy-backs are evidently a more tax efficient form of distribution of free cash than dividends. Open market repurchases seem to be a good mechanism to achieve this for companies seeking to distribute excess cash. The share price need not enter into the evaluation of this tactic; rather it is primarily a question of cash management and required levels of cash reserves.

Buy-backs can be an efficient mechanism to create value through changes in capital structure, especially tender offers. The value created per share, will be the expected value of the capitalized taxes saved from the tax shield of debt. However, if the cyclicality of taxable income is ignored there is a risk of overstating the value created from tax shields. First, the question is whether the tax shield will be fully utilized. Secondly, whether the change in capital structure permanent or temporary. Attributing a capitalized value to the benefit of taxes saved implicitly assumes a permanent increase in leverage. Finally, is the change in leverage appropriate? Is the valuation predicated on a significant growth value or real options that might be forgone without sufficient financial flexibility available to the company?

As mentioned earlier buy-backs can also create value through market signaling. This is particularly true in the cases of tender offers. But, most of the companies normally underestimate how many shares they need to buy to send a credible signal to the markets. While the general share repurchases typically range between 5-10 percent, they need to be closer to 20 percent to give a reasonable signal. And the credibility of a signal is seriously weakened if the company's managers choose not to participate in the buy-back themselves. This gives an impression that "they have not put their own money where their mouths are".

Share buy-backs are becoming an increasingly popular vehicle to create value. But many companies are looking to support share prices suffering from poor fundamental operating results. And executive stock options favor buy-backs ahead of dividends. So, investors must understand the rationale behind a buy-back, and evaluate the deal and investment thesis on its own merit.

GAINS TO INVESTORS

To answer the perennial question regarding – 'who gains?' in a share buy-back, i.e., whether the investor who receives a premium in buy-back or the investor who gets better EPS, we make an attempt to analyze this issue in terms of impact on the market price of the shares of both the tendering and the non-tendering shareholders.

Table 1

S. No.	Issuer Name	Premium Over Prevailing Market Price	Buy-back Price	Price on Opening Date	Price on Closing Date	Price Three Months after Closing Date	Tendering Shareholder		Non-Tendering Shareholder	
			(i)	(ii)	(iii)	(iv)	(i) – (ii) (ii)	(i) – (iii) (iii)	(iii)-(ii) (ii)	(iv)-(ii) (ii)
1	Finolex Cables Ltd.,	7.42%	275	256.00	261.00	257.00	7.42%	5.36%	1.95%	0.39%
2	Great Eastern Shipping Co. Ltd.,	23.35%	42	34.05	24.70	28.70	23.35%	70.04%	–27.46%	–15.71%
3	Indian Rayon & Industries Limited	14.68%	85	NA	76.20	109.25	NA	11.55%	NA	NA
4	Madura Coats Ltd.,	37.61%	30	21.80	21.15	21.00	37.61%	41.84%	–2.98%	–3.67%
5	Raymond Ltd.	13.07%	160	141.50	105.15	83.00	13.07%	52.16%	–25.69%	–41.34%
6	Selan Exploration Technology Ltd.,	38.89%	20	14.40	14.20	14.55	38.89%	40.85%	–1.39%	1.04%
7	Winsome Yarn Ltd.,	43.88%	10	6.95	6.75	4.55	43.88%	48.15%	–2.88%	–34.53%
8	Reliance Industries Ltd.,	–10.55%	303	338.75	373.90	317.30	–10.55%	–18.96%	10.38%	–6.33%

Source: Prowess (CMIE Software Package).

Observations:

i. Reliance Industries is the only company that offered to buy-back its share at a discount to the prevailing market price to buy from its shareholders while all other companies offered at a premium over the prevailing market price.

ii. Except in the case of Reliance Industries, the shareholders of all the other companies who tendered their shares against the buy-back offer benefited both in the short-term and in the long-term.

iii. The shareholders who did not tender their shares against buy-back in Reliance Industries and Finolex Cables, gained marginally in the short-term, while in the long-term the gain was either insignificant or it was a loss.

THE INDIAN SCENARIO

In India, share buy-back was first introduced in 1999. Since then, there has been a spate of announcements regarding stock buy-back. In the recent past companies such as GE Shipping, Raymond, Reliance Industries, Jayshree Tea, Finolex Industries, Bombay Dyeing, Britannia, etc. have all announced their intention to buy-back their shares through the open market.

However, buy-back has not been very popular in India. Despite the fact that many specified group companies qualify for buy-back, not many of them will be able to make use of their cash flow to buy-back their shares, at current prices as it will directly effect their cash requirements for normal operations. Cash rich companies like Bajaj Auto, HLL, TISCO, TELCO, etc., will have to disburse huge amounts to buy-back even a fraction of their equity at prevailing prices, which are apparently higher than the book value of the shares. The other problem is that most of the Indian companies have a debt-equity ratio greater than one. Buy-back would increase this ratio and reduce the capacity of leverage of the firm. This is especially true is case of companies having a high proportion of fixed assets, like TISCO & TELCO. Since the firm will not be allowed to issue new shares for at least one year, it implies that the company will not be able to go in for any expansion for the next one year or so, it would be definitely a big dampener to the whole concept of share repurchase.

Many people feel that in India share repurchases can be used principally as an anti-takeover defense. However, the utility of share repurchases as a tool of defense in India is doubtful under the existing regulations. For example, in the US companies are allowed to borrow to buy-back their shares in case of a takeover bid. However, in India a company is not allowed to assume fresh borrowings for the purpose buy-back. This means that weaker companies which are predictably takeover targets cannot resort to buy-back as a defense mechanism.

Buy-back norms in the Indian scenario have been relaxed recently. The move was initiated by SEBI and has been accepted by the Central Government, which promulgated an ordinance relaxing the norms. Currently, Section 77A(2b) of the Companies Act, 1956, requires that a special resolution should be passed in the general meeting of the company authorizing the buy-back of their own securities (Refer Appendix A at the end of the chapter). The ordinance also provides for the reduction of time limit from 24 months to 6 months. The present Section 77A(8) stipulates that when a company has completed its buy-back of shares it shall not make further issue of the same kind of share within a period of 24 months. However, these guidelines are changed in the new norms.

The relaxation in the buy-back norms is with an intention to improve the market sentiments, which have been quiet, depressed. The recent developments in the US have also been considered before taking these decisions. The main features of the new norms include:

i. Companies would be allowed to buy-back shares every six months as against the earlier time limit of 24 months.

ii. The Board of Directors of a company can decide to buy-back 10 percent of the total paid-up capital and free reserves of the company in a year without waiting for shareholders' approval. Only if the buy-back by the company is more than 10 percent of its paid-up equity capital and free reserves a special resolution would be mandatory.

Buy-back had not been a very popular option with the Indian companies prior to these changes. Despite the fact of companies' having excess cash at their disposal and shares being traded at rock bottom prices not many companies opted to buy-back their shares. It remains to be seen if the relaxation is going to make this an attractive option in the coming years.

Box 6: Buyback of Shares doesn't Succeed in Enthusing Investors
During past one year India Inc's has attempted to buy back shares and have failed to yield the desired results. In present scenario the shares price most of the companies have plummeted. Companies traditionally announce buybacks if they think the current price of stock does not justify the intrinsic value of the firm. A buyback helps reduce outstanding equity and shores up the Earnings per Share (EPS), return on asset and return on equity. Availability of surplus cash and inadequate liquidity in the stock market are also some of the factors that prompt companies to consider buybacks. However, almost all companies, which have announced buyback of shares, have seen their stocks decline, making the entire exercise futile. The drop is also true in cases of companies that have completed buyback of shares since their initial announcement in January last year. At least 10 companies, including Patni Computers, Great Offshore and Distriparks, are among those which have closed their share buyback plans but their share price could not achieved the profitability for shareholder as well for company. "The idea of buybacks is not to provide supernatural returns to some shareholders as it could be detrimental to those who stay back. Analysts are questioning the rationale for companies buying back shares at a time when stock markets are tumbling, which doesn't help investors' confidence. They are asking whether companies should have put their capital to better use like loan repayments etc. A case for example can be taken for DLF, which is struggling to complete projects on time and has been forced to hold back a quarter of its commercial projects. DLF shares tumbled about 9 per cent the day after the company announced its intention to buy back shares. At present the scenario of whole economy is not good and the liquidity position is also tight, meanwhile the most of developer have position of cash crunch. The management of company should be planned strategically that the surplus of capital to use for investing in the business itself. Others feel that companies can do precious little if market sentiments continue to be negative. Geodesic, a local information technology company, on March 6 announced plans to buy back shares. The management of company has explained that we would not like to comment on the success or failure of the past instances of buybacks. However, we have evaluated our options of a buyback after looking at the valuations of the company, cash in the company post acquisitions we have made/ intend making and reserve cash as may be required by the company for our future needs. There are, however, a few exceptions to this. One of them happens to be Eicher Motors, which operates in one of the worst hit segment of automobiles. The company has seen its share price rising after announcing the buyback of shares. The probable explanation is that the commercial vehicle maker opted to buy back shares through tender offer, or directly from shareholders, instead of buying it from the open market.

Source: www.economictimes.com

SHARE BUY-BACK BY DLF – A CASE STUDY

DLF Limited is India's largest real estate developer company, based in New Delhi. The DLF Group was founded by Chaudhury Raghuvendra Singh in 1946. Presently, the company is operated by Indian billionaire Kushal Pal Singh, who inherited the company from Chaudhury Raghuvendra Singh. The company has over 751 million sq. ft. of development area including on-going projects and planned projects.

Company has accomplished 22 urban colonies in Delhi alone. The biggest project completed by the company was DLF city in Gurgaon in the year 1975. Subsequently, it has ventured into a group of housing projects and afterward the company has entered into developing various commodity shopping malls and centres. Presently, the company has expanded in to 11 cities with IT parks, homes, retail, SEZs and Hotels. Company has started to develop land of 125 Acres to launch IT parks across various metros like Mumbai, Delhi, Kolkata, etc.

In the year 2007, the company came out with an IPO by issuing 175 million equity shares of Rs.2 at a price of Rs.525 per share.

Buy-back Offer of Equity Shares:

The DLF Company had announced the Buy-back of its fully paid-up equity shares of Rs.2 each pursuant to the provisions of Sections 77A, 77AA and 77B of the

Companies Act, 1956 read with Securities and Exchange Board of India (Buyback of Securities) Regulations, 1998, as amended. The Buy-back was commenced on October 17, 2008 and was closed on May 06, 2009. The buy back took place thorough Open market purchases through stock exchange at a price not exceeding Rs.600 per share. The company decided to buy back approximately 1,83,33,333 equity shares with a maximum offer price of Rs.600 per share. The company allocated Rs.1,100 crore for this purpose. The capital structure of the company is as follows:

Particulars	Amount (Rs. Crore)
Paid-up Equity Share Capital as on 31 March, 2008	341
Free- Reserves as on 31 March, 2008	10,884
Total	11,225

Taking about buy-back of shares, the Vice-Chairman of DLF Ltd., Mr. Rajiv Singh on 10 July, 2008 "The Company's aim has always been to maximize shareholder value and we see the share-buyback decision as a highly attractive opportunity for our shareholders. This decision would be value accretive for the shareholders. While we respect the market, we believe that our current share prices do not reflect the intrinsic strength and future growth potential of DLF." Mainly the company is looking at a buy-back because the current share price (Rs.350 at the time of Buy back announcement) does not reflect the intrinsic value of the shares. Hence the decision of Buy-back has been taken in keeping the company's desire to enhance overall shareholder value. The Buy-back would lead to reduction in outstanding number of equity shares, and consequential increase in 'Earning Per Share' and improvement in "Return on Net Worth" and other financial ratios.

DLF's move is a positive signal for the stock price as retail investors hold not more than 4 per cent of DLF shares. If the buyback goes through, then DLF would end up purchasing at least 2 percent from retailers for nearly Rs.1,500 crore. The company's stock price may find some stability and it would be trading at a PE of around 8.5 if they buy the shares back at Rs.420-430.

The Actual Details of Buy Back of Equity Shares:

1. The Company has purchased an aggregate of 76,38,567 Equity Shares pursuant to the Buy-back and Company has already extinguished 76,36,567 Equity Shares till date and is in the process of extinguishing further 2,000 Equity Shares.

2. The total amount invested in the Buy-back is Rs.140.69 crore. Till the date of closure of the Buy-back, the Company had utilized 12.79% of the Maximum Offer Size authorized for the Buy-back.

3. The price at which the Equity Shares were bought back under the Buy-back was dependent on the price quoted on the Bombay Stock Exchange Ltd. and the National Stock Exchange of India Ltd. The average price at which such Equity Shares were bought back is Rs.184.19 per equity share.

4. Pursuant to the Buy-back, the Company has bought back less than 1% (one percent) of the total number of outstanding Equity Shares.

CONCEPT OF EXCHANGE OFFERS

An exchange offer is a transaction which provides one class (or more) of securities with the right or option to exchange part or all of their holdings for a different class of the firm's securities. For example, exchange of debt for common stock. The exchange offer enables a change in the capital structure with a change in the investment. The impact of an exchange offer is the same as that of the share repurchase.

Like a tender offer repurchase, an exchange offer is usually open for a month. The terms of the exchange offered necessarily involve new securities of greater market value than the market value before the exchange offer. The management usually specifies in its offer the maximum number of shares which might be exchanged.

If the firm redeems debt at a price below the issue price then, the excess is treated as ordinary income. If the debt is redeemed at a price above the issue price, the difference is treated as ordinary loss. The treatment of tax in the firm just the opposite for an individual tendering the shares (A gain for the firm is a loss for the investor and loss for the firm is a gain for the investor).

When stock is tendered for debt, stockholders incur a capital gains tax liability, as if they had sold their stock for cash.

Debt for common stock offers has the effect of increasing leverage and vice versa. The theory of wealth effects of exchange offers is similar to that of share repurchases. The following characteristics result in positive returns to the shareholders:

i. When the offer increases leverage.

ii. When the offer implies increase in future cash flows.

iii. When the offer implies that the common stock is undervalued by the market.

SUMMARY

- Share repurchase and exchange offers are both considered to be areas of practical significance to the corporate management. Both of them have some similarities in their motives and effects on firms and shareholders.
- Share repurchases for cash effects the firm's leverage ratio. Studies show that the abnormal returns are much higher when the exchange is financed by debt rather than by cash, though there are significant positive returns in cash transactions as well.
- In USA, gains on the repurchases enjoyed by the shareholders are taken as capital gains. However, the Tax Reform Act, 1986, reduces the benefits from this due to the increase in the tax rate. Hence, tax effects play a small role in the gains.
- Gains on the repurchases are also influenced by the information and signaling hypothesis. When the leverage increases, it is a signal to the shareholders that the cash flows will be sufficiently higher in the future and would cover higher interest payments. Also, the repurchase of shares at premiums over the current market price is a signal that the management considers the shares as undervalued by the market. Moreover, the repurchase premium is also considered as a takeover defense measure.
- The exchange offers enable the firm to change its capital structure while holding the investment policy unchanged. The basic characteristics of the exchange offer are; it increases leverage, it implies an increase in future cash flows, and it implies that the market has undervalued the common stock.

Appendix A

Guidelines for Share Repurchases in India, under the Companies Act, 1956

Section 77: Restrictions on purchase by company, or loans by company for purchase of its own or its holding company's shares.

1. No company limited by shares, and no company limited by guarantee and having a share capital, shall have power to buy its own shares, unless the consequent reduction of capital is effected and sanctioned in pursuance of Sections 100 to 104 or of Section 402.
2. No public company, and no private company which is a subsidiary of a public company, shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company or in its holding company:

   Provided that nothing in this subsection shall be taken to prohibit:

   a. The lending of money by a banking company in the ordinary course of its business ; or
   b. The provision by a company, in accordance with any scheme for the time being in force, of money for the purchase of, or subscription for, fully paid shares in the company or its holding company, being a purchase or subscription by trustees of or for shares to be held by or for the benefit of employees of the company, including any director holding a salaried office or employment in the company ; or
   c. The making by a company of loans, within the limit laid down in subsection (3), to persons (other than directors or managers) bonafide in the employment of the company with a view to enabling those persons to purchase or subscribe for fully paid shares in the company or its holding company to be held by themselves by way of beneficial ownership.
3. No loan made to any person in pursuance of clause (c) of the foregoing proviso shall exceed in amount his salary or wages at that time for a period of six months.
4. If a company acts in contravention of sub-sections (1) to (3), the company, and every officer of the company who is in default, shall be punishable with fine which may extend to ten thousand rupees.
5. Nothing in this section shall effect the right of a company to redeem any shares issued under Section 80 or under any corresponding provision in any previous companies law.

Section 77A: Power of company to purchase its own securities.

1. Notwithstanding anything contained in this Act, but subject to the provisions of subsection (2) of this Section and Section 77B, a company may purchase its own shares or other specified securities (herein after referred to as "buy-back") out of:

   i. its free reserves; or
   ii. the securities premium account; or
   iii. the proceeds of any shares or any other specified securities.

   Provided that no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

2. No company shall purchase its own shares or other specified securities under subsection (1) unless:

    a. The buy-back is authorized by its articles;

    b. A special resolution has been passed in general meeting of the company authorizing the buy-back.

    Provided that nothing contained in this clause shall apply in any case where:

    a. The buy-back is or less than ten percent of the total paid-up equity capital and free reserve of the company.

    b. Such buy-back has been authorized by the Board by the means of a resolution passed at its meeting.

        Provided further that no offer of buy-back shall be made within a period of 365 days from the date of preceding offer of buy-back, if any.

        Explanation – For the purpose of this clause, the expression "offer of buy-back" means the offer of such buy-back made in pursuance of the resolution of the Board referred to this proviso.

    c. The buy-back is or less than twenty-five percent of the total paid-up capital and free reserves of the company.

        Provided that the buy-back of equity shares in any financial year shall not exceed twenty-five percent of the total paid-up capital in that financial year.

    d. The ratio of the debt owed by the company is not more than twice the capital and its free reserves after such buy-back.

        Provided that the Central Government may prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies;

        Explanation: For the purposes of this clause, the expression "debt" includes all amounts of unsecured and secured debts.

    e. All the shares or other specified securities for buy-back are fully paid-up;

    f. The buy-back of the shares or other specified securities listed on any recognized stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

    g. The buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with the guidelines as may be prescribed.

3. The notice of the meeting at which special resolution is proposed to be passed shall be accompanied by an explanatory statement stating:

    a. A full and complete disclosure of all material facts;

    b. The necessity for the buy-back;

    c. The class of security intended to be purchased under the buy-back;

    d. The amount to be invested under the buy-back; and

    e. The time limit for completion of buy-back.

4. Every buy-back shall be completed within twelve months from the date passing the special resolution Special resolution or a resolution passed by the Board under clause (b) of subsection (2).

5. The buy-back under subsection (1) may be:

   a. from the existing security holders on a proportionate basis; or

   b. from the open market; or

   c. from odd lots, that is to say, where the lot of securities of a public company whose shares are listed on a recognized stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange; or

   d. by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

6. Where a company has passed a special resolution under clause (b) subsection (2), or the Board has passed a resolution under the first proviso to clause (b) of that subsection to buy-back its own shares or other securities under this section, it shall before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed, and verified by an affidavit to the effect that the board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the Managing Director, if any.

   Provided that no declarations of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognized stock exchange.

7. Where a company buysback its own securities it shall extinguish and physically destroy the securities so bought back within seven days of the last date of completion of buy-back.

8. Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of the same kind of shares (including allotment of further shares under clause (a) of subsection (1) of Section (81) or other specified securities within a period of 6 months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, swear equity or conversion of preference shares or debentures into equity shares.

9. Where a company buys back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

10. A company shall, after the completion of the buy-back under this section file with the Registrar and the Securities Exchange Board of India, a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed.

    Provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognized stock exchange.

11. If a company makes default in complying with the provision of this section or any rules made thereunder, or any regulations made under clause (f) of subsection (2), the company or any officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to fifty thousand rupees or with both.

Explanation: For the purposes of this section, –

a. "specified securities" includes employees' stock option or other securities as may be notified by the Central Government from time to time; and

b. "free reserves" shall have the meaning assigned to it in clause (b) of Explanation to Section 372A.

Section 77AA: Transfer of certain sums to capital redemption reserve account.

Where a company purchases its own shares out of free reserves, then a sum equal to the nominal value of the share so purchased shall be transferred to the capital redemption reserve account referred to in clause (d) of the proviso to subsection (l) of Section 80 and details of such transfer shall be disclosed in the balance sheet.

Section 77B: Prohibition for buy-back in certain circumstances.

1. No company shall directly or indirectly purchase its own shares or other specified securities.
   a. through any subsidiary company including its own subsidiary companies; or
   b. through any investment company or group of investment companies; or
   c. if a default, by the company, in repayment of deposit or interest payable thereon, redemption of debentures, or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institution or bank is subsisting.
2. No company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with provisions of Sections 159, 207 and 211.

RULES UNDER SEBI (BUY-BACK OF SECURITIES) REGULATIONS, 1998

1. A company may buy-back its shares or other specified securities by any one of the following methods:
   a. From the existing shares or other specified securities on a proportionate basis through the tender offer;
   b. From open market through –
      i. Book-building process, and
      ii. Stock exchange.
   c. From odd-lot holders.
2. A company shall not buy-back its shares or other specified securities from any person through negotiated deals, whether on or of the stock exchange or through spot transactions or through any private arrangement.
3. Any person or an insider shall not deal in securities of the company on the basis of unpublished information relating to buy-back of shares or other specified securities of the company.
4. The company shall not issue any shares or other specified securities including by way of bonus till the date of closure of the offer made under these regulations.
5. The company shall pay the consideration only by way of cash.
6. The company shall not withdraw the offer to buy-back after the draft letter of offer is filed with the board or public announcement of the offer to buy-back is made.
7. The promoter or the person shall not deal in the shares or other specified securities of the company in the stock exchange during the period the buy-back offer is open.

The following are the rules to buy-back of own shares through tender offer or odd-lot-buy-back.

1. The offer for buy-back shall remain open to the members for a period not less than 15 days and not exceeding 30 days.
2. The letter of offer shall be sent to the security holders so as to reach the security holders before the opening of the offer.
3. The company shall complete the verifications of the offers received within 15 days of the closure of the offer and the shares or other specified securities lodged shall be deemed to be accepted unless a communication of rejection is made within 15 days from the closure of the offer.
4. The company which buys-back shares must, open an escrow account with cash deposit or bank guarantee favoring the merchant banker; or deposit acceptable securities with appropriate margin with the merchant banker with 25 percent of consideration payable, if the consideration payable is less than Rs.100 crore or 25 percent upto Rs.100 crore and 10 percent above Rs.100 crore of the consideration.
5. The company shall, immediately after the date of closure of the offer, open a special account with a banker to an issue registered with the Board and deposit therein, such sum as would, together with 90 percent of the amount lying in the escrow account make-up the entire sum due and payable as consideration for buy-back in terms of these regulations and for this purpose, may transfer the funds from the escrow account.
6. The company shall within seven days after the date of closure of the offer open make payment of consideration in cash to those security holders whose offer has been accepted or return the shares or other specified securities to the security holders.

The followings are the main guidelines to buy-back from open market through stock exchange:

1. The special resolution of shareholders or the resolution passed by the Board of Directors at its meeting shall specify the maximum price at which the buy-back shall be made;
2. The buy-back of the shares or other specified securities shall not be made from the promoters or persons in control of the company;
3. The public announcement shall be made at least seven days prior to the commencement of buy-back;
4. A copy of the public announcement shall be filed with the Board within two days of such announcement along with the fees;
5. The buy-back shall be made only on stock exchanges having nationwide trading terminals; and
6. The company and the merchant banker shall submit the information regarding the shares or other specified securities bought-back to the stock exchange on a daily basis and publish the said information in a national daily on a fortnightly basis and every time when an additional five percent of the buy-back has been completed.

Provided that where there is no buy-back during a particular period, the company and the Merchant Banker shall not be required to publish the details in a national daily.

A company may buy-back its shares or other specified securities through the book-building process as provided hereunder:

1. The special resolution of shareholders or the resolution passed by the Board of Directors at its meeting shall specify the maximum price at which the buy-back shall be made.

2. The company shall appoint a merchant banker and make a public announcement.
3. The public announcement shall be made at least seven days prior to the commencement of buy-back.
4. The deposit in the escrow account shall be made before the date of the public announcement (as mentioned above).
5 A copy of the public announcement shall be filed with the Board within two days.
6. The public announcement shall also contain the detailed methodology of the book-building process, the manner of acceptance, the format of acceptance to be sent by the security holders pursuant to the public announcement and the details of bidding centers.
7. The book building process shall be made through an electronically linked transparent facility.
8. The number of bidding centers shall not be less than 30 and there shall be atleast one electronically linked computer terminal at all the bidding centers.
9. The offer for buy-back shall remain open to the security holders for a period not less than 15 days and not exceeding 30 days.
10. The final buy-back price, which shall be the highest price accepted shall be paid to all holders whose shares or other specified securities have been accepted for buy-back.
11. No public announcement of buy-back shall be made during the pendency of any scheme of amalgamation or compromise or arrangement pursuant to the provisions of the Companies Act.
12. The company shall within two days of the completion of buy-back issues a public advertisement in a national daily disclosing the number of shares or other specified securities bought, price at which the shares or other specified securities bought and total amount invested in buy-back.

Chapter 13

Takeover Defenses

After reading this chapter, you will be conversant with:

- Friendly vs. Hostile Takeovers
- Takeover Defenses
- Preventive Anti-takeover Measures
- Corporate Charter Amendments
- Golden Parachute
- Active Anti-takeover Defenses
- Takeover Defenses – A Case Study
- Regulation of Takeovers in India

Mergers, acquisitions and takeovers have been a part of the business world for centuries. In today's dynamic economic environment, companies often face decisions concerning acquisitions or mergers. The job of management is to maximize shareholders value. In most cases, the use of mergers and acquisitions strategy can help a company develop a competitive advantage and ultimately increase shareholder value. There are several ways that two or more companies can combine their efforts. They can partner on a project, mutually agree to join forces and merge, or one company can acquire another company completely. Among these, the instruments of takeover are crucial for corporate growth. The purpose of this chapter is to discuss the most commonly used takeover tactics to acquire a company in a hostile takeover attempt and to evaluate the effectiveness of the various takeover defenses commonly employed.

Takeovers may be friendly or hostile.

FRIENDLY TAKEOVER Vs. HOSTILE TAKEOVER

Negotiated settlements often involving bargaining are called friendly takeovers. Here the acquirer does not have to resort to aggressive tactics like the bear hug, proxy contest or the tender offer etc., because both the companies are in a mood to go for such a merger driven by individual interests or strategies.

For example, the takeover of Indian Aluminium Company (Indal) by the Kumarmangalam Birla group. Alcan of Canada held 53 percent stake in Indal. For strategic reasons, Alcan decided to exit from Indal. They voluntarily sold their stake to the Birla group. The Birla group has acquired Indal in a friendly takeover.

A hostile takeover is an unwanted offer made by a potential acquirer, that is, strongly opposed by the target firm. These types of takeovers are usually bad news since the employee moral of the target firm can quickly turn to enmity against the acquiring firm.

One of the earliest cases of hostile acquisition in India was the hostile takeover of Shaw Wallace by Manu Chabria in 1987. The then existing management led by S P Acharya had strongly but unsuccessfully opposed the takeover of the company.

In a hostile takeover, aggressive tactics like the bear hug, proxy contest or the tender offer are adopted by the firms. A bear hug involves the mailing of a letter containing an acquisition proposal to the Board of Directors of a target company without prior warning, but demanding immediate decision from the target. A proxy contest is an effort by a group of dissident shareholders to obtain representation on the Board of directors or to change a firm's by-laws. A tender offer is a takeover tactic in which the acquirer goes directly to the shareholders of the target with an offer to purchase their shares. We will see each of them in detail.

BEAR HUG

When a friendly approach of a takeover through a negotiated settlement is not successful then the acquirer may sometimes try to limit the options available to the management of the target by forcing them to take immediate decision before initiating a tender offer. This is done by contacting the Board of Directors and making a formal acquisition proposal with an expression of interest in acquiring the target. The letter also contains an implied intention to go directly to the stockholders with a tender offer if they do not receive a positive response. It may also be accompanied by a public announcement of the bidder's intent to make a tender offer. This strategy is called the Bear Hug. The bear hug is mainly intended to move the board to a negotiated settlement. The management of the company is motivated to do so because of its fiduciary responsibility to the shareholders. Some target shareholders may file lawsuits against directors who vote against the said acquisition proposal (mainly when the offer price is at a substantial premium to the target's share price).

PROXY CONTESTS

Proxy contests refer to the attempts made by the dissident group of shareholders to obtain representation in the board. Proxy contests represent another aspect of the control and membership on the firm's Board of Directors. They have significant effects on the wealth of the shareholders of the target firm regardless of whether the attempt to takeover will be successful or not. They are sometimes initiated by the shareholders of the firm when the management opposes a takeover attempt. This strategy is used to replace those members of the board or management who oppose the merger with those who are more willing to vote for the merger. Proxy contests can be an effective means of gaining control without owning 51percent of the voting stock. They can also be used to get rid of certain takeover defenses, such as the poison pills before a tender offer is actually made.

The proxy fight is very expensive. Substantial fees will have to be paid to hire proxy solicitors, investment bankers, attorneys, etc. Other expenses like printing, mailing, advertising expenses are also incurred. However, a successful proxy fight is less expensive than a tender offer which requires purchasing the controlling interest in the target by paying a substantial premium.

Impact on Shareholder Value

Proxy fights often result in abnormal returns to the shareholders of the target company regardless of the outcome, i.e., whether the offer attempt would be successful or not. This is because of various reasons like the eventual change in the management in most of the firms involved in proxy fights, the tendency of the new management to restructure the firm and the expectations of the investors of a future change in control due to the merger and acquisition activity. However, presence of both the incumbent and the dissidents on the same board could also result in losses to the shareholders because of the disagreements between the two parties over the appropriate corporate policies.

Box 1: Rice King Faces Hostile takeover by Temptation Foods Ltd.

Suddenly, the aroma of Indian basmati has got mixed up with the scent of gunpowder. A bitter battle is brewing as India's biggest player in the rice market, Kohinoor Foods (formerly Satnam Overseas), which accounts for about 38% of the country's basmati market, is trying to ward off what it sees as a hostile takeover bid.

The Kohinoor management has petitioned the Securities and Exchange Board of India and Company Law Board (CLB) accusing Mumbai-based Temptation Foods Ltd of leading a consortium that has covertly acquired a shareholding of almost 30% in Kohinoor Foods. These anxious calls to SEBI and CLB have happened in the last 15 days. The acquisitions, Kohinoor's petitions to Sebi and CLB alleged, are in violation of the market watchdog's takeover code, which mandates public disclosure by anybody seeking to acquire more than 15% of a company.

It sought an ex parte interim stay from CLB on any further acquisition of Kohinoor shares by Temptation and 45 other entities listed as ''acting in concert'' with Temptation and a suspension of their voting rights.

The list of respondents includes foreign institutional investors like Merrill Lynch Capital Markets Espana SA and Morgan Stanley Mauritius Company Ltd. Among them, Kohinoor alleged in its petition, these 46 entities have picked up shares in bulk since December 2007 adding up to 29.35% of Kohinoor's equity capital.

CLB, in its order of June 20 the day the petition was filed suspended the voting rights of Temptation and 46 others, but did not accept the plea for barring them from acquiring further shares. It also allowed them to respond to Kohinoor's petition within three weeks.

Temptation, on its part, had informed the Bombay Stock Exchange on June 18 that it had acquired a 3.79% stake in Kohinoor. The Kohinoor petition filed before CLB cites an investor meet and some TV mentions to buttress its claims that Temptation has been eyeing Kohinoor as a potential takeover target for sometime now.

The reason Kohinoor's management fears a hostile takover is that the promoters' shareholding in the company was 44.13% in March 2008 and is likely to have dropped to below 36% following the conversion of Foreign Currency Convertible Bonds (FCCB) into equity shares on May 26. Following the conversion, Deutsche Bank held a 14.88% stake in Kohinoor and Rhodes Diversified had a 6.46% stake, but they have since made disclosures to BSE showing that their holdings are down to 3.52% and 4.15% respectively.

In other words, the equity from converted bonds has changed hands, and from Kohinoor's panic, it is apparent that they have not moved to the promoters. With just 36% stake, the Kohinoor promoters are clearly vulnerable, and it might have been worse when the second tranche of bonds was to be converted in the first week of July.

Realising this, Kohinoor informed BSE on Thursday that the conversion of the second tranche now stands cancelled. The announcement is a clear indication that the promoters are unwilling to risk any further dilution in their stake at a time when potential raiders are upping their own holding in the company.

When contacted by TOI, Kohinoor joint MD Satnam Arora refused to comment on the developments. "The matter is sub judice," he said. He refused to get drawn into any discussion on its petitions to SEBI and CLB.

The fears of the Aroras, who control Kohinoor, may or may not be justified, but the company does present an attractive target for a takeover bid. With an Earnings Per Share (EPS) of Rs.8.63 for the nine-month period ending December 2007, its current market price in the region of Rs.100 gives the scrip a Price-Earnings (P/E) ratio of about 10 on an annualized basis.

That's well below the average of over 17 for the sensex, for instance. The fact that Kohinoor is the biggest brand in the rice market with a 38% share makes its current market capitalization of under Rs.270 crore a small price to pay for acquiring even a 100% stake in the company.

Source: www.times of India.indiatimes.com.

Proxy Fight Process

The process starts when a bidder of the firm, who is also a shareholder, attempts to change control at the impending stockholder's meeting. He may have a right to call a special meeting to formally consider the replacement of the management. The rebellious stockholders may also decide to undertake a proxy fight against any major proposal by the management like a sale of a division of the firm or setting up certain anti-takeover amendments.

Before the start of the meeting, the insurgent shareholders meet other shareholders and try to convince them to vote against the management's candidates for the Board of Directors or against the major change proposed by the management. The insurgent group usually hires a proxy solicitor to undertake the process of contacting the other shareholders. On receiving the proxies, the shareholders may then forward their votes to the chosen collector such as a brokerage firm or a bank. The votes are then counted under the strict supervision to make sure that the counting is done accurately.

TENDER OFFERS

This is a method of undertaking a takeover via a public offer to the shareholders of the target. A tender offer puts individual shareholders under pressure to tender their shares regardless of their collective interests with each other. A company usually resorts to a tender offer when a friendly negotiated transaction does not work. A tender offer is more expensive than a negotiated deal because of the various costs associated with it like the publication costs, legal filing fees etc. Once the tender offer is initiated, it is most likely that the target will ultimately be acquired, though not necessarily by the firm that initiated the tender offer.

Box 2: Test to Determine What Constitutes a Tender Offer
The various actions by the bidder are considered a tender offer if they involve the following eight factors. However, all the eight factors need not be presented for an open market operation to be a tender offer. 1. Active and widespread solicitation of public shareholders. 2. Asking for the substantial portion of the issuer's stock. 3. Offer price being at a premium to the current market price. 4. The terms of the offer are firm rather than flexible for negotiation. 5. The offer is contingent on the tender of a fixed number of shares. 6. The offer is open for a limited time. 7. There is a pressure on the shareholders to tender their stock. 8. Public announcement of the proposal to purchase the share proceeds.

Source: Donald DePamphilis – Mergers, Acquisitions and other Restructuring Activities.

Tender offer can be for cash or for stock. In either of the two cases the proposal is made directly to the shareholders. If the offer is extended for a specified period of time it is called an unrestricted or any-or-all offer. If there is a restriction on the time period or on the certain percentage or number of shares to be tendered, it is called a restricted tender offer. If the restricted tender offer is oversubscribed then the bidder might choose to buy all the target shares that are tendered or buy only a portion of the shares tendered on a pro rata basis. Tender offers can also be two tiered offers where the bidders offer a first tier price for the specified maximum number of shares tendered and a second tier price for the remaining shares.

Two Tiered Tender Offer

This is sometimes also referred to as the front end loaded tender offer. The first tier price is always more than the second tier price. This method is designed to put pressure on those shareholders who are worried that they might get lesser compensation in the second tier, if they do not tender the shares in the first tier. In most of the cases cash is offered in the first tier and non-cash compensation like the debentures or securities whose market value is less than the first tier price is offered in the second tier. Acquirers or bidders who do not have access to large amounts of capital choose the two tiered offer. The limited capital is used to pay cash in the first tier and securities are offered for the second tier.

Any-or-All Offer

This offer is believed to be a more effective takeover tactic. The maximum number of shares to be purchase is not specified, but the shares will not be purchased at all if the conditions of the offer are not met. Front end loading takes place even in these offers. The front end price is usually paid in cash and the back end price is given by the terms of clean up merger and typically is equal to the front end cash offer price. However, this is paid only at a later date.

Partial Offer

A partial offer specifies the maximum number of shares to be accepted, but does not specify what will be given to the remaining shares. These offers are mostly unconditional. The front end price is usually paid in cash and the back end price is simply the market value of the remaining shares.

Box 3: History of Tender Offers
The tender offer was the most frequently used hostile takeover tool in the 1980s.
In 1973, International Nickel Company (INCO) first recognized tender offer as a powerful means of taking control of Electric Storage Battery (ESB) Corporation. International Nickel Company employed its tender offer strategy with the help of Morgan Stanley & Company, its investment banker. This takeover was the first hostile takeover by a large reputed company and a leading investment bank. This led to the legitimacy and acceptability of hostile takeovers.
Earlier in the 1960s though there were tender offers prevalent by the less reputed business firms, they were not considered as an acceptable practice within the corporate community. Moreover, investment banks and commercial banks did not provide financing for tender offers. Later by the late 1960s the effectiveness of tender offers was recognized. Tender offers also spread outside United States and represented an important hostile takeover method in the Great Britain. In response to the fear of the corporate control about the out of control growth of tender offers, the New York Stock exchange and the American Stock Exchange imposed certain limitations on them. Still the numbers continued to rise from 8 in 1960 to 45 in 1965.
As the use of tender offers grew, there was large opposition from the Capitol Hill. Spearheaded by Senator Harrison Williams, the Williams Act was passed in 1968. This law initially had a dampening effect on the number of tender offers, which declined from 115 in 1968 to 34 in 1970. In the due course, the market adjusted to the regulations of the new law, and the number rose to 205 in 1981. This was the result of the legitimacy provided by the law to the tender offer practices by providing rules to regulate their use. According to the new law, if tender offers were made in accordance with federal laws, they were reasonable business practices.
By and large the Williams Act facilitated the development of takeover defenses. Prior to the passing of this legislation, stockholders of the target were forced to take quick decisions when a tender offer was made. The Williams Act provided the management with more time to decide before the bidder could purchase the shares. Hence it gives the target time to increase the effective takeover defenses.

Source: Patrick A Gaughan – Mergers, Acquisitions and Corporate Restructurings.

Regulation of the Two Tiered Tender Offers

If the acquisition price in the tender offer (blended price) is less than the market value of the target when it remains independent the pressure to tender will lead to an unclear outcome. Here, the acquisition price is estimated as the weighted average of the front end price and the back end price, using the fraction of the shares purchased in the respective tiers as the weight. According to Comment and Jarrell, the acquisition price can be represented as,

$$P_{BP} = (F \times P_T) + [(1 - F) \times P_{MP}]$$

Where,

P_{BP} = Acquisition or the blended price.

P_T = Offer price (i.e., front end loaded).

P_{MP} = Market price of the remaining shares after the offer

F = The fraction of shares purchased in the front-end offer.

The premium is calculated as $[(P_{BP}/P_{MP}) - 1] \times 100$

Where,

P_P = Pre-offer market price.

Box 4: Grasim Offer for UltraTech Cem Co.,
The A V Birla group flagship Grasim Industries' open offer for acquiring an additional 30 percent stake in UltraTech Cem Co., Larsen & Toubro's demerged cement business, will close on Monday. The open offer, priced at Rs.342.6 a share, began on June 7.
Grasim currently holds a 12.6 percent stake in the UltraTech Cem Co. The open offer, if fully successful, will increase Grasim's holding to 42.6 percent.
Grasim will then purchase an additional 8.5 percent from L&T at Rs.342.60 a share to take its holding to 51.1 percent so as to acquire management control.

Source: Business Standard, June 21st 2004.

Box 5: Indo Tech Transformers — Open Offer by Mexico-based Prolec-GE
Indo Tech Transformers to the open offer made by Mexico-based Prolec-GE, considering the premium offered over the current market price and the uncertainties lingering on the business strategy to be adopted, after the new management takes over. The open offer, priced at Rs.406, is a good 27 percent premium to the current market price Rs.320 and the stock trades at seven times its trailing 12 months earnings. However, the industry average P/E of 5 times, as per the industry the fair value of the stock is about Rs.220. Meanwhile, Prolec-GE is also buying the entire promoter stake of 54.3 percent at the same price through an off-market transaction. Over a three-year period, however, growth in the transformer business in general and the business opportunities arising from the takeover by an international company could provide an upside to the stock. Investors can tender to the open offer and cut their exposures now, as not all the shares that are tendered may be accepted. Those with a two-three year perspective can retain the remaining shares. **About the Offer and Acquirer** The offer made by Prolec-GE is open during 4 to 23 April, 2009. The open offer is for 20 percent i.e.21.24 lakh shares of the share capital. This translates into an acceptance ratio of 43.8 percent. Assumption was made that all shareholders tender their shares; only four out of nine shares tendered would be accepted. On completion of the transactions the Prolec-GE would hold a 74.3 per cent stake in Indo Tech Transformers. Prolec-GE, a Mexican transformer manufacturer has turnover of over Rs.3,000 crore (CY 2007) and is a joint venture between Xignux of Mexico and General Electric Company. This company has a manufacturing facility in Mexico and caters to the markets in North and South America as well as some of the African and West Asian countries. The company produces higher range of transformers compared with Indo Tech's transformers. The offer document states that this acquisition is being made to gain foothold in the emerging markets. This strategy appears appropriate in the Indian context in the light of the aggressive power capacity additions planned in the country. The strategy means that Indo Tech's products may also be exported to more West Asian and African markets, provided the logistics convenience. Indo Tech's export is approximate by 10-12 percent of its FY-08 revenue, and it is expected that exports increase in the coming years. However, it is also possible that Prolec-GE would treat the Indian unit as a low-cost manufacturing base to provide inputs for or supplement its own product range. If this occurs, the high profit margins of Indo Tech (superior to Prolec-GE) may see some contraction. However, given the wide divergence in the product range offered by the two companies, which will generate the revenue from outsourcing to parent may be a smaller proportion of total revenues over the medium-term. **Indo Tech Slowdown but Managed Well** Indo Tech has not been completely immune to the current economic slowdown. While it managed robust growth up to the quarter ended September 2008, the December quarter results were more moderate; where the revenues grew less than 6 percent over the corresponding quarter last year, while net profits increased by 1 percent only. However, the company's operating profit margins dropped by 100 basis points to 32.9 percent on the back of lower realizations which, in turn, have been marginally depressed as a result of passing on commodity price decline to customers with escalation clauses. Order inflows too appear to have slowed. Whereas the company's order book at about Rs.120 crore translates into about two quarter revenues instead of a revenue cover of three-four quarters seen earlier. The company's overall profitability is expected to increase if its newly expanded Kancheepuram facility improves its utilization. Presently, the company is utilizing only 25 to 30 percent of this plant's capacity. This facility, with capacity to produce up to 400 MVA capacity transformers (from 100 MVA earlier), may gradually improve utilization levels once the company starts pre-qualifying for higher range transformers. In this situation, the international acquirer may bring in orders for the higher range of transformers.

Source: www.blonnet.com

OPEN MARKET OPERATIONS

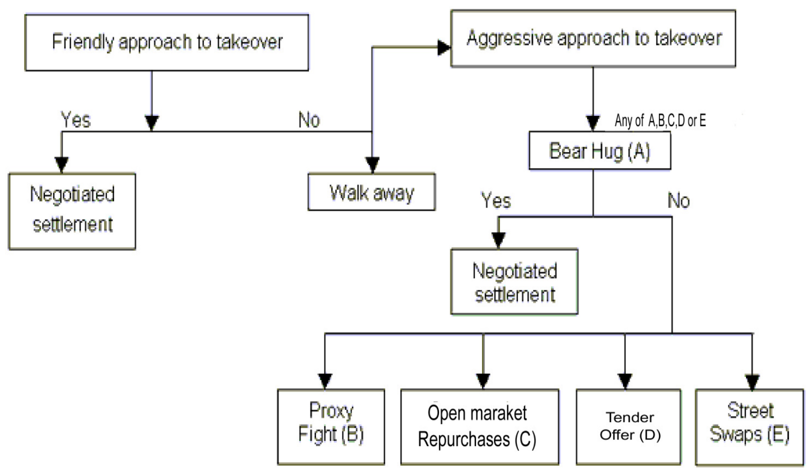
The potential bidders usually build-up stock in the target before making the actual bid by buying them in the open market at a price lower than the eventual offer price. Such early purchase of is usually kept undisclosed by the bidder to ensure that there would be no increase in the price consequently leading to an increase the average price paid for these shares. Such acquisitions are made through various shell corporations or partnerships whose names do not state the true identity of the final purchaser.

The stock is accumulated in this way mainly to get the voting rights associated with the stocks it has purchased. The voting power so acquired can be used later in a proxy fight to remove takeover defenses, or to win the shareholder approval, or for the election of the members of the target's board, etc. If the bid to takeover is not successful the stock acquired can be sold at a gain and used to recover the legal and investment banking expenses incurred.

STREET SWEEPS

Open market operations might not always lead to a tender offer. If the stock is too strictly held by the current stockholders who are long-term investors or if the bidder is unable to get the required number of shares, then the bidder may choose to adopt a street sweep. A street swap involves searching for owners of large blocks of target stock (like the institutional investors), and quickly buying a large amount of stock to gain control.

Figure 1: Takeover Ethics



Some of the other takeover tactics available to a potential bidder are:

Dawn Raid

This is a takeover technique where a firm or an investor buys up a substantial amount of shares in a company first thing in the morning when the stock markets open. Usually a broker does the buying on behalf of the acquirer (the predator) to avoid drawing attention to the buying. It builds up a substantial stake in its target (the victim) at the current stock market price. Because this is done early in the morning the target firm usually does not get informed about this until it is too late and the acquirer has already scooped up controlling interest.

Saturday Night Special

It is a sudden attempt by one company to takeover another by making a public tender offer. The name comes from the fact that this practice used to be done over the weekends.

TAKEOVER DEFENSES

The increase in the corporate takeover activity was also accompanied with many innovations in the art of corporate anti-takeovers. By the end of the 1980s, the art of the anti-takeover defenses became very sophisticated. The major investment banks organized various teams of defense specialists who worked with the managements of larger corporations to establish certain dreadful defenses that might counteract the raiders.

Anti-takeover defenses can be divided into two categories, preventive and active measures. Measures which are designed before a takeover bid is attempted and which are aimed at reducing the possibility of a financially successful hostile takeover are termed as preventive anti-takeover defenses. Measures that are employed after the hostile bid is attempted are called active anti-takeover defenses.

SHAREHOLDER INTEREST HYPOTHESIS AND MANAGEMENT ENTRENCHMENT HYPOTHESIS

Two theories have been proposed to explain the effect of the management's attempt to use takeover defenses. The management entrenchment hypothesis proposes that the shareholders who do not participate lose value in response to the management's actions to prevent the takeover attempts. The wealth of the shareholders is reduced as a response to a revaluation of the firm's stock by the market. The shareholder interest hypothesis also known as the convergence of interest hypothesis suggests that the wealth of the shareholders rises when the management takes actions to prevent changes in control. This resistance for the takeover by the management is considered to be in the best interests of the shareholders, if the resistance would lead to initial bidder increasing the offer price or if the competing bidder offers a higher price.

PREVENTIVE ANTI-TAKEOVER MEASURES

The presence of certain characteristics like the strong and stable cash flows, low levels of debt in the capital structure, low stock price compared to the value of the firm's assets, etc, make a firm vulnerable to a takeover. Hence, some preventive measures are adopted to adjust to these characteristics of the firm beforehand, so that the financial motivation of a bidder to acquire the target is reduced to a large extent. Through these measures the pace of the takeover attempt can be slowed down and the acquisition becomes more expensive for the bidder.

We will now discuss some of the most popular preventive anti-takeover measures.

POISON PILL

Poison pills are shares issued by a firm to its shareholders to make the firm less valuable in the eyes of a hostile bidder. These shares have no value till the happening of a triggering event (acquisition of certain percentage of the firm's voting stock by the bidder). There are generally two triggering events first for issuing the rights and second for exercising them. There are basically two types of poison pills flip-over and flip-in.

Flip-in Plan

In a flip-in plan shareholders are given a common stock dividend in the form of rights for each share they own. Whenever the bidder acquires a certain percentage of stock the rights are activated. The flip-in poison pill plan permits the current shareholders, except the acquirer, to buy more shares of the issuing company at a discount.

Flip-over Plan

In the flip-over poison pill plan, the shareholders are given a common stock dividend in the form of rights to acquire the firm's common or preferred stock at an exercise price above the market price. Whenever the bidder acquires a certain percentage of stock the rights are activated. The rights flip over and allow the holders to purchase the acquirer's shares at a heavy discount.

Box 6: Poison Pills on the Rise: A Reaction to Shareholder Activism or a Signal of the Turbulent

If you thought poison pills were a thing of the past, think again! After a decline in interest in the pill over the past several years, the poison pill, a popular anti-takeover defense created in the early 1980s, reemerged in 2008, as a popular tool for public companies experiencing a decline in the market price of their stock as a result of the ongoing financial crisis.

According to FactSet SharkRepellant, during the first nine months of 2008, at least 40 public companies adopted a pill for the first time. By way of contrast, in all of 2007, only 42 companies adopted pills. Public companies terminating previously adopted poison pills are also on the decline. Only 15 companies terminated pills during the first nine months of 2008, as compared to as many as 45 companies that terminated their pills in 2004. As of August 2008, over 1,300 companies worldwide had poison pills in place.

The increased use of the poison pill has been attributed to the current economic crisis, which has been responsible for the decline in the market values in equity securities of U.S. companies as evidenced by the approximately 40% decrease in the S&P 500 in the last quarter of 2008. As the market for U.S. equities dropped, the stock of a significant number of companies became undervalued and management concerns regarding unsolicited takeover attempts increased. As the market for U.S. equities dropped, the stock of a significant number of companies became undervalued and management concerns regarding unsolicited takeover attempts increased.

The poison pill – or shareholder rights plan – is an anti-takeover device designed to make a hostile takeover more expensive to the acquirer by providing for the issuance of a significant number of additional shares to the company's shareholders, other than the hostile acquirer. The mechanics of a typical poison pill are as follows:

i. The board of directors adopts a rights plan, which consists of warrants or rights to purchase the target company's stock, which allows the warrantholder to buy the target company's common stock at a substantial discount from the market price.

ii. The pill is exercisable in the event an acquirer gains ownership of more than a specified percentage of the target company's stock, generally 10% to 15%, without approval of the board of directors of the target company.

iii. The exercise of the pill eventually makes the target more expensive to acquire and dilutes the ownership interest of the hostile acquirer.

iv. The board of the target can elect not to utilize or eliminate the pill to allow the acquisition of the target company by a friendly acquirer.

v. The most common version of the pill is referred to as a "flip-in" pill. The "flip-in" pill gets its name because if a hostile acquirer trips the specified percentage of the voting stock of the target, without the approval of the target's board, the rights of other shareholders, other than the acquirer, are triggered and these shareholders, other than the acquirer, are permitted to acquire additional shares of the target company at a significant discount, often as much as 50% of the current market price. When shareholders take advantage of this right, the percentage ownership of the hostile acquirer is significantly diluted, making the takeover attempt more expensive. Thus, the pill makes the acquisition more difficult from an expense standpoint for the acquirer to swallow.

The poison pill remained extremely popular throughout the 1980s and early 1990s when shareholder activists, such as T. Boone Pickens and others, who were commonly referred to as "corporate raiders", engaged in hostile takeover attempts of many publicly-traded U.S. companies. Since 1983, over 1,900 U.S. companies and at least 200 foreign companies have adopted poison pills. The most effective argument for the pill is that it advances shareholder interests by enabling a board to resist incentive takeover tactics and allowing the board to negotiate effectively with potential acquirers.

The board's ability to control the company's destiny has angered activist shareholders, who view the ability to resist takeover attempts as harmful to shareholder interests. Activists argue against the pull indicating that the consolidated takeover attempts are typically at substantial premiums over the current market price of the target's stock, so investors benefit. Indeed, since unsolicited or hostile tender offers are generally made at a significant premium above the current market price of the target's stock, shareholders of the target company generally benefit from such tenders, however; management will typically lose their jobs. As a result, institutional shareholders frequently oppose pills because they limit the ability of shareholders to sell their shares at a significant premium.

RiskMetrics Group (formerly ISS), which provides voting advice on shareholder proposals to institutional shareholders, released its revised voting guidelines for the 2009 proxy season on Nov. 25, which address, among other things, poison pills. These guidelines recommend support for management proposals to approve or ratify a poison pill on a case by case basis, but generally would be supportive of a pill which includes, among other things, a 20% trigger, a two- to three-year sunset provision, and no dead hand, slowhand or similar provisions. These guidelines also recommend a vote against the entire board (except new nominees) if the board adopts a pill without shareholder approval or does not commit to put the pill to a shareholder vote within 12 months of its adoption.

In this troubling financial period, effective takeover defenses are more critical than ever. These defenses may include a poison pill as well as other strategies as part of a company's defensive arsenal. These other strategies include, among other things, a staggered board and amendments to articles and bylaws designed to address both a hostile bid and other tactics currently employed by activists.

Although in this new age of shareholder activism, poison pills are not the show-stoppers they were in the 1980s, they still can play an important role in a company's defensive strategy. The reasons for adopting a poison pill remain much the same today as they did in the 1980s. First, the pill is a formable deterrent to a hostile tender offer. For example, Anheuser-Busch's recent hostile bid from InBev was received when the company did not have a pill available to it.

The significant decline in stock market value for the U.S. equities has made companies more susceptible to activist attacks. An effective anti takeover plan enables a board of directors to take a commanding role in negotiating with hostile shareholders. Having a strong negotiating position is critical when confronted with a takeover bid or other activities by activist shareholders. As the old saying goes “the best defense is a good offense” and the same holds true today.

Source: www.blankrome.com

Creation and Redemption of Poison Pills

A poison pill program is created by the Board of Directors (without shareholder approval, but often submits its adoption for shareholders vote) and the board has the authority to redeem it.

First Generation Poison Pills

This involves issuing the preferred stock in the form of a dividend to shareholders, which can be converted into the common stock of the acquiring company after the takeover. When the target company is acquired and merged with the acquirer, the shareholders of the target company holding the poison pills can convert their preferred stock into the common stock of the acquiring company after the takeover. Hence, the acquirer’s ownership interest in the combined companies is diluted.

Though they may keep a hostile bidder at a bay, these first-generation poison pills had certain disadvantages such as:

- If investors fail to take part in the poison pill and buy stock at the discounted price then the outstanding shares will not be diluted enough to defend against a takeover.
- The issuer could only redeem them after an extended period of time, which might be in excess of ten years.
- Preference shares were counted towards the company’s indebtness when analysts compute the leverage and hence the firm becomes more risky in the eye of investors.

Second-Generation Poison Pills-Flip-Over Rights

The second generation poison pill are in the form of right offerings that allow the holders of these shares to purchase stocks in the acquiring firm (that is, flip over) at a low price, i.e., with substantial discount. These rights may be in the form of call option issued by the company, giving the holders of the option the right to purchase a certain amount of stock for a particular price during a specified time period. The rights certificates used in modern poison pills are distributed to shareholders as dividend and become activated after a triggering event. A typical triggering event can be any one of the following:

- An acquisition of 20 percent of the outstanding stock by an individual, partnership or corporation.
- A tender offer for 30 percent or more of the target corporation's outstanding stock.

Flip-over poison pills seemed to be a most effective defense until they were effectively defeated in takeover of the Crown Zellerberth Corporation by Anglo-French financier Sir James Goldsmith in 1985. The flip-over pill failed to provide the expected defense – because the acquirer assumed control of the target (just over 50 percent, but not the 100 percent trigger of the pill), changed the board of directors and redeemed the pill.

Flip-over poisons pills are only effective if the bidder acquires 100 percent of the target. They are not effective in preventing the acquisition of a controlling but less than 100 percent interest in the target. Since most acquirers want to obtain 100 percent of the target's stock so as to have unrestricted access to the target's resources, flip-over provisions may prevent many, but not all control transactions.

Third Generation Poison Pills

These are referred as flip-in, flip-over pill. The third generation flip-in poison pills were an innovation designed mainly to deal with the problem of a bidders who was not trying to purchase the entire 100 percent of the target. With the flip-over positions, a bidder can avoid the impact of the pill simply by not buying the entire outstanding stock of the target. Flip-in provisions allow holders of the rights to acquire stock in the target, as opposed to flip-over rights, which allow holders to acquire stock in the acquirer. The flip-in rights were designed to dilute the target company without even considering whether the bidder merged the target into his company. They can be effective in dealing with raiders who look to acquire a controlling influence in a target while not even acquiring majority control. Ownership can often be controlled with stock holdings of less than 51 percent. This is particularly true if the target firm is a widely held corporation in which most shareholders have a small percentage of outstanding stock. The presence of flip-in rights makes such controlling acquisitions very expensive.

A flip-over plan may also contain flip-in provisions, therefore combining the advantages of a flip-over plan, which is used against a 100 percent hostile acquisition, with a flip-in plan, which is used against a control share acquisition that is not a 100 percent share acquisition.

Box 7: Crown Zellerbach Corporation
Crown Zellerbach Corporation was a San Francisco based forests products company with substantial holdings of forest related assets. Sir James Goldsmith, an Anglo-French financier, attached much higher value to the firm than the stock markets. Sir Goldsmith convictions were reflected in his statement "I believe in forests. I do believe in forest lands. Everybody says they are a disaster, but they are still making profits and forest lands will one day be as valuable as they are." The company's management was concerned about its vulnerability and among other things adopted a poison pill defence strategy. Crown Zellerbach's poison pill allowed stock holders to buy $200 worth of stock in the merged entity for $100. The pill was issued in the form of rights that were activated when an acquirer bought 20 percent of Crown's stock or when an acquirer made a tender offer for 30 percent of Crown's stock. The rights became exercisable after the bidder bought 100 percent of its stock. The rights were to be traded independent of the shares on the stock exchanges. They could be cancelled by the Board of Crown by redeeming them at 50 cents each. However, once the rights were activated (triggered either of the above events), they could no longer be redeemed and would not expire for 10 years. This was designed to make the firm less valuable to the raider. It was assumed that the pill was a formidable obstacle and no raider would trigger them.

Source: Patrick A Gaughan – Mergers, Acquisitions and Corporate Restructurings.

BACK END PLANS

Back End Plans were first developed in 1984 as an alternative to the poison pill. These plans are also known as note purchase rights plan. Under these plans the shareholder receive a rights dividend which gives them the capacity to exchange the right along with a share of stock for cash or senior securities that are equal in value to a specific back end price fixed by the Board of Directors of the issuer. The rights become exercisable when the acquirer purchases shares in excess of a specific percentage of the target's outstanding shares. The back end price is set above the market price, to establish a minimum price for a takeover.

These plans are used to restrict the effectiveness of two tiered tender offers. The name back end refers to the back end of the two tiered offer. The Board of Directors are placed in conflicting role because they have to establish a price for the company while taking the position that the company is not for sale.

VOTING PLANS

These plans were developed in 1985 to prevent any outside entity from obtaining the voting control of the company. The company issues a dividend of preferred stock which entitles the holders of these stocks to super voting rights when any outsider acquires a substantial percentage of the company's stock. This stops the hostile bidder from obtaining voting control of the target.

POISON PUTS

Poison puts are different from poison pills. They involve issuance of bonds that contain a put option which becomes exercisable in the event of a hostile takeover. The option allows the holder to sell a particular security to another individual or firm during a certain time period and for a specific price. The bonds demand for large cash from the merged firm and will make the prospect of the takeover more unattractive.

However, if the acquirer is able to prevail upon the debt providers/bondholders not to exercise the put option, the problem of liquidity can be avoided. Further if the debt carries a coupon which is higher than the prevailing rates, it is unlikely that the option would be exercised.

PEOPLE PILL

Sometimes the entire management team threatens to resign, in the event of a takeover. This threat is especially useful if the incumbent management is a good team. Losing the team could seriously impact the company's performance and hence may discourage the raider to really attempt a takeover.

CORPORATE CHARTER AMENDMENTS

These are the most common anti-takeover defenses. These amendments are also called 'shark repellants'. The Corporate Charter gives a company a legal existence. The corporate charter consists of the Memorandum and Articles of Association in India. The Memorandum of Association consists of the corporation's name, the purpose of existence, the amount of authorized shares, the number and identity of the directors etc., while the Articles contain the rules governing the internal management of the corporation.

The charter can be amended by including various provisions which obstruct the hostile takeover attempts. These are put in place to strengthen the ability of the firm's Board of Directors to retain control. The amendments to the charter generally require approval of the shareholders. The common types of charter amendments are super majority provisions, fair price provisions, staggered boards and dual capitalizations.

STAGGERED OR CLASSIFIED BOARDS

The directors of a firm are divided into a number of different classes. Only one class is up for reelection each year. These amendments delay the effective transfer of control in takeover. For instance, a board of directors consisting of twelve members can be divided into three groups, with only one group up for election in a particular year. Hence, the hostile bidder has to wait for two more annual general meetings to gain the control of the board in spite of holding the majority of the stock. The size of the board is also limited to prevent the insurgent stockholder from simply adding the board seats to take control of the board.

SUPERMAJORITY PROVISIONS

A supermajority provision requires approval by a larger number of votes, than the normal simple majority requirements, to approve the merger. Generally, supermajority clauses require approval by two-thirds or even 80 percent votes for approval of the merger. In extreme cases, amendments have provided for as high as 95 percent of the votes for merger approval. For example, if the management holds 25 percent stake in the firm, the corporate charter can be amended to require 80 percent approval for a merger. Generally, supermajority provisions contain escape clauses called as board-out clauses. These clauses allow the firm to waive or give up the supermajority provision. The board out clause usually provides that the supermajority provisions will not apply if the merger is approved by the Board. However, such clauses are worded carefully to provide that interested directors cannot participate in the proceedings of the Board in which they are interested. For example, if a raider has acquired 20 percent stake in a company and gets a seat on the Board, he is prohibited from exercising his/her votes on the issue of merger.

FAIR PRICE AMENDMENT

Fair price provisions require the acquirer to pay a ‘fair’ price to the minority shareholders of the firm. The fair price may be stated in the form of a minimum price or in terms of a price-earnings multiple at which a tender offer can be made. For example, a fair price amendment may require that any tender offer should be at a price of Rs.70. It is the highest price paid by the bidder during a specified period and is sometimes required to exceed an amount decided relative to the accounting earnings or book value of the target.

Fair price provisions are most useful when the acquirer offers a two tiered bid to the target shareholders. A two tiered offer is generally designed to give the shareholders of the target company an incentive to tender early so as to be a part of the first tier. The provision of fair price in the charter can force the bidder to provide those in the second tier also with the same prices and terms in the first tier. Hence, the existence of a fair price is a disincentive for a bidder to initiate a two tiered offer.

DUAL CAPITALIZATION

This is a defense mechanism used against a hostile takeover bid, according to which the Board of Directors are authorized to create a new class of securities with special voting rights. This voting power is given to a group of stockholders who are friendly to the management. A typical dual capitalization involves the issuance of another stock that has superior voting rights to all the current outstanding stockholders. The stockholders are then given the right to exchange this stock for ordinary stock. The stockholders prefer to exchange the super voting stock to the ordinary stock because the former usually lack marketability and also fetch low dividends. Management retains the special voting stock. This results in the management increasing its voting control of the corporation.

In US, managements of many firms also use corporate charter amendments like:

- Reincorporation, where the target firm chooses to change its state of incorporation to the state with more favorable anti-takeover laws. This involves creation of a new subsidiary in the new state. The parent is then merged with the subsidiary at a later date. Such a move usually requires the approval of the shareholders because the parent is merged with the subsidiary. Several factors like the state's statutes pertaining to the treatment of the various charter amendments, the state's courts ruling for lawsuits alleging breach of corporate director fiduciary responsibility in takeover situation, etc., have to be considered before selecting a state for possible reincorporation.
- Anti-greenmail amendments which restrict a firm's ability to repurchase a raider's shares at a premium. By removing the incentives for greenmail, companies believed that they were making themselves less attractive as potential takeover targets.

GOLDEN PARACHUTE

Golden parachutes are distinctive compensation agreements that the company provides to the top management. The term 'golden' is used because of the attractive compensation that executives covered by these agreements receive. Although companies typically maintain that they adopt such agreements for reasons other than the prevention of takeovers, they may have some anti-takeover effects. These effects may occur when the parachutes are used in a preventive or an anti-takeover manner. They may be used in advance of a hostile bid to make the target less desirable, but they may also be used in the midst of a takeover battle.

A golden parachute agreement provides for lump-sum payments to certain senior management on either voluntary or involuntary termination of their employment. This agreement is usually effective if termination occurs within one year after the change in control. The agreements between the employee and the corporation may have a fixed term or may be an average agreement, in which the term is one year but is automatically extended for an additional year if there is no a change in control during a given year. Funds to back up golden parachutes are sometimes put aside in separate accounts referred to as rabbi trusts. Rabbi trusts offer assurance to the employee that the money will be there for the payment of the parachute.

The variation from the golden parachutes are silver parachutes which are agreements that cover far more number of employees and are also triggered in the same manner as golden parachutes. In some cases tin parachutes cover practically all the employees and consists of very modest payments in case of a takeover.

In US Golden, silver or tin parachutes can be implemented without the approval of the stockholders.

ACTIVE ANTI-TAKEOVER DEFENSES

Defenses which are undertaken in response to a bid are called active anti-takeover defenses. Once a bidder makes an unwanted offer, a variety of additional anti-takeover defenses can be introduced. Some of them are greenmail which is used to discourage the bidder from continuing the pursuit, restructuring and recapitalization strategies which are defenses designed to make the target less attractive and Employee Stock Ownership Plans (ESOPs), white knights, and white squires which place an increasing share of the company's ownership in friendly hands.

GREENMAIL

Greenmail refers to the buying back of shares at a substantial premium from the stockholder holding a significant majority of shares in return for an agreement that he will not initiate a bid for control of the company. It is a form of targeted share repurchase, which is a general term that is more broadly used to include other purchases of stock from the specified group of stockholders who may not ever contemplate a raid on the company. The potential acquirer is required to sign an agreement called the standstill agreement whereby he undertakes not to begin a bid for the control of the company. It is a spin-off of the term blackmail.

STANDSTILL AGREEMENT

A standstill agreement takes place when the target corporation reaches a contractual agreement with a potential acquirer whereby they would be acquirer agrees not to increase its holdings in the target during a particular time period. They are often accompanied with greenmail. Such an agreement takes place when the acquiring firm has established sufficient stockholdings to be able to pose a threat to mount a takeover battle for the target. Many standstill agreements are accompanied by the target's agreement to give the acquirer the right of first refusal in the event that the acquirer decides to sell the shares it currently owns. This agreement is designed to prevent these shares from falling into the hands of another bidder who would force the target to pay them standstill compensation, or even worse, to attempt to takeover the target.

Another version of standstill agreement occurs when the acquirer agrees not to increase its holdings beyond a certain percentage. In other words, the target establishes a ceiling above which the acquirer may not increase its holdings. The acquiring firm agrees to these various restrictions for a fee. Like Greenmail, standstill agreements provide compensation for an acquirer not to threaten to take control of the target. In fact, standstill agreements often accompany greenmail.

Box 9: Gillette: Greenmail & Standstill Agreement
In 1986, Gillette was being pursued by Ronald Perelman of Revlon Corporation. When it appeared that Revlon would launch a hostile tender offer, Gillette responded by paying Revlon $558 million in return to get an agreement from Revlon not to make a tender offer. A unique aspect of this deal was that Gillette paid Drexel Burnham Lambert, the investment banker to Revlon, a sum of $1.75 million. Gillette was worried that having witnessed it's vulnerability, Drexel would approach any raider. The payment was to prevent Drexel from offering its services to any hostile takeover attempt on Gillette for a period of three years. The greenmail was only a temporary fix, as is confirmed by the fact that another raider Coniston Partners attempted to take control of Gillette. During the legal battle that took place between Gillette and Coniston, it was revealed that Gillette had entered into standstill agreements with 10 potential acquirers viz., Colgate Palmolive, Pepsi, Ralston Purina, Anheuser-Busch, Metromedia, Kohlberg Kravis & Roberts, Forstmann Little, Citicorp, Salomon Bros and Kidder Peabody. Gillette eventually reached a settlement with Coniston which was a combination of greenmail and standstill agreement. Gillette agreed to buy-back 16 million shares from Consiton and its associates at a substantial premium to the prevailing market price in return of a standstill agreement.

Source: Patrick A Gaughan – Mergers, Acquisitions and Corporate Restructurings.

WHITE KNIGHTS

When a corporation is the target of an unwanted bid or the threat of a bid from a potential acquirer, it may seek the help of a white knight, that is, another company that would be a more acceptable suitor for the target. To complete such a transaction, a white knight must be willing to acquire the target company on more favorable terms than those of the original bidder. These favorable terms may be a higher price, but management may also look for a white knight that will promise not to disassemble the target or lay off management or other employees. It is sometimes difficult to find a willing bidder who will agree to such restrictive terms. The target often has to bargain for the best deal possible to stay out of the first bidder's hands.

The incumbent managers of the target maintain control by reaching an agreement with the white knight to allow them to retain their current positions. They may also do so by selling the white knight certain assets and keeping control of the remainder of the target.

A target company may find a white knight through its own industry contacts or through the assistance of an investment banker who will survey potential suitors. The potential white knight might request favorable terms or other consideration as an inducement to enter the dispute. However, if this consideration is given only to the white knight and not to hostile bidder and if it is so significant an advantage that it could cause the hostile bidder to withdraw, the deal with the white knight may be a violation of the target's duties.

Box 10: Cities Services Oil Company
In 1982, Cities Services Oil Co., was ranked 38th among the Fortune 500 companies. However, it had consistently exhibited sluggish performance. Mesa Petroleum's CEO T Boone Pickens had coveted Cities Services as it had valuable assets and he believed that they were badly managed. Mesa, which was one-twentieth the size of Cities, had started acquiring shares in the bigger firm since 1979. In June, 1982, Mesa Petroleum made a tender offer for Cities Services Oil at $50 per share. Cities asked Gulf Oil to be its white knight. Gulf Oil was the third largest oil company in the United States at that point of time. Cities saw Gulf Oil as a company similar to itself and friendlier than Mesa. Gulf Oil made a counter tender offer at $63 per share of Cities. In a private deal, Mesa sold its existing holdings in Cities to Gulf Oil at $55 per share and made profit of $40 million. However, Gulf Oil started having second thoughts about the takeover as it would have to take a substantial debt on it's balance sheet to finance the acquisition. Further, it was also worried whether the acquisition might be challenged on anti-trust grounds. Much to Cities Service's dismay and disappointment, Gulf Oil withdrew its tender offer. Cities Service found another white knight in Occidental Petroleum. Occidental made a low bid at $50 per share which was rejected by the Cities Service's Board as 'inadequate'. Occidental revised its offer to $55 per share, which was accepted by Cities Service's Board.

Source: Patrick A Gaughan – Mergers, Acquisitions and Corporate Restructurings.

Box 11: European Steel Maker Arcelor and Mittal Steel
To take Arcelor, a bitter five-month battle involving an Indian-born Lakshmi Mittal, a Russian oligarch and several European governments, Arcelor Chairman Joseph Kinsch announced his board had voted to accept for Mittal's revised cash-and-stock offer. Initially the bid was valued at 21 billion euros in cash and stock (27 billion dollars) by Indian-born Lakshmi Mittal to acquire the world largest European steel maker company Arcelor. After discussion by board members of Arcelor and advised to Mittal to review the bid amount and improved 25.8 billion euro ($32.46 billion) takeover bid from Mittal Steel to create a world giant three times larger than its nearest rival. It was decided unanimously by the Arcelor board that (it will) recommend the new offer by Mittal Steel if that Mittal will be improved bid was a 10 percent premium over its previous offer. Both of them were already world number one and two well ahead of Nippon Steel. The merged company to be called Arcelor Mittal and based in Luxembourg, which will produce about 10 percent of global steel with a joint turnover of some 55 billion euros and worldwide staff of 334,000, according to 2005 data. The decision after a nine-hour board meeting represented a reversal by Arcelor's management, which had cobbled together a white knight deal with Russia's Severstal, controlled by steel magnate Alexei Mordashov, to try to fend off Mittal. Amid mounting shareholder anger at that idea, Arcelor entered talks this month to end the feud over Mittal's unsolicited plan to acquire its rival and create a global champion with an annual output of more than 100 million tones. The decision of the board has proved good in secondary market where, share price is at 40.40 euros a share. Which was 15 percent above Arcelor's last traded price before its shares were suspended on last trading day.

Source: www.http://in.mc946.mail.yahoo.com/mc/welcome.

WHITE SQUIRE

The white squire defense is similar to the white knight defense. In the white squire defense, however, the target company seeks to implement a strategy that will preserve the target company's independence. A white squire is a firm that consents to purchase a large block of the target company's stock. The stock selected is often convertible preferred stock. The convertible preferred share might be already approved through a blank cheque preferred stock amendment of the company's charter.

Box 12: Warren Buffet – A White Squire in Action
Warren Buffet has been the most renowned white squire for the last two decades. He has invested as white squire in companies such as Gillette, Coca-Cola, US Air, Champion International, etc. In 1987, he prevented Ronald Perelman from acquiring Salomon Bros, a leading investment bank. In September, 1987, Buffet was approached by John Gutfreund, the CEO of Salomon to act as a white squire. Minerals & Resources Corporation (Minorco) was a major shareholder in Salomon with a stake of 14 percent. Minorco was unhappy with its investment and had approached Felix Rohatyn (a highly regarded investment banker) to find a buyer. Rohatyn ratcheted pressure on Gutfreund by negotiating a tentative deal with Ron Perelman. Gutfreund was cornered. Salomon could not afford to repurchase Minorco shares at $38, the price offered by Perelman, which was at 20 percent premium to its prevailing market price. Warren Buffett entered the scene and agreed that Berkshire Hathaway (Buffett's firm) would invest $700 million in Salomon in the form of convertible preferred stock. The securities would carry 9 percent guaranteed yield and are convertible into Salomon's common stock (equity shares) at $38 per share. In structuring the deal, Buffett estimated that the 9 percent coupon along with anticipated appreciation of the underlying stock would give Berkshire Hathaway a return of 15 percent. The capital infusion facilitated Salomon to buyout Minorco's holdings and obviated the takeover threat by Perelman.

Source: Bruce Wasserstein – 'Big Deal: The Battle for Control of America's Leading Corporations'.

RECAPITALIZATION

Under a recapitalization plan (also called as leveraged recapitalization), shareholders are usually offered with a super dividend that is typically funded through the assumption of substantial debt. When a company is recapitalized, it substitutes most of its equity for debt while paying shareholders a large dividend. Added to the stock dividends, stockholders at times receive a stock certificate called 'stub' that represent their new shares of ownership in the company.

The concept of recapitalization as an anti-takeover defense was initiated and popularized in 1985 by the Multimedia Corporation with the assistance of Goldman Sachs. Multimedia, a South Carolina-based broadcasting company, initiated this plan, after the original founding family members received unsolicited bids for the company in response to their Leveraged Buyout Offer (LBO). In addition to a cash pay-out, Multimedia stockholders saw their stub appreciate around 6.3 times over a period of two years.

There are several advantages associated with the recapitalization plan. One of the major advantages of this plan is that it allows a company to act as its own 'white knight'. Most of the companies which are victims of a takeover attempts would either look for an outside entity to serve as a white knight or go for an LBO deal. The recapitalization plan is a substitute to both. In addition to this, the increase in company's debt in a large-scale makes the firm less attractive to the bidder. A recapitalization may discourage a hostile bid for shareholders receive a value for their shares that is substantially higher than historical stock prices.

Another important advantage of a recapitalization which is more beneficial to the target company's management is that it may give them a greater controlling power (voting rights) in the target following recapitalization. It may also build-up other security options that may give the management enhanced voting power. However, other stockholders will get only a single share in the recapitalized company as well as whatever combination of cash and debt has been offered. It is highly essential for the company to make sure that all non-management stockholders get at least a reasonable/comparable monetary value for their common stock holdings.

Majority of the recapitalization plans require stockholder approval before they are implemented, of course depending on the available national laws and company's own charter. While introducing a recapitalization plan to stockholders, companies habitually seek approval for other anti-takeover actions that are proposed as part of a joint anti-takeover plan. Some of the other measures such as fair price provisions or staggered boards, etc. might be included here.

Added to the available restrictions in the national laws and company charter, corporates may be prohibited from using the recapitalization defense by restrictive agreements in earlier debt agreements. Companies form these lawful agreements when they raise funds from bankers/investors through floating corporate bonds. Such agreements impose restrictions on the company's future decisions so as to assure the debtors that their debts would be repaid.

ESOPS

Employee Stock Option Plans (ESOPs) involve offering some ownership stake in the company to all or some employees of the firm with a motive to develop ownership position among the employees and bring into line their interests with that of the company and its shareholders. ESOPs can be either in the form of stock option plans, phantom equity plans or stock purchase plans. Companies offer ESOPs to their employees for the following reasons:

- It acts as a very good motivator and can get employees more involved in their duties and focused on corporate performance.
- It is an important means to attract and retain efficient employees, developing long-term relationships with them.
- As a compensation device, ESOPs offer rewards that can exceed the expectations of employees, but are still affordable to the company as they are highly performance driven, and
- ESOPs are used for providing retirement benefits to the employees and as succession plan for owners.

An ESOP can make an unfriendly takeover more difficult. Management and directors can more effectively leverage corporate assets and place a large block of shares in the hands of employees who are likely to be sympathetic to management objectives.

LITIGATION

Litigation is one of the common anti-takeover defenses. Takeover litigation includes antitrust concerns, alleged violation of securities laws, inadequate disclosure by the bidder, etc. Targets often get a court injunction temporarily stopping the takeover attempt until the court decides that the claims of the target are baseless. Such an injunction prevents the acquirer from buying more stock and the firm in turns buys more time to put up more takeover defenses. The additional time also allows the target to seek a white knight. Another important benefit of litigation is to give the bidder the impression that if the offer price and the terms are improved, the target would drop the litigation.

Box 13: Assam's Decision on Karbi Project Upheld
The Supreme Court has dismissed Bharat Hydro Power Corporation Ltd.,'s appeal challenging its takeover by the Assam government and vesting its Rs.200 crore Karbi Langpi project in the state electricity board. The Acquisition Act was passed because there was an inordinate delay in the completion of the project in the power-starved state. The project was sanctioned by the Planning Commission in 1979, but it could not be completed due to litigation and changes in the contracting companies. Earlier, the project was transferred to the National Project Construction Corporation. But the Corporation also could not complete the work causing a steep escalation in cost. Then, the state government set-up a private company with the electricity board holding 11 percent shares, Subhash Project and Marketing Ltd., 40 percent and the public holding 49 percent shares. Even this company could not complete the project due to alleged negligence and serious lapses. This led to litigation and arbitration. To avoid further delay, the state government, passed the acquisition law. An Apex court Bench said the central laws and the state acquisition law operated in different fields and there was no conflict between them. The Court said the state law in this case dealt with acquisition of the corporation and payment of compensation as provided in it. It was enacted only to take over the Bharat Corporation in public interest as it could not complete the project on time. The object was for the state to supervise the construction and achieve early completion. The central laws, on the other hand, made general provisions with regard to supply and use of electricity. They also dealt with licencees, but in this case, the company was not a licencee. For all these reasons, the Supreme Court dismissed the appeal of the Bharat Corporation.

Source: Business Standard, January, 19 2004.

PAC-MAN DEFENSE

This is a highly aggressive defense technique which is rarely used. Here the target company makes a counter tender offer in response to the raider's bid for the target. This defensive technique is named after the popular video game in which the characters try to eat each other before they are eaten up themselves. This defensive technique will only be successful when the target company has the financial resources to make a legitimate bid for the bidder. It may defense may end up being extremely destructive as both the firms may be left with high debt in their efforts to implement hostile tender offer over each other.

Box 14: Takeover of Elf by Totalfina
One of the most colorful takeover battles witnessed in the 90s' was between Totalfina and Elf. The battle began with Total's successful $12.89 billion offer for Belgian Oil Company Petrofina in late 1998. Baron Albert Frere, who controlled 41 percent of Petrofina Stock and Total Chairman Thierry Desmarest rapidly concluded the all share deal, which involved a hefty 36.7 percent premium over Petrofina's prevailing market price, trumping Elf's slow moving merger negotiations with Petrofina. This was a part of a Total's two pronged attack that aimed at acquiring Elf rather than getting acquired. In light of the oil industry's rapid consolidation and Totalfina's and Elf's overlapping assets, a merger between the two was seen as inevitable by the market. The mistake committed by Philippe Jaffre, Chairman of Elf, was not moving in immediately. Analysts believe that a hostile tender offer on Total immediately after its announcement of its intention to takeover Petrofina would have had a better chance to succeed. In July, 1999, two days after closing the tender offer on Petrofina, Total announced a hostile tender offer on Elf. Elf led by Jaffre decided to persue the pacman strategy. It launched a counter offer on Total, which was considered bold but was too late. Totalfina promised to Elf's shareholders that it would raise its bid price if Elf dropped their resistance. Totalfina's tender offer was launched first and scheduled to close earlier. Totalfina also threatened to challenge Elf's tender offer on it in courts, if its tender offer on Elf was not successful. This opened the prospects of a prolonged legal battle with uncertain outcome. Under pressure from its shareholder, Jaffre surrendered in early September. Totalfina acquired Elf at a premium of 30.2 percent to its pre-tender offer market price.

Source: Institutional Investor, January, 2000.

"JUST SAY NO" DEFENSE

This is the most basic form of takeover defense where the target refuses to be taken over by the bidder. The target refuses to take any measures, including taking more cash for its shareholders by saying that it has many other optimistic plans for the future of the company.

CROWN JEWELS

This strategy involves creating a mechanism which ensures that a raider, in the event of a hostile takeover, is denied access to the 'jewels' of the firm. It is based on the argument that a particular aspect of the firm is so highly valued that it attracts raiders. The aspect can be a highly profitable division, a undervalued fixed asset or an intangible asset like a brand or patent. In case, it is made known that even after takeover of the firm, the acquirer would not acquire these jewels, the firm may become less vulnerable.

Box 15: Raasi Cements and India Cements

Raasi Cements was a leading cement producer in South India with an installed capacity of around 2 million tons. It also held a controlling stake in Sri Vishnu Cements, which had an installed capacity of over 1 million tons. Thus, a takeover of Raasi would have given an acquirer control over 3 million tons of cement capacity. The shares of Raasi were quoting at below Rs.100. In a surprise move, India Cements, a Chennai based cement producer, launched a hostile tender offer on Raasi at Rs.300 per share. This offer was consider to be 'highly attractive' by the market with some analysts even suggesting that India Cements has 'over-valued' Raasi. The management of Raasi, B V Raju and his associates, lacked the financial resources to make a counter-offer to their shareholders.

Therefore, under advise from their investment banker Lazard Credit capital, they followed a belated Crown Jewels strategy. The Raasi's controlling stake in Sri Vishnu Cements was sold to B V Raju and his family members. It was thought that with the sale of stake in Sri Vishnu Cements, India Cements would now find Raasi unattractive at Rs.300 per share. It was hoped that this might force them to withdraw their offer. However, India Cements went ahead with the acquisition and challenged the sale of the stake in courts. An year later B V Raju entered into an out of court settlement with India Cements wherein they sold the stake in Sri Vishnu Cements to India Cements.

Source: www.financialexpress.com

SHARE REPURCHASES

This involves the firm buying back its own shares from the public. This is a sound strategy and has several advantages:

- The amount of floating stock which is available for a raider is reduced. Once the target acquires certain shares, these shares will no longer be available for the bidder to purchase.
- The management is able to increase its stake in the company without investing any additional funds. For example, if the paid-up capital of the company comprises of 1 crore shares and the current promoters holding is 24 lakh shares, then the promoters' stake is 24 percent. Suppose the company were to buyback 40 lakh shares from the market, (the existing management does not participate in the buyback), the management's stake in the firm increases to 40 percent in the post buy back capital.
- The acquisition of the target's own shares can allow the corporation to use up its own resources and hence the target cannot use this cash to pay-off some of the debt incurred in the acquisition.
- If the share repurchase is financed through debt then it implies that the target is using up its own borrowing capacity, which could have been used to finance some of the acquisition by the bidder.

RESTRUCTURING

Restructuring of a firm might involve taking a company private, the sale of attractive assets, undertaking a major acquisition or even liquidating the firm.

Going private refers to the restructuring activity where the management of the firm purchases the bulk of the firm's stock. This is a win-win situation for the shareholders of the target who receive a premium for their stock and the management also retains control.

The target company might also make its shares less attractive by selling off the assets which the bidder wants. The proceeds from the sale of such assets can be utilized in other defenses like the share repurchases or payment of special stock holder dividend.

Sometimes in order to defend itself against an acquisition bid the target in turn makes an acquisition to drain its excess cash balances and exhaust the borrowing capacity making itself less attractive. When the target is highly profitable it may acquire a less profitable business thereby reducing its financial comfort. If these acquisitions involve the assumption of greater debt, the target becomes less attractive due to the increased leverage.

Another drastic restructuring activity is liquidation and is undertaken only when the firm believes that it would receive more by liquidating than what is offered by the bidder. The firm chooses to liquidate the company, pay outstanding obligations to the creditors and distribute the remaining proceeds to the shareholders as the liquidating dividend.

To better appreciate the theory of the various defences discussed above, let us look at how these techniques are used through a practical example.

TAKEOVER DEFENSES – A CASE STUDY[1]

ALLIEDSIGNAL VS. AMP

The following example illustrates takeover tactics and defenses. We have chosen an American example as it was the initiator of these changes.

In the first week of August 1998, AlliedSignal Inc., announced that it would bid \$44.50 per share, or \$9.8 billion, for AMP Inc. AMP's stock price immediately jumped by near 50 percent to about \$43 per share. AMP was the world's largest producer of cables and connectors for computers and other electronic equipment. It had just announced a fall of nearly 50 percent in quarterly profits from previous year. The immediate cause for this bad news was economic troubles in Southeast Asia, one of AMP's most important export markets. But longer run performance had also disappointed investors, and the company was widely viewed as ripe for change in operations and management.

AlliedSignal was betting that it could make these changes faster and better than the incumbent management.

AMP at first seemed secure. It was chartered in Pennsylvania, which had passed tough anti-takeover laws. Pennsylvania corporations could 'just say no' to takeovers that might adversely effect employees and local communities. The company also had a strong poison pill.

1 www.perso.club-internet.fr

AlliedSignal made a tender offer to AMP shareholders, and 72 percent accepted. However, the terms of the offer did not require AlliedSignal to buy any shares until the poison pill was removed. In order to do that, AlliedSignal appealed again to AMP's shareholders, asking them to approve a solicitation of consent that is blocking AMP's directors from enforcing the pill.

AMP fought back vigorously and imaginatively. It announced a self-tender offer plan to borrow $3 billion to repurchase its shares at $55 per share (its management's view of the true value of AMP stock). It convinced a federal court to delay AlliedSignal's solicitation of consent. At the same time it asked the Pennsylvania legislature to pass a law which would effectively bar the merger.

Then, AlliedSignal discovered that it had powerful allies. About 80 percent of AMP's shares were owed by mutual funds, pension funds and other institutional investors. Many of these institutions publicly disagreed with AMP's rigidity. The College Retirement Equities Fund (CREF), one of the largest US pension funds, called AMP's defensive tactics "entirely adverse to the principles of shareholder democracy and good corporate governance."

Then the Hixon family, descendants of AMP's co-founder, made public a letter to AMP's management and directors expressing 'dismay', and asking, "Who do management and the board work for? The central issue is that AMP's management will not permit shareholders to voice their will."

AMP had complained all along that AlliedSignal's bid was too low. Robert Ripp, AMP's chairman, reiterated this point in his reply to the Hixons and also said, "As a board, we have an overarching responsibility to AMP and all of its shareholders."

But as the weeks passed, AMP's defenses did not look quite so strong. By mid-October it became clear that AMP would not receive timely help from the Pennsylvania legislature.

In November, the federal court finally gave AlliedSignal the go-ahead for its solicitation of consent to remove the poison pill. Then, suddenly, AMP gave up. It agreed to be acquired by a *white knight*, which is a friendly acquirer, Tyco International for $55 per AMP share. AlliedSignal dropped out of the bidding since it did not think AMP was worth that much.

What are the lessons? First is the strength of poison pills and other takeover defenses. AlliedSignal's offensive gained ground, but with great expense and effort and at a very slow pace.

The second lesson is the potential power of institutional investors. AMP gave up not because its legal and procedural defenses failed but largely because of economic pressure from its major shareholders.

Did AMP's management and board act in shareholders' interests? In the end, yes. They said that AMP was worth more than AlliedSignal's offer, and they found another buyer to prove them right.

REGULATION OF TAKEOVERS IN INDIA

It is a common misunderstanding that regulation of takeover means prevention of hostile takeovers. Formation of such regulations which prevent takeovers would destroy the basis of a free market economy. Therefore, the purpose of takeover regulations is, not to discourage takeovers, but to ensure fairness, transparency and protection of minority interests. Some of the salient features of the Takeover Code of India are:

- The acquirer should intimate the target company and the stock exchanges where the shares are listed as soon as its holding cross 5 percent of the voting capital of the target company.

- As soon as the holding of the acquirer cross 15 percent of the voting capital, it should intimate the same to the stock exchanges. The acquirer is also required to make a public offer to the shareholders to acquire a minimum of another 20 percent of the voting capital.

  The public offer should be priced at higher of the following:

  – the highest price paid by the acquirer to acquired shares in the target company; and

  – the higher of the average price (average of the daily high and low) prevailing in the market for the last six months or the last two weeks.

- The public offer is required to be managed by a SEBI registered Merchant Banker, who is required to exercise due diligence over the process and ensure full disclosures of all material facts.

Thus, it can be observed that the takeover code brings about transparency by ensuring disclosures. It also ensures protection of minority interests by giving the small shareholders an opportunity to exit from their investments. It achieves fairness by ensuring that the minority shareholders get at least the same value as those who transferred the controlling stake.

The Takeover Code has also attracted a reasonable amount of criticism as well. Firstly, it has been criticized that the threshold limit of 15 percent is too low. It has been suggested that the limit should be raised to a "more reasonable" level of say 25 percent to 30 percent. Secondly, the criticism of the requirement to make a tender offer for 20 percent appears to be more valid. The laws in most of the other countries require that the acquirer make a tender offer for the entire balance of the voting capital. This would provide an opportunity to all the shareholders to exit from their investment, if they so desire. However, the requirement to make a tender offer for only 20 percent of the voting capital may necessitate that shareholders are not given adequate opportunities to exit.

The detailed guidelines are given in the takeover code given in the chapter regulatory control.

SUMMARY

- Corporate growth takes place through various forms, and takeovers or acquisition form one of the major tools. Takeovers can be friendly which take place through negotiated settlement or hostile.
- There are three alternatives available for hostile bidders: bear hug, tender offer, proxy fight etc. A bear hug is an offer made directly to the directors of the target corporation. It puts pressure on the directors since it carries an implication that if the offer is not received favorably, a tender offer will follow. An attempt by the dissident group of shareholders to gain representation on the firm's Board of Directors is called a proxy fight. It brings out a change in control or seeks more modest goals. Tender offer is an effective method of financing a takeover via a public offer to the target firm's shareholders to buy their shares.
- There exists a lack of agreement in a takeover activity. There always lies a debate on the desirability of having an auction for the target, the coerciveness of tender offers, and the bargaining role of management. People against takeovers argue that it increases costs and results in inefficiency in the operation of the market for corporate control.

- As per some of the researchers, coerciveness of tender offers should not pose any problem given that the takeover market is competitive. Whatever are the arguments, there would always be optimal incentives for takeover activity along with the existence of anti-takeover mechanisms, and rather they would become more innovative.
- Anti-takeover defenses can be grouped as pre-bid or preventive defenses and post-bid or active defenses.
- These are designed to raise the overall cost of a takeover attempt and to provide the target firm with more time to install additional takeover defenses.
- Preventive defenses generally are divided into three classes: poison pills, corporate chartered amendments or shark repellants and golden parachutes.
- Active defenses are those undertaken in response to a bid. These include greenmail, white knight, litigation, leveraged recapitalization, share repurchases, etc.

Chapter 14

Management Guide for Merger and Acquisition Activity

After reading this chapter, you will be conversant with:

- Diversification and Mergers in the Long Range Planning
- The Rules for Successful Mergers
- Significant Determinants of the Merger Activity
- Value Based Planning
- Merger Analysis in the Value Creation Framework

Successful mergers are few and studies show that 50 percent to 75 percent of acquisitions actually destroy rather than create shareholder value. Given these discouraging statistics, managements have to check what elements make some mergers succeed and others fail. Failure is usually blamed on poor strategic rationale, overpayment, lack of planning, the absence of executive leadership at critical times or a serious mismatch in company cultures. However, effective leadership is the one persistent characteristic of a successful merger. Effective leaders are skilled at identifying great deals, communicating their potential to investors, customers and employees and creating value through a new entity. The leader's role as a stimulant cannot be overlooked in maintaining morale among groups as diverse as shareholders and customers.

Establishing a sound merger and acquisition program involves following of two basic principles. To begin with, merger and acquisition activity of a firm must be related to the diversification program and secondly, both the diversification and the mergers and acquisition programs must be a part of the general planning process of the firm.

DIVERSIFICATION AND MERGERS IN THE LONG RANGE PLANNING

Diversification and mergers have to be a part of the general long range planning of any firm. The success of a merger depends on the merger plan. A wide variety of models and tests have to be employed to develop a plan for a merger. The model depends on the initial assumptions and the results are influenced by the choice of variables, how they are measured and how they are combined. The selection and interpretation of the chosen model/plan is influenced by the idea of the underlying processes involved.

Long range strategic planning process is nothing but a behavior and a way of thinking requiring diverse inputs from all segments of the organization. Essentially it involves the following elements:

i. Assessment of the environment.

ii. A consideration of capabilities, missions, and environmental interface from the point of view of the acquiring firm and its divisions.

iii. An emphasis on the process rather than particular goals or objectives of the firm.

iv. A need for coordination and consistency among the individual divisions, product market activities and optimization from the viewpoint of the firm as a whole.

v. A need to relate effectively to the firm's changing environment and constituencies.

vi. Combining the planning process into a reward and penalty or incentive system, taking a long range time perspective.

Long range strategic planning process involves lessening the gap between the objectives of a firm and its potential based on the present capabilities. The decisions involved in doing so are difficult and involve huge risks and costs. Since the stakes are large, an iterative process should be employed. The process is repeated several times individually from the viewpoint of different management functions and at some point, from the view point of the total enterprise.

Long range strategic planning also involves effective alignment of the firm with its environments and constituencies. This can be achieved by choosing a product line that is related to the needs of those customers who will provide large markets, focusing on the technological bottlenecks or barriers by creating new markets, etc. Diversification program from the base of the existing capabilities or organizational strengths is one of the desired strategies.

If the firm has the strength in the general management functions, can provide expertise of staff in a wide range of areas, can carry over the financial planning and control effectively, and possess specific capabilities like the research, marketing, and manufacturing then the preferred strategy is diversification.

The firm has to first understand its own strengths and weaknesses and try to overcome its weaknesses by clearly defining the specific capabilities that it is seeking to obtain. If the firm does not posses the capability to move into other areas, an alternative strategy must be employed.

The development of a range of capabilities to enter into a diversified field requires substantial investment in training and a band of experienced people.

DIVERSIFICATION PLANNING, MERGERS AND THE CARRY-OVER OF MANAGERIAL CAPABILITY

Growth through mergers and diversification represents a very good alternative to be taken into account in business planning. The external growth contributes to opportunities for effective alignment to the firm's changing environments. The primary reason for acquiring or merging with another business is to produce improved cash flow or to reduce the risk faster at a lower cost than achieving the same goal internally. Thus, the goal of any acquisition is to create a strategic advantage by paying a price for the target that is lower than the total resources required for internal development of a similar strategic position.

Another reason is the expectation on the part of the diversifying or acquiring firm that it has or will have excess capacity of general managerial capabilities in relation to its existing product market activities. Moreover, there is an expectation that in the process of interacting with the generic management activities, the diversifying firms will develop industry specific managerial experience and firm specific organization capital over time.

THE RULES FOR SUCCESSFUL MERGERS

ACHIEVING SUCCESSFUL M&A – FIRST EVALUATE OWN BUSINESS

A key to a successful merger is the ability to identify the potential problems and take into account the interest of employees and investors. The top management must assess the merger whether or not it improves the credibility of the investors and the employees. Employees must believe that the merger is best for the company, and will enable the company to grow and be more profitable in order to gain from the merger, as individuals. Investors and shareholders also need to be convinced about the rationale for the deal. The acquisition premium means that an amount of their fund will be transferred to the target company and such a move needs to be justified.

According to Peter Drucker (1981), economically sensible mergers must follow five rules. The Drucker five commandments for successful acquisitions are:

i. Acquirer must contribute something to the acquired.

ii. A common core of unity is required.

iii. Acquirer must respect the business of the acquired firm.

iv. Acquiring company must be able to provide the top management to the acquired company.

v. Within the first year of merger, managements in both the companies should receive promotion across the entities.

Box 1: Ten Secrets to Successful Mergers and Acquisitions
The following ten rules for successful mergers and acquisitions were derived from the Cisco System's business model. Cisco has acquired 51 companies in 6.5 years, 21 of them in the past 12 months alone. As a result, Cisco is now the world's second-most valuable company. Why? Perhaps their acquisition practices will help answer these questions:
1. Design a company product/service grid: Decide which holes in the grid you have to fill but do not want to or cannot develop yourself. Look for companies that can fill those holes now.
2. Buy strategic minority stakes: Buy into companies to take a quick look at products you might want to own.
3. Move Fast: If you decide an opportunity is right for your company, close the deal now, or someone else will.
4. Do not kill the deal over price. Your competition today is usually an IPO, so if the deal is the key to your company's growth pay whatever it takes and add value later. Do it right and the purchase price will look cheap in 36 months.
5. Wipe out uncertainty. Retain all employees. Protect acquired employees for at least one year. Let them know it. Allow them to concentrate on their jobs, not on job security. Tell each employee that he/she is being retained, what their title is and what their salary and bonus will be. Issue everyone a new ID card. Send in a team to completely integrate computer systems immediately.
6. Be ready to move the day the deal is announced: Hand every employee a package that completely explains who they are, giving them contact people at their company when they can call with questions for clarification. Include a chart that compares every existing benefit with their new benefits. Make sure all of their benefits are better. If they are not change them. Be careful how you ship these items, or the guys on the acquired company's loading dock will know ahead of everyone else.
7. Form a mobile team of transition executives: Set up immediate Internet access with your company. Link new employees with your people at similar levels who also joined your company through an acquisition. Practice full access and full disclosure. This team should research and study every single job at the acquisition and produce a map bringing that job into your firm's matrix.
8. Utilize the acquired company's resources: Where the acquired company has a skill set, use it. Where they don't, send in your team. Learn to recognize the difference.
9. Sales and Marketing is a special case: Do not change commission schedules and house account rules. Raise commissions or leave them alone, but never lower them. You need sales to continue, so don't pull the rug out from beneath its sales force.
10. Set up communication groups: Give new employees an opportunity to voice concerns and gripes. Act on their suggestions. Offer bonuses for ideas that facilitate the acquisition's integration into your company.

Source: www.usa-dsi.com

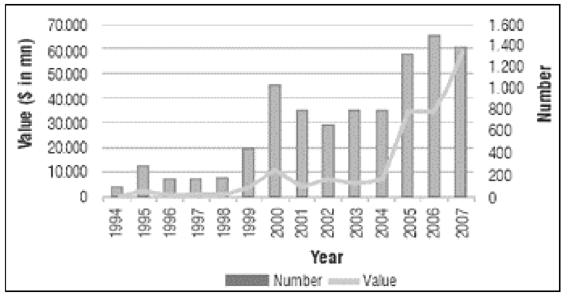
The Success of Mergers and Acquisitions Depends on People[1]

Indian companies increasingly use Mergers and Acquisitions (M&As) to realize their strategic goals. Last year, they had been involved in almost 1,400 transactions with a value of $59 bn (See Figure 1). Cross-border deals are very important and make-up half of all deals. While acquisitions by the Indian companies abroad make-up only 17%, foreign companies are much more acquisitive in India with 32% of all deals. It is an important fact that Indian companies increasingly use M&A transactions to grow international or even globally. The most popular

1 Kummer Christopher, "The Success of Mergers and Acquisitions Depend on People", *HRM Review*, Hyderabad, August, 2008.

destination for acquisitions abroad by the Indian companies in 2007 was the US. Other preferred destinations were the UK, Australia and Germany. The most frequent buyers in India come from the US accounting for almost one-third of all transactions. In total, most M&A deals with the Indian parties involved were done in the financial sector followed by high technology and industrial sectors (See the Figure 2).

Figure 1: Announced M&A Transactions of Indian Companies (1994-2007)



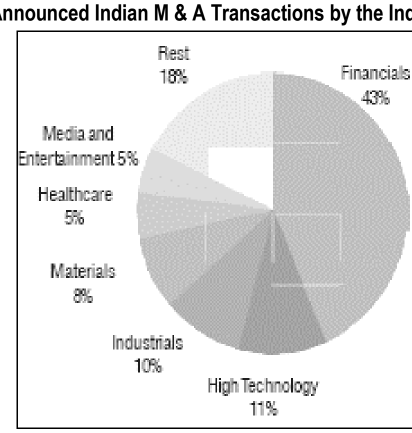
Source: Thomson Financial, PwC Analysis.

However, about 75% of all mergers and acquisitions do not meet the expectations. In most cases, so-called "people issues" are blamed for the failure or results below expectation. Therefore, you should ask yourself before closing a deal: how can you influence the outcome in a positive way and make sure it will be a success? There are two important phases in which this can be achieved: by a thorough human capital due diligence and by mastering the biggest challenges during the integration phase.

THOROUGH HUMAN CAPITAL DUE DILIGENCE

A thorough human capital due diligence is an important cornerstone for laying the foundation of a successful deal. The due diligence, when the target company or merger partner is analyzed for risks and opportunities, offers a chance to learn in detail about the other party and to prepare for the integration phase ahead. If this due diligence is done the right way, it greatly increases the chances of success. The human capital due diligence is only a part of the overall due diligence, which also includes financial, commercial/operational and legal due diligence. Components to be analyzed as part of the human capital due diligence are: talent, organizational design, workforce, remuneration and industrial relations (See the Figure 1). All these components and their respective depths of analysis will vary from case to case, during the M&A process and the likelihood of closing the deal. The results of the human capital due diligence show which risks and opportunities with regard to human capital are realistic. All findings have to be translated into financial numbers and cash flows to demonstrate their effect on the valuation and business model.

Figure 2: Announced Indian M & A Transactions by the Industry in 2007



CHARACTERISTICS OF A THOROUGH HUMAN CAPITAL DUE DILIGENCE

A thorough human capital due diligence has the following characteristics:

- It has to be geared to the strategic goals of the transaction and help understand the interaction of strategy, business model and employees.
- It relates all information in relation to the market or the acquiring company. One of the tools that is valuable in this respect is a human capital profile consisting of various key performance indicators.
- All findings must be translated into financial effects or quantitatively measurable results.
- Not only does it identify the existing and potential risks, it also demonstrates actual room for maneuver and lays the solid foundation for the integration planning.

For such a thorough human capital due diligence, knowledge about the industry and the market, human capital, transactions, proven methods, and adequate people are mandatory.

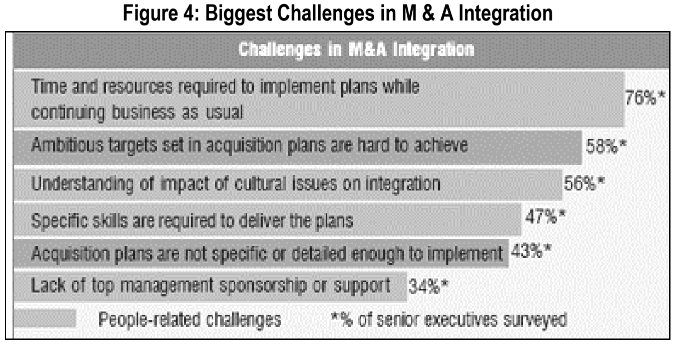
After such an analysis, the next step ahead is mastering the integration phase.

Figure 3: Components and Findings of a Human Capital Due Diligence

MASTERING THE BIGGEST CHALLENGES DURING INTEGRATION PHASE

Arranging and closing an acquisition or a merger causes a lot of work. The essential and hardest workload, however, comes with the integration phase. During integration, four of the six biggest challenges are people-related. (See the Figure 4).

Figure 4: Biggest Challenges in M & A Integration



Source: 2005 PwC Deal Confidence Survey.

Table 1: Success Factors and Barriers to Change Processes

Top 9 Success Factors		Top 9 Barriers	
Ensuring top sponsorship	82%	Competing resources	48%
Treating people fairly	82%	Functional boundaries	44%
Involving employees	75%	Change skills	42%
Giving quality communications	70%	Middle management	38%
Providing sufficient training	68%	Long IT lead times	35%
Using clear performance measures	65%	Communication	34%
Building teams after change	62%	Employee opposition	33%
Focusing on culture/skill changes	62%	People issues	32%
Reward success	60%	Initiative fatigue	32%
Using internal champions	60%	Unrealistic timetables	31%
⇨ 8 out of 10 success factors are people related		⇨ 8 out of 10 success factors are people related	

Source: PwC Survey, Managing Change in Your Business

Table 2: Internal Channels of Communication in M&A

Circular letter	M&A Newsletter
Letter	Corporate newspaper
Memo	Kick-off meetings
E-mail	Information meetings per location, department or team
Brochure/booklet	Workshops
Video/audio message	Breakfast, lunch or evening event
Intranet portal and forums	Party
Phone and E-mail hotline	Excursions

Source: Kummer, Wie Personalisten den Erfolg von Fusionen and Obemahmen beeinflussen konnen.

Managers see the greatest challenge in combining the implementation of integration and change with continuing daily business operations. In order to master that challenge, additional staff resources are needed. The next hurdle is that targets in M&A deals are quite ambitious and hard to reach. This hurdle can be overcome by involving executives who have to realize the integration early during the planning phase so that targets are realistic and detailed enough. Cultural issues are often not well understood and accounted for either, although cultural difference, with suitable analysis methods, can be evaluated rather well in advance. Cultural factors are obvious, particularly during cross-border transactions. You can handle these factors, if only they were considered in your expectations and your analysis and were planned along with integration actions. Additionally, you need to have the necessary competencies and skills available for M&A integration. Top management must also support and facilitate integration after closing the deal.

THE MOST IMPORTANT SUCCESS FACTORS AND BARRIERS TO CHANGE

In most cases, changes are necessary during the integration phase of M&A transactions. Eight out of 10 top success factors and eight out of 10 top barriers of change are people-related (See the Table 1).

With regard to success factors of change projects, support and commitment of top management is the key. It is equally important to treat people fairly in the process. This calls for relatively transparent and rational decision-making processes that lead to comprehensible, and sensible decisions. Honesty and quick decisions belong to a fair treatment to reach necessary clarity. Another success factor is the involvement of employees in the change process. Employees will be quite open to change in M&A, because they expect changes anyway. Involving them in the planning and implementation of change will increase its acceptance and realization.

COMMUNICATION AS A SUCCESS FACTOR AND BARRIER

Communication is both a success factor and a barrier to change. Particularly in M&A transactions, employees get lot of "information" via internal rumors or often find out important news through public media first. Rumors can only be handled if you communicate internally, as early as possible. The least one can do is to synchronize (internal) employee communication with external communication for media and capital markets. For this situation, there are a lot of communication channels (See the Table 2). Suitable moments for communication during M&A processes are, for example, start of exclusive negotiations or conclusion of contract. Content matters as well, together with the form of communication. If nothing can be told about specific goals and consequences of a transaction and its integration, you can at least disclose a time table and the next steps. Communication should not be a one-way street, but must be interactive and allow for questions and feedback. Hence, people account for the success in M&As. Especially, during the vital integration phase and the resulting and necessary changes, you need to consistently pay attention to success factors and potential barriers.

SIGNIFICANT DETERMINANTS OF THE MERGER ACTIVITY

The rate of the merger activity depends on the prospects of the general economy in that particular country. The merger activity is positively correlated with the rates of growth in the real GNP. Hence, we can conclude that merger activity is motivated by the availability of investment opportunities particularly in growth industries.

The relative cost for the individual firms involved in the merger determines their profitability through the merger. A high long-term cost of capital means that there are fewer opportunities and fewer mergers particularly fewer conglomerate mergers. The long-term interest rates are also significant determinants of the merger activity.

Pure conglomerate mergers are particularly dependent on two financial variables. Conglomerate mergers reduce the possibility of bankruptcy thus reducing the borrowing costs and increasing the debt capacity. In such a scenario, the number of conglomerate mergers increase when the general bankruptcy risk is high, and the risk premium on low grade corporate securities is higher. The second variable which is strongly correlated with the conglomerate mergers is the measure of monetary stringency as the spread between short and long-term interest rates. Usually, the cash flow generating capacity of the acquired firm will be less than that of the acquiring firm and therefore, the need for external financing is high. When the availability of funds is tight in the market, it is possible that the cost of capital will be high for smaller and less profitable firms due to their higher risk premiums charged for such companies by investors, underwriters and lenders. Hence, merging with firms with larger internal cash flows and greater access to the capital and money markets may be particularly attractive in periods of tight money.

From the above discussion it is clear that financial synergy is far more important for conglomerate mergers than for product or market extension mergers. Hence, internal funds are an important motive for merger.

THE PROFITABILITY OF MERGERS TO MERGING FIRMS

Generally, the value of a merged firm is greater than the sum of its individual components. Value is created and increased when two firms merge. The methodology of assessing the impact of Mergers and Acquisitions on profitability of a firm can be understood from the viewpoint of: industrial economists and financial economists. Industrial economists concentrate more on the efficiency aspects by comparing profits, sales, employment and other indicators in pre-and post-merger periods. They generally use accounting data generated internally by merging firms.

On the other hand, financial economists view the announcement of a merger as an event and evaluate the stock price to determine the profitability of merger. Most of these researchers use stock prices mainly during announcement period. According to them, because of efficient market hypothesis, it is not necessary to look at the long-term stock price. We will look at some of these findings:

The increase in stockholder wealth must reflect the expected underlying economies and efficiencies from mergers. Some of the findings of various studies indicate the following:

- The shareholders of the acquired firms gain by about 15% in mergers and 30% in tender offers during the period before the announcement of the date of a merger or tender offer. Before the announcement the abnormal return of these firms was negative indicating that these firms were not performing up to their potential.
- The shareholders of the acquiring firms had modest positive returns before announcement of the date of acquisition. Their abnormal returns before the announcement were positive indicating that the acquiring firms were managed successfully.
- The studies also indicated that the acquiring firms generally have higher than average leverage ratios while the acquired firms have lower than average leverage ratios. The leverage is increased even further after the completion of the merger or acquisition. This is because less risky firms can use more leverage and become acquirers of more risky firms which have been restricted to employ low leverage. The risk of bankruptcy and expected bankruptcy costs can be reduced by mergers. Mergers can cause the cost of capital of the merged firm to be lower than the simple weighted sum of the cost of capital of the individual firms.

Studies also revealed that new capital expenditure for investment in the operation of acquired companies increase over the post-merger expenditure. The managerial function of the capital expenditure is generally shifted to the corporate headquarters after the acquisitions. These results indicate that an important motive for mergers is to internalize investment opportunities in the acquired firms' line of business.

The above studies include all the types of mergers horizontal, vertical and conglomerate. Studies of only the conglomerate mergers also yield similar results. In terms of the operating profitability return on assets in conglomerate mergers have been slightly lower than the average for all the manufacturing firms, but their return on assets have been higher than the general industry composite reflecting their higher leverage ratios.

VALUE-BASED PLANNING

We will now look at the free cash flow basis valuation formula which is general and at the same time provides a framework for effective planning in the firm.

The following formula is used for valuing a firm with supernormal growth over a limited period of time followed by no growth.

$$V_0 = X_0\left(1-T\right)\left(1-b_s\right)\sum_{t=1}^{n}\frac{(1+g_s)^t}{(1+k)^t} + \frac{X_0(1-T)(1+g_s)^{n+1}}{k(1+k)^n}$$

This formula can be modified to allow for several variations in the pattern of growth of the firms. Any expansion of the formula will have the same key or critical valuation parameters. These can be:

Growth rate,

- Margin between profitability on new investments and the cost of capital,
- Sound management and Investment opportunities, and
- Prudent management of tax obligations.

Value based planning involves relating the qualitative aspects of strategy to their quantitative financial results with a view towards value enhancement. This needs the use of business economics framework and the concepts from the strategy text integrating them and orienting them to the valuation framework as shown in the equation.

An illustration of how this can be done is provided by Rappaport (1986). He demonstrates how the key valuation parameters which he calls value drivers can be related to tactics supporting either the cost leadership strategy or the product differentiation strategy. The key valuation parameters considered by Rappaport are:

- Growth rate (g) in operating income,
- Operating profit margin,
- Working capital investment,
- Fixed capital investment, and
- Cost of capital.

The following table relates strategy to the various key parameters of valuation models.

Table 3

Value Drivers	Tactics supporting Cost Leadership Strategy
Sales growth rate	– Maintain competitive prices – Pursue market share opportunities to gain economies of scale in production, distribution, etc.
Operating profit margin	– Achieve relevant economies of scale for each of value creating activities. – Initiate mechanisms to improve the rate of learning example standardization, product modifications, etc. – Eliminate overheads that do not add value to the product. – Search for cost which can be reduced.
Working capital investment	– Minimize the cash balance. – Manage accounts receivable to reduce the average number of outstanding days. – Minimize inventory without damaging the required level of customer service.
Fixed capital investment	– Promote policies to increase the utilization of fixed assets. – Sell off unused fixed assets. – Obtain assets which increase productivity.
Cost of capital	– Target an optimal cost structure. – Select debt and equity instruments with minimum costs. – Reduce the business risk factors in manner consistent with the strategy.
Sales growth rate	– Sell at a premium price. – Pursue growth in market segments in which the buyer is willing to pay premium for differentiation.
Operating profit margin	– Choose the combination of value activities that create the most cost effective means of differentiating example lower the buyer's cost and risk and raise performance. – Reduce the costs that do not contribute to the buyers needs.
Working capital investment	– Minimize the cash balance. – Relate the accounts receivable policy to differentiation strategy. – Maintain inventory level consistent with differentiating level of service. – Obtain the best terms for suppliers for accounts payable.
Fixed capital investment	– Invest in specialized assets that create differentiation. – Purchase assets for optimal utilization. – Sell off unused fixed assets. – Obtain assets at least cost example lease vs purchase.
Cost of capital	– Target an optimal cost structure. – Select debt and equity instruments with minimum costs. – Increase differentiation and thereby make less dependent on general economy.

Source: J. Fred Weston, Kwang S. Chung and Susan E. Hoag – Mergers, Restructuring and Corporate Control.

Rappaport Model (1986) and the general free cash flow basis model which we have specified earlier are similar. Both the models demonstrate the fixed relationship between sales, investments, profitability patterns, in relation to the cost of capital.

From the table we can notice that Rappaport uses two different approaches to strategies developed by Porter (1980, 1985, 1987). They are cost leadership strategy and product differentiation strategy. Under the cost leadership strategy, the sales growth requires competitive prices and an emphasis on increasing market share. Operating profit margin requires achieving economies of scale and mechanisms to improve the rate of learning as in the BCG approach.

MERGER ANALYSIS IN THE VALUE CREATION FRAMEWORK

Mergers and Acquisitions should be related to a firm's general planning framework. A merger should be evaluated as a capital budgeting decision. This can be done as follows:

FRAMEWORK FOR EVALUATING ACQUISITION

It consists of the following steps:

Step 1: ***Determine CF(X)***, the equity related post-tax cash flows of the acquiring firm, ***X***, without the merger, over the relevant planning horizon period.

Step 2: ***Determine PV(X)***, the present value of CF(X) by applying a suitable discount rate,

Step 3: ***Determine*** $\boldsymbol{CF(X^1)}$, the equity-related post cash flows of the combined firm $\boldsymbol{X^1}$ which consists of the acquiring firm X and the acquired firm Y over the planning horizon. These cash flows must reflect the post-merger benefits.

Step 4: ***Determine*** $\boldsymbol{PV(X^1)}$, the present value of CF ($\boldsymbol{X^1}$)

Step 5: ***Determine the Ownership Position (OP)*** of the shareholders of firm X in the combined firm $\boldsymbol{X^1}$, with the help of the following formula –

$$OP = N_x/[N_x + ER\ (N_y)]$$

Where,

N_x = Number of outstanding equity shares of firm X (the acquiring firm) before the merger.

N_y = Number of outstanding equity shares of firm Y (the acquired firm) before the merger.

ER = Exchange ratio representing the number of shares of firm X exchanged for every share of firm Y.

Step 6: Calculate NPV of the merger proposal from the point of view of X as follows:

$$NPV(X) = OP\ [PV\ (X^1)] - PV\ (X)$$

Where,

NPV(X) = NPV of the merger proposal from the point of view of shareholders of X.

OP = Ownership position of the shareholder of firm X.

$PV(X^1)$ = PV of the cash flows of the combined firm X^1.

PV(X) = PV of the cash flows of firm X, before the merger.

Let us look at a simple illustration:

Illustration 1

Consider the firm X Limited.

Step 1: Estimated equity related post-tax cash flow $CF(X)_t$ of X limited are as follows:

Year	1	2	3	4	5
$CF(X)_t$ (Rs.)	100	120	136	148	160

After five years, $CF(X)_t$ will grow at a compound rate of 5% per annum.

Step 2: Determination of PV of cash flows using the discount rate of 15%.

$$PV(X) = 100/1.15 + 120/(1.15)^2 + 136/(1.15)^3 + 148/(1.15)^4 + 160/(1.15)^5 + 160(1.05)/[(0.15 - 0.05)(1.15)^5]$$
$$= 1{,}266.71$$

The last item in the above equation represents the PV of the perpetual stream of cash flows beyond the fifth year.

Step 3: Assume that the estimation of the equity-related cash flows of the combined firm X^1 is as follows:

Year	1	2	3	4	5
$CF(X^1)_t$ (Rs.)	220	260	310	330	350

After five years cash flows of the combined firm is expected to grow at the compounded rate of 6% per year.

Step 4: Determination of PV of expected cash flows of the combined firm.

$$PV(X^1) = 220/1.15 + 260/(1.15)^2 + 310/(1.15)^3 + 330/(1.15)^4 + 350/(1.15)^5 + 350(1.06)/[(0.15 - 0.06)(1.15)^5]$$
$$= 3{,}004.18$$

Step 5: Determining the ownership position of the shareholders of X. Assume that the number of outstanding shares of firm X before merger also 100 and the number of outstanding shares of firm Y are also 100 and that the proposed Exchange Ratio (ER) is 0.6. The ownership position of the shareholders of firm X in the combined firm X^1 will be –

$$OP = 100 / [100 + 0.6(100)] = 0.625$$

Step 6: Calculation of NPV of the merger proposal from the point of view of shareholders X.

$$NPV(X) = (0.625)\ 3004.18 - 1266.71 = 610.90$$

Since the NPV is positive the firm should go ahead with the merger.

From the operational view point, the mergers and acquisitions should be related to the firm's general planning framework. Let us look at this concept by using an illustrative case example to express the ideas more clearly.

Illustration 2

Ace Ltd. is an Indian based company, and is a leading manufacturer of trucks. Because of the low internal profitability rate and lack of favorable investment opportunities in the existing line of business, the management has decided to expand the operations through a merger to achieve more favorable growth and profitability opportunities. It has made an extensive search of a large number of firms and has identified two firms as possible merger candidates based on a number of characteristics. Base Ltd. is a manufacturer of spare parts of automobiles and is a strong research and marketing. It has had high internal profitability and substantial investment opportunities. Case Ltd. is a manufacturer of ball bearings. It has a better profitability record than Base Ltd. The data for Relevant data for the three firms is as follows:

(Rs. in lakh)

Particulars	Firm Ace	Firm Base	Firm Case
Book value per share	15	30	30
P/E ratio	5.8	12.2	9.26
Number of shares	6	1.5	1.5
Debt ratio (D/E)	30%	30%	30%
Beta for existing leverage	1.15	1.3	1.55
Internal profitability (r)	0.05	0.14	0.18
Investment rate (b)	0.15	1.5	1
Growth rate (g)	0.008	0.20	0.16

Additional information on market parameters:

– The risk-free rate is 5.5% and the expected rate of return on the market is 12%.

– Each firm pays 10% interest rate on its debt. The tax rate of each is 40%.

– A supernormal growth period will be 10 years.

Solution

From the above information we can formulate the capital structure of the three firms.

Particulars	Firm Ace	Firm Base	Firm Case
Debt	27	13.5	13.5
Equity (BV x No. of shares)	90	45	45
Total Assets	117	58.5	58.5

Calculation of Market Price Per Share

Particulars	Ace	Base	Case
Total Assets	117	58.5	58.5
Internal Profitability (r)	0.05	0.14	0.18
Earnings rate	0.083	0.23	0.3
Net operating income	9.75	13.65	17.55
Interest on debt	2.7	1.35	1.35
Profit before tax	7.05	12.3	16.2
Tax @ 40%	2.82	4.92	6.48
Net income	4.23	7.38	9.72
Number of shares	6	1.5	1.5
Earnings per share	0.705	4.92	6.48
P/E ratio	5.8	12.2	9.26
Market price per share	4	60	60
Total market value of equity	24.534	90.036	90.007

Effects of Merger on EPS

	With Base	With Case
Number of new shares	15	15
Existing shares	1.5	1.5
Total new shares	16.5	16.5
Earnings after taxes	4.92	6.48
A's after tax earnings	4.23	4.23
Total new earnings	9.15	10.71
New earnings per share	0.555	0.649
A's old EPS	0.71	0.71
Net effect	–0.155	–0.06
Percent dilution	–21.895	–8.575

Reflecting the qualitative capabilities let us assume that the new financial parameters of the combined firms would be:

	Ace/Base (AB)	Ace/Case (AC)
Net operating income	25	20
Internal profitability (r)	0.16	0.14
Investment rate (b)	0.95	0.95
Growth rate (g)	15%	14%

We can now evaluate the two alternative acquisition prospects, using valuation analysis. We have to calculate the new beta for the merged company under the two alternatives. The beta for the combined companies is a market value weighted average of the betas of the individual companies. New beta has to be calculated to obtain the cost of equity capital for each of the combined firms.

$$\beta_{AB} = 1.15\,[24.5/(24.5 + 90)] + 1.3\,[90/(24.5 + 90)]$$

$$= 0.246 + 1.022 = 1.27$$

$$k_e = R_f + \beta(R_m - R_f)$$

$$= 5.5 + 1.27\,(12 - 5.5) = 13.75\%$$

$$\beta_{AC} = 1.15\,[24.5/(24.5 + 90)] + 1.55\,[90/(24.5 + 90)]$$

$$= 0.246 + 1.218 = 1.46$$

$$k_e = R_f + \beta(R_m - R_f)$$

$$= 5.5 + 1.46\,(12 - 5.5) = 14.99\% \text{ or } 15\%$$

The capital structure of the combined firms will be:

	Ace/Base	Ace/Case
Debt	40.5	40.5
Equity	114	114
Total value	154.5	154.5

Weighted average cost of capital:

$$k_o = k_e \frac{S}{V} + k_d(1-t)\frac{B}{V}$$

$$k_{AB} = 0.1375\,(114/154.5) + 0.10\,(1- 0.4)(40.5/154.5)$$

$$= 0.1015 + 0.016 = 0.1175 \text{ or } 11.75\%$$

$$k_{AC} = 0.15\,(114/154.5) + 0.10\,(1 - 0.4)\,(40.5/154.5)$$

$$= 0.1106 + 0.016 = 0.1266 \text{ or } 12.66\%$$

We can now estimate the value of the two alternative combinations.

Valuation of a Firm with temporary supernormal growth, followed by no growth.

$$V_0 = X_0(1-T)(1-b_s)\sum_{t=1}^{n}\frac{(1+g_s)^t}{(1+k)^t} + \frac{X_0(1-T)(1+g_s)^{n+1}}{k(1+k)^n}$$

$$V_{AB} = 25(1-0.4)(1-0.95)\sum_{t=1}^{10}\frac{(1.15)^t}{(1.1175)^t} + \frac{25(1-0.4)(1.15)^{11}}{0.1175(1.1175)^{10}}$$

$$= 0.75 \text{ x } \Sigma\,(1.029)^t + 195.57$$

$$= 0.75\,(1.029)\text{ FVIFA}_{(2.9\%\,,\,10yrs)} + 195.57$$

$$= 0.75 \text{ x } 11.7476 + 195.57 = 204.38$$

$$V_{AB} = 20(1 - 0.4)(1-0.95)\sum_{t=1}^{10}\frac{(1.14)^t}{(1.1266)^t} + \frac{20(1 - 0.4)(1.14)^{11}}{0.1266(1.1266)^{10}}$$

$$= 0.6 \text{ x } \sum_{t=1}^{10} (1.01189)^{t} + 121.62$$

$$= 0.6\ (1.012)\ \text{FVIFA}_{(1.2\%,10\text{ yrs})} + 121.62$$

$$= 0.6 \text{ x } 10.678 + 121.62$$

$$= 6.4068 + 121.62 = 128.03$$

Comparison of the Two Mergers

	Ace & Base	Ace & Case
Post-merger value V	204.4	128
Less: Amount of debt	40.5	40.5
Value of equity	163.9	87.5
Less: A's pre-merger market value	24	24
Gain in equity value	139.9	63.5
Less: Cost if acquired at market price	90	90
Gain in value	49.9	(26.5)

The above mentioned illustration provides a general methodology for the management analysis of a merger activity, which utilizes a number of principles. Here, the acquiring firm (A) is considering two different firms as merger candidates. To find out the right candidate for the merger the prospective risk and return from the various alternative merger combinations should be estimated. While the historical data is used as inputs, a forecast of the returns and the risk in the future that may arise after the merger should be estimated.

A forecast of the variables that measure the prospective returns and risk for alternative post-merger combinations is very critical for proper evaluation of the merger alternatives.

SUMMARY

- Strategic planning process plays an important role in the life cycle of a firm. The process involves assessment of the firm's environment, analysis of the firm's resources and capabilities and studying the business opportunities. Goals are formulated at this stage.
- Plans for mergers and acquisitions are also made in order to help move the firm closer to its goals. The process is never complete as the firm's capabilities keep changing with respect to the environment.
- Firms are of late being defined more in terms of their range of capabilities rather than in terms of the products and markets. This creates both opportunities as well as increased competitive threats in the dynamic economy.
- Studies carried out have enabled us to draw certain conclusions about Mergers and Acquisitions: (a) Mergers, takeovers and restructuring create value, the shareholders of the acquired firm gains while those of the acquiring firm do not lose; (b) Availability of alternative investment opportunities affects the usage of Mergers and Acquisitions in order to achieve the firm's goals; (c) Mergers and Acquisitions result in an increase in the leverage; (d) Capital outlays have also increased due to Mergers and Acquisitions.
- The financial analysis of the merger candidate supplements the planning framework for Mergers and Acquisitions of the analysis. The acquiring company should not be paying too high a price for the target company.
- Various models and approaches are considered for arriving at the price of the target company. All the approaches go for maximizing the returns on investments by controlling costs and minimizing investments.

Chapter 15

Takeover Models

After reading this chapter, you will be conversant with:

- Free Rider Problem, Initial Shareholding, and the Equilibrium Bid
- Preemptive Bidding and Entrance Costs
- Choice of the Medium of Exchange
- Bidder Elimination and Value Reduction Strategies
- Takeover Methods and Capital Structure

Diversification and Mergers are necessarily a part of the overall long range planning of any firm. The success of a merger depends on the strategic intent of the merger plan and its effective execution. Researchers have developed and published many models/tests to ensure the success of a merger. Each of these models have their own set of assumptions and obviously the results are influenced by the choice of variables, how they are measured and how they are combined. Some of the critical variables that are identified as having influence on the success or otherwise of a merger are listed hereunder:

- Microeconomics – competition or market power; bargaining – Game theory.
- Form of auction: English, Dutch or other.
- Form of equilibrium: Pooling, separating, sequential.

Incentives for shareholders, managers and bidders.

- Friendly/unfriendly merger.
- Form of tender – Unconditional bid for any or all shares; conditional bid on acquiring a specified number of percentage shares or control.
- Form of two part bids: front and back-end bids; only front-end bids; competition from multiple bidders.
- Degree to which bids provide information or signal to shareholders, managers and bidders.
- Atomistic versus finite shareholders.
- Kinds and amounts of transaction costs in multiple or successive bids.
- Investigation costs of first bidder and subsequent bidders.
- Degree to synergy.
- Extent to which target could restructure, all by itself.
- Quantum and value of the information provided by the target.
- Effects of taxes.
- Degree to which the prices paid incorporate earn-outs and bonuses.
- Impact of leverage funds on acquisition.
- Potential to eliminate some bidders and the advantages or disadvantages thereof.

Each model has got its own unique feature fitting into a particular situation. Incidentally, these models are found to give conflicting results. It is generally perceived that no model published till date could give results that are consistant with broad economic evidence. Nevertheless, these models can give better insight into the whole merger process besides providing precise empirical specification of tests of takeover process. The common topics under mergers studied by many researchers have centered on:

- Free rider problem, initial shareholdings and the equilibrium bid.
- Preemptive bidding and entrance costs.
- Choice of the medium of exchange.
- Bidder elimination and value reduction strategies.
- Other themes in theoretical models.

We shall now briefly discuss about the pioneering work done by Shleifer and Vishny (1986): Jagadeesh and Chowdhry: Fishman (1988): Hansen (1987) Stulz (1988).

FREE RIDER PROBLEM, INITIAL SHAREHOLDING, AND THE EQUILIBRIUM BID

In a firm held by a large number of shareholders, spread far and wide, it makes no sense for a small shareholder to spend on monitoring the performance of its management. In other words, they simply "free-ride" on the efforts made by other big shareholders in monitoring the performance of the management and share the benefits resulting from it. In the financial parlance, this phenomenon is known as free rider problem.

Grossman and Hart (1980) observe that the free rider problem often discourages the outsiders to engage in a costly takeover exercise of a diffusely held firm. But, Spatt (1989) has a different opinion: it is unclear whether an unconditional (any-and-all) offer can provide an equilibrium basis for a free-rider interpretation. To better appreciate this, let us presume that,

"v" = value of a share with improvement due to a takeover

"p" = offer price

"q" = value of a share without improvement: and

$v > p > q$.

Against this backdrop, presume that an unconditional tender offer is made for acquisition of the so diffusely-held firm at a price "p". In such a scenario, if each shareholder perceives that the tender will be successful, then he will not tender in the hope of realizing the price "v" – the value of a share with improvement due to takeover. On the other hand, if they believe that the tender will fail, then each will participate in the tender to receive "p" – offer price which is higher than "q". It is thus evident that a *pure strategy* equilibrium does not exist.

The free rider problem arises even when the tender offer is made conditional – in terms of say, the minimum number of shares being tendered. Under such an offer if $p < v$, the shareholders will not tender their shares. In the resulting *dominant strategy* equilibrium, shareholders prefer to free ride and therefore, the tender is likely to fail.

The researchers have however come forward with a variety of solutions to overcome the free rider problem and among them, the following merit attention:

i. After the takeover, the bidder may be permitted to dilute the remaining non-tendered shares of the target firm. As Grossman and Hart (1980) suggested dilution could be achieved by simply limiting the rights of minority shareholders. It could also be achieved by supplying overpriced inputs to the target or buying underpriced products or other assets of the target. This dilution is expected to encourage the shareholders to tender their shares at a price below the price that reflects the post-takeover improvement resulting in profit to the bidder.

ii. Free rider problem can also overcome by offering a two-tier price where under, the bidder would buy target shares up to a certain percentage of the firm at a first-tier price followed by the takeover of the remaining shares at the second-tier price which is a lower price.

iii. A large shareholder of a firm or an outsider who has secretly accumulated a large fraction of equity can also avoid the free rider problem by making a tender offer. But, Shleifer and Vishny (1986), argue that a profit, after the costs of a takeover, can be realized through an increase in value of the shares held by the large shareholder, although the shareholder does not profit from the additional shares purchased through the tender offer.

Large Shareholder and Corporate Control: Shleifer and Vishny Model (1986)

The model developed by Shleifer and Vishny explores the implications of the increase in the holdings of the large shareholder on the takeover. It argues that as the proportion of the firm's shares held by the large shareholders increases, the potential for its takeover improves substantially. This increases the price of the firm's share, but the tender's offer premium remains lower. This is more so because the large shareholder, by virtue of already having a high-shareholding, is willing to takeover even if it leads to a smaller increase in the firm's value. Let us take a deeper look at the model itself.

The Shleifer and Vishny model assumes that,

i. A firm does have large shareholders and small shareholders and small shareholders are by nature risk neutral,

ii. The large shareholders try to takeover the firm,

iii. Small shareholders are uninformative about the exact level of the bid by large shareholders,

iv. When the large shareholder offers a bid, the small shareholders prefer to tender if they are indifferent, and

v. Small shareholders are atomistic in nature and believe that their individual decisions to tender will not make a major difference for the success of the tender.

The model assumes that a large shareholder obtains a stake of S of a firm with value D. To get the control over the firm, the large shareholder should obviously increase his stake to a minimum of 50 percent of the equity of the firm. As the large shareholder already owns a stake of S, he has to now purchase further (0.5 – S) shares of the firm from small shareholders.

Before arriving at a takeover decision, the large shareholder has to conduct the research to know whether the value of the firm will increase upon acquisition or not. To do this, let us assume that the large shareholder invests an amount of R in research and arrives at a conclusion that the probability of improvement in the value of the firm is quite impressive.

Further, in order to purchase the shares from small shareholders let us assume that the large shareholder offers a takeover premium of "A" per share.

Here, it is worth remembering that the large shareholder takes the decision of acquisition only if he gains from the takeover process i.e., the difference between the value of the firm upon acquisition and the costs incurred for acquisition should be positive.

Here, by costs incurred we mean the cost of research and the takeover premium offered to the small shareholders.

Therefore,

The Gain from the takeover process = Value of the stake of large shareholder – (Takeover premium offered to the small shareholders + Research expenses).

As the value of the firm is D and the large shareholder wants to purchase the 50% shares of the firm, after the takeover process the value of his stake will be 0.5D. As he has to purchase (0.5 – S) shares with a takeover premium of A per share, additional amount offered to the small shareholders will be (0.5 – S) A and as we assumed previously, he invests R in research. This gives,

$$0.5D - (0.5 - S)A - R \geq 0$$

Multiplying both the sides with 2, we get,

$$D - (1 - 2S)A - 2R \geq 0$$

In short, the large shareholder will bid if,

$$0.5D - (0.5 - S)A - R \geq 0 \qquad \ldots (1)$$

As assumed earlier that the small shareholders being uninformative and risk neutral, they make a best forecast of D. Mathematically, it can be represented as follows:

$E[D/(1)]$

The small shareholders tender their shares if the takeover premium is greater than their best forecast. Hence, the difference between the takeover premium paid and the best forecast by the small shareholder should be positive i.e.,

$A - E[D/(1)] \geq 0$

In short, small shareholders will tender if,

$$A - E[D/(1)] \geq 0 \quad \ldots(2)$$

Hence, for the materialization of the takeover both (1) and (2) should be in an equilibrium status. Let us assume that in the equilibrium status, a(p) is the smallest value of A and d(p) is the smallest value of D.

But here a(p) – the takeover premium will decrease with an increase in the number of shares held by the large shareholder since, more the number of shares he holds, lesser the demand for the additional shares to be obtained from small shareholders. This obviously results in a decrease in the takeover premium.

Apart from it, more the number of shares held by the large shareholder, better the chances for the takeover to materialize and as a result, the cut-off value of A becomes less since the number of shares already held is large.

The market value of the firm will be equal to the sum of value of the firm under present management plus the probability of a takeover times the post-takeover increase in the value of the firm.

Market value of the firm = Present value of the expected profits under the current management + Probability of a takeover times the post-takeover increase in the value of the firm.

We could therefore infer that with an increase in the number of shares held by the large shareholder the takeover premium decreases but it increases the market value of the firm.

Pre Takeover Share Acquisition Strategy: Jagadeesh and Chowdhry (1988)

The takeover model developed by Jagadeesh and Chowdhry studies the bidder's strategy for the acquisition of the shares in the pretender context. It has the following implications:

i. For any given level of initial shareholding, the net benefit of bidding low is greater for a bidder with low valuation, as compared to bidding higher.

ii. For any given bid, the cost of choosing a lower level of initial shareholding as opposed to a higher level is identical for the bidder regardless of his valuation.

Assumptions

i. In the takeover process, there exist two firms, the bidder and the target.

ii. Initially, the bidder is an outsider and later on strategically he will become the shareholder of the target firm and he is risk-neutral in general.

iii. The target shares are held by the atomistic shareholders who are risk-neutral in nature.

iv. The level of the valuation is characterized by the bidder type and it is not public information.

v. To get the initial shareholding, the bidder purchases the shares in the open market at the market value.

vi. The target management does not resist the takeover process until and unless it gains from the takeover process.

vii. The cumulative distribution of the benefits by having the control by the present management is continuous.

viii. The inverse of probability that for the value of the control of target firm falls below the value of the potential gain on their shareholding in the bidding process is convex in pattern.

ix. The probability of success with the increase in bid amount increases but at a decreasing rate.

x. Free rider costs all the bidders equally.

Model

Let us assume that a bidder observes a valuation Z of a firm. To get the initial shareholding, he enters into the open market and purchases a stake of α of the firm. To get the control over the firm, the bidder should increase his stake to a minimum of 50 percent of the total stock of the firm. As he obtains a stake of α, he has to purchase further (0.5 – α) shares. To obtain it, let us assume that he launches a conditional tender offer to the target shareholders. At the time of launching the tender offer, the bidder's shareholding becomes public information.

In response to this bidding offer, each atomistic shareholder strategically arrives at the tendering decision and will not tender his shares unless the bid is at least as large as the expected valuation which depends on the observed α and the bid price, B. Mathematically, it can be represented as:

$$B \geq E(Z/\alpha, B) \qquad \ldots(1)$$

A shareholder will tender his/her shares if the bid price is greater than his/her expected price and the above mathematical condition is fulfilled.

The probability of the success of acquisition P(B), is the probability that the bid B will be as large as the median of the expected price of shareholders. Assuring that the expected value of the tender offer at bid price B is V(B, α; Z), the Valeria fermium can be expressed as:

$$V(B,\alpha;Z) = P(B)[0.5Z - B(0.5-\alpha)] \qquad \ldots(2)$$

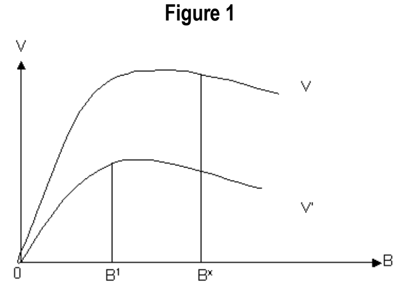
The risk-neutral bidder makes the choice of α and B strategically to maximize the value function. But he has to make the choice of α and B under the expectations of the target shareholders. This bidder's problem can be mathematically expressed as follows:

$$\max_{\alpha,\beta} V(B,\alpha;Z) \text{ subject to } B \geq E(Z/\alpha, B)$$

Let $\alpha^*(Z)$ and $B^*(Z)$ be the solutions to the above problem.

The model, based on the assumptions made earlier (vii) and (viii) depicts the following relationship for two different observed valuations:

Figure 1



From the above graph, we can infer that the difference between V and V' becomes smaller as B is decreased and becomes larger as B is increased. This would mean that for any given level of initial shareholdings, the net benefit of bidding low is greater for a bidder with low valuation, as compared to bidding higher

(Implication (i)). It can be further concluded that as bidding low always leads to the lower probability of success, a fall in the probability of success discourages the bidder more if his valuation is high since he has more to gain from the success of the offer precisely because his valuation is higher. Hence, the net benefit of bidding lower is higher for the lower valuation bidder.

Further from equation (2), V can be increased despite an increase in α. This indicates that for any given bid, the cost of choosing a lower level of initial shareholdings as opposed to a higher level is identical for the bidder regardless of his valuation (Implication (ii)). It can be further explained as: the cost of choosing a lower level of initial shareholding is that the bidder could have acquired additional shares in the open market at a small price on average than having to pay B later, with the probability P(B), once the tender offer is made. For any given bid B, this expected loss does not depend on the level of valuation by the bidder.

PREEMPTIVE BIDDING AND ENTRANCE COSTS

Tender offers, unlike merger bids, are directly made to the shareholder rather than to the management. In a conditional tender offer, the small shareholders of the target perceive that their decision to offer or not to offer the share cannot alter the outcome of the takeover process. Therefore, they compare the offer price with that of the expected value of the share if the bid succeeds and decide whether or not to sell the shares.

But in the case of a merger bid, targets management decides whether to accept or reject the bid based on the likely value of the firm if the offer is rejected. In rejecting, the target management may also expect a better bid to come from another and hence competing bids impact the ultimate decision on the offer price. Researchers have been studying the strategic behavior of the bidders and target management in accepting the bids made.

Fishman (1988) in his model on the takeover bidding contest suggests that a special form of auction known as English auction is often used by the bidders to outsmart the earlier bidders. Once a bid is made and the target management has declined the offer, the potential bidder updates his information on the target firm and bids at a higher price.

In view of this eventuality, many a time the first bidder while deciding his initial offer takes into consideration the cost of updating information by the potential bidder to offer a higher price. Looking to this scope, the model developed by Fishman arrives at equilibrium so as to facilitate the first bidder to quote a high premium "preemptive" bid to send signals about its high valuation and thereby deter the potential bidder from competing in the takeover. The model thus explains the reasons behind high premiums offered by the first bidders rather than making a lower bid and then raising it subsequently.

CHOICE OF THE MEDIUM OF EXCHANGE

In mergers and acquisition transactions, the acquiring firms usually use cash, equity or debt as a mode of payment in financing the transaction. When there are no asymmetries in information, no transaction costs, and no taxes, the medium of exchange hardly matters in a merger but in reality, they are a fact of life.

The main difference between the cash offer and a security offer is the pricing of the securities which is dependent on the profitability of the target after the acquisition. When the profitability of the target turns out to be high (low) the value of the security will also be high (low), implying a higher (lower) payment to the target than otherwise. When the bidders have private information about the value of the target but the target does not, the value of the securities offered will be presumed to have a low value, i.e., because the bidder will offer cash instead of securities when it knows the securities have a high value. The adverse selection problem will thus lead to the use of cash since no party has private information on the value of cash. The models reviewed earlier assume that only the bidders have private information and therefore consider only cash offers.

Hansen and Fishman, argue that there is a possibility of the target firm having private information about the successes of the takeover. When the target has private information and cash is offered, the target will accept the offer only when the value of the offer made exceeds the actual value of the firm. To protect itself from the rejection of the offer, the bidder can make a securities offer whose value is dependent on the future profitability of the takeover. Here, Hansen considers the bargaining process and shows that the stock offer, having contingent-pricing effect, increases the probability of a trade occurring.

The transacting process of a merger or acquisition has been investigated by Hansen (1987) to decide on the choice of the medium of exchange (either cash or stock). The process is treated as a bargaining game involving the two-agent under asymmetric information and throughout the takeover process the target's information on the value of the firm remains private. Let us take a deeper look at Hansen and Fishman model to better appreciate the implications of the mode of payment on the takeover success.

The takeover model developed by Hansen studies the transacting process of a takeover to formulate a model for the choice of exchange. The model provides an optimal choice of exchange under both the situations i.e., when the bidder's value is public or private before the takeover process.

IMPLICATIONS

i. When the bidder's value is public before takeover process, the offer of risky assets is optimal.

ii. When the bidder's value is private before takeover process, the offer of cash is optimal.

Let us assume that the target obtains a value of v that is not publicly known but for the public, the value may lie anywhere in a certain range $\mathrm{F(v)}$ and the bidder obtains a value of x. As the value of target is not publicly known, the bidder estimates a range of continuous values w(v) over it and offers a first and final bid to the target. The offer may be in the form of risky assets or in the form of cash. To give more insights, the model studies the situation in two cases, when the information of the bidder's value is public and when it is private.

Case (i)

Advantage of Risky Assets when the Information is Public: This result can be explained with an example. Let us assume that for public the value of the firm i.e., F(v) takes place within a range of 0 to 100. Mathematically, it can be expressed as F(v) = (0, 100). And let us further assume that the bidder observes a 1.5 times more value of the target. It can be mathematically expressed as $\mathrm{w}(\mathrm{v})=1.5\mathrm{v}$. Let us assume, that based upon its estimation, the bidder offers an amount of C to target to takeover. Let us further assume that the offered amount is more than or equal to the value of the firm i.e., v ≤ C. As the target gains under this offer, it accepts it. Now the expected value of the target's assets to the acquirer, conditional on the offer being accepted, is –

$$
\begin{aligned}
\mathrm{E}[\mathrm{w}(\mathrm{v})/\mathrm{v}<\mathrm{C}] &= \mathrm{E}[1.5\mathrm{v}/\mathrm{v}<\mathrm{C}] \ \ (\text{since } \mathrm{w}(\mathrm{v})=1.5\mathrm{v}) \\
&= 1.5\mathrm{E}[\mathrm{v}/\mathrm{v}<\mathrm{C}] \\
&= (1.5)\frac{\mathrm{C}}{2} \\
&\quad (\text{since the nature of the distribution of } \mathrm{E}[v/v<\mathrm{C}]) \\
&= 0.75\mathrm{C}
\end{aligned}
$$

Hence, eventhough the bidder offers an amount of C, after the takeover process it expects to receive the assets worth 0.75C ...(1)

Now let us consider the second case, where the bidder offers the ownership share of p to the target firm after the takeover process. If the bidder's initial value is x and after the takeover if it observes a synergy of $1.5\,v$, the value of the firm after the takeover process will be (x + $1.5\,v$). If it offers a share of p to the target, it will be p(x + $1.5\,v$). But the target accepts it when the offer is greater than its value.

$$p(x+1.5v) \geq v$$

As the v takes the range of 0 to 100, if the above inequality satisfies the value at 100, it has to satisfy the remaining range. So, if v = 100.

$$p(x+150) \geq 100$$

$$\Rightarrow p \geq \frac{100}{(x+150)} \qquad ...(2)$$

But the deal should be beneficial to the bidder also. The deal will be beneficial to the bidder if the value of the bidder after takeover process exceeds the value of the bidder before takeover. Since, the bidder gains the synergy of only 75% of the target firm after the takeover and the offered share to the target being p, the condition for the acquirer will be,

$$(1-p)(x+75) \geq x$$

$$\Rightarrow (x+75) - p(x+75) \geq x$$

$$\Rightarrow x + 75 - px - p75 \geq x$$

$$\Rightarrow 75 - px - p75 \geq 0$$

$$\Rightarrow 75 - p(x+75) \geq 0 \Rightarrow -p(x+75) \geq -75 \Rightarrow p(x-75) \leq 75$$

$$\Rightarrow p \leq \frac{75}{(x+75)} \qquad ...(3)$$

From the example, we may conclude that the two conditions can be mutually consistent when $x \leq 150$; p = 0.55; and x = 50 and that is where a mutually beneficial offer exists.

The above example indicates that the bidder gains more by offering the risky assets than cash. From the bidder's point of view, he can always avoid the adverse selection by perceiving the value of the firm after takeover process. From the target point of view, the target will be encouraged to accept the offer by perceiving the higher-level value of the firm after takeover process.

Case (ii)

Advantage of Cash when the Information is Private: The second case of the Hansen model focuses on a situation where the value of the bidder is not public information. This model argues that when the value of the bidder is not public information, cash as the medium of exchange has the edge over risky securities. Because, if the value of the bidder is private and it is underestimated by the target, he may not accept the risky assets as the medium of exchange. Therefore, it makes business sense to offer cash when the bidders value is private.

BIDDER ELIMINATION AND VALUE REDUCTION STRATEGIES

It is normal to witness defensive actions being initiated by the target management whenever there is a takeover attempt by another firm indicating a conflict of interests between the acquirer and the acquired. But the review of literature reveals that there is always a potential for increasing the benefits to target shareholders by offering management resistance to the bids.

Takeover defenses offered by the managements to eliminate a bidder or to reduce the target company's value to a bidder are often found potential-enough to increase *ex-ante* the takeover premium. Shleifer and Vishny (1986) observe that managers of the target firms can increase the expected gains by buying the stake of a potential bidder whose synergies are low and thereby drive him away while encouraging others to explore the taking over of the firm. They also advocate that the findings made under the usage of greenmail are equally applicable to any other defensive action taken by target managers.

GREENMAIL AND THE STOCK PRICE

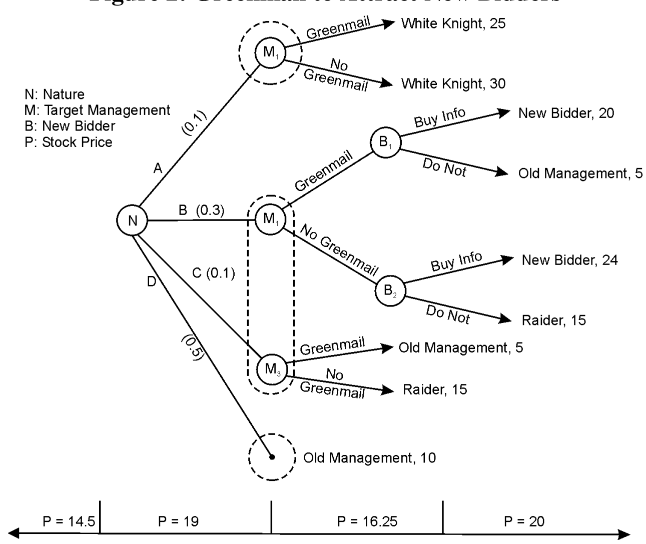
According to the model developed by Shleifer and Vishny (1986) managers can increase the expected gains from a takeover by buying the stake of one potential bidder (with low synergies) driving that bidder away with a standstill agreement, and encouraging others to explore taking over of the firm.

Shleifer and Vishny show that eliminating a potential acquirer through the payment of greenmail accompanied with a standstill agreement may enable the target to signal that it has not found a "white knight". This elimination of one potential acquirer can encourage others to investigate synergy opportunities with the target and to make competing bids. A white knight is a potential acquirer invited by the target management to stop an initial offer opposed by that management. The invitation assures the white knight of the cooperation of the target to profit maximally from the takeover. Shleifer and Vishny suggest that even when the target has a white knight, it may delay the release of that information to promote information acquisition by others to stimulate further bidding.

If the payment of greenmail signals that the target is "weak" (that is, it has not found a white knight), the share price may decline as the market responds to this information. The fall in the share price happens even when managers are attempting to maximize the long run value of the firm. The analysis by Shleifer and Vishny thus indicate that negative abnormal stock returns found by some event studies of greenmail cannot automatically be taken as evidence of the managerial entrenchment hypothesis.

Given that management maximizes the final value of shares, the analysis shows that the payment of greenmail can be an optimal strategy to attract higher bids from the prospective bidders.

Figure 2: Greenmail to Attract New Bidders



Source: Adapted from the Eric Rasmusen Games and Information, New York: Basil Blackwell, 1989, p.304.

To understand better the concept of using greenmail as a tool to attract better bidding, let us borrow the numerical example of Rasmusen (1989) that captures well the whole gamut of game plan in simple terms as also graphically depicted as above. In the game tree depicted above, let us assume that there are four possible states of nature, A, B, C and D with probabilities 0.1, 0.3, 0.1, and 0.5.

Also presume that in state A, B or C a Raider appears and offers a price of 15 and no Raider appears in state D. In state A, B or C the management considers whether to pay greenmail and extinguish the Raider's offer at a cost of 5 per share.

In state A, the management finds a white knight and supplies all the information required for valuation at no cost. Through bargaining, the White Knight becomes ready to offer 30 if greenmail is not paid to the Raider and 25 if the Raider goes away with the payment of greenmail. Thus, in state A, the management does not pay greenmail and the white knight takes over the firm at 30 per share.

In state B or C, the target finds no White Knight and does not know which state (B or C) will obtain. If greenmail is paid, a New Bidder will appear in state B, but not in state C. The New Bidder can buy information at a cost of 8. If it does, it will find that its valuation of the target is 31 and will make an offer. Assuming that its offer has to be at least 24 if the Raider's offer is not withdrawn and 20 otherwise, it will buy information only if greenmail is paid. Thus, in the present example the New Bidder has a dominant strategy – buy information and bid 20 if greenmail is paid and not otherwise. Assume that if no New Bidder appears after the payment of greenmail, the incumbent management continues to control the target and in this case the value of the target will be 5. Since state B is three times as likely as state C, the expected value of the firm when greenmail is paid is,

$$0.75(20) + 0.25(5) = 16.25$$

which is greater than the Raider's offer of 15. Thus, the management decides to pay greenmail in states B and C.

Finally, in state D in which no raider appears, the old management continues to control the firm. The final value of the firm in this state is assumed to be 10.

The point that Shleifer and Vishny emphasize that the share price will fall upon the payment of greenmail, as it signals that the firm is weak. The price of the share before the Raider appears will be:

$$0.1(30) + 0.3(20) + 0.1(5) + 0.5(10) = 14.5$$

Upon the announcement of the offer by the Raider, the price will rise to:

$$0.2(30) + 0.6(20) + 0.2(5) = 19$$

as state D is eliminated and the market does not know whether the firm has a White Knight or not. When greenmail is paid, the market realizes that the firm does not have a White Knight and consequently the price falls to 16.25.

If the management "deviates" in the information set (B, C) by refusing to pay greenmail, the price may rise to 30 as the market initially believes that the firm has a White Knight. By the time the market realizes that no White Knight offer is forthcoming, the price will fall to 15 since the management will accept the Raider's offer. Note that the New Bidder will not appear since it expects a negative profit in the face of competition from the Raider ($31 - 8 - 24 = -1$). The shareholders will fail to profit from the temporary price of 30. The reason is that when the management indicates overvaluation of the stock to the shareholders, the market will also learn of the overvaluation and refuse to buy.

This example also shows that the whole process of "raiding" can be beneficial to the shareholders, as observed by Holderness and Sheehan (1985). Shleifer and Vishny thus show that eliminating a bidder can serve the interests of the target shareholders, although this would not necessarily always be the case in practice.

TAKEOVER METHODS AND CAPITAL STRUCTURE

Harris and Raviv (1988) in their studies on the effect of financial leverage on the takeover methods and their price effects have concluded that incumbent management of the target firm can influence the type of takeover attempt and its success by choosing the quantum of shareholding to be held by them.

Harris and Raviv (1988) studied the effect of the financial leverage in the takeover methods (tender offers vs proxy fights) and their price effects in their model. The idea behind their model is that the incumbent management of a takeover target can affect the type of takeover, attempt and its probability of success by choosing to own the right fraction of the voting rights of the firm's equity by altering the amount of debt issued.

The strategy of the management is based on a trade off between the potential gain in firm value due to improvement in management through takeover and the loss of personal benefits derived from being in control of the firm. Increase in debt increases the voting control of the management but reduces the expected benefits of control by increasing the probability of bankruptcy.

According to this model, all the parties are aware that one of the teams either the incumbent or the acquiring team are in a position to manage the firm better than the other team but the identity of the better team is nor certain. In a contest for control, some of the passive shareholders who perceive that the incumbent management is better would vote for the incumbent management. Thus, the target can choose an appropriate method to achieve control by choosing the optimal level of the controlling voting right through change in the optimal capital structure.

A tender offer will be successful when the acquirer acquires enough portion of equity to guarantee controlling power even if the target management is better than the acquiring team. In an unsuccessful tender offer, the incumbent management succeeds to retains sufficient control through a leveraged recapitalization, despite the acquirer being superior to it.

The main insight of this model is that the incumbent management can influence the type and outcome of the takeover activity by choosing a resistance strategy based on the capital structure of the firm.

FRIENDLY VERSUS HOSTILE BIDS

As discussed earlier a merger is a bargaining game between the managements of the acquirer and acquiring firms, while a tender offer is akin to a open option under which the acquirer competes for the target. The target firm usually prefers a merger over a public tender offer since it reveals more about the target firm to the external world. In view of this, it is evident that for a friendly bid to be successful, it is essential that the target firm's management approves the offer first followed by the shareholders.

In a study carried out by Nyborg, it is revealed that hostile takeovers occur more frequently when the potential for improvement in the target upon takeover is large, and friendly takeovers occur more frequently when the potential is small.

WINNER'S CURSE

The winner's curse hypothesis states that winner of a sealed bid is usually the one who overestimates the true value of the target firm. Obviously he will be cursing himself for the over bidding. Some researchers argue that the managers infected with hubris syndrome try to maximize firm value but make positive valuation errors and thereby endup with winner's curse. To avoid winner's curse optimal bidding strategies call for a decrease in the bid with an increasing the number of competing bidders.

SUMMARY

- Merger model can be formed based on the different combinations of the factors that are of concern to the acquirer.
- The phenomena of the small shareholders simply free riding on the investigation and monitoring efforts of large shareholders is a common problem prominent among diffusely held corporations. This also had an impact on the success of a takeover.
- The Shleifer and Vishny model studies the implications of an increase in the holdings of shares by a large shareholder on the takeover process.
- The Jegadeesh and Chowdhry model investigates the bidder's strategy for pre-tender offer acquisition of target shares. It takes into consideration the level of synergy as observed by the bidder, which is unknown to the shareholders.
- The Fishman model shows that lowering information cost makes preemption by the bidder more difficult and thereby promotes competition and in turn increases the expected pay off to the target.
- Possession of private information by the target management leads to "lemons" problem, making the medium of payment for such acquisition highly relevant.

Chapter 16

Mergers and Acquisitions – Regulatory Control

After reading this chapter, you will be conversant with:

- Evolution of Regulatory Control of Mergers and Acquisitions in India
- Compliance under the Companies Act, 1956
- Regulatory Framework of Takeovers in India
- Takeover Regulations under SEBI
- The Provisions under the Competition Act, 2002
- Implications under the Income Tax Act, 1961

Mergers and acquisitions have become a representation of the new economic world. One reads of a new merger or acquisition doing the rounds of the corporate circles more or less everyday. The M&A activities also bring with it complex issues relating to laws and regulations impacting such decisions. In today's business scenario, every company is a possible target for an acquisition or a merger. As a result the knowledge of the laws relating to them is extremely useful. At the same time, they are critical to the health of the businesses and thereby the shareholders.

Hence this subject is assuming greater importance. In this chapter, we will attempt to bring out the relevant issues under the Companies Act, 1956, the Income Tax Act, 1961 and the takeover code under the SEBI regulations that have a bearing on the mergers and acquisitions decisions.

The other statute having relevance to the mergers is The Competition Act, 2002 which was introduced in the place of MRTP Act. The Act has an area of concern for, the mergers can have an adverse impact on consumers and public interest such as reduction in the number of players in the market, acquisition of enormous economic strength by the resultant undertakings, discouragement of new entrants in the markets, dictation of prices by the large merged undertakings and the exercise of dominance by the merged entities. Hence, the authorities are still vested with certain powers to monitor merger activities.

However, all mergers do not necessarily have the above drawbacks. Many of them bring in various benefits. For instance, in a merger, there could be cost reduction arising from economies of scale, savings from the integration of production facilities, rationalization and financial economies. There could also be efficiencies from improvements in product quality, introduction of better products, innovation and better product/service choice.

Therefore, merger regulation needs to evaluate the trade-off between reduction in competition and potential gains in economic efficiencies. With the opening of trade and foreign direct investment, Indian firms need to go through a period of consolidation in order to be competitive. Any law on merger regulation in India must take account of this reality.

EVOLUTION OF REGULATORY CONTROL OF MERGERS AND ACQUISITIONS IN INDIA

In the present economic scenario and market trends, corporate restructuring through mergers, amalgamations, takeovers and acquisitions, has emerged as major thrust for survival and growth. The opening up of the Indian economy and the decision of the government to disinvest has made corporate restructuring more significant these days.

In recent times, India has followed the global trends in consolidation of companies through mergers and acquisitions. Various companies are being taken over, units are being hived off, and joint ventures similar to acquisitions are being made.

Mergers, amalgamations and takeover bids were not rare before the 1991, amendments. During the period of five years preceding the amendments, there were about 120 successful mergers and takeovers and about 40 which failed to succeed. Most of these mergers were amongst firms within the same industry and were therefore horizontal mergers. But since 1991, the number of mergers has accelerated. The number of mergers and acquisitions in the last few years were more than the corresponding number in fourty years after independence.

The Supreme Court of India in the landmark judgment of HLL-TOMCO merger has said that "in this era of hypercompetitive capitalism and technological change, industrialists have realized that mergers/acquisitions are perhaps the best route to reach a size comparable to global companies so as to effectively compete with them. The harsh reality of globalization has dawned that companies which cannot compete globally must sell out as an inevitable alternative".

Let us now look into an overview of the procedural aspects under the Indian Companies Act, 1956 of effecting mergers and the consequent implications arising in respect to the Income Tax. As per the Companies (Amendment) Act, 2002, the powers of the High Court relating to reduction of capital, amalgamation and disputes will be transferred to 'National Company Law Tribunal (NCLT)'. These rules have also been mentioned as in appearing in the Companies Act.

COMPLIANCE UNDER THE COMPANIES ACT, 1956

i. **Scheme of Amalgamation/Merger:** The Scheme of amalgamation/merger should be prepared by the companies which have arrived at a consensus to merge.

ii. **Approval of Board of Directors for the scheme:** Respective Board of Directors of transferor and transferee companies are required to approve the scheme of amalgamation/merger.

iii. **Approval of the scheme by financial institutions banks/trustees for debenture holders:** The Board of Directors should in fact approve the scheme only after it has been cleared by the financial institutions/banks which have granted loans to these companies or the debenture trustees to void any major change in the meeting of creditors to the convened at the instance of the company NCLTs under Section 391 of the Companies Act, 1956.

iv. **Intimation to stock exchange about proposed amalgamation/merger:** Listing agreements entered into between company and stock exchange require the company to communicate price-sensitive information to the stock exchange immediately and simultaneously when released to press and other electronic media on conclusion of Board meeting according approval to the scheme.

v. **Application to NCLT for Directions:** The next step is to make an application under Section 391(1) of the Companies Act to the NCLT having jurisdiction over the Registered office of the company, for an order calling a meeting of its members. The transferor company and the transferee company should make separate applications to the NCLT.

vi. **NCLT Directions for Members' Meeting:** Upon the hearing of the summons, the NCLT shall give directions fixing the date, time and venue and quorum for the members' meeting and appoint and Advocate Chairman to preside over the meeting and submit a report to the NCLT.

vii. **Approval of Registrar of NCLT to notice for calling the meeting of members:** Pursuant to the directions of the NCLT, the transferor as well as the transferee companies shall submit for approval to the Registrar of the respective NCLTs the draft notices calling the meetings of the members together with a scheme of arrangements and explanations, statement under Section 393 of the Companies Act and form of proxy to be sent to members along with the said notice.

viii. **Dispatch of Notices to Members/Shareholders:** Once the notice has been signed by the chairman of the forthcoming meeting as aforesaid it could be dispatched to the members under certificate of posting at least 21 days before the date of the meeting.

ix. **Advertisement of the notice of member meeting:** The NCLT may direct the issuance of notice of the meeting of these shareholders by advertisement.

x. **Confirmation about service of the notice:** Ensure that at least one week before the date for the meeting the Chairman appointed for the meetings files an Affidavit to the NCLT about the service of notices to the shareholders that the directions regarding the issue of notices and advertisement have been duly compiled with.

xi. **Holding the shareholders general meeting and passing the resolutions:** The general meeting should be held on the appointed date. The amalgamation/merger scheme should be approved by the members by a majority in number of members present in person or on proxy and voting of the resolution and this majority must represent at least 3/4th in value of the shares held by the members who vote in the poll.

xii. **Filing of resolutions of general meetings with Registrar of Companies:** Once the shareholders' general meetings approves the amalgamation/merger scheme by a majority in number of members holding not less that 3/4th in value of the equity shares, the scheme is binding on all the members of the company. A copy of the resolution passed by the shareholders approving the scheme of amalgamation/merger should be filed with the Registrar of Companies within 30 days from the date of passing the resolution.

xiii. **Submission of report of the chairman of the general meeting to NCLT:** The chairman of the general meeting of shareholders is required to submit to the NCLT within 7 days from the date of the meetings a report setting out therein the number of persons who attend either personally or by proxy, and the percentage of shareholders who voted in favor of the scheme as well as the resolution passed by the meeting.

xiv. **Submission of joint petition to NCLT for sanctioning the scheme:** Within 7 days from date on which the chairman has submitted his report about the result of the meeting to the NCLT, both the companies should make a joint petition to the NCLT for approving the scheme of amalgamation/merger.

xv. **Issue of notice to Regional Director's Company Law Board under Section 394A:** On receipt of the petition for amalgamation/merger under Section 391 the NCLT will give notice of the petition to the Regional Director, Company Law Board and will take into consideration the representations, if any, made by him.

xvi. **Hearing of petition and confirmation of scheme:** Having taken up the petition by the NCLT for hearing it will hear the objections first and if there is no objection to the amalgamation/merger scheme from Regional Director or from any other person who is entitled to oppose the scheme, the NCLT may pass an order approving the scheme of amalgamation/merger.

xvii. **Filing of NCLTs order with ROC by both the Companies:** Both the transferor and transferee companies should obtain the NCLT's order sanctioning the scheme of amalgamation/merger and file the same with ROC with their respective jurisdiction as required vide Section 394(3) of the within 30 days after the date of the NCLT's order.

xviii. **Dissolution of transferor company:** Section 394(1)(iv) vests powers in the NCLT, either by order sanctioning the scheme or by a subsequent order of dissolution, without winding up, of any transferor company provided the official liquidation has, on scrutiny of the books and papers of the company, made a report to the NCLT that the affairs of the company have not been conducted in a manner prejudicial to the interests of its members or to public interest.

xix. **Transfer of assets and liabilities:** Section 394(2) vests power in the NCLT to order for the transfer of any property or liabilities from transferor company to transferee company.

xx. **Allotment of shares to shareholders of transferor company:** Pursuant to the sanctioned scheme of amalgamation/merger, the shareholders of the transferor company are entitled to get shares in the transferee company in the exchange ratio provided under the said scheme.

xxi. **Listing of shares at stock exchange:** After the amalgamation/merger is affected, the company which takes over the assets and liabilities of the transferor company should apply to the Stock Exchanges where its securities are listed, for listing the new shares allotted to the shareholders of the transferor company.

xxii. **NCLT order to be annexed to memorandum of transferee company:** It is the mandatory requirement vide Section 391(4) that after the certified copy of the NCLT's order sanctioning the scheme of amalgamation/merger is filed with the Registrar, it should be annexed to every copy of the Memorandum issued by the transferee company.

xxiii. **Preservation of books and papers of amalgamated company:** Section 396A of the Act requires that the books and papers of the amalgamated company should be preserved and not be disposed off without prior permission of the Central Government.

xxiv. **Post-merger secretarial obligation:** There are various formalities to be compiled with after amalgamation of the companies is given effect to and allotment of shares to the shareholders of the transferor company is over. These formalities include filing of returns with Registrar of Companies, transfer of investments of transferor company in the name of the transferee, intimating banks and financial institutions, creditors and debtors about the transfer of the transferor company's assets and liabilities in the name of the transferee company.

THE COMPANIES ACT, 1956

Section 376 – Condition Prohibiting Reconstruction or Amalgamation of Company

Where any provision in the memorandum or articles of a company, or in any resolution passed in general meeting by, or by the Board of Directors of, the company, or in an agreement between the company and any other person, whether made before or after the commencement of this Act, prohibits the reconstruction of the company or its amalgamation with any other body corporate or bodies corporate, either absolutely or except on the condition that the managing director or manager of the company is appointed or reappointed as managing director or manager of the reconstructed company or of the body resulting from amalgamation, as the case may be, shall become void with effect from the commencement of this Act, or be void, as the case may be.

Section 390 – Interpretation of Sections 391 and 393

In Sections 391 and 393,

a. the expression "company" means any company liable to be wound up under this Act;

b. the expression "arrangement" includes a reorganization of the share capital of the company by the consolidation of shares of different classes, or by the division of shares into shares of different classes or, by both those methods; and

c. unsecured creditors who may have filed suits or obtained decrees shall be deemed to be of the same class as other unsecured creditors.

Section 391 – Power to Compromise or make Arrangements with Creditors and Members

1. Where a compromise or arrangement is proposed

    a. between a company and its creditors or any class of them; or

    b. between a company and its members or any class of them;

The NCLT may, on the application of the company or of any creditor or member of the company, or, in the case of a company which is being wound up, of the liquidator, order a meeting of the creditors or class of creditors, or of the members or class of members, as the case may be, to be called, held and conducted in such manner as the NCLT directs.

2. If a majority in number representing three-fourths in value of the creditors, or class of creditors, or members, or class of members, as the case may be, present and voting either in person or, where proxies are allowed under the rules made under Section 643, by proxy, at the meeting, agree to any compromise or arrangement, the compromise or arrangement shall, if sanctioned by the NCLT, be binding on all the creditors, all the creditors of the class, all the members, or all the members of the class, as the case may be, and also on the company, or, in the case of a company which is being wound up, on the liquidator and contributories of the company:

   Provided that no order sanctioning any compromise or arrangement shall be made by the NCLT unless the NCLT is satisfied that the company or any other person by whom an application has been made under subsection (1) has disclosed to the NCLT, by affidavit or otherwise, all material facts relating to the company, such as the latest financial position of the company, the latest auditor's report on the accounts of the company, the pendency of any investigation proceedings in relation to the company under Sections 235 to 251, and the like.

3. An order made by the NCLT under subsection (2) shall have no effect until a certified copy of the order has been filed with the Registrar.

4. A copy of every such order shall be annexed to every copy of the memorandum of the company issued after the certified copy of the order has been filed as aforesaid, or in the case of a company not having a memorandum, to every copy so issued of the instrument constituting or defining the constitution of the company.

5. If default is made in complying with subsection (4), the company, and every officer of the company who is in default, shall be punishable with fine which may extend to one hundred rupees for each copy in respect of which default is made.

6. The NCLT may, at any time after an application has been made to it under this section, stay the commencement or continuation of any suit or proceeding against the company on such terms as the NCLT thinks fit, until the application is finally disposed off.

Section 392 – Power of NCLT to Enforce Compromises and Arrangements

1. Where a NCLT makes an order under Section 391 sanctioning a compromise or an arrangement in respect of a company, it

   a. shall have power to supervise the carrying out of the compromise or arrangement; and

   b. may, at the time of making such order or at any time thereafter, give such directions in regard to any matter or make such modifications in the compromise or arrangement as it may consider necessary for the proper working of the compromise or arrangement.

2. If the NCLT aforesaid is satisfied that a compromise or arrangement sanctioned under Section 391 cannot be worked satisfactorily with or without modifications, it may, either on its own motion or on the application of any person interested in the affairs of the company, make an order winding up the company, and such an order shall be deemed to be an order made under Section 433 of this Act.

3. The provisions of this section shall, so far as may be, also apply to a company in respect of which an order has been made before the commencement of the Company (Amendment) Act, 2002 sanctioning a compromise or an arrangement.

Section 393 – Information as to Compromises or Arrangements with Creditors and Members

1. Where a meeting of creditors or any class of creditors, or of members or any class of members, is called under Section 391,
   a. with every notice calling the meeting which is sent to a creditor or member, there shall be sent also a statement setting forth the terms of the compromise or arrangement and explaining its effect; and in particular, stating any material interests of the directors, managing director or manager of the company, whether in their capacity as such or as members or creditors of the company or otherwise, and the effect on those interests, of the compromise or arrangement, if, and in so far as, it is different from the effect on the like interests of other persons; and
   b. in every notice calling the meeting which is given by the advertisement, there shall be included either such a statement as aforesaid or a notification of the place at which and the manner in which creditors or members entitled to attend the meeting may obtain copies of such a statement as aforesaid.
2. Where the compromise or arrangement affects the rights of debenture holders of the company, the said statement shall give the like information and explanation as respects the trustees of any deed for securing the issue of the debentures as it is required to give as respects the company's directors.
3. Where a notice given by advertisement includes a notification that copies of a statement setting forth the terms of the compromise or arrangement proposed and explaining its effect can be obtained by creditors or members entitled to attend the meeting, every creditor or member so entitled shall, on making an application in the manner indicated by the notice, be furnished by the company, free of charge, with a copy of the statement.
4. Where default is made in complying with any of the requirements of this section, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to fifty thousand rupees; and for the purpose of this subsection any liquidator of the company and any trustee of a deed for securing the issue of debentures of the company shall be deemed to be an officer of the company:

   Provided that a person shall not be punishable under this subsection if he shows that the default was due to the refusal of any other person, being a director, managing director, manager or trustee for debenture holders, to supply the necessary particulars as to his material interests.
5. Every director, managing director or manager of the company, and every trustee for debenture holders of the company, shall give notice to the company of such matter relating to himself as may be necessary for the purposes of this section; and if he fails to do so, he shall be punishable with fine which may extend to five thousand rupees.

Section 394 – Provisions for Facilitating Reconstruction and Amalgamation of Companies

1. Where an application is made to the NCLT under Section 391 for the sanctioning of a compromise or arrangement proposed between a company and any such persons as are mentioned in that section, and it is shown to the NCLT.
   a. that the compromise or arrangement has been proposed for the purposes of, or in connection with, a scheme for the reconstruction of any company or companies, or the amalgamation of any two or more companies; and

b. that under the scheme the whole or any part of the undertaking, property or liabilities of any company concerned in the scheme (in this section referred to as a "transferor company") is to be transferred to another company (in this section referred to as the "transferee company").

The NCLT may, either by the order sanctioning the compromise or arrangement or by a subsequent order, make provision for all or any of the following matters:

i. The transfer to the transferee company of the whole or any part of the undertaking, property or liabilities of any transferor company;

ii. The allotment or appropriation by the transferee company of any shares, debentures, policies, or other like interests in that company which, under the compromise or arrangement, are to be allotted or appropriated by that company to or for any person;

iii. The continuation by or against the transferee company of any legal proceedings pending by or against any transferor company;

iv. The dissolution, without winding up, of any transferor company;

v. The provision to be made for any person who, within such time and in such manner as the NCLT directs, dissent from the compromise or arrangement; and

vi. Such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation shall be fully and effectively carried out:

Provided that no compromise or arrangement proposed for the purposes of, or in connection with, a scheme for the amalgamation of a company, which is being wound up, with any other company or companies, shall be sanctioned by the NCLT unless the NCLT has received a report from the Company Law Board or the Registrar that the affairs of the company have not been conducted in a manner prejudicial to the interests of its members or to public interest:

Provided further that no order for the dissolution of any transferor company under clause (iv) shall be made by the NCLT unless the Official Liquidator has, on scrutiny of the books and papers of the company, made a report to the NCLT that the affairs of the company have not been conducted in a manner prejudicial to the interests of its members or to public interest.

2. Where an order under this section provides for the transfer of any property or liabilities, then, by virtue of the order, that property shall be transferred to and vest in, and those liabilities shall be transferred to and become the liabilities of, the transferee company; and in the case of any property, if the order so directs, freed from any charge which is, by virtue of the compromise or arrangement, to cease to have effect.

3. Within thirty days after the making of an order under this Section, every company in relation to which the order is made shall cause a certified copy thereof to be filed with the Registrar for registration. If default is made in complying with this subsection, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees.

4. In this section

   a. "property" includes property, rights and powers of every description; and "liabilities" includes duties of every description; and

   b. "transferee company" does not include any company other than a company within the meaning of this Act; but "transferor company" includes any body corporate, whether a company within the meaning of this Act or not.

Section 394A – Notice to be given to Central Government for Applications under Sections 391 and 394

The NCLT shall give notice of every application made to it under Section 391 or 394 to the Central Government, and shall take into consideration the representations, if any, made to it by that Government before passing any order under any of these sections.

Section 395 – Power and duty to Acquire Shares of Shareholders Dissenting from Scheme or Contract Approved by Majority

1. Where a scheme or contract involving the transfer of shares or any class of shares in a company (in this section referred to as "the transferor company") to another company (in this section referred to as "the transferee company"), has, within four months after the making of the offer in that behalf by the transferee company, been approved by the holders of not less than nine-tenths in value of the shares whose transfer is involved (other than shares already held at the date of the offer by, or by a nominee for, the transferee company or its subsidiary), the transferee company may, at any time within two months after the expiry of the said four months, give notice in the prescribed manner to any dissenting shareholder, that it desires to acquire his shares; and when such a notice is given, the transferee company, shall, unless, on an application made by the dissenting shareholder within one month from the date on which the notice was given, the NCLT thinks fit to order otherwise, be entitled and bound to acquire those shares on the terms on which, under the scheme or contract, the shares of the approving shareholders are to be transferred to the transferee company:

   Provided that where shares in the transferor company of the same class as the shares whose transfer is involved are already held as aforesaid to a value greater than one-tenth of the aggregate of the values of all the shares in the company of such class, the foregoing provisions of this subsection shall not apply, unless –

   a. the transferee company offers the same terms to all holders of the shares of that class (other than those already held as aforesaid) whose transfer is involved; and

   b. the holders who approve the scheme or contract, besides holding not less than nine-tenths in value of the shares (other than those already held as aforesaid) whose transfer is involved, are not less than three-fourths in number of the holders of those shares.

2. Where, in pursuance of any such scheme or contract as aforesaid, shares, or shares of any class, in a company are transferred to another company or its nominee, and those shares together with any other shares or any other shares of the same class, as the case may be, in the first-mentioned company held at the date of the transfer by, or by a nominee for, the transferee company or its subsidiary comprise nine-tenths in value of the shares, or the shares of that class, as the case may be, in the first-mentioned company, then,–

   a. the transferee company shall, within one month from the date of the transfer (unless on a previous transfer in pursuance of the scheme or contract it has already complied with this requirement), give notice of that fact in the prescribed manner to the holders of the remaining shares or of the remaining shares of that class, as the case may be, who have not assented to the scheme or contract; and

   b. any such holder may, within three months from the giving of the notice to him, require the transferee company to acquire the shares in question;

   and where a shareholder gives notice under clause (b) with respect to any shares, the transferee company shall be entitled and bound to acquire those shares on the terms on which, under the scheme or contract, the shares of the approving shareholders were transferred to it, or on such other terms as may be agreed, or as the NCLT on the application of either the transferee company or the shareholder thinks fit to order.

3. Where a notice has been given by the transferee company under subsection (1) and the NCLT has not, on application made by the dissenting shareholder, made an order to the contrary, the transferee company shall, on the expiry of one month from the date on which the notice has been given, or, if an application to the NCLT by the dissenting shareholder is then pending, after that application has been disposed of, transmit a copy of the notice to the transferor company together with an instrument of transfer executed on behalf of the shareholder by any person appointed by the transferee company and on its own behalf by the transferee company, and pay or transfer to the transferor company the amount or other consideration representing the price payable by the transferee company for the shares which, by virtue of this section, that company is entitled to acquire; and the transferor company shall –

   a. thereupon register the transferee company as the holder of those shares, and

   b. within one month of the date of such registration, inform the dissenting shareholders of the fact of such registration and of the receipt of the amount or other consideration representing the price payable to them by the transferee company:

      Provided that an instrument of transfer shall not be required for any share for which a share warrant is for the time being outstanding.

4. Any sums received by the transferor company under this section shall be paid into a separate bank account, and any such sums and any other consideration so received shall be held by that company in trust for the several persons entitled to the shares in respect of which the said sums or other considerations were respectively received.

   a. The following provisions shall apply in relation to every offer of a scheme or contract involving the transfer of shares or any class of shares in the transferor company to the transferee company, namely

      i. every such offer or every circular containing such offer or every recommendation to the members of the transferor company by its directors to accept such offer shall be accompanied by such information as may be prescribed;

      ii. every such offer shall contain a statement by or on behalf of the tranferee company, disclosing the steps it has taken to ensure that necessary cash will be available;

      iii. every circular containing, or recommending acceptance of, such offer shall be presented to the Registrar for registration and no such circular shall be issued until it is so registered;

      iv. the Registrar may refuse to register any such circular which does not contain the information required to be given under sub-clause (i) or which sets out such information in a manner likely to give a false impression; and

      v. an appeal shall lie to the NCLT against an order of the Registrar refusing to register any such circular.

   b. Whoever issues a circular referred to in sub-clause (iii) of clause (a), which has not been registered, shall be punishable with fine which may extend to five thousand rupees.

5. In this Section –

   a. "dissenting shareholder" includes a shareholder who has not assented to the scheme or contract and any shareholder who has failed or refused to transfer his shares to the transferee company in accordance with the scheme or contract;

   b. "transferor company" and "transferee company" shall have the same meaning as in Section 394.

6. In relation to an offer made by the transferee company to shareholders of the transferor company before the commencement of this Act, this Section shall have effect –

   a. with the substitution, in subsection (1), for the words "the shares whose transfer is involved (other than shares already held at the date of the offer by, or by a nominee for, the transferee company or its subsidiary)," of the words "the shares affected" and with the omission of the proviso to that subsection;

   b. with the omission of subsection (2);

   c. with the omission in subsection (3) of the words "together with an instrument of transfer executed on behalf of the shareholder by any person appointed by the transferee company and on its own behalf by the transferee company" and of the proviso to that subsection; and

   d. with the omission of clause (b) of subsection.

Section 396 – Power of Central Government to Provide for Amalgamation of Companies in National Interest

1. Where the Central Government is satisfied that it is essential in the public interest that two or more companies should amalgamate, then, notwithstanding anything contained in Sections 394 and 395 but subject to the provisions of this Section, the Central Government may, by order notified in the Official Gazette, provide for the amalgamation of those companies into a single company with such constitution; with such property, powers, rights, interests, authorities and privileges; and with such liabilities, duties, and obligations; as may be specified in the order.

2. The order aforesaid may provide for the continuation by or against the transferee company of any legal proceedings pending by or against any transferor company and may also contain such consequential, incidental and supplemental provisions as may, in the opinion of the Central Government, be necessary to give effect to the amalgamation.

3. Every member or creditor (including a debenture holder) of each of the companies before the amalgamation shall have, as nearly as may be, the same interest in or rights against the company resulting from the amalgamation as he had in the company of which he was originally a member or creditor; and to the extent to which the interest or rights of such member or creditor in or against the company resulting from the amalgamation are less than his interest in or rights against the original company, he shall be entitled to compensation which shall be assessed by such authority as may be prescribed and every such assessment shall be published in the Official Gazette. The compensation so assessed shall be paid to the member or creditor concerned by the company resulting from the amalgamation.

3A. Any person aggrieved by any assessment of compensation made by the prescribed authority under subsection (3) may, within thirty days from the date of publication of such assessment in the Official Gazette, prefer an appeal to NCLT and thereupon the assessment of the compensation shall be made by the NCLT.

4. No order shall be made under this section, unless
   a. a copy of the proposed order has been sent in draft to each of the companies concerned;
      aa. the time for preferring an appeal under subsection (3A) has expired, or where any such appeal has been preferred, the appeal has been finally disposed of; and
   b. the Central Government has considered, and made such modifications, if any, in the draft order as may seem to it desirable in the light of any suggestions and objections which may be received by it from any such company within such period as the Central Government may fix in that behalf, not being less than two months from the date on which the copy aforesaid is received by that company, or from any class of shareholders therein, or from any creditors or any class of creditors thereof.
5. Copies of every order made under this section shall, as soon as may be after it has been made, be laid before both Houses of Parliament.

Section 396A – Preservation of Books and Papers of Amalgamated Company

The books and papers of a company which has been amalgamated with, or whose shares have been acquired by, another company under this Chapter shall not be disposed of without the prior permission of the Central Government and before granting such permission, that Government may appoint a person to examine the books and papers or any of them for the purpose of ascertaining whether they contain any evidence of the commission of an offence in connection with the promotion or formation, or the management of the affairs, of the first-mentioned company or its amalgamation or the acquisition of its shares.

REGULATORY FRAMEWORK OF TAKEOVERS IN INDIA

In a market economy, instruments such as takeovers are essential for corporate growth. But it also requires certain regulations to ensure fair play and transparency. In India, the first attempt to regulate takeovers was made by the incorporation of clause 40 in the Listing Agreement. Subsequently, the Securities and Exchange Board of India’s takeover code 1994 was introduced. The function of these regulations was to supervise the determination of the takeover price and execution of various goals of the acquisition process so that the interests of the investors or the shareholders are protected. However, the 1994 code proved inadequate in controlling hostile takeovers. The Bhagwati Committee was set up to examine areas of deficiencies in the existing regulations and suggest amendments. Consequently the 1997 SEBI (substantial acquisition of shares and takeover) Regulations, was created, which has undergone several amendments already.

The Takeover Regulations of SEBI are specialized regulations directly affecting and regulating corporate restructuring transactions. They regulate only transactions of takeovers of companies and acquisitions of substantial interest in the form of shares in companies. The basic purpose of these regulations is that outside shareholders should have an opportunity to exit the company if a group takes over or consolidate its control over a company.

Therefore, a person who is looking to takeover the company or increase his interest in it will have to offer to the outside shareholders an opportunity to exit. Such exit will be by acquisition of shares at the same price which he has paid to the sellers or the average of quoted prices calculated in the prescribed manner. The regulations have been drafted to ensure that the acquirer cannot easily get away from making such a public offer even if he is able to pass a special resolution. There are several other provisions also in the SEBI Takeover Regulations which gives some degree of protection to outside shareholders.

An important limitation of the SEBI Takeover Regulations is that it focuses completely on takeovers and particularly does not govern mergers, acquisitions and divestitures. Therefore, for such transactions, the general protection available under other laws has to be referred to.

There is another regulation of SEBI which does not have a direct effect over such transactions and has been a cause of concern in many other countries. This relates to ESOPs, i.e., the employee stock option plans. In respect of such plans, it is found abroad that in many cases, the management increases its control by issuing itself shares at quite a low value. Thus, from a nominal stake, the management increases the holding to a controlling interest at a low cost. Even the low price for the shares is not paid and the management merely grants itself stock options for which no price is to be paid immediately. Thus, effectively, it has a potential controlling interest without paying any money. However, in India, the SEBI guidelines relating to ESOPs do not permit grant of ESOPs to the promoters.

TAKEOVER REGULATIONS UNDER SEBI

SECURITIES AND EXCHANGE BOARD OF INDIA (SUBSTANTIAL ACQUISITION OF SHARES AND TAKEOVERS) REGULATIONS, 1997

Preliminary

Short Title and Commencement

1. (1) These Regulations shall be called the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

(2) These Regulations shall come into force on the date of their publication in the Official Gazette.

Definitions

2. (1) In these Regulations, unless the context otherwise requires: –

(a) "Act" means the Securities and Exchange Board of India Act, 1992 (15 of 1992);

(b) "acquirer" means any person who, directly or indirectly, acquires or agrees to acquire shares or voting rights in the target company, or acquires or agrees to acquire control over the target company, either by himself or with any person acting in concert with the acquirer;

(c) "control" shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner;

Explanation: (i) Where there are two or more persons in control over the target company, the cesser of any one of such persons from such control shall not be deemed to be a change in control of management nor shall any change in the nature and quantum of control amongst them constitute change in control of management.

Provided that the transfer from joint control to sole control is effected in accordance with clause (e) of sub-regulation (1) of regulation 3.

(ii) If consequent upon change in control of the target company in accordance with regulation 3, the control acquired is equal to or less than the control exercised by person (s) prior to such acquisition of control, such control shall not be deemed to be a change in control".

(cc) “disinvestment” means the sale by the Central Government or by the State Government as the case may be] of its shares or voting rights and/or control in a listed Public Sector Undertaking;

(d) “investigating officer” means any person appointed by the Board under Regulation 38;

(e) “person acting in concert” comprises, –

(1) persons who, for a common objective or purpose of substantial acquisition of shares or voting rights or gaining control over the target company, pursuant to an agreement or understanding (formal or informal),directly or indirectly co-operate by acquiring or agreeing to acquire shares or voting rights in the target company or control over the target company.

(2) Without prejudice to the generality of this definition, the following persons will be deemed to be persons acting in concert with other persons in the same category, unless the contrary is established:

(i) a company, its holding company, or subsidiary of such company or company under the same management either individually or together with each other;

(ii) a company with any of its directors, or any person entrusted with the management of the funds of the company;

(iii) directors of companies referred to in sub-clause(i) of clause (2) and their associates;

(iv) mutual fund with sponsor or trustee or asset management company;

(v) foreign institutional investors with sub account(s);

(vi) merchant bankers with their client(s) as acquirer;

(vii) portfolio managers with their client(s) as acquirer;

(viii) venture capital funds with sponsors;

(ix) banks with financial advisers, stock brokers of the acquirer, or any company which is a holding company, subsidiary or relative of the acquirer.

Provided that sub-clause (ix) shall not apply to a bank whose sole relationship with the acquirer or with any company, which is a holding company or a subsidiary of the acquirer or with a relative of the acquirer, is by way of providing normal commercial banking services or such activities in connection with the offer such as confirming availability of funds, handling acceptances and other registration work.

(x) any investment company with any person who has an interest as director, fund manager, trustee, or as a shareholder having not less than 2% of the paid-up capital of that company or with any other investment company in which such person or his associate holds not less than 2% of the paid up capital of the latter company.

Note: For the purposes of this clause ‘associate’ means:

(a) any relative of that person within the meaning of section 6 of the Companies Act, 1956 (1 of 1956); and

(b) family trusts and Hindu Undivided Families.

(f) offer period' means the period between the date of entering into Memorandum of Understanding or the public announcement, as the case may be and the date of completion of offer formalities relating to the offer made under these regulations;

(g) "panel" means a panel constituted by the Board for the purpose of Regulation 4;

(h) Promoter' means –

(a) any person who is in control of the target company;

(b) any person named as promoter in any offer document of the target company or any shareholding pattern filed by the target company with the stock exchanges pursuant to the Listing Agreement, whichever is later;

and includes any person belonging to the promoter group as mentioned in Explanation I:

Provided that a director or officer of the target company or any other person shall not be a promoter, if he is acting as such merely in his professional capacity.

Explanation I: For the purpose of this clause, 'promoter group' shall include:

(a) in case promoter is a body corporate –

(i) a subsidiary or holding company of that body corporate;

(ii) any company in which the promoter holds 10% or more of the equity capital or which holds 10% or more of the equity capital of the promoter;

(iii) any company in which a group of individuals or companies or combinations thereof who holds 20% or more of the equity capital in that company also holds 20% or more of the equity capital of the target company; and

(b) in case the promoter is an individual –

(i) the spouse of that person, or any parent, brother, sister or child of that person or of his spouse;

(ii) any company in which 10% or more of the share capital is held by the promoter or an immediate relative of the promoter or a firm or HUF in which the promoter or any one or more of his immediate relative is a member;

(iii) any company in which a company specified in (i) above, holds 10% or more, of the share capital; and

(iv) any HUF or firm in which the aggregate share of the promoter and his immediate relatives is equal to or more than 10% of the total.

Explanation II: Financial Institutions, Scheduled Banks, Foreign Institutional Investors (FIIs) and Mutual Funds shall not be deemed to be a promoter or promoter group merely by virtue of their shareholding. Provided that the Financial Institutions, Scheduled Banks and Foreign Institutional Investors (FIIs) shall be treated as promoters or promoter group for the subsidiaries or companies promoted by them or mutual funds sponsored by them.

(i) "public financial institution" means a public financial institution as defined in Section 4A of the Companies Act, 1956.

(ii) "Public Sector Undertaking" means a company in which the Central Government or a State Government holds 50% or more of its equity capital or is in control of the company;

(j) "public shareholding" means shareholding held by persons other than promoters as defined under clause (h)

(k) "shares" means shares in the share capital of a company carrying voting rights and includes any security which would entitle the holder to receive shares with voting rights but shall not include preference shares.

(l) "sick industrial company" shall have the same meaning assigned to it in clause (o) of sub-section (1) of Section 3 of the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) or any statutory re-enactment thereof.

(m) "state level financial institution" means a state financial corporation established under Section 3 of the State Financial Institutions Act, 1951and includes development corporation established as a company by a State Government with the object of development of industries or agricultural activities in the state;

(n) "stock exchange" means a stock exchange which has been granted recognition under Section 4 of the Securities Contracts (Regulation) Act, 1956 (42of 1956);

(o) "target company" means a listed company whose shares or voting rights or control is directly or indirectly acquired or is being acquired;

(p) "working days" shall mean the working days of the Board.

(2) All other expressions unless defined herein shall have the same meaning as have been assigned to them under the Act or the Securities Contracts (Regulation) Act, 1956, or the Companies Act, 1956, or any statutory modification or reenactment thereto, as the case may be.

Applicability of the Regulation

3. (1) Nothing contained in Regulations 10, Regulation11 and Regulation 12 of these regulations shall apply to:

(a) allotment in pursuance of an application made to a public issue.

Provided that if such an allotment is made pursuant to a firm allotment in the public issues, such allotment shall be exempt only if full disclosures are made in the prospectus about the identity of the acquirer who has agreed to acquire the shares, the purpose of acquisition, consequential changes in voting rights, shareholding pattern of the company and in the Board of Directors of the Company, if any, and whether such allotment would result in change in control over the company.

(b) allotment pursuant to an application made by the shareholder for rights issue,

(i) to the extent of his entitlement; and

(ii) upto the percentage specified in Regulation 11:

Provided that the limit mentioned in sub-clause(ii) will not apply to the acquisition by any person presently in control of the company and who has in the rights letter of offer made disclosures that they intend to acquire additional shares beyond their entitlement if the issue is undersubscribed.

Provided further that this exemption shall not be available in case the acquisition of securities results in the change of control of management;

(d) allotment to the underwriters pursuant to any underwriting agreement;

(e) interse transfer of shares amongst: –

(i) group coming within the definition of group as defined in the Monopolies and Restrictive Trade Practices Act, 1969 (54 of 1969) where persons constituting such group have been shown as group in the last published Annual Report of the target company.;

(ii) relatives within the meaning of Section 6 of the Companies Act, 1956 (1 of 1956) ;

(iii) (a) Qualifying] Indian promoters and foreign collaborators who are shareholders;

(b) qualifying promoters:

Provided that the transferor(s) as well as the transferee(s) have been holding shares in the target company for a period of at least three years prior to the proposed acquisition;

Explanation: For the purpose of the exemption under sub-clause (iii) the term "qualifying promoter" means – (i) any person who is directly or indirectly in control of the company; or (ii) any person named as promoter in any document for offer of securities to the public or existing shareholders or in the shareholding pattern disclosed by the company under the provisions of the Listing Agreement, whichever is later; and includes,

(a) where the qualifying promoter is an individual, –

(1) a relative of the qualifying promoter within the meaning of section 6 of the Companies Act, 1956 (1 of 1956);

(2) any firm or company, directly or indirectly, controlled by the qualifying promoter or a relative of the [qualifying] promoter or a firm or Hindu undivided family in which the qualifying promoter or his relative is a partner or a coparcener or a combination thereof:

Provided that, in case of a partnership firm, the share of the qualifying promoter or his relative, as the case may be, in such firm should not be less than fifty percent (50%);

(b) where the qualifying promoter is a body corporate, –

(1) a subsidiary or holding company of that body; or

(2) any firm or company, directly or indirectly, controlled by the qualifying promoter of that body corporate or by his relative or a firm or Hindu undivided family in which the qualifying promoter or his relative is a partner or coparcener or a combination thereof:

Provided that, in case of a partnership firm, the share of such qualifying promoter or his relative, as the case may be, in such firm should not be less than fifty percent (50%).

(iv) the acquirer and persons acting in concert with him, where such transfer of shares takes place three years after the date of closure of the public offer made by them under these Regulations.

Explanation: (1) The exemption under sub-clauses (iii) and (iv) shall not be available if inter se transfer of shares is at a price exceeding 25% of the price as determined in terms of sub-regulations (4) and (5) of regulation 20.

(2) The benefit of availing exemption under this clause, from applicability of the Regulations for increasing shareholding or *inter se* transfer of shareholding–shall be subject to such transferor(s)and transferee(s) having complied with Regulation 6, Regulation 7 and Regulation 8.

(f) acquisition of shares in the ordinary course of business by,

(i) a registered stock-broker of a stock exchange on behalf of clients;

(ii) a registered market maker of a stock exchange in respect of shares for which he is the market maker, during the course of market making;

(iii) by Public Financial Institutions on their own account;

(iv) by banks and public financial institutions as pledgees;

(v) the International Finance Corporation, Asian Development Bank, International Bank for Reconstruction and Development, Commonwealth Development Corporation and such other international financial institutions;

(vi) a merchant banker or a promoter of the target company pursuant to a scheme of safety net under the provisions of the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000 in excess of limit specified in sub-regulation (1) of Regulation 11.

[(ff)acquisition of shares by a person in exchange of shares received under a public offer made under these Regulations.

(g) acquisition of shares by way of transmission on succession or inheritance;

(h) acquisition of shares by government companies within the meaning of Section 617 of the Companies Act, 1956(1 of 1956) and statutory corporations;

"Provided that this exemption shall not be applicable if a Government company acquires shares or voting rights or control of a listed Public Sector Undertaking through the competitive bidding process of the Central Government or the State Government as the case may be] for the purpose of disinvestment."

(i) transfer of shares from state level financial institutions, including their subsidiaries, to co-promoter(s)of the company or their successors or assignee(s) or an acquirer who has substituted an erstwhile promoter pursuant to an agreement between such financial institution and such co-promoter(s);

(ia) transfer of shares from venture capital funds or foreign venture capital investors registered with the Board to promoters of a venture capital undertaking or venture capital undertaking pursuant to an agreement between such venture capital fund or foreign venture capital investors with such promoters or venture capital undertaking;

(j) pursuant to a scheme –

(i) framed under Section 18 of the Sick Industrial Companies (Special Provisions) Act,1985;

(ii) of arrangement or reconstruction including amalgamation or merger or demerger under any law or regulation, Indian or foreign.

(ja) change in control by takeover of management of the borrower target company by the secured creditor or by restoration of management to the said target company by the said secured creditor in terms of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002).

(k) acquisition of shares in companies whose shares are not listed on any stock exchange; **Explanation:** The exemption under clause(k) above shall not be applicable if by virtue of acquisition or change of control of any unlisted company, whether in India or abroad, the acquirer acquires shares or voting rights or control over a listed company.

(ka) acquisition of shares in terms of guidelines or regulations regarding delisting of securities specified or framed by the Board".

(l) other cases as may be exempted from the applicability of Chapter III by the Board under Regulation 4.

(1A) For the removal of doubt, it is clarified that nothing contained in sub-regulation (1) shall affect the applicability of the listing requirements.

(2) Nothing contained in Chapter III of the Regulations shall apply to the acquisition of Global Depository Receipts or American Depository Receipts so long as they are not converted into shares carrying voting rights.

(3) In respect of acquisitions under clauses (e), (h)and (i) of sub-regulation (1), the stock exchanges where the shares of the company are listed shall, for information of the public, be notified of the details of the proposed transactions at least 4 working days in advance of the date of the proposed acquisition, in case of acquisition exceeding 5% of the voting share capital of the company.

(4) In respect of acquisitions under clauses(a), (b), (e) and (i) of sub-regulation (1), the acquirer shall, within 21 days of the date of acquisition, submit a report along with supporting documents to the Board giving all details in respect of acquisitions which (taken together with shares or voting rights, if any, held by him or by persons acting in concert with him) would entitle such person to exercise 15%or more of the voting rights in a company.

Explanation: For the purposes of sub-regulations (3) and (4), the relevant date incase of securities which are convertible into shares shall be the date of conversion of such securities.

(5) The acquirer shall, along with the report referred to under sub-regulation(4), pay a fee of twenty five thousand rupees to the Board, either by a bankers cheque or demand draft in favour of the Securities and Exchange Board of India, payable at Mumbai.

The Takeover Panel

4. (1) The Board shall for the purposes of this Regulation constitute a Panel of majority of independent persons from within the categories mentioned in sub-section (5) of Section 4 of the Act.

(2) For seeking exemption underclause (l) of sub-regulation (1) of Regulation (3), the acquirer shall file an application supported by a duly sworn affidavit with the Board, giving details of the proposed acquisition and the grounds on which the exemption has been sought.

(3) The acquirer shall, along with the application referred to under sub pay a fee of one lakh rupees to the Board, either by a bankers cheque or demand draft in favor of the Securities and Exchange Board of India, payable at Mumbai.

(4) The Board shall within 5 days of the receipt of an application under sub-regulation (2) forward the application to the Panel.

(5) The Panel shall within 15 days from the date of receipt of application make a recommendation on the application to the Board.

(6) The Board shall after affording reasonable opportunity to the concerned parties and after considering all the relevant facts including the recommendations, if any, pass a reasoned order on the application under sub-regulation (2) within 30days thereof.

(7) The order of the Board under sub-regulation(6) shall be published by the Board.

Power of the Board to Grant Exemption

5. In order to remove any difficulties in the interpretation or application of the provisions of these Regulations, the Board shall have the power to issue directions through guidance notes or circulars:

Provided that where any direction is issued by the Board in a specific case relating to interpretation or application of any provision of these Regulations, it shall be done only after affording a reasonable opportunity to the concerned parties and after recording reasons for the direction.

Chapter II: Disclosures of Shareholding and Control in a Listed Company

Transitional Provision

6. (1) Any person, who holds more than five percent shares or voting rights in any company, shall within two months of notification of these Regulations disclose his aggregate shareholding in that company, to the company.

(2) Every company whose shares are held by the persons referred to in sub-regulation (1) shall, within three months from the date of notification of these Regulations, disclose to all the stock exchanges on which the shares of the company are listed, the aggregate number of shares held by each person.

(3) A promoter or any person having control over a company shall within two months of notification of these Regulations disclose the number and percentage of shares or voting rights held by him and by person(s) acting in concert with him in that company, to the company.

(4) Every company, whose shares are listed on a stock exchange, shall within three months of notification of these Regulations, disclose to all the stock exchanges on which the shares of the company are listed, the names and addresses of promoters and, or person(s) having control over the company, and number and percentage of shares or voting rights held by each such person.

Acquisition of 5% and More Shares of a Company

7. (1) Any acquirer, who acquires shares or voting rights which (taken together with shares or voting rights, if any, held by him) would entitle him to more than five percent or ten percent or fourteen percent, or fifty four percent or seventy four percent shares or voting rights in a company, in any manner whatsoever, shall disclose at every stage the aggregate of his shareholding or voting rights in that company to the company and to the stock exchanges where shares of the target company are listed.

(1A) Any acquirer who has acquired shares or voting rights of a company under sub-regulation(1) of regulation 11, shall disclose purchase or sale aggregating two percent. or more of the share capital of the target company to the target company, and the stock exchanges where shares of the target company are listed within two days of such purchase or sale along with the aggregate shareholding after such acquisition or sale.

Explanation for the purposes of sub-regulations (1) and (1A), the term 'acquirer' shall include a pledgee, other than a bank or a financial institution and such pledgee shall make disclosure to the target company and the stock exchange within two days of creation of pledge.

(2) The disclosures mentioned in sub-regulations (1) and (1A)] shall be made within two days, –

(a) the receipt of intimation of allotment of shares; or

(b) the acquisition of shares or voting rights, as the case may be.

(2A) The stock exchange shall immediately display the information received from the acquirer under sub-regulations (1) and (1A) on the trading screen, the notice board and also on its website.

(3) Every company, whose shares are acquired in a manner referred to in sub-regulation(1) and (1A) shall disclose to all the stock exchanges on which the shares of the said company are listed the aggregate number of shares held by each of such persons referred above within seven days of receipt of information under sub-regulations(1) and (1A).

Continual Disclosures

8. (1) Every person, including a person mentioned in Regulation 6 who holds more than fifteen percent shares or voting rights in any company, shall, within 21 days from the financial year ending March 31, make yearly disclosures to the company, in respect of his holdings as on31st March.

(2) A promoter or every person having control over a company shall, within 21 days from the financial year ending March31, as well as the record date of the company for the purposes of declaration of dividend, disclose the number and percentage of shares or voting rights held by him and by persons acting in concert with him, in that company to the company.

(3) Every company whose shares are listed on a stock exchange, shall within 30 days from the financial year ending March 31, as well as the record date of the company for the purposes of declaration of dividend, make yearly disclosures to all the stock exchanges on which the shares of the company are listed, the changes, if any, in respect of the holdings of the persons referred to under sub-regulation (1) and also holdings of promoters or person(s) having control over the company as on 31st March.

(4) Every company whose shares are listed on a stock exchange shall maintain a register in the specified format to record the information received under sub-regulation (3) of Regulation 6, sub-regulation (1) of Regulation 7 and sub-regulation (2) of Regulation 8.

Disclosure of Pledged Shares

8A. (1) A promoter or every person forming part of the promoter group of any company shall, within seven working days of commencement of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) (Amendment) Regulations, 2009, disclose details of shares of that company pledged by him, if any, to that company.

(2) A promoter or every person forming part of the promoter group of any company shall, within 7 working days from the date of creation of pledge on shares of that company held by him, inform the details of such pledge of shares to that company.

(3) A promoter or every person forming part of the promoter group of any company shall, within 7 working days from the date of invocation of pledge on shares of that company pledged by him, inform the details of invocation of such pledge to that company.

Explanation: For the purposes of sub-regulations (1), (2) and (3) the term "promoter" and "promoter group" shall have the same meaning as is assigned to them under Clause 40A of the Listing Agreement.

(4) The company shall disclose the information received under sub regulations (1), (2) and (3) to all the stock exchanges, on which the shares of company are listed, within 7 working days of the receipt thereof, if, during any quarter ending March, June, September and December of any year,

(a) aggregate number of pledged shares of a promoter or every person forming part of promoter group taken together with shares already pledged during that quarter by such promoter or persons exceeds twenty five thousand; or

(b) aggregate of total pledged shares of the promoter or every person forming part of promoter group along with the shares already pledged during that quarter by such promoter or persons exceeds one percent of total shareholding or voting rights of the company, whichever is lower.

Power to Call for Information

9. The stock exchanges and the company shall furnish to the Board information with regard to the disclosures made under Regulations 6, Regulation 7 and Regulation 8 as and when required by the Board.

Chapter III: Substantial Acquisition of Shares or Voting Rights in and Acquisition of Control Over a Listed Company

Acquisition of Fifteen or more of the Shares or Voting Rights of any Company

10. No acquirer shall acquire shares or voting rights which (taken together with shares or voting rights, if any, held by him or by persons acting in concert with him), entitle such acquirer to exercise fifteen percent or more of the voting rights in a company, unless such acquirer makes a public announcement to acquire shares of such company in accordance with the Regulations.

Consolidation of Holdings

11. (1) No acquirer who, together with persons acting in concert with him, has acquired, in accordance with the provisions of law, 15 percent or more but less than fifty five percent (55%) of the shares or voting rights in a company, shall acquire, either by himself or through or with persons acting in concert with him, additional shares or voting rights entitling him to exercise more than 5% of the voting rights, in any financial year ending on 31st March, unless such acquirer makes a public announcement to acquire shares in accordance with the Regulations.

(2) No acquirer, who together with persons acting in concert with him holds, fifty five percent. (55%) or more but less than seventy five percent. (75%) of the shares or voting rights in a target company, shall acquire either by himself or through persons acting in concert with him any additional shares entitling him to exercise voting rights or voting rights therein, unless he makes a public announcement to acquire shares in accordance with these Regulations:

Provided that in a case where the target company had obtained listing of its shares by making an offer of at least ten percent. (10%) of issue size to the public in terms of clause (b) of sub-rule (2) of rule 19 of the Securities Contracts (Regulation) Rules, 1957, or in terms of any relaxation granted from strict enforcement of the said rule, this sub-regulation shall apply as if for the words and figures 'seventy five percent. (75%)', the words and figures 'ninety percent. (90%)' were substituted.

Provided further that such acquirer may, without making a public announcement under these Regulations, acquire, either by himself or through or with persons acting in concert with him, additional shares or voting rights entitling him upto five percent (5%). voting rights in the target company subject to the following:

(i) the acquisition is made through open market purchase in normal segment on the stock exchange but not through bulk deal/block deal/negotiated deal/ preferential allotment; or the increase in the shareholding or voting rights of the acquirer is pursuant to a buy back of shares by the target company;

(ii) the post acquisition shareholding of the acquirer together with persons acting in concert with him shall not increase beyond seventy five percent.(75%).

(2A) Where an acquirer who (together with persons acting in concert with him) holds fifty five percent. (55%) or more but less than seventy five percent. (75%) of the shares or voting rights in a target company, is desirous of consolidating his holding while ensuring that the public shareholding in the target company does not fall below the minimum level permitted by the Listing Agreement, he may do so only may do so in accordance with these regulations:

Provided that in a case where the target company had obtained listing of its shares by making an offer of at least ten percent. (10%) of issue size to the public in terms of clause (b) of sub-rule (2) of rule 19 of the Securities Contracts (Regulation) Rules, 1957, or in terms of any relaxation granted from strict enforcement of the said rule, this sub-regulation shall apply as if for the words and figures 'seventy five percent (75%)', the words and figures 'ninety percent. (90%)' were substituted.

(3) Not withstanding anything contained in Regulations 10, 11 and 12, in case of disinvestment of a Public Sector Undertaking, an acquirer who together with persons acting in concert with him, has made a public announcement, shall not be required to make another public announcement at the subsequent stage of further acquisition of shares or voting rights or control of the Public Sector Undertaking provided –

(i) both the acquirer and the seller are the same at all the stages of acquisition, and

(ii) disclosures regarding all the stages of acquisition, if any, are made in the letter of offer issued in terms of Regulation 18 and in the first public announcement.

Explanation: For the purposes of Regulation 10 andRegulation11, acquisition shall mean and include,

(a) direct acquisition in a listed company to which the Regulations apply;

(b) indirect acquisition by virtue of acquisition o companies, whether listed or unlisted, whether in India or abroad.

Acquisition of Control over a Company

12. Irrespective of whether or not there has been any acquisition of shares or voting rights in a company, no acquirer shall acquire control over the target company, unless such person makes a public announcement to acquire shares and acquires such shares in accordance with the Regulations.

Provided that nothing contained herein shall apply to any change in control which takes place in pursuance to a special resolution passed by the shareholders in a general meeting.

"Provided further that for passing of the special resolution facility of voting through postal ballot as specified under the Companies (Passing of the Resolutions by Postal Ballot) Rules, 2001 shall also be provided.

Explanation: For the purposes of this Regulation, acquisition shall include direct or indirect acquisition of control of target company by virtue of acquisition of companies, whether listed or unlisted and whether in India or abroad.

Appointment of a Merchant Banker

13. Before making any public announcement of offer referred to in Regulation 10 or Regulation 11 or Regulation 12, the acquirer shall appoint a merchant banker in Category-I holding a certificate of registration granted by the Board, who is not associate of or group of the acquirer or the target company.

Timing of the Public Announcement of Offer

14. (1) The public announcement referred to in Regulation10 or Regulation 11 shall be made by the merchant banker not later than four working days of entering into an agreement for acquisition of shares or voting rights or deciding to acquire shares or voting rights exceeding the respective percentage specified therein:

Provided that in case of disinvestment of a Public Sector Undertaking, the public announcement shall be made by the merchant banker not later than 4 working days of the acquirer executing the Share Purchase Agreement or Shareholders Agreement with the Central Government or the State Government as the case may be for the acquisition of shares or voting rights exceeding the percentage of share holding referred to in Regulation 10 or Regulation11 or the transfer of control over a target Public Sector Undertaking

(2) In case of an acquirer acquiring securities, including Global Depositories Receipts or American Depository Receipts which, when taken together with the voting rights, if any already held by him or persons acting in concert with him, would entitle him to voting rights, exceeding the percentage specified in Regulation 10 or Regulation11, the public announcement referred to in sub-regulation(1) shall be made not later than four working days before he acquires voting rights on such securities upon conversion, or exercise of option, as the case may be.

(3) The public announcement referred to in Regulation12 shall be made by the merchant banker not later than four working days after any such change or changes are decided to be made as would result in the acquisition of control over the target company by the acquirer.

(4) Incase of indirect acquisition or change in control, a public announcement shall be made by the acquirer within three months of consummation of such acquisition or change in control or restructuring of the parent or the company holding shares of or control over the target company in India.

Public Announcement of Offer

15. (1) The public announcement to be made under Regulations 10 or Regulation 11 or Regulation 12 shall be made in all editions of one English national daily with wide circulation, one Hindi national daily with wide circulation and a regional language daily with wide circulation at the place where the registered office of the target company is situated and at the place of the stock exchange where the shares of the target company are most frequently traded.

(2) Simultaneously with publication of the announcement in the newspaper in terms of sub-regulation (1), a copy of the public announcement shall be,

(i) submitted to the Board through the merchant banker,

(ii) sent to all the stock exchanges on which the shares of the company are listed for being notified on the notice board,

(iii) sent to the target company at its registered office for being placed before the Board of Directors of the company.

(4) The offer under these Regulations shall be deemed to have been made on the date on which the public announcement has appeared in any of the newspapers referred to in sub-regulation (1).

Contents of the Public Announcement of Offer

16. The public announcement referred to in Regulations 10 orRegulation11 or Regulation 12 shall contain the following particulars, namely:

(i) the paid-up share capital of the target company, the number of fully paid-up and partly paid up shares;

(ii) the total number and percentage of shares proposed to be acquired from the public, subject to a minimum as specified in sub-regulation(1) of Regulation 21;

(iii) the minimum offer price for each fully paid-up or partly paid-up share;

(iv) mode of payment of consideration;

(v) the identity of the acquirer(s) and in case the acquirer is a company or companies, the identity of the promoters and, or the persons having control over such company(ies) and the group, if any, to which the company(ies) belong;

(vi) the existing holding, if any, of the acquirer in the shares of the target company, including holdings of persons acting in concert with him;

(via) the existing shareholding, if any, of the merchant banker in the target company ;

(vii) salient features of the agreement, if any, such as the date, the name of the seller, the price at which the shares are being acquired, the manner of payment of the consideration and the number and percentage of shares in respect of which he acquirer has entered into the agreement to acquire the shares or the consideration, monetary or otherwise, for the acquisition of control over the target company, as the case maybe;

(viii) the highest and the average price paid by the acquirer or persons acting in concert with him for acquisition, if any, of shares of the target company made by him during the twelve month period prior to the date of public announcement;

(ix) Object and purpose of the acquisition of the shares and future plans, if any, of the acquirer for the target company, including disclosures whether the acquirer proposes to dispose of or otherwise encumber any assets of the target company in the succeeding two years, except in the ordinary course of business of the target company.

Provided that where the future plans are set out, the public announcement shall also set out how the acquirers propose to implement such future plans.

"Provided further that the acquirer shall not sell, dispose of or otherwise encumber any substantial asset of the target company except with the prior approval of the shareholders.

(ixa) an undertaking that the acquirer shall not sell, dispose of or otherwise encumber any substantial asset of the target company except with the prior approval of the shareholders.

(x) the 'specified date' as mentioned in Regulation19;

(xi) the date by which individual letters of offer would be posted to each of the shareholders;

(xii) the date of opening and closure of the offer and the manner in which and the date by which the acceptance or rejection of the offer would be communicated to the shareholders;

(xiii) the date by which the payment of consideration would be made for the shares in respect of which the offer has been accepted;

(xiv) disclosure to the effect that firm arrangement for financial resources required to implement the offer is already in place, including details regarding the sources of the funds whether domestic i.e., from banks, financial institutions, or otherwise or foreign i.e., from Non-Resident Indians or otherwise;

(xv) provision for acceptance of the offer by person(s)who own the shares but are not the registered holders of such shares;

(xvi) statutory approvals, if any, required to be obtained for the purpose of acquiring the shares under the Companies Act,1956 (1 of 1956), the Monopolies and Restrictive Trade Practices Act, 1969(54 of 1969), The Foreign Exchange Regulation Act, 1973, (46 of 1973) and/or any other applicable laws;

(xvii) approvals of banks or financial institutions required, if any;

(xviii) whether the offer is subject to a minimum level of acceptance from the shareholders; and

(xix) such other information as is essential for the shareholders to make an informed decision in regard to the offer.

Brochures, Advertising Material etc.

17. The public announcement of the offer or any other advertisement, circular, brochure, publicity material or letter of offer issued in relation to the acquisition of shares shall not contain any misleading information.

Submission of Letter of offer to the Board

18. (1) Within fourteen days from the date of public announcement made under Regulation 10, Regulation11 or Regulation 12 as the case may be, the acquirer shall, through its merchant banker, file with the Board, the draft of the letter of offer, containing disclosures as specified by the Board.

(2) The letter of offer shall be dispatched to the shareholders not earlier than 21 days from its submission to the Board under sub-regulation (1).

Provided that if, within 21 days from the date of submission of the letter of offer, the Board specifies changes, if any, in the letter of offer, (without being under any obligation to do so) the merchant banker and the acquirer shall carry out such changes before the letter of offer is dispatched to the shareholders.

Provided further that if the disclosures in the draft letter of offer are inadequate or the Board has received any complaint or has initiated any enquiry or investigation in respect of the public offer, the Board may call for revised letter of offer with or without rescheduling the date of opening or closing of the offer and may offer its comments to the revised letter of offer within seven working days of filing of such revised letter of offer.

(3) The acquirer shall, while filing the draft letter of offer with the Board under sub-regulation (1), pay a fee as mentioned in the following table, by bankers' cheque or demand draft drawn in favor of the 'Securities and Exchange Board of India', payable at Mumbai:

Offer Size	Fee (Rs.)
Less than or equal to ten crore rupees.	One lakh rupees (Rs.1,00,000).
More than ten crore rupees, but less than or equal to one thousand crore rupees.	0.125% of the offer size.
More than one thousand crore rupees, but less than or equal to five thousand crore rupees.	One Crore twenty five lakh rupees (Rs.1,25,00,000)plus 0.03125 percent of the portion of the offer size in excess of one thousand crore rupees (Rs.1000,00,00,000).
More than five thousand crore rupees.	A flat charge of three crore rupees (Rs.3,00,00,000).

Specified Date

19. The public announcement shall specify a date, which shall be the specified date' for the purpose of determining the names of the shareholders to whom the letter of offer should be sent.

Provided that such specified date shall not be later than the thirtieth day from the date of the public announcement.

Offer Price

20. (1) The offer to acquire shares under regulations 10, 11 or 12 shall be made at a price not lower than the price determined as per sub-regulations (4) and (5).

(2) The offer price shall be payable –

(a) in cash;

(b) by issue, exchange and, or transfer of shares (other than preference shares) of acquirer company, if the person seeking to acquire the shares is a listed body corporate; or

(c) by issue, exchange and, or transfer of secured instruments of acquirer company with a minimum 'A' grade rating from a credit rating agency registered with the Board;

(d) a combination of clause (a),(b)or (c):

Provided that where the payment has been made in cash to any class of shareholders for acquiring their shares under any agreement or pursuant to any acquisition in the open market or in any other manner during the immediately preceding twelve months from the date of public announcement, the letter of offer shall provide an option to the shareholders to accept payment either in cash or by exchange of shares or other secured instruments referred to above:

Provided further that the mode of payment of consideration may be altered in case of revision in offer price or size subject to the condition that the amount to be paid in cash as mentioned in any announcement or the letter of offer is not reduced.

(3) In case the offer price consists of consideration payable in the form of securities issuance of which requires approval of the shareholders, such approval shall be obtained by the acquirer within seven days from the date of closure of the offer:

Provided that in case the requisite approval is not obtained, the acquirer shall pay the entire consideration in cash.

(4) For the purposes of sub-regulation (1), the offer price shall be the highest of –

(a) the negotiated price under the agreement referred to in sub-regulation(1) of regulation 14;

(b) price paid by the acquirer or persons acting in concert with him for acquisition, if any, including by way of allotment in a public or rights or preferential issue during the twenty six week period prior to the date of public announcement, whichever is higher;

(c) the average of the weekly high and low of the closing prices of the shares of the target company as quoted on the stock exchange where the shares of the company are most frequently traded during the twenty-six weeks or the average of the daily high and low of the prices of the shares as quoted on the stock exchange where the shares of the company are most frequently traded during the two weeks preceding the date of public announcement, whichever is higher.

Provided that the requirement of average of the daily high and low of the closing prices of the shares as quoted on the stock exchange where the shares of the company are most frequently traded during the two weeks preceding the date of public announcement, shall not be applicable in case of disinvestment of a Public Sector Undertaking.

Explanation: In case of disinvestment of a Public Sector Undertaking, the relevant date for the calculation of the average of the weekly prices of the shares of the Public Sector Undertaking, as quoted on the stock exchange where its shares are most frequently traded, shall be the date preceding the date when the Central Government or the State Government opens the financial bid.

(5) Where the shares of the target company are infrequently traded, the offer price shall be determined by the acquirer and the merchant banker taking into account the following factors:

(a) the negotiated price under the agreement referred to in sub-regulation(1) of regulation 14;

(b) the highest price paid by the acquirer or persons acting in concert with him for acquisitions, if any, including by way of allotment in a public or rights or preferential issue during the twenty six week period prior to the date of public announcement;

(c) other parameters including return on net worth, book value of the shares of the target company, earning per share, price earning multiple vis-à-vis the industry average:

Provided that where considered necessary, the Board may require valuation of such infrequently traded shares by an independent merchant banker (other than the manager to the offer) or an independent chartered accountant of minimum ten years' standing or a public financial institution.

Explanation: (i) For the purpose of sub-regulation (5), shares shall be deemed to be infrequently traded if on the stock exchange, the annualized trading turnover in that share during the preceding six calendar months prior to the month in which the public announcement is made is less than five percent. (by number of shares) of the listed shares. For this purpose, the weighted average number of shares listed during the said six months period may be taken.

(ii) In case of disinvestment of a Public Sector Undertaking, the shares of such an undertaking shall be deemed to be infrequently traded, if on the stock exchange, the annualized trading turnover in the shares during the preceding six calendar months prior to the month, in which the Central Government or the State Government as the case may be opens the financial bid, is less than five percent. (by the number of shares) of the listed shares. For this purpose, the weighted average number of shares listed during the six months period may be taken.

(iii) In case of shares which have been listed within six months preceding the public announcement, the trading turnover may be annualised with reference to the actual number of days for which the shares have been listed.

(6) Notwithstanding anything contained in sub-regulation (5), in case of disinvestment of a Public Sector Undertaking, whose shares are infrequently traded, the minimum offer price shall be the price paid by the successful bidder to the Central Government or the State Government, arrived at after the process of competitive bidding of the Central Government or the State Government for the purpose of disinvestment.

(7) Notwithstanding anything contained in the provisions of sub-regulations (2), (4), (5) and (6), where the acquirer has acquired shares in the open market or through negotiation or otherwise, after the date of public announcement at a price higher than the offer price stated in the letter of offer, then, the highest price paid for such acquisition shall be payable for all acceptances received under the offer:

Provided that no such acquisition shall be made by the acquirer during the last seven working days prior to the closure of the offer.

Provided further that nothing contained in sub-regulation (7) shall be construed to authorize an acquirer who makes a public announcement in terms of sub-regulation (2A) of regulation 11 to acquire any shares during the offer period in the open market or through negotiation or in any other manner otherwise than under the public offer.

(8) Any payment made to the persons other than the target company in respect of non compete agreement in excess of twenty five percent. of the offer price arrived at under sub-regulations (4) or (5) or (6)shall be added to the offer price.

(9) In case where shares or secured instruments of the acquirer company are offered in lieu of cash payment, the value of such shares or secured instruments shall be determined in the same manner as specified in sub-regulation (4) or sub-regulation (5) to the extent applicable, as duly certified byan independent merchant banker (other than the manager to the offer) oran independent chartered accountant of a minimum ten years standing or a public financial institution.

(10) The offer price for partly paid up shares shall be calculated as the difference between the offer price and the amount due towards calls-in-arrears or calls remaining unpaid together with interest, if any, payable on the amount called up but remaining unpaid.

(11) The letter of offer shall contain justification or the basis on which the price has been determined.

Explanation: (i) The highest price under clause (b) or the average price under clause(c) of sub-regulation (4) may be adjusted for quotations, if any, on cum-rights or cum-bonus or cum-dividend basis during the said period.

(ii) Where the public announcement of offer is pursuant to acquisition by way of firm allotment in a public issue or preferential allotment, the average price under clause (c) of sub-regulation (4) shall be calculated with reference to twenty six week period preceding the date of the board resolution which authorized the firm allotment or preferential allotment.

(iii) Where the shareholders have been provided with an option to accept payment either in cash or by way of exchange of security, the pricing for the cash offer could be different from that of a share exchange offer or offer for exchange with secured instruments provided that the disclosures in the letter of offer contains suitable justification for such differential pricing and the pricing is subject to other provisions of this regulation.

(iv) Where the offer is subject to a minimum level of acceptance, the acquirer may, subject to the other provisions of this regulation, indicate a lower price for the minimum acceptance upto twenty percent., should the offer not receive full acceptance.

(12) The offer price for indirect acquisition or control shall be determined with reference to the date of the public announcement for the parent company and the date of the public announcement for acquisition of shares of the target company, whichever is higher, in accordance with sub-regulation (4) or sub-regulation (5).]

Acquisition Price under Creeping Acquisition

20A. (1) An acquirer who has made a public offer and seeks to acquire further shares under sub-regulation (1) of regulation 11 shall not acquire such shares during the period of 6 months from the date of closure of the public offer at a price higher than the offer price.

(2) Sub-regulation (1) shall not apply where the acquisition is made through the stock exchanges.]

Minimum Number of Shares to be Acquired

21. (1) The public offer made by the acquirer to the shareholders of the target company shall be for a minimum twenty percent of the voting capital of the company.

(2) If the acquisition made in pursuance of a public offer results in the public shareholding in the target company being reduced below the minimum level required as per the Listing Agreement, the acquirer

shall take necessary steps to facilitate compliance of the target company with the relevant provisions thereof, within the time period mentioned therein.

(3) Where the public offer is made under sub-regulation (2A) of regulation 11 the minimum size of the public offer shall be the lesser of the following –

(a) twenty percent of the voting capital of the company; or

(b) such other lesser percentage of the voting capital of the company as would, assuming full subscription to the offer, enable the acquirer, together with the persons acting in concert with him, to increase his holding to the maximum level possible, which is consistent with the target company meeting the requirements of minimum public shareholding laid down in the Listing Agreement."

(4) The letter of offer shall state clearly the option available to the acquirer under sub-regulation (3).

(5) For the purpose of computing the percentage referred to sub-regulation(1) and (3) the voting rights as at the expiration of fifteen days after the closure of the public offer shall be reckoned.

(6) Where the number of shares offered for sale by the shareholders are more than the shares agreed to be acquired by the person making the offer, such person shall, accept the offers received from the shareholders on a proportional basis, in consultation with the merchant banker, taking care to ensure that the basis of acceptance is decided in a fair and equitable manner and does not result in non-marketable lots.

Provided that acquisition of shares from a shareholder shall not be less than the minimum marketable lot or the entire holding if it is less than the marketable lot.

Offer Conditional upon Level of Acceptance

21A. (1) Subject to the provisions of sub-regulation (8) of regulation 22, an acquirer or any person acting in concert with him may make an offer conditional as to the level of acceptance which may be less than twenty percent:

Provided that where the public offer is in pursuance of a Memorandum of Understanding, the Memorandum of Understanding shall contain a condition to the effect that in case the desired level of acceptance is not received the acquirer shall not acquire any shares under the Memorandum of Understanding and shall rescind the offer.

General Obligations of the Acquirer

22. (1) The public announcement of offer to acquire the shares of the target company shall be made only when the acquirer is able to implement the offer.

(2) Within 14 days of the public announcement of the offer, the acquirer shall send a copy of the draft letter of offer to the target company at its registered office address, for being placed before the board of directors and to all the stock exchanges where the shares of the company are listed.

(3) The acquirer shall ensure that the letter of offer is sent to all the shareholders (including non-resident Indians) of the target company, whose names appear on the register of members of the company as on the specified date mentioned in the public announcement, so as to reach them within 45 days from the date of public announcement.

Provided that where the public announcement is made pursuant to an agreement to acquire shares or control over the target company, the letter of offer shall be sent to shareholders other than the parties to the agreement.

Explanation: (i) A copy of the letter of offer shall also be sent to the Custodians of Global Depository Receipts or American Depository Receipts to enable such persons to participate in the open offer, if they are entitled to do so.

(ii) A copy of the letter of offer shall also be sent to warrant holders or convertible debenture holders, where the period of exercise of option or conversion falls within the offer period.

(4) The date of opening of the offer shall be not later than the fifty-fifth day from the date of public announcement.

(5) The offer to acquire shares from the shareholders shall remain open for a period of twenty days.

(5A) The shareholder shall have the option to withdraw acceptance tendered by him up to three working days prior to the date of closure of the offer.

(6) In case the acquirer is a company, the public announcement of offer, brochure, circular, letter of offer or any other advertisement or publicity material issued to shareholders in connection with the offer must state that the directors accept the responsibility for the information contained in such documents.

Provided that if any of the directors desires to exempt himself from responsibility for the information in such document, such director shall issue a statement to that effect, together with reasons thereof for such statement.

(7) During the offer period, the acquirer or persons acting in concert with him shall not be entitled to be appointed on the board of directors of the target company.

Provided that in case of acquisition of shares or voting rights or control of a Public Sector Undertaking pursuant to a public announcement made under the proviso to sub-regulation (1) of Regulation 14, the provisions of sub-regulation (8) of Regulation23 shall be applicable.

Provided further that where the acquirer, other than the acquirer who has made an offer under regulation 21A, after assuming full acceptances, has deposited in the escrow account hundred percent. of the consideration payable in cash where the consideration payable is in cash and in the form of securities where the consideration payable is by way of issue, exchange or transfer of securities or combination thereof, he may be entitled to be appointed on the Board of Directors of the target company after a period of twenty one days from the date of public announcement.

(8) Where an offer is made conditional upon minimum level of acceptances, the acquirer or any person acting in concert with him –

(i) shall, irrespective of whether or not the offer received response to the minimum level of acceptances, acquire shares from the public to the extent of the minimum percentage specified in sub-regulation(1) of Regulation 21:

Provided that the provisions of this clause shall not be applicable in case the acquirer has deposited in the escrow account, in cash, 50%of the consideration payable under the public offer.

(ii) shall not acquire, during the offer period, any shares in the target company, except by way of fresh issue of shares of the target company, as provided for under Regulation 3;

(iii) shall be liable for penalty of forfeiture of entire escrow amount, for the non-fulfillment of obligations under the Regulations.

(9) If any of the persons representing or having interest in the acquirer is already a director on the board of the target company or is an "insider "within the meaning of Securities and Exchange Board of India (Insider Trading) Regulations, 1992, he shall recuse himself and not participate in any matter(s)concerning or 'relating' to the offer including any preparatory steps leading to the offer.

(10) On or before the date of issue of public announcement of offer, the acquirer shall create an escrow account as provided under Regulation28.

(11) The acquirer shall ensure that firm financial arrangements has-been made for fulfilling the obligations under the public offer and suitable disclosures in this regard shall be made in the public announcement of offer.

(12) The acquirer shall, within a period of fifteen days from the date of the closure of the offer, complete all procedures relating to the offer including payment of consideration to the shareholders who have accepted the offer and for the purpose open a special account as provided under Regulation 29.

Provided that where the acquirer is unable to make the payment to the shareholders who have accepted the offer before the said period of fifteen days due to non-receipt of requisite statutory approvals, the Board may, if satisfied that non-receipt of requisite statutory approvals was not due to any wilful default or neglect of the acquirer or failure of the acquirer to diligently pursue the applications for such approvals, grant extension of time for the purpose, subject to the acquirer agreeing to pay interest to the shareholders for delay beyond fifteen days, as may be specified by the Board from time to time.

(13) Where the acquirer fails to obtain the requisite statutory approvals in time on account of willful default or neglect or inaction or non-action on his part, the amount lying in the escrow account shall be liable to be forfeited and dealt wit h in the manner provided in clause(e) of sub regulation 12 of Regulation 28, apart from the acquirer being liable for penalty as provided in the Regulations.

(14) In the event of withdrawal of offer in terms of the Regulations, the acquirer shall not make any offer for acquisition of shares of the target company for a period of six months from the date of public announcement of withdrawal of offer.

(15) In the event of non-fulfillment of obligations under Chapter III or Chapter IV of the Regulations, the acquirer shall not make any offer for acquisition of shares of any listed company for a period of twelve months from the date of closure of offer.

(16) If the acquirer, in pursuance to an agreement, acquires shares which along with his existing holding, if any, increases his share holding beyond 15%, then such an agreement for sale of shares shall contain a clause to the effect that in ca se of non-compliance of any provisions of this regulation, the agreement for such sale shall not be acted upon by the seller or the acquirer.

Provided that in case of acquisition of shares of a Public Sector Undertaking pursuant to a public announcement made under the Regulations, the provisions of sub-regulation (8) of Regulation 23 shall be applicable.

(17) Where the acquirer or persons acting in concert with him has acquired any shares in terms of sub-regulation (7) of regulation 20 ata price equal to or less or more than the offer price, he shall disclose the number, percentage, price and the mode of acquisition of such shares to the stock exchanges on which the shares of the target company are listed and to the merchant banker within 24 hours of such acquisition and the stock exchanges shall forthwith disseminate such information to the public.

(18) Where the acquirer has not either, in the public announcement, and, or in the letter of offer, stated his intention to dispose of or otherwise encumber any assets of the target company except in the ordinary course of business of the target company, the acquirer, where he has acquired control over the target company, shall be debarred from disposing of or otherwise encumbering the assets of the target company for a period of2 years from the date of closure of the public offer.

(19) The acquirer and the persons acting in concert with him shall be jointly and severally responsible for fulfilment of obligations under these Regulations.

General Obligations of the Board of Directors of the Target Company

23. (1) Unless the approval of the general body of shareholders is obtained after the date of the public announcement of offer, the board of directors of the target company shall not, during the offer period,

(a) sell, transfer, encumber or otherwise dispose of or enter into an agreement for sale, transfer, encumbrance or for disposal of assets otherwise, not being sale or disposal of assets in the ordinary course of business, of the company or its subsidiaries; or

(b) issue or allot any authorized but unissued securities carrying voting rights during the offer period; or

(c) enter into any material contracts.

Explanation: Restriction on issue of securities under clause (b) of sub-regulation (1) shall not affect –

(i) the right of the target company to issue or allot shares carrying voting rights upon conversion of debentures already issued or upon exercise of option against warrants, as per pre-determined terms of conversion or exercise of option.

(ii) issue or allotment of shares pursuant to public or rights issue in respect of which the offer document has already been filed with the Registrar of Companies or Stock Exchanges, as the case may be.

(2) The target company shall furnish to the acquirer, within 7 days of the request of the acquirer or within 7 days from the specified date, whichever is later, a list of shareholders or warrant holders or convertible debenture holders as are eligible for participation under Explanation(ii) to sub-regulation (3) of Regulation 22 containing names, addresses, shareholding and folio number, and of those persons whose applications for registration of transfer of shares are pending with the company.

(3) Once the public announcement has been made, the board of directors of the target company shall not,

(a) appoint as additional director or fill in any casual vacancy on the board of directors, by any person(s) representing or having interest in the acquirer, till the date of certification by the merchant banker as provided under sub-regulation(6) below.

Provided that upon closure of the offer and the full amount of consideration payable to the shareholders being deposited in the special account, changes as would give the acquirer representation on the Board or control over the company, c an be made by the target company.

(b) allow any person or persons representing or having interest in the acquirer, if he is already a director on the board of the target company before the date of the public announcement, to participate in any matter relating to the offer, including any preparatory steps leading thereto.

(4) The board of directors of the target company may, if they so desire, send their unbiased comments and recommendations on the offer(s) to the shareholders, keeping in mind the fiduciary responsibility of the directors to the shareholders an d for the purpose seek the opinion of an independent merchant banker or a Committee of Independent Directors;

Provided that for any misstatement or for concealment of material information, the directors shall be liable for action in terms of these Regulations and the Act.

(5) The board of directors of the target company shall facilitate the acquirer in verification of securities tendered for acceptances.

(6) Upon fulfillment of all obligations by the acquirers under the Regulations as certified by the merchant banker, the board of directors of the target company shall transfer the securities acquired by the acquirer, whether under the agreement or from open market purchases, in the name of the acquirer and, or allow such changes in the board of directors as would give the acquirer representation on the board or control over the company.

(7) The obligations provided for in sub-regulation (16) of regulation 22 shall be complied with by the company in the circumstances specified therein.

(8) The restrictions –

(a) for appointment of directors on the Board of a target company by the acquirer under sub-regulation (7)of Regulation 22.

(b) for acting on agreement for under sub-regulation (16) of Regulation 22;

(c) for appointment of directors by the target company under clause(a) of sub-regulation 3 of this Regulation; and

(d) for on transfer of securities or changes in the Board of Directors of the target company under sub-regulation (6)of this Regulation, shall not be applicable, in case of sale of shares of a Public Sector Undertaking by the Central Government or the State Government, and the agreement to sell contains a clause to the effect that in case of non-compliance of any of the provisions of the Regulations by the acquirer, transfer of shares or change of management or control of Public Sector Undertaking shall vest back with the Central Government or the State Government and the acquirer shall be liable to such penalty as may be imposed by the Central Government or the State Government.

General Obligations of the Merchant Banker

24. (1) Before the public announcement of offer is made, the merchant banker shall ensure that,

    (a) the acquirer is able to implement the offer;

    (b) the provision relating to escrow account referred to in Regulation 28 has been made;

    (c) firm arrangements for funds and money for payment through verifiable means to fulfil the obligations under the offer are in place;

    (d) the public announcement of offer is made in terms of the Regulations;

    (e) his shareholding, if any in the target company is disclosed in the public announcement and the letter of offer.

(2) The merchant banker shall furnish to the Board a due diligence certificate which shall accompany the draft letter of offer.

(3) The merchant banker shall ensure that the public announcement and the letter of offer is filed with the Board, target company and also sent to all the stock exchanges on which the shares of the target company are listed in accordance with the Regulations.

(4) The merchant banker shall ensure that the contents of the public announcement of offer as well as the letter of offer are true, fair and adequate and based on reliable sources, quoting the source wherever necessary.

(5) The merchant banker shall ensure compliance of the Regulations and any other laws or rules as may be applicable in this regard.

(5A) The merchant banker shall not deal in the shares of the target company during the period commencing from the date of his appointment in terms of regulation 13 till the expiry of the fifteen days from the date of closure of the offer.

(6) Upon fulfillment of all obligations by the acquirers under the Regulations, the merchant banker shall cause the bank with whom the escrow amount has been deposited to release the balance amount to the acquirers.

(7) The merchant banker shall send a final report to the Board within 45 days from the date of closure of the offer.

Competitive Bid

25. (1) Any person, other than the acquirer who has made the first public announcement, who is desirous of making any offer, shall, within 21 days of the public announcement of the first offer, make a public announcement of his offer for acquisition of the shares of the same target company.

    Explanation: An offer made under sub-regulation (1) shall be deemed to be a competitive bid.

(2) No public announcement for an offer or competitive bid shall be made after 21 days from the date of public announcement of the first offer.

(2A) No public announcement for a competitive bid shall be made after an acquirer has already made the public announcement under the proviso to sub pursuant to entering into a Share Purchase or Shareholders Agreement with the Central Government or the State Government as the case may be, for acquisition of shares or voting rights or control of a Public Sector Undertaking.

(2B) No public announcement for a competitive bid shall be made after an acquirer has already made the public announcement pursuant to relaxation granted by the Board in terms of regulation 29A.

(3) Any competitive offer by an acquirer shall be for such number of shares which, when taken together with shares held by him along with persons acting in concert with him, shall be at least equal to the holding of the first bidder including the number of shares for which the present offer by the first bidder has been made.

(4) Upon the public announcement of a competitive bid or bids, the acquirer(s) who had made the public announcement(s) of the earlier offer(s), shall have the option to make an announcement revising the offer.

Provided that if no such announcement is made within fourteen days of the announcement of the competitive bid(s), the earlier offer(s) on the original terms shall continue to be valid and binding on the acquirer(s) who had made the offer(s) except that the date of closing of the offer shall stand extended to the date of closure of the public offer under the last subsisting competitive bid.

(5) The provisions of these Regulations shall ***mutatis-mutandis*** apply to the competitive bid(s) made under sub-regulation (1).

(6) The acquirers who have made the public announcement of offer(s)including the public announcement of competitive bid(s) shall have the option to make upward revisions in his offer(s), in respect to the price and the number of shares to be acquired, at any time upto seven working days prior to the date of closure of the offer:

Provided that the acquirer shall not have the option to change any other terms and conditions of their offer except the mode of payment following an upward revision in offer.

Provided further that any such upward revision shall be made only upon the acquirer,

(a) making a public announcement in respect of such changes or amendments in all the newspapers in which the original public announcement was made;

(b) simultaneously with the issue of public announcement referred in clause (a), informing the Board, all the stock exchanges on which the shares of the company are listed, and the target company at its registered office;

(c) increasing the value of the escrow account as provided under sub-regulation (9) of Regulation 28.

(7) Where there is a competitive bid, the date of closure of the original bid as also the date of closure of all the subsequent competitive bids shall be the date of closure of public offer under the last subsisting competitive bid and the public offers under all the subsisting bids shall close on the same date.

Upward Revision of Offer

26. Irrespective of whether or not there is a competitive bid, the acquirer who has made the public announcement of offer, may make upward revisions in his offer in respect to the price and the number of shares to be acquired, at anytime upto seven working days prior to the date of the closure of the offer.

Provided that any such upward revision of offer shall be made only upon the acquirer –

(a) making a public announcement in respect of such changes or amendments in all the newspapers in which the original public announcement was made;

(b) simultaneously with the issue of such public announcement, informing the Board, all the stock exchanges on which the shares of the company are listed, and the target company at its registered office;

(c) increasing the value of the escrow account as provided under sub-regulation (9) of Regulation 28.

Withdrawal of Offer

27. (1) No public offer, once made, shall be withdrawn except under the following circumstances:

(b) the statutory approval(s) required have been refused;

(c) the sole acquirer, being a natural person, has died;

(d) such circumstances as in the opinion of the Board merits withdrawal.

(2) In the event of withdrawal of the offer under any of the circumstances specified under sub-regulation (1), the acquirer or the merchant banker shall:

(a) make a public announcement in the same newspapers in which the public announcement of offer was published, indicating reasons for withdrawal of the offer.

(b) simultaneously with the issue of such public announcement, inform -

(i) the Board;

(ii) all the stock exchanges on which the shares of the company are listed; and

(iii) the target company at its registered office.

Provision of Escrow

28. (1) The acquirer shall as and by way of security for performance of his obligations under the Regulations, deposit in an escrow account such sum as specified in sub-regulation (2).

(2) The escrow amount shall be calculated in the following manner,

(a) For consideration payable under the public offer, – upto and including Rs.100 crore – 25%; exceeding Rs.100 crore – 25%upto Rs.100 crore and 10% thereafter.

(b) For offers which are subject to a minimum level of acceptance, and the acquirer does not want to acquire a minimum of 20%, then 50% of the consideration payable under the public offer in cash shall be deposited in the escrow amount.

(3) The total consideration payable under the public offer shall be calculated assuming full acceptances and at the highest price if the offer is subject to differential pricing, irrespective of whether the consideration for the offer is payable in cash or otherwise.

(4) The escrow account referred in sub-regulation(1) shall consist of,

(a) cash deposited with a scheduled commercial bank ; or

(b) bank guarantee in favor of the merchant banker; or

(c) deposit of acceptable securities with appropriate margin, with the merchant banker; or

(d) cash, deposited with a scheduled commercial bank in case of clause (b) of sub-regulation (2)of this Regulation.

(5) Where the escrow account consists of deposit with a scheduled commercial bank, the acquirer shall, while opening the account, empower the merchant banker appointed for the offer to instruct the bank to issue a banker's cheque or demand draft for the amount lying to the credit of the escrow account, as provided in the Regulations.

(6) Where the escrow account consists of bank guarantee, such bank guarantee shall be in favor of the merchant banker and shall be valid at least for a period commencing from the date of public announcement until twenty days after the closure of the offer.

(7) The acquirer shall, in case the escrow account consists of securities empower the merchant banker to realize the value of such escrow account by sale or otherwise provided that if there is any deficit on realization of the value of the securities, the merchant banker shall be liable to make good any such deficit.

(8) In case the escrow account consists of bank guarantee or approved securities, these shall not be returned by the merchant banker till after completion of all obligations under the Regulations.

(9) In case there is any upward revision of offer, consequent upon a competitive bid or otherwise, the value of the escrow account shall be increased to equal at least 10% of the consideration payable upon such revision.

(10) Where the escrow account consist of bank guarantee or deposit of approved securities, the acquirer shall also deposit with the bank a sum of at least 1% of the total consideration payable, as and by way of security for fulfillment of the obligations under the Regulations by the acquirers.

(11) The Board shall in case of non-fulfillment of obligations under the Regulations by the acquirer forfeit the escrow account either in full or in part.

(11A) In case of failure by the acquirer to obtain shareholders' approval required under sub-regulation (3) of regulation 20, the amount in escrow account may be forfeited.

(12) The escrow account deposited with the bank in cash shall be released only in the following manner,

(a) the entire amount to the acquirer upon withdrawal of offer in terms of Regulation 27 upon certification by the merchant banker;

(b) for transfer to the special account opened in terms of sub-regulation(1) of Regulation 29.

Provided the amount so transferred shall not exceed 90% of the cash deposit made under clause (a) of sub-regulation(2) of this regulation.

(c) to the acquirer, the balance of 10 percent of the cash deposit made under clause (a) of sub-Regulation(2) of this Regulation or the cash deposit made under sub of this Regulation, on completion of all obligations under the Regulations, and upon certification by the merchant banker;

(d) the entire amount to the acquirer upon completion of all obligations under the Regulations, upon certification by the merchant banker, where the offer is for exchange of shares or other secured instruments;

(e) the entire amount to the merchant banker, in the event of forfeiture for non-fulfillment of any of the obligations under the Regulations, for distribution among the target company, the regional stock exchange and to the shareholders who had accepted the offer in the following manner, after deduction of expenses, if any, of the merchant banker and the registrars to the offer,

(i) one third of the amount to the target company;

(ii) one third of the amount to the regional stock exchange for credit of the investor protection fund or any other similar fund for investor education, research, grievance redressal and similar such purposes as may be specified by the Board from time to time;

(iii) residual one third to be distributed pro-rata among the shareholders who have accepted the offer.

(13) In the event of non-fulfillment of obligations by the acquirer, the merchant banker shall ensure realization of escrow amount by way of foreclosure of deposit, invocation of bank guarantee or sale of securities and credit proceeds thereof t o the regional stock exchange of the target company, for the credit of the Investor Protection Fund or any other similar fund.

Payment of Consideration

29. (1) For the amount of consideration payable in cash, the acquirer shall, within a period of seven days from the date of closure of the offer, open a special account with a Bankers to an Issue registered with the Board and deposit therein, such sum as would, together with 90% of the amount lying in the escrow account, if any, make up the entire sum due and payable to the shareholders as consideration for acceptances received and accepted in terms of these Regulations and for this purpose, transfer the funds from the escrow account.

(2) The unclaimed balance lying to the credit of the account referred in sub-regulation (1) at the end of 3 years from the date of deposit thereof shall be transferred to the investor protection fund of the regional stock exchange of the target company.

(3) In respect of consideration payable by way of exchange of securities, the acquirer shall ensure that the securities are actually issued and dispatched to the shareholders.

Relaxation from the Strict Compliance of Provisions of Chapter III in Certain Cases

29A. The Board may, on an application made by a target company, relax any or more of the provisions of this Chapter, subject to such conditions as it may deem fit, if it is satisfied that –

(a) The Central Government or State Government or any other regulatory authority has removed the board of directors of the target company and has appointed other persons to hold office as directors thereof under any law for the time being in force for orderly conduct of the affairs of the target company;

(b) such directors have devised a plan which provides for transparent, open, and competitive process for continued operation of the target company in the interests of all stakeholders in the target company and such plan does not further the interests of any particular acquirer;

(c) the conditions and requirements of the competitive process are reasonable and fair;

(d) the process provides for details including the time when the public offer would be made, completed and the manner in which the change in control would be effected;

(e) the provisions of this Chapter are likely to act as impediment to implementation of the plan of the target company and relaxation from one or more of such provisions is in public interest, the interest of investors and the securities market.

Chapter IV: Bail Out Takeovers

Bail Out Takeovers

30. (1) The provisions of this Chapter shall apply to a substantial acquisition of shares in a financially weak company not being a sick industrial company, in pursuance to a scheme of rehabilitation approved by a public financial institution or a scheduled bank; (hereinafter referred to as lead institution).

(2) The lead institution shall be responsible for ensuring compliance with the provisions of this Chapter.

(3) The lead institution shall appraise the financially weak company taking into account the financial viability, and assess the requirement of funds for revival and draw up the rehabilitation package on the principle of protection of interests of minority shareholders, good management, effective revival and transparency.

(4) The rehabilitation scheme shall also specifically provide the details of any change in management.

(5) The scheme may provide for acquisition of shares in the financially weak company in any of the following manner:

(a) outright purchase of shares, or

(b) exchange of shares, or

(c) combination of both.

Provided that the scheme as far as possible may ensure that after the proposed acquisition the erstwhile promoters do not own any shares in case such acquisition is made by the new promoters pursuant to such scheme.

Explanation: For the purpose of this chapter, the expression “financially weak company” means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50%but less than 100% of its net worth as at the beginning of the previous financial year, that is to say, of the sum total of the paid-up capital and free reserves.

Manner of Acquisition of Shares

31. (1) Before giving effect to any scheme of rehabilitation the lead institution shall invite offers for acquisition of shares from atleast three parties.

(2) After receipt of the offers under sub-regulation(1), the lead institution shall select one of the parties having regard to the managerial competence, adequacy of financial resources and technical capability of the person acquiring shares to rehabilitate the financially weak company.

(3) The lead institution shall provide necessary information to any person intending to make an offer to acquire shares about the financially weak company and particularly in relation to its present management, technology, range of products manufactured, shareholding pattern, financial holding and performance and assets and liabilities of such company for a period covering five years from the date of the offer as also the minimum financial and other commitments expected of from the person acquiring shares for such rehabilitation.

Manner of Evaluation of Bids

32. (1) The lead institution shall evaluate the bids received with respect to the purchase price or exchange of shares, track record, financial resources, reputation of the management of the person acquiring shares and ensure fairness and transparency in the process.

(2) After making evaluation as provided in sub-regulation(1), the offers received shall be listed in order of preference and after consultation with the persons in the affairs of the management of the financially weak company accept one of the bids.

Person Acquiring Shares to make an Offer

33. The person acquiring shares who has been identified by the lead institution under sub-regulation (2) of Regulation 32, shall on receipt of a communication in this behalf from the lead institution make a formal offer to acquire shares from the promoters or persons in charge of the affairs of the management of the financially weak company, financial institutions and also other shareholders of the company at a price determined by mutual negotiation between the person acquiring the shares and the lead institution.

Explanation: Nothing in this regulation shall prohibit the lead institution offering the shareholdings held by it in the financially weak company as part of the scheme of rehabilitation.

Person Acquiring Shares to Make Public Announcement

34. (1) The person acquiring shares from the promoters or the persons in charge of the management of the affairs of the financially weak company or the financial institution shall make a public announcement of his intention for acquisition of shares from the other shareholders of the company.

(2) Such public announcement shall contain relevant details about the offer including the information about the identity and background of the person acquiring shares, number and percentage of shares proposed to be acquired, offer price, the specified date, the date of opening of the offer and the period for which the offer shall be kept open and such other particulars as may be required by the board.

(3) The letter of offer shall be forwarded to each of the shareholders other than the promoters or the persons in charge of management of the financially weak company and the financial institutions.

(4) If the offer referred to in sub-regulation (1) results in the public shareholding being reduced to 10% or less of the voting capital of the company, the acquirer shall either –

(a) within a period of three months from the date of closure of the public offer, make an offer to buy out the outstanding shares remaining with the shareholders at the same offer price, which may have the effect of delisting the target company; OR

(b) undertake to disinvest through an offer for sale or by a fresh issue of capital to the public which shall open within a period of 6 months from the date of closure of public offer, such number of shares so as to satisfy the listing requirements.

(5) The letter of offer shall state clearly the option available to the acquirer under sub-regulation (4).

(6) For the purposes of computing the percentage referred to in the sub the voting rights as at the expiration of twenty days after the closure of the public offer shall be reckoned.

(7) While accepting the offer from the shareholders other than the promoters or persons in charge of the financially weak company or the financial institutions, the person acquiring shares shall offer to acquire from the individual shareholder his entire holdings if such holding is upto hundred shares of the face value of rupees ten each or ten shares of the face value of rupees hundred each.

Competitive Bid

35. No person shall make a competitive bid for acquisition of shares of the financially weak company once the lead institution has evaluated the bid and accepted the bid of the acquirer who has made the public announcement of offer for acquisition of shares from the shareholders other than the promoters or the persons in charge of the management of the financially weak company.

Exemption from the Operations of Chapter III

36. (1) Every offer which has been made in pursuance ofRegulation30 shall be accompanied with an application to the Board for exempting such acquisitions from the provisions of Chapter III of these Regulations.

(2) For considering such request the Board may call for such information from the company as also from the lead institution, in relation to the manner of vetting the offers, evaluation of such offers and similar other matters.

(3) Notwithstanding grant of exemption by the board, the lead institution or the acquirer as far as may be possible, shall adhere to the time limits specified for various activities for public offer specified in Chapter III.

Acquisition of Shares by a State Level Public Financial Institution

37. Where proposals for acquisition of shares in respect of a financially weak company is made by a state level public financial institution, the provisions of these Regulations in so far as they relate to scheme of rehabilitation prepared by a public financial institution, shall apply except that in such a case the Industrial Development Bank of India, a corporation established under the Industrial Development Bank of India Act, 1964 shall be the agency or ensuring the compliance of these Regulations for acquisition of shares in the financially weak company.

Chapter V: Investigation and Action by the Board

Board's Right to Investigate

38. The Board may appoint one or more persons as investigating officer to undertake investigation for any of the following purposes, namely:

(a) to investigate into the complaints received from the investors, the intermediaries or any other person on any matter having a bearing on the allegations of substantial acquisition of shares and takeovers;

(b) to investigate suo-moto upon its own knowledge or information, in the interest of securities market or investors interests, for any breach of the Regulations;

(c) to ascertain whether the provisions of the Act and the Regulations are being complied with.

Notice before Investigation

39. (1) Before ordering an investigation under Regulation38, the Board shall give not less than 10 days notice to the acquirer, the seller, the target company, the merchant banker, as the case may be.

(2) Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of the investors no such notice should be given, it may, by an order in writing direct that such investigation be taken up without such notice.

(3) During the course of an investigation, the acquirer, the seller, the target company, the merchant banker, against whom the investigation is being carried out shall be bound to discharge his obligation as provided in Regulation 40.

Obligations on Investigation by the Board

40. (1) It shall be the duty of the acquirer, the seller, the target company, the merchant banker whose affairs are being investigated and of every director, officer and employee thereof, to produce to the investigating officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to his activities as the investigating officer may require, within such reasonable period as the investigating officer may specify.

(2) The acquirer, the seller, the target company, the merchant banker and the persons being investigated shall allow the investigating officer to have reasonable access to the premises occupied by him or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the acquirer, the seller, the target company, the merchant banker or such other person and also provide copies of documents or other materials which, in the opinion of the investigating officer are relevant for the purposes of the investigation.

(3) The investigating officer, in the course of investigation, shall be entitled to examine or to record the statements of any director, officer or employee of the acquirer, the seller, the target company, the merchant banker.

(4) It shall be the duty of every director, officer or employee of the acquirer, the seller, the target company, the merchant banker to give to the investigating officer all assistance in connection with the investigation, which the investigating officer may reasonably require.

Submission of Report to the Board

41. The investigating officer shall, as soon as possible, on completion of the investigation, submit a report to the Board: Provided that if directed to do so by the Board, he may submit interim reports.

Communication of Findings

42. (1) The Board shall, after consideration of the investigation report referred to in Regulation 41, communicate the findings of the investigating officer to the acquirer, the seller, the target company, the merchant banker, as the case may be, and give him an opportunity of being heard.

(2) On receipt of the reply if any, from the acquirer, the seller, the target company, the merchant banker, as the case may be, the Board may call upon him to take such measures as the Board may deem fit in the interest of the securities market and for due compliance with the provisions of the Act and the Regulations.

Appointment of Auditor

43. Notwithstanding anything contained in this Regulation, the Board may appoint a qualified auditor to investigate into the books of account or the affairs of the person concerned: Provided that the auditor so appointed shall have the same powers of the investigating authority as stated inRegulation38 and the obligations of the person concerned in Regulation40 shall be applicable to the investigation under this Regulation.

Directions by the Board

44. Without prejudice to its right to initiate action under Chapter VIA and section 24 of the Act, the Board may, in the interest of securities market or for protection of interest of investors, issue such directions as it deems fit including:

(a) directing appointment of a merchant banker for the purpose of causing disinvestment of shares acquired in breach of regulations 10, 11 or12 either through public auction or market mechanism, in its entirety or in small lots or through offer for sale;

(b) directing transfer of any proceeds or securities to the investors protection Fund of a recognized stock exchange;

(c) directing the target company or depository to cancel the shares where an acquisition of shares pursuant to an allotment is in breach ofregulations10,11 or 12;

(d) directing the target company or the depository not to give effect to transfer or further freeze the transfer of any such shares and not to permit the acquirer or any nominee or any proxy of the acquirer to exercise any voting or other rights attached to such shares acquired in violation of regulations 10, 11 or 12;

(e) debarring any person concerned from accessing the capital market or dealing in securities for such period as may be determined by the Board;

(f) directing the person concerned to make public offer to the shareholders of the target company to acquire such number of shares at such offer price as determined by the Board;

(g) directing disinvestment of such shares as are in excess of the percentage of the shareholding or voting rights specified for disclosure requirement under the regulations 6,7 or 8;

(h) directing the person concerned not to dispose of assets of the target company contrary to the undertaking given in the letter of offer;

(i) directing the person concerned, who has failed to make a public offer or delayed the making of a public offer in terms of these Regulations, to pay to the shareholders, whose shares have been accepted in the public offer made after the delay, the consideration amount along with interest at the rate not less than the applicable rate of interest payable by banks on fixed deposits.

Manner of Service of Summons and Notices Issued by the Board

44A. A summons, notice issued by the Board under these regulations may be served in the manner provided in regulation 22 of the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002.

Penalties for Non-compliance

45. (1) Any person violating any provisions of the Regulations shall be liable for action in terms of the Regulations and the Act.

(2) If the acquirer or any person acting in concert with him, fails to carry out the obligations under the Regulations, the entire or part of the sum in the escrow amount shall be liable to be forfeited and the acquirer or such a person shall also be liable for action in terms of the Regulations and the Act.

(3) The board of directors of the target company failing to carry out the obligations under the Regulations shall be liable for action in terms of the Regulations and Act.

(4) The Board may, for failure to carry out the requirements of the Regulations by an intermediary, initiate action for suspension or cancellation of registration of an intermediary holding a certificate of registration under section 12 of the Act.

Provided that no such certificate of registration shall be suspended or cancelled unless the procedure specified in the Regulations applicable to such intermediary is complied with.

(5) For any mis-statement to the shareholders or for concealment of material information required to be disclosed to the shareholders, the acquirers or the directors where he acquirer is a body corporate, the directors of the target company, the merchant banker to the public offer and the merchant banker engaged by the target company for independent advice would be liable for action in terms of the Regulations and the Act.

(6) The penalties referred to in sub-regulation (1) to (5) may include –

(a) criminal prosecution under section 24 of the Act;

(b) monetary penalties under section 15 H of the Act;

(c) directions under the provisions of Section 11B of the Act.

(d) directions under section 11(4) of the Act;

(e) cease and desist order in proceedings under section 11D of the Act;

(f) adjudication proceedings under section 15HB of the Act.

Appeal to the Securities Appellate Tribunal

46. Any person aggrieved by an order of the Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, (i.e., after 16thDecember 1999), under these regulations may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter.

Repeal and Saving

47. (1) The Securities and Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 are hereby repealed.

(2) Notwithstanding such repeal:

(a) Anything done or any action taken or purported to have been done or taken including approval of letter of offer, exemption granted, fees collected any adjudication, enquiry or investigation commenced or show cause notice issued under the said regulations shall be deemed to have been done or taken under the corresponding provisions of these regulations;

(b) Any application made to the Board under the said regulations and pending before it shall be deemed to have been made under the corresponding provisions of these regulations;

(c) Any appeals preferred to the Central Government under the said regulations and pending before it shall be deemed to have been preferred under the corresponding provisions of these regulations.

Format for filing the information with SEs by acquirer as required u/r 3(3)

Name of the Target Company (T.C)				
Name of acquirer(s) alongwith PAC {Referred together as "acquirers" hereinafter}				
Share holding / voting rights of acquirer(s) in T.C	Before the said Acquisition	Proposed after the said Acquisition		
	No of shares	% (shares/voting rights)	No of shares	% (shares /voting rights)
Type of acquisition (By way of public /rights /preferential allotment/inter-se-transfer) Please specify				
In case, the acquisition is by way of inter-se transfer as per regulations, disclose names of transfer or send their share holding in T.C before transfer				
No and % of shares / voting rights of T.C proposed to be acquired through the acquisition.				
Acquisition price per share				
Date of proposed acquisition				

THE PROVISIONS UNDER THE COMPETITION ACT, 2002

In line with the international trend and to cope with changing realities, India has reviewed the Monopolies and Restrictive Trade Practices Act, 1969 and enacted the Competition Act, 2002 with the many innovations w.e.f. 14.1.2003. The Act seeks to repeal the M.R.T.P. Act.

The main provisions of the Act are:

A. The following transactions are out of the scope of mergers or acquisitions under the Act.

   i. If a receiver or liquidator or an underwriter or a jobber acquires more rights in undertaking.

   ii. All of the undertakings involved in the merger or acquisition are directly or indirectly, under the control of the same undertaking.

   iii. If an undertaking which carries out transaction and deals in securities for its own account or for the accounts of others acquires control of other undertakings.

B. The deal must be completed with in 12 months from the date on which merger is announced, exceptions are available to some specific cases.

C. The Act imposes rules on the Authority on approval of the deals.

(1) For the purposes of this Act, a merger or acquisition occurs if –

(a) 2 or more undertakings, previously independent of one another, merge, or

(b) one or more individuals or other undertakings who or which control one or more undertakings acquire direct or indirect control of the whole or part of one or more other undertakings, or

(c) the result of an acquisition by one undertaking (the "first undertaking") of the assets, including goodwill, (or a substantial part of the assets) of another undertaking (the "second undertaking") is to place the first undertaking in a position to replace (or substantially to replace) the second undertaking in the business or, as appropriate, the part concerned of the business in which that undertaking was engaged immediately before the acquisition.

(2) For the purposes of this Act, control, in relation to an undertaking, shall be regarded as existing if, by reason of securities, contracts or any other means, or any combination of securities, contracts or other means, decisive influence is capable of being exercised with regard to the activities of the undertaking and, in particular, by –

(a) ownership of, or the right to use all or part of, the assets of an undertaking, or

(b) rights or contracts which enable decisive influence to be exercised with regard to the composition, voting or decisions of the organs of an undertaking.

(3) For the purposes of this Act, control is acquired by an individual or other undertaking if he or she or it –

(a) becomes holder of the rights or contracts, or entitled to use the other means, referred to in *subsection (2)*, or

(b) although not becoming such a holder or entitled to use those other means, acquires the power to exercise the rights derived therefrom.

(4) The creation of a joint venture to perform, on an indefinite basis, all the functions of an autonomous economic entity shall constitute a merger falling within *subsection (1)(b)*.

(5) In determining whether influence of the kind referred to in *subsection (2)* is capable of being exercised regard shall be had to all the circumstances of the matter and not solely to the legal effect of any instrument, deed, transfer, assignment or other act done or made.

(6) For the purposes of this Act, a merger or acquisition shall not be deemed to occur if –

(a) the person acquiring control is a receiver or liquidator acting as such or is an underwriter or jobber acting as such, or

(b) all of the undertakings involved in the merger or acquisition are, directly or indirectly, under the control of the same undertaking, or

(c) control is acquired solely as a result of a testamentary disposition, intestacy or the right of survivorship under a joint tenancy, or

(d) control is acquired by an undertaking referred to in *subsection (7)* in the circumstances specified in *subsection (8)*.

(7) The undertaking mentioned in *subsection (6)(d)* is an undertaking the normal activities of which include the carrying out of transactions and dealings in securities for its own account or for the account of others.

(8) The circumstances mentioned in *subsection (6)(d)* are that the control concerned is constituted by the undertaking's holding, on a temporary basis, securities acquired in another undertaking and any exercise by the undertaking of voting rights in respect of those securities, whilst that control subsists, is for the purpose of arranging for the disposal, within the specified period, of all or part of the other undertaking or its assets or securities and not for the purpose of determining the manner in which any activities of the other undertaking, being activities that could affect competition in markets for goods or services in the State, are carried on.

(9) In *subsection (8)* "specified period" means –

(a) the period of 1 year from the date on which control of the other undertaking was acquired, or

(b) if in a particular case the undertaking shows that it is not reasonably possible to effect the disposal concerned within the period referred to in *paragraph (a)*, within such longer period as the Authority determines and specifies with respect to that case.

18. **Obligations to notify certain mergers and acquisitions**

(1) Where a merger or acquisition is agreed or will occur if a public bid that is made is accepted and –

(a) in the most recent financial year –

(i) the world-wide turnover of each of 2 or more of the undertakings involved in the merger or acquisition is not less than €40,000,000,

(ii) each of 2 or more of the undertakings involved in the merger or acquisition carries on business in any part of the island of Ireland, and

(iii) the turnover in the State of any one of the undertakings involved in the merger or acquisition is not less than €40,000,000,

or

(b) the merger or acquisition falls within a class of merger or acquisition specified in an order under *subsection (5)*, each of the undertakings involved in the merger or acquisition shall notify the Authority in writing of the proposal to put the merger or acquisition into effect, and provide full details thereof, within 1 month after the conclusion of the agreement or the making of the public bid.

(2) For the purpose of *subsection (1)* –

(a) "turnover" does not include any payment in respect of value-added tax on sales or the provision of services or in respect of duty of excise,

(b) subject to *paragraph (c)* an undertaking shall not be deemed to be involved in a merger or acquisition by virtue only of its being the vendor of any securities or other property involved in the merger or acquisition, and

(c) in relation to a merger or acquisition that will occur by reason of the acquisition concerned being an acquisition referred to in *section 16(1)(c)* –

(i) subparagraphs (i) and (iii) of paragraph (a) of subsection (1), in their application to the second-mentioned undertaking in *section 16*(1)(c), shall apply as if the references in them to the world-wide turnover and turnover in the State were, in relation to that undertaking, references, respectively, to the world-wide turnover and turnover in the State generated from the assets of that undertaking that are the subject of the acquisition mentioned in *section 16*(1)(c), and

(ii) notwithstanding *paragraph (b)*, that second-mentioned undertaking shall, for the purposes of *paragraph (a)* or *(b)* of *subsection (1)* but not so as to place on it an obligation to notify the Authority of the proposal to put the merger or acquisition into effect, be deemed to be involved in the merger or acquisition.

(3) If –

(a) 2 or more undertakings agree to a merger or acquisition, or

(b) a merger or acquisition will occur if a public bid that is made is accepted, being in either case a merger or acquisition to which *subsection (1)* does not apply, any of the undertakings which have agreed to or are involved in the merger or acquisition may notify the Authority in writing of the proposal to put the merger or acquisition into effect, and provide full details thereof, within 1 month after the conclusion of the agreement or the making of the public bid.

(4) Nothing in this section or any other provision of this Act prejudices the operation of Council Regulation (EEC) No. 4064/89 on the control of concentrations between undertakings.

(5) Where he or she is of opinion that the exigencies of the common good so warrant, the Minister may, after consultation with the Authority, by order specify a class or classes of merger or acquisition for the purposes of *subsection (1)(b)*.

(6) The Minister may by order amend or revoke an order under *subsection (5)* or a previous order under this subsection.

(7) Every order under this section shall have effect on and from the date on which it is made and shall be laid before each House of the Oireachtas as soon as may be after it is made; if a resolution confirming the order is not passed by each such House within the next 21 days after that House has sat after the order is laid before it, the order shall lapse, but without prejudice to the validity of anything previously done thereunder.

(8) A notification in accordance with this section shall be accompanied by such fee as may be prescribed and different fees may be prescribed for different classes of notification; if the notification is not accompanied by that fee the notification shall be invalid.

(9) Where there is a contravention of *subsection (1)* or *section 20(2)* the person in control of an undertaking which has failed to notify the Authority within the specified period or failed to supply the information required within the period specified by the Authority, as the case may be, shall be guilty of an offence and shall, subject to *subsection (10)*, be liable –

(a) on summary conviction, to a fine not exceeding €3,000,

(b) on conviction on indictment, to a fine not exceeding €250,000.

(10) *Subsection (9)* operates so that if the contravention concerned continues one or more days after the date of its first occurrence, the person referred to in that subsection is guilty of a separate offence under that subsection for each day that the contravention occurs; but in respect of the second or subsequent offence of which he or she is guilty by reason of that continued contravention, *subsection (9)* shall have effect as if –

(a) in *paragraph (a)*, "€300" were substituted for "€3,000",

(b) in *paragraph (b)*, "€25,000" were substituted for "€250,000".

(11) For the purposes of *subsection (9)* the person in control of an undertaking is –

(a) in the case of a body corporate, any officer of the body corporate who knowingly and wilfully authorises or permits the contravention,

(b) in the case of a partnership, each partner who knowingly and wilfully authorises or permits the contravention,

(c) in the case of any other form of undertaking, any individual in control of that undertaking who knowingly and wilfully authorises or permits the contravention.

(12) A notification for the purposes of *subsection (1)* or *(3)* shall not be valid where any information provided or statement made under *subsection (1)* or *(3)* or *section 20(2)* is false or misleading in a material respect, and any determination under this Part made on foot of such notification is void.

(13) The transmission to the Authority by the Commission of a copy of a notification made to the Commission under Council Regulation (EEC) No. 4064/89 on the control of concentrations between undertakings shall constitute a notification under *subsection (1)* in relation to the merger or acquisition concerned.

(14) Irrespective of the date on which the Commission transmits a copy of the notification referred to in *subsection (13)*, the date of receipt by the Authority of the Commission's decision under Council Regulation No. 4064/89 in relation to the merger or acquisition, the subject of the notification, shall be deemed to be the date of the notification for the purposes of this Act.

19. **Limitation on merger or acquisition being put into effect**

(1) A merger or acquisition to which paragraph (a) or (b) of *section 18*(1) applies, or which is referred to in subsection (3) of *section 18* and has been notified to the Authority in accordance with that subsection, shall not be put into effect until –

(a) subject to *subsection (3)*, the Authority, in pursuance of *section 21* or *22*, has determined that the merger or acquisition may be put into effect, or

(b) the Authority has made a conditional determination in relation to the merger or acquisition, or

(c) subject to *subsection (4)*, the period specified in *subsection (2)* of *section 21* has elapsed without the Authority having informed the undertakings which made the notification concerned of the determination (if any) it has made under *paragraph (a)* or *(b)* of that *subsection (2)*, or

(d) subject to *subsection (5)*, 4 months after the appropriate date have elapsed without the Authority having made a determination under *section 22* in relation to the merger or acquisition, whichever first occurs.

(2) Any such merger or acquisition which purports to be put into effect, where that putting into effect contravenes *subsection (1)*, is void.

(3) Notwithstanding *subsection (1)(a)*, the determination referred to in that provision shall not operate to permit the merger or acquisition concerned to be put into effect if the merger or acquisition is not put into effect before the expiry of the period of 12 months after the date on which the determination is made.

(4) Notwithstanding *subsection (1)(c)*, the failure by the Authority to inform the undertakings concerned of the matter referred to in that provision shall not operate to permit the merger or acquisition concerned to be put into effect if the merger or acquisition is not put into effect before the expiry of the period of 13 months after the appropriate date.

(5) Notwithstanding *subsection (1)(d)*, the absence of a determination by the Authority in the circumstances referred to in that provision shall not operate to permit the merger or acquisition concerned to be put into effect if the merger or acquisition is not put into effect before the expiry of the period of 16 months after the appropriate date.

(6) In this section “appropriate date” means –

(a) unless *paragraph (b)* applies, the date of receipt by the Authority of the notification of the merger or acquisition concerned under *section 18*,

(b) if the Authority has, under *section 20(2)*, made, within 1 month from the date of receipt by it of the notification of the merger or acquisition concerned under *section 18*, a requirement or requirements of one or more of the undertakings concerned –

(i) the date on which the requirement is complied with or, in case 2 or more requirements are made and each is complied with, whichever of the dates on which the requirements are complied with is the later or latest,

(ii) where the requirement is not complied with or each of the 2 or more requirements is not complied with, the date immediately following the expiry of the period specified in the requirement or, as the case may be, the date immediately following the expiry of whichever of the respective periods specified in the requirements is the last to expire, or

(iii) in case 2 or more requirements are made but one or more but not all of them are complied with, the later or latest of the following dates, namely the dates provided by applying –

(i) *subparagraph (i)* to the requirement or requirements complied with, and

(ii) *subparagraph (ii)* to the requirement or requirements not complied with.

(7) The reference in the definition of “appropriate date” in *subsection (6)* to the period specified in a requirement is a reference to the period specified in the requirement as being the period within which the information concerned shall be supplied.

(8) For the purpose of the reference in *subsection (6)*, and in any other provision of this Act, to the date on which the Authority receives a notification under *section 18*, if a single notification is not made by all the undertakings concerned, the said reference shall be construed as a reference to the later or latest of the dates on which a notification of the merger or acquisition concerned under *section 18* is received by the Authority.

(9) Subsection (8) is without prejudice to *section 18*(14).

20. **Examination by Authority of notification**

(1) In respect of a notification received by it, the Authority –

(a) shall, unless the circumstances involving the merger or acquisition are such that the Authority considers it would not be in the public interest to comply with this paragraph –

(i) cause a notice of the notification to be published within 7 days after the date of receipt of it,

(ii) consider all submissions made, whether in writing or orally, by the undertakings involved in the merger or acquisition or by any individual or any other undertaking,

(b) may enter into discussions with the undertakings involved in the merger or acquisition or with any individual or any other undertaking with a view to identifying measures which would ameliorate any effects of the merger or acquisition on competition in markets for goods or services, and

(c) shall form a view as to whether the result of the merger or acquisition would be to substantially lessen competition in markets for goods or services in the State.

(2) Where the Authority is of the opinion that, in order to consider for the purposes of this Part a merger or acquisition, it requires further information it may, by notice in writing served on the undertaking, require any one or more of the undertakings concerned to supply to it within a specified period specified information, and an undertaking of whom such a requirement is made shall comply with it.

(3) In the course of the Authority's activities under *subsection (1)(b)*, any of the undertakings involved in the merger or acquisition concerned may submit to the Authority proposals of the kind mentioned in *subsection (4)* with a view to the proposals becoming binding on it or them if the Authority takes the proposals into account and states in writing that the proposals form the basis or part of the basis of its determination under *section 21* or *22* in relation to the merger or acquisition.

(4) The proposals referred to in *subsection (3)* are proposals with regard to the manner in which the merger or acquisition may be put into effect or to the taking, in relation to the merger or acquisition, of any other measures referred to in *subsection (1)(b)*.

21. **Determination of issues concerned without full investigation, etc.**

(1) In this section "appropriate date" has the same meaning as it has in *section 19*.

(2) In respect of a notification received by it, the Authority shall, within 1 month after the appropriate date, inform the undertakings which made the notification and any individual or any other undertaking from whom

a submission concerning the notification was received of whichever of the following determinations it has made, namely –

(a) that, in its opinion, the result of the merger or acquisition will not be to substantially lessen competition in markets for goods or services in the State and, accordingly, that the merger or acquisition may be put into effect, or

(b) that it intends to carry out an investigation under *section 22* in relation to the merger or acquisition.

(3) Where the Authority makes a determination referred to in paragraph (a) or (b) of subsection (2), it shall publish that determination, with due regard for commercial confidentiality, within 2 months after the making of the determination.

(4) If any of the undertakings which have made the notification concerned submits to the Authority proposals to which *section 20*(3) applies, then subsection (2) shall have effect as if "45 days" were substituted for "1 month" in that subsection.

22. **Determination of issues concerned on foot of full investigation**

(1) In this section "appropriate date" has the same meaning as it has in *section 19*.

(2) Having considered a notification made to it, the Authority may decide that it shall carry out an investigation (in this section referred to as a "full investigation") in relation to the merger or acquisition concerned.

(3) On completion of a full investigation in relation to the merger or acquisition concerned, the Authority shall make whichever of the following determinations it considers appropriate, namely that the merger or acquisition –

(a) may be put into effect,

(b) may not be put into effect, or

(c) may be put into effect subject to conditions specified by it being complied with, on the ground that the result of the merger or acquisition will or will not, as the case may be, be to substantially lessen competition in markets for goods or services in the State or, as appropriate, will not be to substantially lessen such competition if conditions so specified are complied with.

(4) Where the Authority makes a determination under subsection (3), it shall reduce the determination to writing (and the determination in that form is referred to in paragraph (a) and subsection (7) as a "written determination") and –

(a) furnish to the undertakings which made the notification a copy of the written determination within 4 months after the appropriate date, and

(b) publish the determination, with due regard for commercial confidentiality, within 1 month after the making of the determination.

(5) A determination under subsection (3)(c) that the merger or acquisition may be put into effect subject to specified conditions being complied with is referred to in this section as a "conditional determination".

(6) A conditional determination shall include a condition requiring the merger or acquisition to be put into effect within 12 months after the making of the determination.

(7) A written determination under subsection (3) shall state the reasons for its making and shall include a report in relation to the full investigation.

(8) Before making a determination under subsection (3), the Authority shall have regard to any relevant international obligations of the State.

23. **Provisions with regard to media mergers**

(1) Within 5 days after the receipt by it of a notification in relation to a media merger, the Authority shall –

(*a*) forward a copy of the notification to the Minister, and

(*b*) notify the undertakings involved in the merger that it considers the merger to be a media merger.

(2) If the Authority makes a determination referred to in *section 21(2)(a)* in relation to a media merger it shall, immediately after doing so, inform the Minister of that fact and the Minister may, notwithstanding that determination, within 10 days after the date on which that determination is made, direct the Authority to carry out an investigation under *section 22* in relation to the merger.

(3) Upon such a direction being given –

(a) the determination referred to in *section 21(2)(a)* shall not operate to permit the media merger to be put into effect, and

(b) the Authority shall notify the undertakings involved in the merger that an investigation under *section 22* in relation to the merger will be carried out pursuant to the direction.

(4) Where the Authority makes a determination under *paragraph (a)* or *(c)* of *subsection (3)* of *section 22* in relation to a media merger it shall, immediately after doing so, inform the Minister of the determination and the Minister may within 30 days after the date of the making of that determination, notwithstanding that determination, having regard to, and only to, the relevant criteria, by order provide –

(a) that the merger may be put into effect,

(b) that the merger may be put into effect subject to specified conditions being complied with, or

(c) that the merger may not be put into effect.

(5) The Minister shall publish, with due regard for commercial confidentiality, a statement of the reasons for his or her making such an order within 2 weeks after the date on which the order is made.

(6) For the purpose of the exercise of the power under *subsection (4)*, the Minister may consider such submissions or observations from persons claiming to be interested in the matter as the Minister thinks proper.

(7) In addition to the functions conferred on it by *section 22* in relation to a merger or acquisition, the Authority shall, in dealing with a merger or acquisition under that section that is a media merger, form an opinion as to how the application of the relevant criteria should affect the exercise by the Minister of his or her powers under *subsection (4)* in relation to the merger.

(8) The Authority shall inform the Minister of the opinion it has so formed on request being made by the Minister of it to do so.

(9) The following provisions shall have effect on account of the additional procedures provided by the foregoing provisions in relation to media mergers:

(a) a media merger which could otherwise be put into effect upon a determination referred to in *section 21(2)(a)* being made in relation to it may not be put into effect until the expiry of 10 days after the date on which that determination is made,

(b) a determination under *section 22* in relation to a media merger shall not have effect until the expiry of 30 days after the date on which that determination is made and then only if, within that period, the Minister has not made an order under *subsection (4)* in relation to the merger or has stated in writing that he or she does not propose making such an order in relation to the merger.

(10) In this section –

"broadcasting service" means a service which comprises a compilation of program material of any description and which is transmitted or relayed by means of wireless telegraphy, a cable system or a multipoint microwave distribution system, a satellite device or any other transmission system, directly or indirectly for reception by the general public, whether that material is actually received or not, and includes a sound broadcasting service within the meaning of the Radio and Television Act, 1988, but does not include any such service (whether involving audio-visual material or audio material) that is provided by means of the system commonly known as the Internet;

"cable system" has the same meaning as it has in the Broadcasting Act, 2001;

"media business" means –

(a) a business of the publication of newspapers or periodicals consisting substantially of news and comment on current affairs,

(b) a business of providing a broadcasting service, or

(c) a business of providing a broadcasting services platform;

"media merger" means a merger or acquisition in which one or more of the undertakings involved carries on a media business in the State;

"program material" has the same meaning as it has in the Broadcasting Act, 2001;

"providing a broadcasting service" shall be construed in accordance with *subsection (11)*;

"providing a broadcasting services platform" shall be construed in accordance with *subsection (12)*;

"relevant criteria" means the following matters –

(a) the strength and competitiveness of media businesses indigenous to the State,

(b) the extent to which ownership or control of media businesses in the State is spread amongst individuals and other undertakings,

(c) the extent to which ownership and control of particular types of media business in the State is spread amongst individuals and other undertakings,

(d) the extent to which the diversity of views prevalent in Irish society is reflected through the activities of the various media businesses in the State, and

(e) the share in the market in the State of one or more of the types of business activity falling within the definition of "media business" in this subsection that is held by any of the undertakings involved in the media merger concerned, or by any individual or other undertaking who or which has an interest in such an undertaking.

(11) A reference in this section to providing a broadcasting service shall be construed as a reference to the doing of either or both of the following:

(a) supplying a compilation of program material for the purpose of its being transmitted or relayed as a broadcasting service,

(b) transmitting or relaying as a broadcasting service program material.

(12) A reference in this section to providing a broadcasting services platform shall be construed as a reference to the transmitting or re-transmitting of program material by means of wireless telegraphy, a cable system or a multipoint microwave distribution system, a satellite device or any other transmission system.

24. **Appeal to the High Court against determination of the Authority**

(1) An appeal may be made to the High Court against a determination of the Authority under *paragraph (b)* or *(c)* of *section 22(3)*.

(2) *Subsection (1)* does not apply to a determination made in relation to a media merger unless it is a determination that has effect by virtue of *section 23(9)* or *25(2)*.

(3) An appeal under this section –

(*a*) may be made by any of the undertakings which made the notification in relation to the merger or acquisition concerned, and

(*b*) shall be made within 1 month after the date on which the undertaking is informed by the Authority of the determination concerned or, in case the determination is one in relation to a media merger, after the expiry of the period specified in *Section 23(9)*.

(4) Any issue of fact or law concerning the determination concerned may be the subject of an appeal under this section but, with respect to an issue of fact, the High Court, on the hearing of the appeal, may not receive evidence by way of testimony of any witness and shall presume, unless it considers it unreasonable to do so, that any matters accepted or found to be fact by the Authority in exercising the relevant powers under *section 22* were correctly so accepted or found.

(5) Notwithstanding *subsection (4)*, the High Court, on the hearing of an appeal under this section, may receive evidence by way of the testimony of one or more witnesses if it considers it was unreasonable for the Authority to have accepted or found as a fact any matter concerned.

(6) Without limiting the exercise of the judicial function with respect to a particular case, it shall be the duty of the High Court, in so far as it is practicable, to hear and determine an appeal under this section within 2 months after the date on which the appeal is made to it.

(7) On the hearing of an appeal under this section, the High Court may, as it thinks fit –

(*a*) annual the determination concerned,

(*b*) confirm the determination concerned, or

(*c*) confirm the determination concerned subject to such modifications of it as the court determines and specifies in its decision.

(8) The High Court may, where it appears to the court that the circumstances so warrant, or shall, where the operation of *section 25(1)* results in an order under *section 23(4)* being annulled after the expiry of the period hereafter mentioned, extend the period mentioned in *subsection (3)(b)* in which an appeal under this section may be made to it.

(9) An appeal to the Supreme Court against a decision of the High Court under any of the foregoing provisions of this section shall lie only on a question of law.

25. **Laying of order under section 23(4) before Houses of the Oireachtas**

(1) An order under *section 23(4)* shall be laid before each House of the Oireachtas as soon as may be after it is made and, if a resolution annulling the order is passed by either such House within the next 21 days on which that House has sat after the order is laid before it, the order shall be annulled accordingly.

(2) If an order under *section 23(4)* is annulled pursuant to *subsection (1)* the determination made by the Authority under *section 22(3)* in relation to the media merger concerned shall, notwithstanding *section 23(9)* but without prejudice to the right of appeal under *section 24*, have effect.

26. **Enforcement of certain commitments, determinations and orders**

(1) In this section –

"commitment" means an obligation on the part of an undertaking arising by virtue of a proposal put forward by it being the subject of a statement in writing by the Authority such as is mentioned in *section 20(3)*;

"determination" means a determination of the Authority made under *section 21* or *22*;

"order" means an order made by the Minister under *section 23(4)*.

(2) It shall be lawful for a court of competent jurisdiction to grant an injunction on the motion of the Authority or of any other person to enforce compliance with the terms of a commitment, a determination or an order, for the time being in force.

(3) *Subsection (2)* shall not affect any other right of the Authority or other person to bring proceedings (whether civil or criminal) for the enforcement of compliance with the terms of a commitment, a determination or an order.

(4) A person who contravenes (whether by act or omission) a provision of a commitment, a determination or an order for the time being in force shall be guilty of an offence and shall be liable –

(*a*) on summary conviction, to a fine not exceeding €3,000 or to imprisonment for a term not exceeding 6 months or to both such fine and such imprisonment, or

(*b*) on conviction on indictment, to a fine not exceeding €10,000 or to imprisonment for a term not exceeding 2 years or to both such fine and such imprisonment.

(5) Every person who aids, abets or assists another person, or conspires with another person, to do anything (whether by way of act or of omission) the doing of which is an offence by virtue of *subsection (4)* shall himself or herself be guilty of an offence under this Section and shall be liable to be proceeded against and punished as if he or she were guilty of the first-mentioned offence.

(6) Where an offence under *subsection (4)* or *(5)* which is committed by a body corporate or by a person purporting to act on behalf of a body corporate or an unincorporated body of persons is proved to have been so committed with the consent or connivance of, or to be attributable to any neglect on the part of, any person who is a director, manager,

secretary, member of the committee of management or other controlling authority of any such body, or who is any other similar officer of any such body, that person shall also be guilty of an offence and shall be liable to be proceeded against and punished as if he or she was guilty of the first-mentioned offence.

(7) *Subsections (4), (5)* and *(6)* operate so that if the contravention concerned continues one or more days after the date of its first occurrence, the person referred to in the subsection concerned is guilty of a separate offence under that subsection for each day that the contravention occurs; but in respect of the second or subsequent offence of which he or she is guilty by reason of that continued contravention, *subsection (4)* shall have effect as if –

(a) in *paragraph (a)*, "€300" were substituted for "€3,000", and

(b) in *paragraph (b)*, "€1,000" were substituted for "€10,000".

(8) Summary proceedings in relation to an offence under this section may be brought by the Authority.

(9) Notwithstanding section 10(4) of the Petty Sessions (Ireland) Act, 1851, summary proceedings for an offence under this section may be instituted within 12 months after the day on which the offence was committed.

27. **Relationship between this Part and other Enactments**

(1) The Minister may make an order once, and once only, in each year, beginning with the year following the year in which this section is commenced, amending *subsection (1)(a)* of *section 18* by substituting for the monetary amount standing specified in *subparagraph (i)* or *(iii)* of that provision for the time being a monetary amount that is greater than that amount.

(2) In making an order under *subsection (1)*, the Minister shall have regard to, and only to, such economic data as the Minister considers to be relevant to the purpose.

(3) Every order under this section shall have effect on and from the date on which it is made and shall be laid before each House of the Oireachtas as soon as may be after it is made; if a resolution confirming the order is not passed by each such House within the next 21 days after that House has sat after the order is laid before it, the order shall lapse, but without prejudice to the validity of anything previously done thereunder.

28. **Relationship between this Part and other Enactments**

(1) Nothing in an enactment specified in *subsection (2)* prejudices the operation of this Part.

(2) The enactment mentioned in *subsection (1)* is an enactment (other than an enactment contained in this Part) that requires, in respect of the doing of the act or acts that comprise a merger or acquisition to which *paragraph (a)* or *(b)* of *section 18(1)* applies, the doing of that act or those acts to be either –

(*a*) sanctioned, whether such sanctioning takes the form of the making by a court of an order or the granting by a person of any other form of consent, or

(*b*) the subject of any form of registration of a resolution passed by one or more undertakings.

(3) Neither the giving of a sanction such as is referred to in *subsection (2)(a)* nor the carrying out of a registration such as is referred to in *subsection (2)(b)* shall be done or completed in relation to a merger or acquisition to which *paragraph (a)* or *(b)* of *section 18(1)* applies unless

and until no step remains to be taken, or power of any person or court or of either House of the Oireachtas remains to be exercised, under this Part, being a step or power the taking or exercising of which would, by virtue of this Part, prevent the merger or acquisition from being put into effect.

IMPLICATIONS UNDER THE INCOME TAX ACT, 1961

The incentive of carrying forward losses under the Income Tax (I-T) Act has also led to sick undertakings merging with healthy undertakings. As a consequence, the profits of the healthy units are adjusted against the losses of the sick units.

DEFINITION OF AMALGAMATION

According to Section 2(1B) of the Income Tax Act, 1961 (hereinafter referred to as the Act), amalgamation in relation to companies means the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that

- All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of amalgamation.
- All the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of amalgamation.
- Shareholders holding not less than 3/4th in value of the shares in amalgamating company or companies (other than shares held therein immediately before the amalgamation or by a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of distribution of such property to the other company after the winding up of first mentioned company.

TAX CONCESSIONS

If any amalgamation takes place within the meaning of Section 2(1B) of the Act, the following tax concession shall be available

- Tax concession to amalgamating company;
- Tax concession to shareholders of the amalgamating company;
- Tax concession to amalgamated company.

i. **Tax Concession to Amalgamating Company: Capital Gains Tax not Attracted:** According to Section 47(vi) where there is a transfer of any capital asset in the scheme of amalgamation, by an amalgamating company to the amalgamated company, such transfer will not be regarded as a transfer for the purpose of capital gain provided the amalgamated company, to whom such assets have been transferred, is an Indian company.

ii. **Tax Concessions to the Shareholders of an Amalgamating Company – Section 47(vii):** Whereas shareholder of an amalgamating company transfers his shares, in a scheme or amalgamation, such transaction will not regards as a transfer for capital gain purposes, if following conditions are satisfied:

   - The transfer of shares is made in consideration of the allotment to him of any share or shares in the amalgamated company;

- The amalgamated company is an Indian company;
- Cost of acquisition of such shares of the amalgamated company is later on transferred;
- The cost of acquisition of such shares of the amalgamated company shall be the cost or acquisition of the shares in the amalgamating company. Further, for computing the period of holding of such shares, the period for which such shares were held in the amalgamating company shall also be included.

iii. **Tax Concessions to the Amalgamated Company:** The amalgamated company shall be eligible for tax concessions only if the following two conditions are satisfied:

- The amalgamation satisfies all the three conditions laid down in section 2(1B);
- The amalgamated company is an Indian company;

If the above conditions are satisfied the amalgamated company shall be eligible for following tax concessions.

a. **Expenditure on Scientific Research – Section 35(5):** Where an amalgamating company transfers any asset represented by capital expenditure on the scientific research to the amalgamated Indian company in a scheme of amalgamation, the provisions of Section 35 which were applicable to the amalgamating company shall become applicable to the amalgamated company consequently.

- Unabsorbed capital expenditure on scientific research of the amalgamating company will be allowed to be carried forward and set off in the hands of the amalgamated company.
- If such asset ceases to be used in a previous year for scientific research related to the business of amalgamated company and is sold by the amalgamated company without having being used for other purposes, the sales price, to the extent of the cost of the asset shall be treated as business income other amalgamated company. The excess of the sale price over the cost of the asset shall be subjected to the provisions of the capital gains.

b. **Expenditure on Acquisition of patent rights or copy rights – Section 35A(6):** Where the patent or copyrights acquired by the amalgamating company is transferred to any amalgamated Indian company, the provisions of Section 35A which were applicable to the amalgamating company shall become applicable in the same manner to the amalgamated company consequently

- The expenditure on patents copyrights not yet written-off shall be allowed to the amalgamated company in the same number or balance installments.
- Where such rights are later on sold by the amalgamated company, the treatment of the deficiency/surplus will be same as would have been in the case of the amalgamating company.

However, if such expenditure is incurred by the amalgamating company after 31-3-1998, deduction under Section 35A is not allowed, as such expenditure will be eligible for depreciation as intangible asset. In this case, provisions of depreciation shall apply.

c. **Expenditure of Know-how – Section 35AB(3):** With effect from assessment year 2000-01, where there is a transfer of an undertaking under a scheme of amalgamation, the amalgamated company shall be entitled to claim deduction under Section 35AB in respect of such undertaking to the same extent and in respect of the residual period as it would have been allowable to the amalgamating company, had amalgamation not taken place.

However, if such expenditure is incurred by the amalgamating company after 31-3-1998, deduction under Section 35AB is not allowed, as such expenditure will be eligible for depreciation as intangible asset. In this case provisions of depreciation shall apply.

d. **Treatment of Preliminary Expenses – Section 35D(5):** Where an amalgamating company merges in a scheme of amalgamation with the amalgamated company, the amount of preliminary expenses of the amalgamating company, which are not yet written off, shall be allowed as deduction to the amalgamated company in the same manner as would have been allowed to the amalgamating company.

e. **Amortization of Expenditure in case of Amalgamation – Section 35DD:** Where an assessee, being an Indian company, incurs any expenditure, on or after the 1st day of April, 1999, wholly and exclusively for the purposes of amalgamation or demerger of an undertaking, the assessee shall be allowed a deduction of an amount equal to one-fifth of such expenditure for each of the five successive previous years beginning with the previous year in which the amalgamation or demerger takes place.

f. **Treatment of Capital Expenditure on Family Planning – Section 36(1)(ix):** Where the asset representing the capital expenditure on family planning is transferred by the amalgamating company to the Indian amalgamated company, in a scheme of amalgamation, the provisions of Section 36(a)(ix) to the amalgamating company shall become applicable in the same manner, the amalgamated company. Consequently

   - Such transfer shall not be regarded as transfer by the amalgamating company.
   - The capital expenditure on family planning not yet written off shall be allowable to the amalgamated company in the same number of balance installments.
   - Where such assets are sold by amalgamated company, the treatment of the deficiency/surplus will be same as would have been in the case of amalgamating company.

g. **Treatment of bad debts – Section 36(1)(vii):** Where due to amalgamation, the debts of amalgamating company have been taken over by the amalgamated company and subsequently such debt or part of the debt becomes bad, such bad debt will be allowed a deduction to the amalgamated company.

h. **Deduction available under – Section 80-IA or 80-IB:** Where an undertaking which is entitled to deduction under Section 80-IA/80-IB is transferred in the scheme of amalgamation before the expiry of the period of deduction under Section 80-IA or 80-IB then,

   - No deduction under Section 80-IA or 80-IB shall be available to the amalgamating company for the previous year in which amalgamation takes place, and
   - The provisions of Section 80-IA or 80-IB shall apply to the amalgamated company in such manner in which they would have applied to the amalgamating company.

i. **Carry forward and set off of business losses and unabsorbed depreciation of the amalgamating company:** Under the new provisions of Section 72A of the Act, the amalgamated company is entitled to carry forward the unabsorbed depreciation and brought forward loss of the amalgamating company provided the following conditions are fulfilled.

   - The amalgamation should be of a company owning an industrial undertaking or ship.

- The amalgamated company holds at least 3/4th of the book value of fixed assets of the amalgamating company for a continuous period of 5 years from the date of amalgamation.
- The amalgamated company continuous the business of the amalgamating company for period of 5 years from the date of amalgamation.
- The amalgamated company fulfills such other conditions, as may be prescribed to ensure that revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purposes.

It may be noted that in case of amalgamation, the amalgamated company gets a fresh lease of 8 years to carry forward and set-off the brought forward loss and unabsorbed depreciation for the amalgamating company.

SUMMARY

- In India, Mergers and Acquisitions are governed by various statutes some of which being the Companies Act 1956, the SEBI Takeover Regulations, and the Income Tax Act, 1961.
- The rules and regulations of the Government will make Mergers and Acquisitions an even more practical business strategy.
- In the Companies Act, 1956 the process of mergers or amalgamations is governed by Sections 391 to 394.
- The Companies Act requires approval of shareholders, creditors, financial institutions, high NCLT, and the Reserve Bank of India.
- SEBI the watch dog of stock markets in India also control the takeover activity. In 1994, SEBI announced a takeover code for the regulation of substantial acquisition of shares, aims at ensuring better transparency and minimizing the occurrence of concealed deals.
- In accordance with the regulations prescribed in the takeover code, on any acquisition in a company which results in the acquirer's aggregate shareholding exceeding 15%, the acquirer is required to make a public offer. The takeover code covers three types of takeovers – negotiated takeovers, open market takeovers and bail out takeovers.
- The Income Tax Act, 1961 provides for the treatment of income for tax purposes of both the amalgamating companies.

Chapter 17

Turnaround Management

After reading this chapter, you will be conversant with:

- Gauging the Danger Symptoms
- Choosing Appropriate Turnaround Strategy
- Implementation of the Change Process and its Monitoring
- Debt Restructuring
- Corporate Debt Restructuring Mechanism
- Nursing of Distressed Firms
- Liquidation of Firms
- Bankruptcy
- BIFR and Its Role

Many companies are in the danger of becoming distressed during economic crises. Growth is not only critical for improving corporate performance but also vital to weathering the crises. Restoring stability involves aggressive strategies – reorganization, restructuring, repositioning, and even bankruptcy – as well as significant legal, accounting, and financial ramifications. Turnaround management is one of the restructuring strategies. It involves the formulation and implementation of strategic plans and a course of action for organization renewal and restructuring that improves financial performance of the companies. In other words, turnaround management refers to the management measures which turn a sick-company back into a healthy one. Turnaround management usually requires strong leadership and can include an investigation of the root causes of failure, corporate restructuring and redundancies, and long-term programs to revitalize the organization. There are three phases in turnaround management. They are:

i. Gauging the danger symptoms,

ii. Choosing appropriate turnaround strategy, and

iii. Implementation of the change process and its monitoring.

GAUGING THE DANGER SYMPTOMS

A firm becomes sick gradually. Before a firm goes bankrupt, it shows a number of symptoms, which diagnosed and corrected in time, can save the firm.

Some of these symptoms are:

- **Production**
  - Low capacity utilization
  - High operating cost
  - Failure of production lines
  - Accumulation of finished goods.
- **Sales and Marketing**
  - Declining/Stagnant sales
  - Loss of distribution network to competitors.
- **Finance**
  - Increased borrowing at exorbitant rates
  - Increased borrowing against assets
  - Failure to pay term loans
  - Failure to pay current liabilities, salaries etc.
  - Failure to make statutory payments.
- **Human Resource Management**
  - Repeated turnover of key personnel
  - Tolerance of incompetence
  - Deteriorating work culture.
- **Others**
  - Autocratic rule and an unbalanced top management team
  - A declining trend in share price
  - Persistent cash losses
  - Frequent changes in accounting policies to enhance profits
  - Frequent change of accounting years for undeclared reasons.

PREDICTION OF SICKNESS OF THE COMPANY

As the incidents of sickness became more frequent, a need was felt to evolve techniques and methods to predict the failure of a firm. While symptoms listed earlier are good indicators of the financial health, they are not the best predictors of sickness. A number of models are available to accurately predict sickness of a firm. These models provide early warning signals, so that a potentially disastrous situation can be averted. Most of these techniques involve financial ratio analysis. A study has revealed that financial ratios are useful in accurately predicting the failure of a firm for a period up to 5 years before sickness. A number of Indian models are also available. Some of the models are discussed below.

International Models

- Beaver Model
- Wilcox Model
- Blum Marc's Failing Company Model
- Altman's Z Score Model
- Argenti Score Board.

Beaver Model

Beaver was the first to make a conscious effort to use financial ratios as predictors of failure. He defined failure as "inability of a firm to pay its financial obligations as they mature."

He used 30 ratios classified under six categories. Beaver tested these ratios to predict the failure of a company. The ratio of cash flow to total debt was found to be the best single predictor of failure. The study further revealed that financial ratios are useful in predicting failure at least five years prior to the event.

He described the company as a reservoir of financial resources and the probability of company failure in terms of the expected flow of these resources. The other things are being equal, on would expect that the probability of failure becomes more likely when;

- The reservoir is smaller. After all, a larger reservoir would be a better buffer against uncertainties,
- The inflow of resources from operations is smaller, in both the short-run and long-run,
- The claim on its resources by creditors is larger,
- The out flow of resources that is required by the operations of business is greater,
- The earnings and claims against the resources, represented by the outflows to maintain current operations and by the obligations to creditors, are more highly variable. After all, the less variable inflows and outflows are, the more likely future events can be predicted and/ or
- The industry segments of a firm's business activities are expected to be more failure-prone.

Wilcox Model

Wilcox proposed that the net liquidation value of a firm is the best indicator of its financial health. The net liquidation value can be obtained from the difference in liquidation value of a firm's assets and the liquidation value of its liabilities. Liquidation value is the market value of assets and liabilities, if liquidated at that point of study.

Blum Marc's Failing Company Model

Blum Marc's model predicts the financial health of a firm using 12 ratios divided into three groups: Liquidity ratios, Profitability ratios and Variability ratios. Using these ratios, Blum Marc tried to accurately predict failure and draw a distinction between bankrupt and non-bankrupt firms. He took 115 companies for study and groped those companies on the basis of investment in assets, type of industry, volume of sales, and number of employees.

Altman's Z Score Model

Altman improved upon the earlier models using ratio analysis to predict failure. Altman's model is based on the fact that various ratios when used in combinations, can have better predictive ability than when used individually. 22 ratios were considered in various combinations as predictors of failure. He used a statistical technique called the Multiple Discriminant Analysis (MDA) to distinguish between bankrupt and non-bankrupt firms.

Out of these 22 ratios, five ratios were selected as they were found to be better predictors of failure. Weights were given to these ratios on the basis of their significance to predict the health of the firm. He developed a discriminant score called the Z-score on the basis of these ratios.

Z	=	$1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 1.0X_5$
where,		
Z	=	Discriminant score
X_1	=	Working capital/Total assets
X_2	=	Retained earnings/Total assets
X_3	=	EBIT/Total assets
X_4	=	Market value of equity/Book value of debt
X_5	=	Sales/Total assets.

If Z score for a firm is less than 1.81, the firm is likely to go bankrupt. If Z score is more than 2.99, it is regarded as a healthy company. The range between 1.81 – 2.99 is treated as an area of ignorance.

Z Score	Classification
< 1.81	Bankrupt firm
1.81 – 2.99	Area of ignorance
> 2.99	Healthy firm

Argenti Score Board

J. Argenti, in his famous article 'Company Failure — Long Range Prediction is Not Enough', developed a scoreboard for evaluating the health of the firm. The model is based on numerical assessment of the weaknesses of the firm. The weaknesses are classified as defects (Management and Accounting), mistakes and symptoms. He has delineated a list of factors to be looked into along with the respective scores. All the scores are to be summed up. The cut-off point for a "healthy firm" is a score of 25. This model has been criticized for being "subjective" and "arbitrary". A firm which scores more than 25 is on the road to sickness. The lesser the score, the better the health of the firm.

Box 1		
Defects	In management – Score	
	8	The chief executive is an autocrat
	4	He is also the chairman
	2	Passive board – an autocrat will see to that
	2	Unbalanced board – too many engineers or too many finance types
	2	Weak finance director
	1	Poor management depth
	15	Poor response to change, old-fashioned product, obsolete factory, old directors, out-of-date marketing

	In accountancy –		
	3	No budgets or budgetary controls (to assess variance, etc.)	
	3	No cash flow plans, or not updated	
	3	No costing system. Cost and contribution of each product unknown	
Total Score	43	Pass should be less than	10
Mistakes	15	High leverage, firm could get into trouble by stroke of bad luck	
	15	Overtrading. Company expanding faster than its funding. Capital base too small or unbalanced for the size and type of business	
	15	Big project gone wrong. Any obligation which the company cannot meet if something goes wrong	
Total Score	45	Pass should be less than	15
Symptoms	4	Financial signs, such as Z-score, appear near failure	
	4	Creative accounting. Chief executive is the first to see signs of failure and, in an attempt to hide it from creditors and the banks, accounts are "glossed over" by, for instance, overvaluing stocks, using lower depreciation, etc. Skilled observers can spot these things	
	3	Non-financial signs, such as untidy offices, frozen salaries, chief executive "ill", high staff turnover, low morale, rumors	
Total Score	12		
Total possible score	100	Pass should be less than	25

Source: J. Argenti, "Company Failure – Long Range Prediction is Not Enough," Accountancy, August, 1977.

Indian Model

L.C. Gupta Model

L.C. Gupta's model was the first Indian model proposed to predict failure. He used 56 ratios and sought to determine the best set of ratios to predict failure. These were categorized as profitability ratios and balance sheet ratios. He applied these ratios to a sample of sick and non-sick companies and arrived at the best set of ratios. They are:

Profitability Ratios

- EBDIT/Net Sales
- OCF/Sales
- EBDIT/(Total Assets + Accumulated Depreciation)
- OCF/Total Assets
- EBDIT/(Interest + 0.25 Debt).

Balance Sheet Ratios

- Net Worth/Total Debt
- All Outside Liabilities/Tangible Assets.

Where,

EBDIT = Earnings Before Depreciation, Interest and Tax

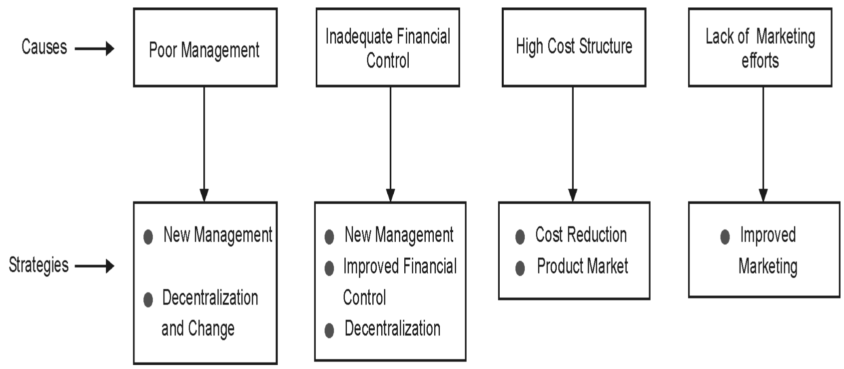
OCT = Operating Cash Flow

The model was found to have a high degree of accuracy in predicting sickness two to three years before failure.

CHOOSING APPROPRIATE TURNAROUND STRATEGY

Using the above analysis, if it is found that the firm is in trouble, it has to frame an appropriate turnaround strategy. Turnaround strategies help to strengthen the business and achieve good financial performance. Hoffer has identified choice of strategies that include changes in management, organizational process, improved financial control, growth via acquisition and new financial strategies in addition to strategic and operating turnaround suggested by him. The following figure depicts the causes of decline and the appropriate strategies required.

Figure 1



Some of the other turnaround strategies are:

- Selling off assets to raise cash are to save the remaining part of the business.
- Revising the existing strategy.
- Launching efforts to boost revenues.
- Pursuing cost reduction.
- Using a combination of these efforts.

These strategies are explained in detailed below:

Selling Off Assets: When generation of cash flow within the business becomes critical, the most appropriate strategy is asset-reduction. The most practical ways to generate cash are: (a) through sale of some of the firm's assets, and (b) through divestment, it includes pruning of marginal products from the product line, closing or selling older plants, reducing workforce, withdrawing from outlying markets, and cutting back customer service. Some companies may not sell off too much assets, but they will sell non-core business assets to support strategy renewal in the firm's core businesses.

Strategy Revision: When cause for weak performance is bad strategy, that strategy must be updated or modified to suit the present environment. The task of strategy overhaul can proceed along any of the following lines: (a) shifting to a new competitive approach to rebuild the firm's market position; (b) overhauling internal operations and functional area strategies to better support the same overall business strategy, (c) merging with another firm in the industry and forging a new strategy keyed to the newly merged firm's strengths; and (d) Focusing on a reduced core of products and customers more closely matched to the firm's strengths. This can be achieved by hiving off marginal/loss making product lines.

Boosting Revenues: This strategy aims at increasing sales volume. There are so many ways by which the firm can increase revenues. They are, price cuts, increased promotion, a bigger sales force, added customer services, and quickly achieved product improvements. Strategic decisions to increase revenues and sales volumes are necessary in those situations where there is no chance to cut expenses in operating budgets. If there are no price sensitive factors in the market based on the company's good product quality, then the firm may easily go for price increase strategy to boost short-term revenues instead of volume-building price cuts.

Cutting Costs: Cost-reducing turnaround strategies work best when an ailing firm's value chain and cost structure are flexible enough to permit radical surgery, when operating inefficiencies are identifiable and readily correctable, when the firm's costs are obviously bloated and there are many places where savings can be quickly achieved, and when the firm is relatively close to its break-even point. Accompanying a general belt-tightening can be an increased emphasis on paring administrative overheads, elimination of non-essential and low-value-added activities in the firm's value chain, modernization of existing plant and equipment to gain greater productivity, delay of non-essential capital expenditures, and debt restructuring to reduce interest costs and stretch out repayments.

Combination: This strategy is usually essential in grim situations that require fast action on a broad front. Likewise, combination actions frequently come into play when new managers are brought in and given a free hand to make whatever changes they see fit.

IMPLEMENTATION OF THE CHANGE PROCESS AND ITS MONITORING

Change in Leadership: Becoming sick causes loss of credibility at the top management level. Therefore, changing the leadership restores the confidence of stakeholders and shows the intention to change. However, when causes of decline are purely external factors or economic conditions, leadership change may have no effect on the turnaround process.

Forming the Team at the Top: During decline phase, most of the key managers may leave the firm creating a gap in the top management. That gap can be filled by retired senior managers or executives in junior and middle levels.

Change in Strategy: If the business is going sick, the management has to change its strategy. It has to evaluate the competitive environment and identify its strategies. It has to search for new triggers for business growth.

Divestment of Assets and Retrenchment of People: Downsizing manpower helps the organization to become more flexible to changes and is perceived as an essential activity to ease the cash flow problems at the initial stages. Effectiveness of downsizing tactics depends on whether the organization is undergoing a concurrent strategic reorientation or streamlining of operations.

Updating Technology: The sick firm has to update or modify its production technology. The new innovative technology reduces production cost and increases quality of the product. But technology change may not always be a feasible option available. Hence, the firm avoids more investment in upgradation of technology.

Financial Restructuring: Interest burden is one of the most important causes for decline in profitability. Turnaround requires adequate financial restructuring with the help of banks, financial institutions and in some cases from the parent company.

Organizational Change: Reallocation of people and structural changes to implement the strategic changes are also essential for successful turnarounds. Successful turnaround management involves both long-term strategic response and short-term operational response.

LIQUIDATION

Sometimes a business in trouble is too far gone to be salvaged or is not worth salvaging given the resources it will take and its profit prospects. Closing a crisis-ridden business down and liquidating its assets is sometimes the best and wisest strategy. Of all the strategic alternatives, liquidation is the most unpleasant and painful because of the hardships of job eliminations and the effects of business closings on local communities. Nonetheless, in hopeless situations, an early liquidation effort usually serves owner-stockholder interests better than an inevitable bankruptcy. Prolonging the pursuit of a lost cause merely exhausts an organization's resources further and leaves less to salvage, not to mention the added stress and potential career impairment for all the people involved. The problem, of course, is differentiating between when a turnaround is achievable and when it isn't. It is easy for owners or managers to let their emotions and pride overcome sound judgment when a business gets in such deep trouble and a successful turnaround is remote.

DEBT RESTRUCTURING

There are instances when companies find themselves in financial distress because of certain internal or external factors. Companies default on debt when the cash flows they receive are far below their expectations or when there is a slump in the demand for their goods or when the company performs badly or when the economy is sluggish or when the company's debtors default. In such conditions, companies restructure their debt to avoid default. Debt restructuring is a process, whereby, the corporates with outstanding debt obligations alter their debt agreements so as to continue their business operations devoid of any danger of debt repayment pressures. Corporate debt restructuring is important for the restoration of a distressed company. It is also cheaper than going for bankruptcy. However, the restructuring has to be done with due diligence so as to make the turnaround successful. The initial step in the process of restructuring is identifying and understanding the reasons of shortfall and/or the changed approach of the creditors so as to workout possible solutions. While doing a financial restructuring exercise, the new financial structure best suited for the business has to be evaluated. To attain a lower weighted average cost of capital and also to achieve further positive net cash flows, the debt/equity ratio has to be improved.

The debt structures in most of the restructuring cases are adapted to suit the expected future cash flows. This can be achieved with the help of reduced interest rates, deferred interest payments, and stretched out debt maturities.

During the restructuring process, often, corporates raise new capital; but here the task is to make these new securities interesting for the investors. Companies also issue warrants to the existing shareholders to encourage an optimistic market reaction to the new securities issue.While taking up debt restructuring, the best kind of equity and/or mix of debt and/or the amount of foreign currency have to be determined. Alternatives like issue of convertibles (Eg: FCCB), hybrids, mezzanine financing and issue of debt tranches which can be converted into equity have also to be considered.

***Corporate Debt Restructuring (CDR) System*:** Sometimes corporates find themselves in financial difficulty because of factors beyond their control and also due to certain internal reasons. For the revival of the corporates as well as for the safety of the money lent by the banks and Financial Institutions, timely support through restructuring in genuine cases is called for. However, delay in agreement amongst different lending institutions often comes in the way of such endeavors. Based on the experience in other countries like the U.K., Thailand, Korea, etc., of putting in place institutional mechanism for restructuring of corporate debt and need for a similar mechanism in India, a Corporate Debt Restructuring System was evolved, and detailed guidelines were issued by the Reserve Bank of India (RBI) on August 23, 2001, for implementation by banks. Based on the recommendations made by the Working Group under the head of Shri Vepa Kamesam, Deputy Governor, RBI, the 2001 guidelines were modified and reviewed guidelines were issued by the RBI on February 5, 2003.

The CDR system was established with the objective to ensure timely and transparent restructuring of corporate debts of viable entities facing problems, which are outside the purview of the Board for Industrial and Financial Reconstruction (BIFR), Debt Recovery Tribunal (DRT) and other legal proceedings. In particular, the system aimed at preserving viable corporates/businesses that are impacted by certain internal and external factors, thus minimizing the losses to the creditors and other stakeholders. The system has addressed the problems due to the rise of NPAs. Although CDR has been effective, it largely takes care of the interest of bankers and ignores (to some extent) the interests of other stakeholders. The secured lenders like banks and FIs, through CDR, merely address the financial structure of the company by deferring the loan repayment and aligning interest rate payments to suit the company's cash flows. The banks do not go for a one time large write-off of loans in the initial stages.

Scope of Corporate Debt Restructuring (CDR) System: The CDR Mechanism has been designed to facilitate restructuring of advances of borrowers enjoying credit facilities from more than one bank/Financial Institution (FI) in a coordinated manner. The CDR Mechanism is an organizational framework institutionalized for speedy disposal of restructuring proposals of large borrowers availing finance from more than one bank/FI. This mechanism will be available to all borrowers engaged in any type of activity subject to the following conditions:

i. The borrowers enjoy credit facilities from more than one bank/FI under multiple banking/syndication/consortium system of lending.

ii. The total outstanding (fund-based and non-fund based) exposure is Rs.10 crore or above.

CORPORATE DEBT RESTRUCTURING MECHANISM

CDR system has a three-tier structure:

- CDR Standing Forum and its Core Group,
- CDR Empowered Group,
- CDR Cell.

CDR Standing Forum and its Core Group: The CDR Standing Forum is the representative general body of all financial institutions and banks participating in the CDR system. All financial institutions and banks should participate in the system in their own interest. CDR Standing Forum will be a self-empowered body, which will lay down policies and guidelines, and monitor the progress of corporate debt restructuring. The Forum will also provide an official platform for both the creditors and borrowers (by consultation) to amicably and collectively evolve policies and guidelines for working out debt restructuring plans in the interest of all concerned. This Forum includes the Chairman & Managing Director of Industrial Development Bank of India Ltd, Chairman of State Bank of India, Managing Director & CEO of ICICI Bank Limited, Chairman of Indian Banks' Association as well as Chairperson and Managing Directors of all banks and financial institutions participating as permanent members in the system. Since institutions like Unit Trust of India, General Insurance Corporation, and Life Insurance Corporation may have assumed exposures on certain borrowers, these institutions may participate in the CDR system. The RBI would not be a member of the CDR Standing Forum and Core Group.

The Forum would elect its Chairman for a period of one year and the principle of rotation will be followed in the subsequent years. However, the Forum may decide to have a Working Chairman as a whole-time officer to guide and carry out the decisions of the CDR Standing Forum. The CDR Standing Forum shall meet at least once every six months and would review and monitor the progress of corporate debt restructuring system. The Forum would also lay down the policies and guidelines including those relating to the critical parameters for restructuring (for example, maximum period for a unit to become viable under a restructuring package, minimum level of promoters' sacrifice etc.) to be followed by the CDR Empowered Group and CDR Cell for debt restructuring and would ensure their smooth functioning and adherence to the prescribed time schedules for debt restructuring. It can also review any individual decisions of the CDR Empowered Group and CDR Cell. The CDR Standing Forum may also formulate guidelines for dispensing special treatment to those cases, which are complicated and are likely to be delayed beyond the time frame prescribed for processing.

A CDR Core Group will be carved out of the CDR Standing Forum to assist the Standing Forum in convening the meetings and taking decisions relating to policy, on behalf of the Standing Forum. This Group would lay down the policies and guidelines to be followed by the CDR Empowered Group and CDR Cell for debt restructuring. These guidelines shall also suitably address the operational difficulties experienced in the functioning of the CDR Empowered Group. The CDR Core Group shall also prescribe the PERT chart for processing of cases referred to the CDR system and decide on the modalities for enforcement of the time frame. The CDR Core Group shall also lay down guidelines to ensure that over-optimistic projections are not assumed while preparing/approving restructuring proposals especially with regard to capacity utilization, price of products, profit margin, demand, availability of raw materials, input-output-ratio and the likely impact of imports/international cost competitiveness.

CDR Empowered Group: The individual cases of corporate debt restructuring shall be decided by the CDR Empowered Group, consisting of ED level representatives of Industrial Development Bank of India Ltd., ICICI Bank Ltd. and State Bank of India as standing members, in addition to ED level representatives of financial institutions and banks who have an exposure to the concerned company. While the standing members will facilitate the conduct of the Group's meetings, voting will be in proportion to the exposure of the creditors only. In order to make the CDR Empowered Group effective and broadbased and operate efficiently and smoothly, it would have to be ensured that participating institutions/banks approve a panel of senior officers to represent them in the CDR Empowered Group and ensure that they depute officials only from among the panel to attend the meetings of the CDR Empowered Group. Further, nominees who attend the meeting pertaining to one account should invariably attend all the meetings pertaining to that account instead of deputing their representatives. The level of representation of banks/financial institutions on the CDR Empowered Group should be at a sufficiently senior level to ensure that the concerned bank/FI abides by the necessary commitments including sacrifices, made towards debt restructuring. There should be a general authorization by the respective Boards of the participating institutions/banks in favour of their representatives on the CDR Empowered Group, authorizing them to take decisions on behalf of their organization, regarding restructuring of debts of individual corporates.

The CDR Empowered Group will consider the preliminary report of all cases of requests of restructuring, submitted to it by the CDR Cell. After the Empowered Group decides that restructuring of the company is prima-facie feasible and the enterprise is potentially viable in terms of the policies and guidelines evolved by the Standing Forum, a detailed restructuring package will be worked out by the CDR Cell in conjunction with the Lead Institution. However, if the lead institution faces difficulties in working out the detailed restructuring package, the participating banks/financial institutions should decide upon the alternate institution/bank which would work out the detailed restructuring package at the first meeting of the Empowered Group when the preliminary report of the CDR Cell comes up for consideration.

The CDR Empowered Group would be mandated to look into each case of debt restructuring, examine the viability and rehabilitation potential of the Company and approve the restructuring package within a specified time frame of 90 days, or at best within 180 days of reference to the Empowered Group. The CDR Empowered Group shall decide on the acceptable viability benchmark levels on the following illustrative parameters, which may be applied on a case-by-case basis, based on the merits of each case:

- Return on Capital Employed (ROCE),
- Debt Service Coverage Ratio (DSCR),
- Gap between the Internal Rate of Return (IRR) and the Cost of Fund (CoF),
- Extent of sacrifice.

The Board of each bank/FI should authorize its Chief Executive Officer (CEO) and/or Executive Director (ED) to decide on the restructuring package in respect of cases referred to the CDR system, with the requisite requirements to meet the control needs. The CDR Empowered Group will meet on two or three occasions in respect of each borrowal account. This will provide an opportunity to the participating members to seek proper authorizations from their CEO/ED, in case of need, in respect of those cases where the critical parameters of restructuring are beyond the authority delegated to him/her. The decisions of the CDR Empowered Group shall be final. If restructuring of debt is found to be viable and feasible and approved by the Empowered Group, the company would be put on the restructuring mode. If restructuring is not found viable, the creditors would then be free to take necessary steps for immediate recovery of dues and/or liquidation or winding up of the company, collectively or individually.

CDR Cell: The CDR Standing Forum and the CDR Empowered Group will be assisted by a CDR Cell in all their functions. The CDR Cell will make the initial scrutiny of the proposals received from borrowers/creditors, by calling for proposed rehabilitation plan and other information and put up the matter before the CDR Empowered Group within one month to decide whether rehabilitation is prima facie feasible. If found feasible, the CDR Cell will proceed to prepare detailed Rehabilitation Plan with the help of the creditors and, if necessary, experts can be engaged from outside. If not found prima facie feasible, the creditors may start action for recovery of their dues. All references for corporate debt restructuring by creditors or borrowers will be made to the CDR Cell. It shall be the responsibility of the lead institution/major stakeholder to the corporate, to work out a preliminary restructuring plan in consultation with other stakeholders and submit to the CDR Cell within one month. The CDR Cell will prepare the restructuring plan in terms of the general policies and guidelines approved by the CDR Standing Forum and place for consideration of the Empowered Group within 30 days for decision. The Empowered Group can approve or suggest modifications but ensure that a final decision is taken within a total period of 90 days. However, for justified reasons, the period can be extended up to a maximum of 180 days from the date of reference to the CDR Cell. The CDR Cell will have adequate members of staff deputed from banks and financial institutions. The CDR Cell may also take outside professional help. The cost in operating the CDR mechanism including CDR Cell will be met from the contribution of the financial institutions and banks in the Core Group at the rate of Rs.50 lakh each and contribution from other institutions and banks at the rate of Rs.5 lakh each.

ELIGIBILITY CRITERIA FOR CORPORATE DEBT RESTRUCTURING (CDR)

The scheme will not apply to accounts involving only one financial institution or one bank. The CDR mechanism will cover only multiple banking accounts/ syndication/consortium accounts of corporate borrowers engaged in any type of activity with outstanding fund-based and non-fund based exposure of Rs.10 crore and above by banks and institutions. Two categories of debt restructuring facilities were available under the CDR system. Accounts, which are classified as ‘standard’ and ‘sub-standard’ in the books of the lenders, will be restructured under the first category (Category 1). Accounts which are classified as ‘doubtful’ in the books of the lenders would be restructured under the second category (Category 2).

Category 1 CDR System

The Category 1 CDR system will be applicable only to accounts classified as ‘standard’ and ‘sub-standard’. There may be a situation where a small portion of debt by a bank might be classified as doubtful. In that situation, if the account has been classified as ‘standard’/‘substandard’ in the books of at least 90% of creditors (by value), the same would be treated as standard / substandard, only for the purpose of judging the account as eligible for CDR, in the books of the remaining 10% of creditors. There would be no requirement of the account/company being sick, NPA or being in default for a specified period before reference to the CDR system. However, potentially viable cases of NPAs will get priority. This approach would provide the necessary flexibility and facilitate timely intervention for debt restructuring. Prescribing any milestone(s) may not be necessary, since the debt restructuring exercise is being triggered by banks and financial institutions or with their consent.

The accounts where recovery suits have been filed by the creditors against the company, may be eligible for consideration under the CDR system provided, the initiative to resolve the case under the CDR system is taken by at least 75% of the creditors by value and 60% of creditors by number.

BIFR cases are not eligible for restructuring under the CDR system. However, large value BIFR cases, may be eligible for restructuring under the CDR system if specifically recommended by the CDR Core Group. The Core Group shall recommend exceptional BIFR cases on a case-to-case basis for consideration under the CDR system. It should be ensured that the lending institutions complete all the formalities in seeking the approval from BIFR before implementing the package.

Category 2 CDR System

There have been instances where the projects have been found to be viable by the creditors but the accounts could not be taken up for restructuring under the CDR system as they fell under ‘doubtful’ category. Hence, a second category of CDR is introduced for cases where the accounts have been classified as ‘doubtful’ in the books of creditors, and if a minimum of 75% of creditors by value and 60% creditors by number satisfy themselves of the viability of the account and consent for such restructuring, subject to the following conditions:

i. It will not be binding on the creditors to take up additional financing worked out under the debt restructuring package and the decision to lend or not to lend will depend on each creditor bank/FI separately. In other words, under the proposed second category of the CDR mechanism, the existing loans will only be restructured and it would be up to the promoter to firm up additional financing arrangement with new or existing creditors individually.

ii. All other norms under the CDR mechanism such as the standstill clause, asset classification status during the pendency of restructuring under CDR, etc., will continue to be applicable to this category also.

Legal Status of CDR System

CDR is a non-statutory mechanism which is a voluntary system based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The Debtor-Creditor Agreement (DCA) and the Inter-Creditor Agreement (ICA) shall provide the legal basis to the CDR mechanism. All participants in the CDR mechanism through their membership of the Standing Forum shall have to enter into a legally binding agreement, with necessary enforcement and penal clauses, to operate the System through laid-down policies and guidelines. The ICA signed by the creditors will be initially valid for a period of 3 years and subject to renewal for further periods of 3 years thereafter. The lenders in foreign currency outside the country are not a part of the CDR system. Such creditors and also creditors like GIC, LIC, UTI, etc., who have not joined the CDR system, could join the CDR mechanism of a particular corporate by signing transaction to transaction ICA, wherever they have exposure to such corporate.

The Inter-Creditor Agreement would be a legally binding agreement amongst the creditors, with necessary enforcement and penal clauses, wherein the creditors would commit themselves to abide by the various elements of CDR system. Further, the creditors shall agree that if 75 percent of creditors by value and 60 percent of the creditors by number, agree to a restructuring package of an existing debt (i.e., debt outstanding), the same would be binding on the remaining creditors. Since Category 1 CDR Scheme covers only standard and sub-standard accounts, which in the opinion of 75 percent of the creditors by value and 60 percent of creditors by number, are likely to become performing after introduction of the CDR package, it is expected that all other creditors (i.e., those outside the minimum 75 percent by value and 60 percent by number) would be willing to participate in the entire CDR package, including the agreed additional financing.

In order to improve effectiveness of the CDR mechanism a clause may be incorporated in the loan agreements involving consortium/syndicate accounts whereby all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.

One of the most important elements of Debtor-Creditor Agreement would be 'stand still' agreement binding for 90 days, or 180 days by both sides. Under this clause, both the debtor and creditor(s) shall agree to a legally binding 'stand-still' whereby both the parties commit themselves not to take recourse to any other legal action during the 'stand-still' period. This would be necessary for enabling the CDR System to undertake the necessary debt restructuring exercise without any outside intervention, judicial or otherwise. However, the stand-still clause will be applicable only to any civil action either by the borrower or any lender against the other party and will not cover any criminal action. Further, during the stand-still period, outstanding foreign exchange forward contracts, derivative products, etc., can be crystallized, provided the borrower is agreeable to such crystallization. The borrower will additionally undertake that during the stand-still period, the documents will stand extended for the purpose of limitation and also that he will not approach any other authority for any relief and the directors of the borrowing company will not resign from the Board of Directors during the stand-still period.

Sharing of Additional Finance and Exit Option

Additional finance, if any, is to be provided by all creditors of a 'standard' or 'substandard account' irrespective of whether they are working capital or term creditors, on a pro-rata basis. The providers of additional finance, whether existing creditors or new creditors, shall have a preferential claim, to be worked out under the restructuring package, over the providers of existing finance with respect to the cash flows out of recoveries, in respect of the additional exposure.

A creditor (outside the minimum 75 percent and 60 percent) who for any internal reason does not wish to commit additional finance will have an option. At the same time, in order to avoid the "free rider" problem, it is necessary to provide some disincentive to the creditor who wishes to exercise this option. Such creditor can either (a) arrange for its share of additional finance to be provided by a new or existing creditor, or (b) agree to the deferment of the first year's interest due to it after the CDR package becomes effective. The first year's deferred interest as mentioned above, without compounding, will be payable along with the last installment of the principal due to the creditor.

In addition, the exit option will also be available to all lenders within the minimum 75 percent and 60 percent, provided the purchaser agrees to abide by the restructuring package approved by the Empowered Group. The exiting lenders may be allowed to continue with their existing level of exposure to the borrower provided they tie up with either the existing lenders or fresh lenders taking up their share of additional finance. The lenders who wish to exit from the package would have the option to sell their existing share to either the existing lenders or fresh lenders, at an appropriate price, which would be decided mutually between the exiting lender and the taking over lender. The new lenders shall rank on par with the existing lenders for repayment and servicing of the dues since they have taken over the existing dues to the exiting lender.

In order to bring more flexibility in the exit option, One Time Settlement can also be considered, wherever necessary, as a part of the restructuring package. If an account with any creditor is subjected to One Time Settlement (OTS) by a borrower before its reference to the CDR mechanism, any fulfilled commitments under such OTS may not be reversed under the restructured package. Further, payment commitments of the borrower arising out of such OTS may be factored into the restructuring package.

Recent CDR Examples

In the recent past, companies have looked at reduction of debt as an important way of improving profitability. For example, Maytas Infra Ltd., chalked out plans to restructure an overall Rs.1,700 crore outstanding debt. Another family promoted company, Wockhardt Ltd., went for CDR in the recent past. The promoter family held 74% stake in the company and pledged 79.21 percent of it with various banks and financial institutions. In December 2008, the total debt of the company was Rs.3,400 crore whereas its market capitalization was Rs.935.71 crore.

Box 2: Wockhardt gets CDR lifeline, with riders

Wockhardt Ltd gor clearance for the CDR by the Corporate Debt Restructuring (CDR) Empowered Group headed by ICICI Bank approved the package on June 30, 2009. "Restructuring of debt, release of working capital and fresh priority debt by banks pending divestment of non-core assets is a positive step forward and will provide a great impetus to the core operations of the company," as per the package, a priority loan of Rs 516 crore would be given by the CDR lenders, repayable in eight equal quarterly instalments starting September 15 next year. Wockhardt can also avail of an additional working capital of Rs 255 crore.

The foreign currency convertible bond (FCCBs) holders will have two options: Cash buyback or exchange of existing bonds with the preference shares of the company equivalent to the redemption value.

The company had to repay FCCBs worth $110 million, which were due for redemption in October, and external commercial borrowings of $250 million.

In the first option, the company will buy back the bonds only if the bondholders offer average discount in excess of 65 per cent of the redemption value of the bond.

By the second option, half of the preference shares will be optionally convertible to equity after October 25, 2015, at the then applicable Sebi formula. The balance will be given cumulative dividend and be redeemed at a premium of 38 per cent on December 31, 2018.

Source: http://www.business-standard.com/india/storypage.php?autono=363508

The sharp economic downturn and liquidity crunch, especially since October 2008, put enormous strain on the financial health of Indian companies, and the level of non-performing assets for banks is on the rise. The cases referred to the Corporate Debt Restructuring Cell increased to 34 at the end of March 2009, as against 10 at the end of 2007-08. In January 2009, Retailer Subhiksha Trading Services Ltd., had applied for CDR to a consortium of 13 banks from which it borrowed Rs.750 crore.

SME Debt Restructuring Mechanism

Apart from CDR Mechanism, the RBI has framed simpler mechanism for restructuring of loans availed by Small and Medium Enterprises (SMEs). Unlike in the case of CDR Mechanism, the operational rules of this mechanism have been left to be formulated by the banks concerned. SMEs Debt Restructuring mechanism will be applicable to all the borrowers which have funded and non-funded outstanding up to Rs.10 crore under multiple/consortium banking arrangement. Major elements of these arrangements are as under:

i. Under this mechanism, banks may formulate, with the approval of their Board of Directors, a debt restructuring scheme for SMEs within the prudential norms laid down by RBI. Banks may frame different sets of policies for borrowers belonging to different sectors within the SME if they so desire.

ii. While framing the scheme, banks may ensure that the scheme is simple to comprehend and will, at the minimum, include parameters indicated in these guidelines.

iii. The main plank of the scheme is that the bank with the maximum outstanding may work out the restructuring package, along with the bank having the second largest share.

iv. Banks should work out the restructuring package and implement the same within a maximum period of 90 days from the date of receipt of requests.

v. The SME Debt Restructuring Mechanism will be available to all borrowers engaged in any type of activity.

vi. Banks may review the progress in rehabilitation and restructuring of SME accounts on a quarterly basis and keep the Board informed.

NURSING OF DISTRESSED FIRMS

Nursing of a firm is a more sensible solution when faced with the possibility of bankruptcy as it will be in a better position to repay its debts, when it is alive and operating, than when it is liquidated. There are a number of cases of firms that have been successfully turned around from a state of hopeless bankruptcy.

In case, nursing is not a viable option and the firm no longer has the ability to operate and earn profits to pay-off its liabilities, liquidation is the only alternative available. All the assets are sold and the proceeds are distributed to creditors and other concerned parties.

In the Indian context, the decision to nurse/liquidate a firm vests with BIFR (Board of Industrial and Financial Reconstruction). The BIFR takes this decision based on a thorough techno-economic viability study of the firm in co-ordination with the management of the firm, the financial institutions, etc.

If the study reveals that it is possible for a sick industry to make its net worth exceed the accumulated losses by itself within a reasonable time, the BIFR may give the company the necessary time under conditions, to reorganize itself. In case BIFR decides that it is not possible for a sick company to make its net worth positive, it may decide to provide financial assistance, or alternatively, it may decide to wind up the company and forward its opinion to the concerned court.

The steps involved in reorganization of a firm are:

- Techno-economic viability study
- Formulation and execution of the reorganization plan
- Monitoring the activities of the firm.

Techno-economic Viability Study

A nursing plan is worked out on the basis of a techno-economic viability study of the firm. This study sets out to identify the strengths and weaknesses of the firm, the causes of failure, the viability of future operations and the course of action to be taken to bring about a turnaround. The techno-economic viability study is undertaken by the operating agencies assigned to the firm. These operating agencies are generally financial institutions and banks such as IDBI, IFCI, ICICI, IRBI, SBI, PNB, etc.

The techno-economic viability study covers all the functional areas of a firm: management, finance, production and marketing.

Management: The effectiveness and ability of the management is one of the most important factors that determines the success or failure of a firm. A detailed study is done in terms of the objectives of the firm, both short-term and long-term, the corporate strategy, the corporate culture, the management-labor relations, the organizational hierarchy, the decision-making process, etc. The study tries to determine the effectiveness of management and its integrity. The areas of mismanagement are also determined.

Finance: Finance is the main functional area of business. It is a measurable indicator of the firm's health and performance. A thorough analysis of the firm's Balance Sheet and Profit/Loss statement is made.

These statements when properly analyzed give the financial stability and liquidity of the firm; profitability and uses of funds. The analysis also identifies the capital structure and the sources of funds. The analysis gives insight into working capital management and management of earnings.

Production and Technology: Production and Technology function assumes immense importance in the viability study. The various areas that are looked into are, the firm's equipment and machinery, the maintenance of the equipment, the technology used in production, the production capacity and utilization, the products being offered by the firm, the quality control system, production planning and inventory control.

Marketing: A number of firms have failed because of lack of good marketing management. The various areas of marketing that are studied are, the product mix of the firm, the past sales of the product in terms of quantity and value, the market share of the firm, the demand for the product range, the study of the customer profile, the price of the products, the distribution channels being used, the kind of promotion-mix being used and the most important of all is the marketing team. This study is done in comparison with the competitors.

Formulation and Execution of the Plan

The viability study serves as the basis for formulation of a rehabilitation plan. A thorough study of the various functional areas of the firm reveals the strengths, weaknesses, opportunities and threats of the firm. It gives a comprehensive idea about the status of the firm, the viability of the firm both technically and economically and the additional funds required for rehabilitation.

The formulation plan involves the changes and action to be taken regarding the various functions of the firm. It may decide to make changes in the management, if it is not found competent. Some of the labor may be retrenched/recruited depending on the situation. The amount of financial assistance to be given is determined and arrangements are made to secure the loan. Various steps are taken to improve the production function in terms of new machinery and new technology. The viable level of operations are determined and steps are taken to achieve this production level. The product-mix, the pricing, the quality of the products, distribution channels and the promotion-mix are to be changed to suit the needs of the customers, to achieve the desired sales levels. Once the plan is formulated, the plan is carefully executed. All the necessary changes prescribed by the plan are made. The funds are disbursed in a phased manner as and when required. The necessary concessions and reliefs are provided. A close watch is kept on the activities of the firm and a continuous evaluation is done.

Monitoring

Monitoring is a very important part of a rehabilitation plan. It is done to evaluate the execution of the plan. Regular meetings are held between the firm, the bankers, the financial institutions and other concerned parties to verify and evaluate the process of execution. Monitoring is done to ensure the proper utilization of funds and adherence to the terms of rehabilitation plan. It also ensures the proper working of the firm. Feedback is obtained and remedial measures are taken as and when the situation demands. The impact of rehabilitation becomes evident in a short period. Once the success of the firm becomes evident, the role of agencies and banks is confined to constantly hold meetings to assess and review the process. This continues till the firm is successful. In case the firm is found incapable of making a turnaround despite the plan, then the steps to liquidate the firm are undertaken.

LIQUIDATION OF FIRMS

A firm is faced with liquidation when it is established that there is no hope of bringing about a turnaround and coming out of financial crisis. Liquidation requires the firm to dispose its claims and settle liabilities on a priority basis.

Section 425 of the Companies Act, 1956 gives the ways in which a company may be liquidated:

1. Compulsory winding-up under the Court order.
2. Voluntary winding-up; (a) members voluntary winding-up and (b) creditors voluntary winding-up.
3. Voluntary winding-up under supervision of the Court.

Section 433 of the Companies Act, 1956 gives the circumstances under which a company be wound-up by an order of the Court:

Compulsory Winding Up

- If the company passes a special resolution to wind-up by the court.
- If the firm fails in holding the statutory meeting or in delivering the statutory report to the registrar.
- If the firm fails to commence business within a year from its incorporation.
- Reduction in members of the company, below seven in case of a public company and below two in case of a private company.
- If it is unable to pay its debts.
- When the Court is of opinion that it is just and equitable that the firm be wound-up.

Voluntary Liquidation

Voluntary liquidation is a form of liquidation under which the firm and creditors come up with a creative plan to dispose off the liabilities in a manner that makes sense to everybody involved. This happens when the firm realizes that there is no hope of turnaround and liquidation is the only option that either occurs without the involvement of the court or under the supervision of the court.

Voluntary winding-up is of two kinds:

- **Members voluntary winding-up (Section 489):** In this case the majority of the directors declare that the company has no debts or will be able to pay its debts in full, within a certain period, not exceeding three years from commencing of winding up. The declaration must be delivered to the Registrar for registration, accompanied by a copy of the auditors' report, Profit and Loss Account and The Balance Sheet of the company. A liquidator is appointed and his remuneration is fixed by the company. The liquidator has to inform the Registrar of his appointment within thirty days and publish the fact in the official gazette. On the appointment of the liquidator, all the powers of the board of directors cease. The liquidator summons a creditors' meeting and winding-up procedure starts. Once the affairs of the company are fully wound-up, the liquidator makes a statement of the accounts of winding up. He calls a general meeting of the company and sends the accounts to the Registrar, who registers the documents and the company is deemed to be dissolved.
- **Creditors Winding-Up (Section 499):** In this case, the company calls a meeting of its creditors. The full statement of the position of the company's affairs and a list of the creditors of the company and the estimated amount of their claims is laid down in the meeting. A copy of the resolution passed at the creditors' meeting must be filed with the Registrar. A liquidator is appointed by the members of the board and the creditors. The creditors and the company may appoint 5 members each to a committee of inspection. The liquidator then follows the procedure of winding up which is essentially the same for all kinds of liquidation.

BANKRUPTCY

A firm is said to be bankrupt if it is unable to meet its current obligations to the creditors, and a company is insolvent if its assets are insufficient to meet its liabilities after the costs and expenses of the winding up have been paid. Bankruptcy may occur because of a number of external and internal factors.

The definition criteria that qualifies an Indian Company to be declared either as sick or potentially sick is captured below. The criteria differ for the SME, and Non-SME units.

Sick Industrial Company

The Sick Industrial Companies (Special Provisions) Act, 1985 or SICA defines a sick industry as "an industrial company (being a company registered for not less than five years) which has at the end of any financial year accumulated losses equal to or exceeding its net worth".

Weak Unit

A non-SSI industrial unit is defined as 'weak' if its accumulation of losses as at the end of any accounting year resulted in the erosion of fifty percent or more of its peak net worth in the immediately preceding four accounting years. It is clarified that weak units will not only include those which fall within the purview of Sick Industrial Companies (Special Provisions) Act, 1985 (of industrial companies) but also other categories such as partnership firms, proprietory concerns, etc. A weak Industrial Company should be termed as "potentially sick" company.

Sick SSI Unit

A Small-Scale Industrial (SSI) unit, as per RBI is classified as sick when:

a. Any of its borrowal accounts has become a doubtful advance, i.e., principal or interest in respect of any of its borrowal accounts has remained overdue for periods exceeding $2\frac{1}{2}$ years and

b. There is erosion in net worth due to accumulated cash losses to the extent of 50% or more of its peak net worth during the preceding 2 (two) accounting years.

In case of tiny/decentralized sector units, if requisite financial data is not available, a unit may be considered as sick if the loan/advance in which any amount to be received has remained past due for one year or more.

Box: Goswami Committee (On Industrial Sickness)

The committee proposed:

- Changes in definition of sickness: if a company defaults for 180 days or more on term loans, working capital or cash credit, it should be labeled sick.
- Setting of five recovery and five winding up tribunals to hasten the recovery of dues and winding up of sick units.
- The Sick Industrial Companies Act (SICA) should override the Foreign Exchange Regulation Act to permit foreigners to buy sick companies.
- SICA to override the Urban land (ceiling and Regulations) Act. So that creditors will be able to sell a sick company's assets, including land, to recover the dues.
- Amendment to sections 25(N) and 25(O) of the Industrial Dispute Act, so that the State Labour Commissioner's permission is not needed for retrenching labour.
- Raise retrenched workers' compensation for 15 days wages per day year of completed service to 30 days.
- The center should try to convince the state governments to reduce stamp duty in cases of merger.

> The recommendations sought to
>
> i. Make it easier for a company's creditors to spot symptoms of sickness for taking effective action,
>
> ii. Speed up winding
>
> iii. Provide for better compensation to workers in case of retrenchment. The committee also redefined sickness. The creditors of such a unit can then go to the recovery tribunals or High Court to get their money back.

FORECASTING INDUSTRIAL SICKNESS

Banks and financial institutions verify the previous financial statements of a firm to forecast whether the firm is sick or has the symptoms of the incipient sickness. They observe the levels of current assets, current liabilities, long-term debts, net worth, and internal cash generation capacity of the firm. They apply ratio analysis technique to find the financial strength of the firm. They use current ratio, debt-equity ratio; ratio between internal cash generation to long-term liabilities, and the ratio between net profit and net worth. As current ratio indicates the short-term liquidity position of the firm, it must atleast be at the 1:1 level, i.e., the firm's current assets must be sufficient to pay off its current liabilities.

For long-term investment, the firm depends on the borrowed capital, but the debt-equity ratio must not be too high. If the ratio between borrowed funds and equity funds is more than 3:1, it indicates the difficulty of long-term survival of the firm. The repayment of maturing long-term liabilities must come out of the internal cash flows. To avoid sickness, the firm must get atleast 10 per cent return on its net worth and should have sufficient retained earnings to meet the contingencies.

A few banks and financial institutions find the total score of the following ratios to predict sickness or incipient sickness symptoms in a firm. If the total is more than 20, it indicates that the firm has serious financial burden. Higher the score the more intense is the sickness in the firm.

$$\frac{\text{Current Liabilities}}{\text{Current Assets}} = 1$$

$$\frac{\text{Outside Liabilities}}{\text{New Worth}} = 3$$

$$\frac{\text{Long-Term Liabilities}}{\text{Internal Cash Generation}} = 5$$

$$\frac{\text{Net Worth}}{\text{Profit after tax}} = 10$$

$$\frac{\text{Share Capital}}{\text{Net Worth}} = 1$$

Total = 20

Reliefs and Concessions Available to the Sick Units

Sick SSIs can get the following concessions from the banks and financial institutions:

- Waiver of penal interest on default debts.
- Reduction of interest on term loans by less than 2%.
- Rephasing the time period (not more than 7 years) for the outstanding term loans.

- Granting of fresh financial assistance through a line of credit with 9% interest. The irregularities in clearance of cash credits can be converted into fresh working capital term loan carrying a special interest rate of 5% below the prevailing minimum lending rate.
- Granting new loans to meet creditors, outstanding current liabilities and salaries and wages of workers at 9% rate of interest.
- To meet the cost of rationalization of labor, and working capital requirements, banks extend new financial assistance at 1.5 % below the prevailing minimum lending rate.
- The banks can convert unpaid interest on term loans and cash credits into Funded Interest on Term Loan (FITL) carrying no interest and repayable within 3 years.

Sick Non-SSIs can get the following concessions from the banks and financial institutions:

- Waiver of penal interest on default debts.
- Reduction of interest on term loans by less than 2%.
- Rephasing the time period (not more than 10 years) for the outstanding term loans.
- Getting fresh financial assistance through a line of credit with 9% interest.
- Irregularities in clearance of cash credits can be converted into fresh working capital term loan carrying a special interest rate between 1.5% and 3% below the prevailing minimum lending rate.
- Granting new loans to meet creditors, outstanding current liabilities and salaries and wages of workers at an interest of 1.5% below the prevailing minimum lending rate.
- To meet the cost of rationalization of labor, and working capital requirements, banks extend new financial assistance at 1.5 % below the prevailing minimum lending rate.
- The banks can convert unpaid interest on term loans and cash credits into Funded Interest on Term Loan (FITL) carrying 6.5% interest below the prevailing minimum lending rate and repayable within 3 to 5 years.

BIFR AND ITS ROLE

In the wake of sickness in the country's industrial climate prevailing in the eighties, the Government of India set up in 1981, a Committee of Experts under the Chairmanship of Shri T.Tiwari to examine the matter and recommend suitable remedies. Based on the recommendations of the Committee, the Government of India enacted a special legislation namely, the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) commonly known as the SICA.

The main objective of SICA is to determine sickness and expedite the revival of potentially viable units or closure of unviable units (unit herein refers to a Sick Industrial Company). It was expected that by revival, idle investments in sick units will become productive and by closure, the locked up investments in unviable units would get released for productive use elsewhere.

The Sick Industrial Companies (Special Provisions) Act, 1985 (hereinafter called the Act) was enacted with a view to securing the timely detection of sick and potential sick companies owning industrial undertakings, the speedy determination by a body of experts of the preventive, ameliorative, remedial and other measure which need to be taken with respect to such companies and the expeditious enforcement of the measures so determined and for matters connected therewith or incidental thereto.

The Board of experts named the Board for Industrial and Financial Reconstruction (BIFR) was set up in January, 1987 and functional with effect from 15th May 1987. The Appellate Authority for Industrial and Financial Reconstruction (AAIRFR) was constituted in April 1987. Government companies were brought under the purview of SICA in 1991 when extensive changes were made in the Act including, inter-alia, changes in the criteria for determining industrial sickness.

SICA applies to companies both in public and private sectors owning industrial undertakings:-

a. pertaining to industries specified in the First Schedule to the Industries (Development and Regulation) Act, 1951, (IDR Act) except the industries relating to ships and other vessels drawn by power and;

b. not being "small scale industrial undertakings or ancillary industrial undertakings" as defined in Section 3(j) of the IDR Act.

c. The criteria to determine sickness in an industrial company are (i) the accumulated losses of the company to be equal to or more than its net worth i.e. its paid up capital plus its free reserves (ii) the company should have completed five years after incorporation under the Companies Act, 1956 (iii) it should have 50 or more workers on any day of the 12 months preceding the end of the financial year with reference to which sickness is claimed. (iv) it should have a factory license.

National Company Law Tribunal and Appellate Tribunal

The Government appointed a Committee under the Chairmanship of Justice V. Balakrishna Eradi, a retired Supreme Court Judge, to review the law relating to insolvency and winding up of companies, the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), and laws related to the speedy disposal of the colossal insolvency, winding up and debt reconstruction cases pending before the High Court and the Companies Law Board. The Committee made various recommendations with the main objective of expediting the revival/ rehabilitation of a sick company and protection of workers' interest, which were incorporated in the Companies (Amendment) Bill, 2001. The said Bill was subsequently passed by both the Houses of the Parliament and finally got the assent of the President of India on 13th January, 2002, and became the Companies (Amendment) Act, 2002. It provided a road map for setting up of the National Company Law Tribunal (NCLT). The NCLT will handle all the matters relating to the companies which were earlier handled by various High Courts, CLB, BIFR and AAIFR. The NCLT consists of a President and other Judicial and Technical Members; the total constitution not exceeding 62 members. The Central Government formed an Appellate Tribunal, which is called 'The National Company Law Appellate Tribunal (NCLAT).' The NCLAT consists of a Chairperson and not more than two members. The setting up of NCLT is entangled in litigation. In the meantime BIFR as well as AAIFR continue to function and deal with sick industrial units.

SUMMARY

- Turnaround management is one of the restructuring strategies. It involves the formulation and implementation of strategic plans and a course of action for organization renewal and restructuring that improves financial performance of the companies.
- Turnaround management usually requires strong leadership and can include an investigation of the root causes of failure, corporate restructuring and redundancies, and long-term programs to revitalize the organization. There are three phases in turnaround management. They are: (i) Getting the danger symptoms, (ii) Choosing appropriate turnaround strategy, and (iii) Implementation of the change process and its monitoring.

- Debt restructuring is a process, whereby, the corporates with outstanding debt obligations alter their debt agreements so as to continue their business operations devoid of any danger of debt. Corporate debt repayment process is important for the restoration of a distressed company. It is also cheaper than going for bankruptcy.
- The CDR system was established with the objective to ensure timely and transparent restructuring of corporate debts of viable entities facing problems, which are outside the purview of the Board for Industrial and Financial Reconstruction (BIFR), Debt Recovery Tribunal (DRT) and other legal proceedings.
- Sick industry can be defined as "an industrial company (being a company registered for not less than five years) which has at the end of any financial year accumulated losses equal to or exceeding its net worth".

Bibliography

1. Alexandra M. Post, *Anatomy of a Merger*, Prentice-Hall, Inc., 1994.
2. Aswath Damodaran, *Corporate Finance Theory and Practice*, John Wiley & Sons, Inc., 1997.
3. Aswath Damodaran, *Investment Valuation*, John Wiley & Sons, Inc., 2002.
4. Curt Schleier, *How to Think like the World's Greatest Masters of M&A*, Mc Graw-Hill Companies, 2001.
5. David J. Bendeniel, Arthur H. Rosenbloom, *International M&A*, Joint Ventures and Beyond Doing the Deal, John Wiley and Sons, Inc., 1998.
6. David M. Schweiger, *M&A Integration,* A Framework for Executives & Managers, Tata McGraw-Hill Companies, 2002.
7. Donald De Pamphillis, *Mergers, Acquisitions and Other Restructuring Activities*, Academic Press, 2001.
8. Ed Paulson with Court Huber, *The Technology M&A Guidebook*, John Wiley & Sons, Inc., 2001.
9. Frank C. Evans, David M. Bishop, *Valuation for M&A,* Building Value in Private Companies, John Wiley and Sons, Inc., 2001.
10. Harvard Business, *Review on Mergers and Acquisitions*, Harvard Business School Press, 2001.
11. Fred Weston J., Kwang S. Chung and Susan E. Hoag, *Mergers, Restructuring, and Corporate Control*, Prentice-Hall Inc., 1990.
12. Joseph H. Marren, *Mergers and Acquisitions – A Valuation Handbook,* Irwin Professional Publishing, 1993.
13. Khan M. Y. & Jain P. K., *Financial Management Text and Problems*, Tata McGraw Hill Publishing Company Limited, 1992.
14. Palepu, Healy, Bernard, *Business Analysis & Valuation*, Southern-Western College Publishing, 2000.
15. Patrick A. Gaughan, *Mergers, Acquisitions and Corporate Restructuring*, John Wiley & Sons, Inc., 1999.
16. Prasanna Chandra, *Financial Management Theory and Practice*, Tata McGraw-Hill Publishing Company Limited, 2001.
17. Robert Lawrence Kuhn, *Mergers Acquisitions and Leveraged Buyouts*, Dow Jones & Company, Inc., 1990.
18. Stuart C. Gilson, *Creating Value through Corporate Restructuring,* Case Studies in Bankruptcies, Buyouts and Breakups, John Wiley & Sons, Inc., 2001.
19. Stanley Foster Reed, Alexandra Reed Lajoux, *The Art of M&A,* The Mc-Graw-Hill Companies, Inc., 1999.
20. Shiva Ramu S., *Corporate Growth through Mergers and Acquisitions*, Response Books, 1998.
21. Ramanujam S., *Mergers et al,* Issues, Implications and Case Laws in Corporate Restructuring, Tata McGraw-Hill Publishing Company Limited, 2000.
22. Timothy J. Galpin, Mark Herndon, *The Complete Guide to Mergers and Acquisitions,* Process Tools to support M&A Integration at every level, Jossey-Bass, Inc., 2000.
23. Tom Copeland, Tim Koller & Jack Murrin, *Valuation – Measuring and Managing the Value of Companies,* Mc Kinsey & Co., John Wiley & Sons, Inc., 2000.

Research Papers

- *Ashoka Mody and Shoko Negishi* – The Role of Cross-Border Mergers and Acquisitions in Asian Restructuring, www.amody.com.
- *Bhagwan Chowdhry and Narasimhan Jagadeesh* – Pre-Tender Offer Share Acquisition Strategy in Takeovers, Journal of Financial and Quantitative Analysis. Vol. 29 No.1 March 1994.
- *Christopher J. Zinski and Jason Zellers* – Mergers and Acquisitions of Financial Institutions: Recent Trends and Issues, www.schiffhardin.com.
- *Edith S. Hotchkiss, Boston College* – Acquisitions as a Means of Restructuring Firms, www2.bc.edu.
- *Fishman, Michael J.* – A theory of Preemptive Takeover Bidding, RAND Journal of Economics, Spring 1988.
- *George W. Fenn & Nelli Liang* – Good News and Bad News about Share Repurchases, www.federalreserve.gov
- *Harris M. and A. Raviv* – Corporate Control Contests and Capital Structure, Journal of financial economic, 20, 1988.
- *Hansen R.* – A Theory for the Choice of Exchange Medium in Mergers and Acquisitions, Journal of Business, 60, January 1987.
- *Hirshleifer, David, and Sheridan Titman* – Share tendering strategies and the success of hostile takeover bids, forthcoming, Journal of Political Economy, April 1990.
- *Janez Bešter* – Takeovers Theories and Prediction Models – The case of Slovenian Privatised Companies, www.ier.si
- *Jesse M. Fried, Boalt Hall School of Law, U. C. Berkerly* – The uneasy case for Share Repurchases, www.yale.edu (Work on the article is still under process.)
- *Jegadeesh N. and B. Chowdhry* – Optimal Pre-Tender Offer Share Acquisition Strategy in Takeovers, UCLA Anderson School of Management, Working paper, September 1988.
- *Kai Li, Faculty of Commerce, University of British Columbia* – Open Market versus Tender Offer Share Repurchases – A Conditional Event Study, www.finance.commerce.ubc.ca.
- *Paul Oyer Scott Schaefer, Stanford University* – Why do some firms give stock options to all employees? December 2002.
- *Rhona L. Ferling* – Spin-Offs and Equity Carve-out. Achieving Faster growth and better performance, Financial Executive Research Foundation.
- *Spatt, Chester S.* – Strategic Analyses of Takeover Bids, in S. Bhattachary and G.Constantinides, eds., Financial Markets and Incomplete Information, Totowa, N J: Rowman and Littlefield, 1989.
- *S. Vish Viswanathan, Corporate Finance, Duke University* – Dividends and Share Repurchases, www.duke.edu.
- *Shleifer, Andrei, and Robert W. Vishny* – Large Shareholders and Corporate Control, Journal of Political Economy.
- *Stulz, R. M.* – "Managerial Control of Voting Rights," Journal of Financial Economics, 20, 1988.

Websites

- www.afferguson.com
- www.businessworldindia.com
- www.banknetindia.com
- www.blonnet.com
- www.biz.yahoo.com
- www.business.lycos.com
- www.business2media.com
- www.cmie.com
- www.companylawinfo.com
- www.clb.nic.in
- www.credpr.stanford.edu.
- www.capitalideasonline.com
- www.ciol.com
- www.economictimes.com
- www.etinvest.com
- www.esopassociation.org
- www.expressindia.com
- www.eaglesecurities.com.
- www.financialexpress.com
- www.hindustantimes.com
- www.icfaipress.org
- www.indiainfoline.com
- www.investindia.com
- www.investopedia.com
- www.indianexpress.com
- www.indiacode.nic.in
- www.info.som.umist.ac.uk
- www.imf.org
- www.jacksonville.bizjournals.com
- www.kpcapital.com
- www.manupatra.com
- www.myiris.com
- www.marketscanindia.com
- www.mergerstat.com
- www.moneycontrol.com
- www.nishithdesai.com
- www.nic.in
- www.perso.club-internet.fr
- www.sebi.com
- www.stblaw.com
- www.themaexchange.com
- www.tillighast.com

Glossary

Acquisition : Buying of a firm by another firm.

Acquisition MLP : A Master Limited Partnership which is formed by an offering of MLP interests to the public with the proceeds used to purchase the assets.

Agency Problem : Conflicts of interests among stockholders, bondholders and managers.

Aggregate Concentration Ratio : Overall concentration in an industry nationwide. For instance, the percentage of sales controlled by the largest 30 firms in an industry.

Amortization : Repayment of loan through installments.

Anergy : Negative synergy. The phenomenon where business units have more value separately than as a single unit.

Anti-Greenmail Amendment : Corporate charter amendment which prohibits the targeted share repurchases at a premium from an unwanted acquirer without the approval of the non participating shareholders.

Anti-Takeover Amendment : Corporate charter amendment which is intended to make it more difficult for an unwanted acquirer to takeover the firm.

Any-Or-All Offer : A type of tender offer which does not mention the maximum number of shares to be purchased. If the conditions of the offer are not met, none of the shares will be purchased.

Atomistic Competition : Several small sellers and buyers, none of whom have the power to influence market prices or output.

Auction : Two or more bidders competing for a single target. An auction increases the price which the shareholders of the target would receive.

Back End Rights Plan : A poison pill takeover defense in which the share holders of a target are issued rights dividend which becomes exercisable if an acquirer obtains a triggering amount of target stock.

Back End Value : The amount paid to remaining shareholders in the second stage of a two-tier or partial tender offer.

Bear Hug : A takeover strategy in which the acquirer, without previous warnings, sends a letter to the directors of the target company announcing the acquisition proposal and demanding a quick decision.

Beta : The measure of a systematic risk of the asset.

Bidder : The acquiring firm in the tender offer.

Board-Out Clause : A provision in most supermajority anti-takeover amendments which gives the Board of Directors the power to decide when and if the supermajority rights will be in effect.

Book Value	:	The value at which the asset is carried in the company's balance sheet.
Bust-up Takeover	:	An acquisition followed by divestiture of some or all of the operating units of the acquired firm which are presumably worth more in pieces than as a going concern.
Buy-Back	:	Nothing but a share repurchase where a public corporation buys back its own shares by a tender offer in the open market or in a negotiated buy back from a large block holder.
Capitalization	:	Term used to describe a company's permanent capital, long-term debt and equity.
Capital Asset Pricing Model	:	An element of modern portfolio theory. A mathematical model showing an "appropriate" price, based on relative risk combined with the return on risk-free assets.
Cash Flow	:	The excess of sources of cash over uses of cash.
Cash Flow Statement	:	An analysis of all the changes that affect the cash account during an accounting period. These changes may be shown as either sources or uses of cash.
Capitalization Ratio	:	It is the measurement of the company's debt component. Measures the extent of debt used in relation to the company's permanent capital. Determined by dividing long-term debt by long-term debt plus equity.
Common Shares Outstanding	:	The number of common shares of stock outstanding at the end of the year, including stock held by the company in its treasury.
Common Stock	:	A security that represents a share of ownership in a corporation.
Circular Merger	:	A kind of merger in which companies producing distinct products to share common distribution and research facilities and promote market enlargement. The acquiring company benefits by economies of resource sharing and diversification.
Clandestine Takeover (Or) Creeping Takeover	:	The clause 40 of the listing agreement of stock exchange which allows a person to buy up to 5% stake in a company without any prior permission. After 5%, they ought to inform the stock exchange.
Classified Board	:	An anti-takeover measure which divides a firm's Board of Directors into several classes, only one of which is up for election in any given year, thus delaying effective transfer of control to a new owner in a takeover.
Clean-up Merger	:	The consolidation of the acquired firm into the acquiring firm after the acquirer has obtained control. Also called a take-out merger.
Coercive Tender Offer	:	A tender offer which puts pressure on the target shareholders to tender by offering a higher price to those who tender early.

Collateral Restraints	:	Agreements between the parties to a joint venture to limit competition between themselves in certain areas.
Collusion	:	Illegal cooperation or coordination among the competitors with respect to price or output.
Competitive Bid	:	This can be made by any person within 21 days of public announcement of the offer made by the acquirer. This can be made through a public announcement and should be for the equal number of shares or more for which the first offer was made.
Complementarity	:	The phenomenon where the strengths of one firm offset the weaknesses of another firm with which it combines.
Concentric Merger	:	A merger in which there is carry-over in specific management functions or complementarity in relative strengths among specific management functions rather than carry over or complementarity in only generic management functions.
Conglomerate Merger	:	A merger between firms operating in unrelated industries. Any combination which is not horizontal or vertical.
Consolidation	:	The fusion of two companies in which both the companies lose their identity and form a new company. Shareholders get the shares of the new company.
Contingent Voting Rights	:	Rights to vote in corporate elections which become exercisable upon the occurrence of a particular event.
Convergent of Interests Hypothesis	:	The hypothesis which predicts a positive relationship between the proportion of management stock ownership and the market's valuation of the assets of the firm.
Covenants	:	Provisions in the legal agreements on loans, bonds, or lines of credit. Usually written by the lender to protect its position as a creditor of the borrowers.
Crown Jewels	:	Section 23 of SEBI Takeover Regulations indicate that the company calls its precious assets as crown jewels to depict the greed of the acquirer under the takeover bid. These precious assets attract the raider to bid for the company's control. The company sells these assets at its own initiative leaving the rest of the company intact. (Instead of selling the assets, the company may also lease them or mortgage them so that the attraction of free assets to the predator is suppressed.)
Cumulative Voting Rights	:	The option available to the shareholders where instead of one vote per candidate the shareholders can vote for one candidate or divide the total votes among a desired number of candidates.

Defensive Merger : The directors of a threatened company may acquire another company for shares as a defensive measure to prevent the unwelcome takeover bid. To do this, they put large block of shares of their own company in the hands of shareholders of friendly company to make their own company least attractive for takeover bid.

Defined Contribution Plan : A pension plan in which the annual contributions are specified in advance. Benefits upon retirement depend on the performance of the assets in which the contributions are invested.

Delphi Technique : An information gathering technique in which questionnaires are sent to informed individuals. The responses are summarized into feedback report that is used to generate subsequent questionnaires to probe more deeply into the issue under study.

Demergers or Corporate Split : This takes place when part of a company's undertaking is transferred to a newly formed or an existing company. Some or a specified part of the shares of the first company are also transferred to the new company. The reminder of the first company's undertaking continues to be vested in it and the shareholders of the main company gets reduced to that extent.

Differential Managerial Efficiency : A theory which infers that more efficient managements takeover the firms with less efficient managements and achieve gains by improving the efficiency of the target.

Dilution : The reduction of earnings, or the value of a stock, that can occur in a merger when more shares are issued; or with conversion of convertible securities into common stock.

Dissident : A shareholder or a group of shareholders who disagree with the incumbent management and seeks to make changes via a proxy contest to gain representation on the Board of Directors.

Diversification : Holding assets whose returns are not perfectly correlated with each other.

Divestiture : The sale of a segment of a company to a third party which is an outsider for cash or for securities.

Dual Class Recapitalization : Corporate restructuring used to create two classes of common stock with the superior voting stock concentrated in the hands of the management.

Dual Class Stock : Two classes of common stock with equal rights to cash flows, but with unequal voting rights.

Earn Out : The portion of the purchase price that is contingent on future performance. It is payable to the sellers only when certain pre-defined levels of sales or income are achieved in the years after acquisition.

Employee Stock Ownership Plan (ESOP) : Defined contribution pension plan (stock bonus and/or money purchase) designed to invest primarily in the stock of the employer.

Equity Carve Out : It is a type of divestiture and is different to spin off. It resembles the IPO of some portion of equity stock of a wholly owned subsidiary by the parent company. Some of the subsidiary's shares are offered for sale to general public for increasing cash inflow without losing control. This is also called splitoff IPO.

Exchange Offer : A transaction which provides one class (or more) of securities with the right or option to exchange part or all of their holdings for a different class of the firm's capital structure with no change in investment.

Exercise Price : The price at which an option may be exercised. This is also known as the strike price.

Fallen Angel : A bond issued at investment grade whose rating is subsequently dropped to below investment grade, below BBB.

Financial Synergy : A theory which suggests a financial motive for mergers, especially between firms with high internal cash flows and poor investment opportunities and firms with low internal cash flows and high investment opportunities which in the absence of a merger require expensive external financing.

Free Cash Flow : Cash available for distribution after taxes but before the effects of financing. Calculated as net income plus depreciation less expenditure required for working capital and capital items adjusted to remove effects of financing.

Free Cash Flow Hypothesis : This is Jensen's theory of how the pay-out of free cash flow helps resolve the agency problem between the managers and the shareholders. It says that the paying of current and future free cash flows reduces the power of the management.

Free Rider Problem : When atomistic shareholders (large number of shareholders having small proportions of shares) reasons that their decision has no impact on the outcome of the tender offer and refrains from tendering to free-ride on the value increase resulting from the merger, thus causing the bid to fail.

Friendly Mergers : Mergers and acquisitions through the negotiations, willingness and consent of the target company are called friendly mergers.

Front-End Loading : A tender offer in which the offer price is greater than the value of any unpurchased shares. This arrangement resolves the free rider problems by providing an incentive to tender early.

Generic Management Functions	:	Those functions that are not industry specific and thus transferable even in conglomerate mergers.
Going Concern Value	:	The gross value of a company as an operating business. This value may exceed or be at a discount from the liquidating value.
Going Private	:	The transformation of a public corporation into a privately-held firm. It often takes place via a leveraged buy-out or a management buy-out.
Golden Parachutes (Or) First Class Passengers Strategy	:	This envisages a termination package for senior executives and is used as a protection tool against the takeover.
Goodwill	:	The amount by which the price paid for a company exceeds the company's estimated net worth at market value of the underlying assets and liabilities.
Greenmail	:	A large block of shares is held by an unfriendly company, which forces the target company to repurchase the stock at a substantial premium to prevent the takeover. (This could prove to be an expensive deal to the raider.)
Grey Knight	:	A friendly party of the target company who seeks to takeover the predator.
Herfindahl-Hirschman Index (HHI)	:	The measure of concentration under the 1982 merger guidelines in the US, which is defined as the sum of the squares of the market shares of all the firms in the industry.
Holding Company	:	The holding company would have more than 50% of the total voting power and has the control on the other company.
Horizontal Merger	:	It is a merger of two competing firms, which are at same stage of industrial process.
Hostile Takeovers	:	An acquirer may not offer the proposal to acquire the target company's undertaking, but may silently and unilaterally pursue efforts to gain controlling interest in it against the wishes of the management. They are also called raids or takeover raids.
Hubris Hypothesis	:	It is the theory of Roll which says that an acquiring firm's managers commit errors of over optimism in evaluating merger opportunities and end up paying too high a price for acquisitions.
Increased Debt Capacity Hypothesis	:	A theory that after the merger the financial leverage increase is a result of increased debt capacity due to reduced expected bankruptcy costs.

Indenture	:	Same as a Covenant. The contract between a firm and its bondholders which sets out the terms and the conditions of the borrowing, and the rights and obligations of each party.
Inferior Vote Stock	:	In dual class stock firms, the class of common stock which has less voting power.
Initial Public Offering	:	The first offering to the public of common stock.
Interlocking Shareholdings or Cross Shareholdings	:	Two or more group companies acquire shares of each other in large quantity or one company may distribute shares to the shareholders of its group company to avoid threats of takeover bids. (If the interlocking of shareholdings is accompanied by joint voting agreement then the joint system of defense is termed as "Pyramiding", which is the safest device or defense.)
Internal Rate of Return	:	A capital budgeting method which finds the discount rate which equates the present value of cash inflows and investment outlays. The IRR must be more than the relevant risk adjusted cost of capital for the project to be acceptable.
Investment Requirement Ratio	:	A firm's investment expenditures in relation to the after tax cash flows.
Joint Venture	:	This is an agreement between two or more companies where there will be an agreed contribution and participation of the respective companies.
Joint Holding or Joint Voting Agreement	:	Two or more major shareholders may enter into an agreement to block voting or to block sale of shares or may sell the shares together. This agreement is entered into with the cooperation of the acquirer company's management.
Junk Bond	:	A bond that involves greater than usual risk as an investment and pays a relatively high rate of interest, typically issued by a company lacking an established earnings history or having a questionable credit history. Junk bonds became a common means for raising business capital in the 1980s, when they were used to help finance the purchase of companies, especially by leverages buy-outs.
Kick-In-The-Pant Hypothesis	:	The hypothesis which attributes the increase in a takeover target's stock price to the impetus given by the bid to target management to implement a higher valued strategy.
Leveraged Buy-Out	:	The purchase of the company by a small group of investors, financed largely by debt. Usually involves going private.
Leveraged Cash Out (LCO)/Leveraged	:	A defensive reorganization of the firm's capital structure in which outside shareholders receive a large one time cash dividend and inside

Recapitalization shareholders receive new shares of stock instead. The cash dividend is largely financed with newly borrowed funds, leaving the firm highly leveraged and with a greater proportional ownership share in the hands of management.

Liquidating Value : The value of a company based on the market value of its assets, net of liabilities.

Liquidation : Divestiture of all the assets of the firm so that the firm ceases to exist.

Liquidation MLP : A master limited partnership which is formed by a complete liquidation of a corporation into an MLP.

Management Buy-Out (MBO) : A going private transaction led by the incumbent managers of the formerly public firm.

Market Extension Merger : A combination of firms whose operations had formerly been concluded in non-overlapping geographic areas.

Master Limited Partnership (MLP) : An organizational form in which limited partnership interests are publicly traded (like shares of corporate stock), while retaining the tax attributes of a partnership.

Maximum Limit Offer : A stock repurchase tender offer in which all tendered shares will be purchased if the offer is undersubscribed; but if the offer is oversubscribed, shares may be purchased only on a pro rata basis.

Merger : Merger is the fusion of two or more companies (OR) Merger is a combination of two or more companies into a single company where, it survives and others lose the corporate identity. The survivor acquires the assets and liabilities of the rest.

Merchant Banker : They are the middle men in settling negotiations for merger or takeover between the acquirer and the target.

Mezzanine Financing : Subordinated debt issued in connection with leveraged buy-outs.

Multinational Enterprise (MNE) : A business organization with operations in more than one country beyond import/export operations.

Negotiated Share Repurchase : Buying back of the stock of a large block holder (an unwanted acquirer) at a premium over market price.

Net Cash Flow : Cash available for distribution after taxes and after the effects of financing. Calculated as net income plus depreciation less expenditure required for working capital and capital items.

Net Present Value : A capital budgeting criterion which compares the present value of cash inflows of a project discounted at the risk adjusted cost of capital to the present value of investment outlays (discounted at the risk adjusted cost of capital).

Net Operating Loss Carry Over : Tax provision allowing firms to use the net operating losses to offset taxable income over a period of years before and after the loss. This provision is available for firms which acquire a loss firm only under strictly specified conditions.

Non-Leveraged ESOP : Same as stock bonus plan. An employee stock ownership plan recognized under the ERISA which does not provide for borrowing by the ESOP.

Open Market Share Repurchase : A corporation's buying back of its own shares in the open market at the going price just as any other investor might buy the corporation's shares.

Operating Synergy : A phenomenon where combining of two or more firms results in gains in revenues or cost reductions because of complementarities or economies of scale and scope.

Ownership Flip-In-Plan : A poison pill antitakeover defense often included as part of a flip-over plan. Target stockholders are issued rights to purchase target shares at a discount if an acquirer passes a specified level of share ownership. The acquirer's rights are void, and his ownership interest becomes diluted.

Pac-Man Strategy : The target company attempts to takeover the hostile raider. This happens when the target company is larger than the predator.

Partial Bid : When a bid is made for acquiring part of the shares of a class of capital where the offerer intends to obtain effective control. This is made for the equity shares.

Par Value : The face value of a bond. Also, the arbitrary value given to the stock by the issuing company. This figure is relatively meaningless since the current value of a stock is its price established in the market, regardless of its stated par value.

Poison Pill : An antitakeover defense which creates securities that provide their holders with special rights. The exercise of these rights would make it more difficult and/or costly for an acquirer to takeover the target against the will of its Board of Directors.

Poison Put : A covenant allowing the bond holder to demand repayment in the event of a hostile takeover.

Premium Buy Back : The repurchasing of shares of a large block holder at a premium over the market price.

Present Value : The value today of a future payment or stream of payments, discounted at some appropriate compound interest (discount) rates.

Product Differentiation : The development of a variety of product configurations to appeal to a variety of consumer tastes.

Product Extension Merger : A type of conglomerate merger which involves a combination between firms in related business activities that broadens the product lines of the firms. These are also called concentric mergers.

Pro Forma Statements : Are used to illustrate the likely expectation of a series of events in a set period of time i.e., if we have completed 10 months of a calendar year, and if we need to do the evaluation based on the completed year.

Pro Forma Balance Sheets : In privately held companies, there are often redundant assets underutilized assets that need to be removed from the company prior to the sale of the business. A pro forma balance sheet is used to illustrate the likely balance sheet of the company, at the time of sale.

Proxy Contest : An attempt made by the dissident group of shareholders to gain representation on the firm's Board of Directors. They take place when the agenda items at the meeting are likely to be opposed by dissident shareholders.

Pure Conglomerate Merger : A combination of firms in non-related business activities that is neither a product extension nor a geographic-extension merger.

q-Ratio (Tobin's q Ratio) : The ratio of market value of the firm's securities to the replacement costs of its physical assets.

Redistribution Hypothesis : A theory that the increase in value in mergers represents wealth shifts among the stakeholders rather than a real increase in value.

Restricted Vote Stock : In dual class stock firms, the stock with inferior voting rights.

Return On Investment (ROI) : The rate of return at which the sum of the discounted future cash flows for the five pro forma years plus the discounted residual value equals the initial cash outlay.

Reverse LBOS : Firms, or divisions of firms, which go public again after having been taken private in a leveraged buy-out transaction.

Risk-Free Rate : The return on the asset with no risk of default. Theoretically, the return on the short-term government securities.

Roll-out MLP : A Master Limited Partnership which is formed by a combination of two or more partnerships into one publicly traded partnership. Also called spin off MLP.

Roll-up MLP : A Master Limited Partnership which is formed by a combination of two or more partnerships into one publicly traded partnership.

Saturday Night Special : A hostile tender offer with a short time for response.

Scorched Earth Defense : Actions to make the target less attractive to the acquiring firm and which may also leave the target in weakened condition.

Secondary Initial Public Offering : The reoffering to the public of common stock in a company which had initially been public, but had then been taken private.

Sell-off : General term for divestiture of part or all of a firm by any one of a number of means, e.g., sale, liquidation, spin-off and so-on.

Shareholder Interest Hypothesis : The theory that shareholders benefits of antitakeover defenses outweigh management entrenchment motives and effects.

Share Repurchase : A public corporation buys its own shares, by tender offer, in the open market or in a negotiated buy back from a large block holder.

Shark Repellent : The companies amend their Bye-Laws and regulations to be less attractive for the raider company. Such features are called Shark Repellents. The company may issue that 80-95% of the shareholders should approve for the takeover and 75% of the Board of Directors consent.

Shark Watcher : A firm usually a proxy solicitation firm which monitors trading activity in its clients stock to detect early accumulations by an unwanted acquirer before the 5 percent disclosure threshold.

Sitting on the Goldmine Hypothesis : The theory which attributes the increase in a takeover target's stock price to information disclosed during the takeover process that the target's assets are undervalued by the market.

Split-off : This occurs when equity shares of a subsidiary company are distributed to some of the parent company's shareholders in exchange for their holdings in parent company.

Split-up : It is a diversion of a company into two or more parts through transfer of stock and parent company ceases to exist.

Spin-off : It is a kind of a demerger where an existing parent company distributes on a pro rata basis all the shares it owns in a controlled subsidiary to its own shareholders by which it gains effect to make two of the one company or corporation. There is no money transaction, subsidiary's assets are not valued, transaction is not treated as stock dividend and tax free exchange. Both the companies exist and carry on business. It does not alter ownership proportion in any company.

Staggered Board : An antitakeover measure which divides a firm's Board of Directors into several classes only one which is up for election in any given year, thus delaying the effective transfer of control to a new owner in a takeover. Also called classified board.

Stakeholder : Any individual or group who has an interest in a firm in addition to shareholders and bondholders. Includes consumers, creditors, suppliers, the employees, etc.

Standstill Agreement : A voluntary contract by a large group of shareholders not to make further investments in the target company for a specified period of time.

Start-up MLP : Also called acquisition MLP the assets of an existing entity are transferred to a Master Limited Partnership and the business is henceforth conducted as an MLP.

Stock Bonus Plan : A defined contribution pension plan in which the firm contributes a specified number of shares to the plan annually. The benefits to the plan beneficiaries depend on the stock performance.

Strategy : The long range planning process for an organization. A succession of plans with procedures for implementation for the future of the firm.

Strip Financing : A type of financing often used in leveraged buy-outs in which all claimants hold approximately the same proportion of each security.

Stub : New shares issued in exchange for old shares in a leveraged recaptilization.

Superior Vote Stock : In dual class stock firms, the class of stock which has more power to elect directors. This type of stock is usually concentrated in the hands of the management.

Supermajority : A requirement in many antitakeover charter amendments that a change of control must be approved by more than a simple majority of shareholders.

Swap Ratio : This is an exchange rate of the shares of the companies that would undergo a merger. This is calculated by the valuation of various assets and liabilities of the merging companies.

Synergy : The phenomenon where the combination of two entities is greater than the sum of their individual outputs.

Takeover : This is similar to acquisition. Takeover differs with merger in approach to business combinations i.e., the process of takeover, transaction involved, determination of share exchange. For example, process of takeover is unilateral and the acquirer company decides about the maximum price. Time taken in completion of the takeover is less than that in the merger.

Takeover Bid : It is the intention of the acquirer, reflected in the action of acquiring the shares of the Target Company.

Targeted Share Repurchase : The repurchasing of the stock of a large block holder at a premium over the market price (greenmail).

Tender Offer : The acquirer pursues takeover (without consent of the target) by making a tender offer directly to shareholders of the target company to sell their shares. This offer is made for cash.

Two-Tier Tender Offer : Tender offers in which the bidder offers a superior first-tier price for a specified maximum number of shares it will accept and simultaneously announces its intentions to acquire remaining shares at a second-tier price.

Undervaluation : A firm's securities are selling for less than their intrinsic, or potential, or long run value for one or more reasons.

Vertical Merger : This would give backward integration to the company to assimilate the sources of supply and forward integration towards the market. i.e., the merging undertaking would be a buyer or a supplier using its product as intermediary material for final production.

Voluntary Winding Up : The original company which has split into several companies after division could be wound up voluntarily.

Voting Plan : A poison pill antitakeover defense plan which issues voting preferred stock to target firm shareholders. At a trigger point, preferred stockholders (other than the bidder for the target) become entitled to super voting privileges, making it difficult for the bidder to obtain voting control.

Voting Trust : A device by means of which shareholders retain cash flow rights to their shares while giving the right to vote those shares to another entity.

White Knights : White knight enters the fray when the target company is raided by a hostile suitor. The clause 25 of SEBI takeover regulations gives the provision to the White Knight to offer a higher price than the predator to avert the takeover bid. (With the higher bid offered by the White Knight, the predator might not remain interested in acquisition and hence the target company is protected from the raid.)

White Squire : A third party friendly to management who helps a company avoid an unwanted takeover without taking over the company on its own.

Winner's Curse Hypothesis : The tendency that in a bidding contest or in some types of auctions, the winner is the bidder with the highest estimate of value. This explains the high frequency of negative returns to the acquiring firms in takeovers with multiple bidders.

Working Capital : The excess of current assets over current liabilities.