Lecture-1

Merger and amalgamation

INTRODUCTION

A company may decide to accelerate its growth by developing into new business areas, which may or may not be connected with its traditional business areas, or by exploiting some competitive advantage that it may have. Once a company has decided to enter into a new business areas, it has to explore various alternatives to achieve its aims.

Basically, there can be three alternatives available to it:

(i) the formation of a new company;

(ii) The acquisition of an existing company;

(iii) Merger with an existing company.

The decision as to which of these options are to be accepted will depend on the company's assessment of various factors including in particular:

(i) the cost that it is prepared to incur;

(ii) the likelihood of success that is expected;

(iii) the degree of managerial control that it requires to retain.

For a firm desiring immediate growth and quick returns, mergers can offer an attractive opportunity as they obviate the need to start from 'scratch' and reduce the cost of entry into an existing business. However, this will need to be weighed against the fact that part of the ownership of the existing business remains with the former owners. Merger with an existing company will, generally, have the same features as an acquisition of an existing company. However, identifying the right candidate for a merger or acquisition is an art, which requires sufficient care and caliber. Once an organization has identified the various strategic possibilities, it has to make a selection amongst them. There are several managerial factors which moderate the ultimate choice of strategy. This would depend upon its growth objectives, attitude towards risk, the present nature of business and technology in use, resources at its command, its own internal strengths and weaknesses, Government policy, etc. The changing economic environment is creating its own compulsions for a consolidation of capacity. With growing competition and economic liberalization, the last two decades have witnessed a large number of cases of corporate mergers.

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CONCEPT OF MERGER AND AMALGAMATION

A merger has been defined as the fusion or absorption of one thing or right into another. It may also be understood as an arrangement, whereby the assets of two (or more) companies become vested in, or under the control of one company (which may or may not be one of the original two companies) which has as its shareholders all or substantially all, the shareholders of the two companies. In other words, in a merger one of the two existing companies merges its identity into another existing company or one or more existing companies may form a new company and merge their identities into a new company by transferring their businesses and undertakings including all other assets and liabilities to the new company (hereinafter referred to as the merged company). The shareholders of the company or companies, as the case may be) will have substantial shareholding in the merged company. They will be allotted shares in the merged company in exchange for the shares held by them in the merging company or companies, as the case may be, according to the share exchange ratio incorporated in the scheme of merger as approved by all or the prescribed majority of the shareholders of the merging company or companies and the merged company in their separate general meetings and sanctioned by the court.

The term "amalgamation" contemplates two or more companies deciding to pool their resources to function either in the name of one of the existing companies or to form a new company to take over the businesses and undertakings including all other assets and liabilities of both the existing companies. The shareholders of the existing companies (known as the amalgamating companies) hold substantial shares in the new company (referred to as the amalgamated company). They are allotted shares in the new company in lieu of the shares held by them in the amalgamating companies according to share exchange ratio incorporated in the scheme of amalgamation as approved by all or the statutory majority of the shareholders of the companies in their separate general meetings and sanctioned by the court.

In other words, in amalgamation, the undertaking comprising property, assets and liabilities of one or more companies are taken over by another or are absorbed by and transferred to an existing company or a new company. The transferor company merges into or integrates with the transferee company. The transferor company losses its legal

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identity and is dissolved (without winding up). Both the existing companies may from a new company and amalgamate themselves with the new company. The shareholders of each amalgamating company become the shareholders in the amalgamated company. To give a simple example of amalgamation, we may say A Ltd. and B Ltd. and merge their legal identities into C Ltd. It may be said in another way that A Ltd. + B Ltd. = C Ltd. Therefore, the essence of amalgamation is to make an arrangement thereby uniting the undertakings of two or more companies so that they become vested in, or under the control of one company which may or may not be original of the two or more of such uniting companies.

According to the mandatory Accounting Standard 14 (AS-14) issued by the Institute of Chartered Accountants of India (ICAI), 'amalgamation' means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies. Under the said AS-14, two methods of amalgamation have been contemplated, viz., (a) amalgamation in the nature of merger and (b) amalgamation in the nature of purchase.

In an amalgamation by purchase, one company's assets and liabilities are taken over by another and lump sum is paid by the latter to the former as consideration, which is within the purview of Sections 391 and 394 of the Act – Re SPS Pharma Ltd. (1997) 25 CLA 110 (AP).

Thus, an amalgamation is an organic unification or amalgam of two or more legal entities or undertakings or a fusion of one with the other. There is not bar to more than two companies being amalgamated under one scheme – Re. Patrakar Prakasham Pvt. Ltd. (1997) 33 (MP) 13 SCL.

In simple terms:

- Companies Act, 1956 is the legislation that facilitates amalgamation of two or more companies. – For purpose of Companies Act, the terms 'Merger' and 'Amalgamation' are synonymous. – Amalgamation is not defined in the Companies Act, 1956.

- Chapter V containing Section 390-396A of the Companies Act contains provisions on 'compromise, arrangements and reconstructions'. - Amalgamation is an 'arrangement' or

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'reconstruction'. – Companies (Court) Rules, 1959 lay down procedure for carrying out amalgamation.

- The word 'amalgamation' has no definite legal meaning. It contemplates a state of things under which two companies are so joined as to form a third entity, or one company is absorbed into and blended with another company. [per Romer LJ, Walker's Settlement, In re. Royal Exchange Assurance Corporation v. Walker (1935) 5 Comp Cas 412 (CA)].

- In amalgamation the undertaking comprising property, assets and liabilities, or one (or more) company (amalgamating or transferor company) are absorbed by and transferred to an existing company or a new company (amalgamated or transferee company).

- Transferor company mergers into or integrates with transferee company.

- This definition is relevant inter alia for Sections 35(5), 35A(6), 35E(7), 41(4) Explanation 2 43(1) Explanation 7 43(6) Explanation 2 43C, 47 (vi) & (vii), 49(1) (iii) (e), 49(2), 72A of IT Act.

- Transfer of assets to the transferee company pursuant to a scheme of amalgamation is not a 'transfer' and does not attract capital gains tax under Section 47(vi). Likewise, shares allotted to shareholders of the transferor company is not a transfer attracting capital gains tax under Section 47(vii).

- No company involved in amalgamation need be financially unsound or under winding-up though as per Section 390(a). For purposes of Section 391 'company' means "any company liable to be wound up". But it does not debar amalgamation of financially sound companies.

[Re Rossell Inds Ltd. (1995) 5 SCL 79 Cal].

- Section 390(a) is applicable to a company incorporated outside India. If court has jurisdiction to wind up such a company on any of the grounds specified in the Act, court has jurisdiction to sanction scheme of amalgamation if a company incorporated outside India is a transferor company. [Bombay Gas Co. Pvt. Ltd.v.Regional Director (1996) 21 CLA 269 (Bom)].

- There is no bar to a company amalgamating with a fifteen-day old company having no assets and business. [Re Apco Industries Ltd. (1996) 86 Comp Cas 457 (Guj)].

- Amalgamation calls for compliance with both Sections 391 and 394.

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- Amalgamation involving a 'sick industrial company' as transferor or transferee company is outside the purview of Companies Act. It is governed by the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA).
- Amalgamation of a company licensed under Section 25 of the Companies Act with a commercial, trading or manufacturing company could be sanctioned under Section 391/394. [Re Sir Mathurdas VissanjiFoundation (1992) 8 CLA (Bom); Re Walvis Flour Mills Company P.Ltd. (1996) 23 CLA 104]. There is nothing in law to prevent a company carrying on business in shares from amalgamating with one engaged in transport. [Re EITA India Ltd. (1997) 24 CLA 37 (Cal)].

Merger/Absorption

A merger may also mean absorption of one company by another company, wherein one of two existing companies loses its legal identity and its assets, liabilities and other properties are transferred to the other company as per scheme of arrangement approved by all or the statutory majority of the shareholders of both the companies in their separate general meetings and sanctioned by the court. This is also achieved in accordance with the applicable provisions of the Companies Act, 1956.

In the case of a merger or an amalgamation or an absorption, the shareholders of the merging or amalgamating or absorbing company are issued shares in the merged or amalgamated or absorbed company in exchange for the shares in their respective companies according to the exchange ratio determined under an approved and sanctioned scheme of merger or amalgamation or absorption, as the case may be.

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Lecture-2

The Main Idea

One plus one makes three: this equation is the special alchemy of a merger or an acquisition. The key principle behind buying a company is to create shareholder value over and above that of the sum of the two companies. Two companies together are more valuable than two separate companies - at least, that's the reasoning behind M&A.

This rationale is particularly alluring to companies when times are tough. Strong companies will act to buy other companies to create a more competitive, cost-efficient company. The companies will come together hoping to gain a greater market share or to achieve greater efficiency. Because of these potential benefits, target companies will often agree to be purchased when they know they cannot survive alone.

Distinction between Mergers and Acquisitions

Although they are often uttered in the same breath and used as though they were synonymous, the terms merger and acquisition mean slightly different things.

When one company takes over another and clearly established itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.

In the pure sense of the term, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals." Both companies' stocks are surrendered and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

In practice, however, actual mergers of equals don't happen very often. Usually, one

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company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's technically an acquisition. Being bought out often carries negative connotations, therefore, by describing the deal as a merger, deal makers and top managers try to make the takeover more palatable.

A purchase deal will also be called a merger when both CEOs agree that joining together is in the best interest of both of their companies. But when the deal is unfriendly - that is, when the target company does not want to be purchased - it is always regarded as an acquisition.

Whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders.

Synergy

Synergy is the magic force that allows for enhanced cost efficiencies of the new business. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from the following:

- Staff reductions - As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments. Job cuts will also include the former CEO, who typically leaves with a compensation package.
- Economies of scale - Yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. Mergers also translate into improved purchasing power to buy equipment or office supplies - when placing larger orders, companies have a greater ability to negotiate prices with their suppliers.
- Acquiring new technology - To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a

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smaller company with unique technologies, a large company can maintain or develop a competitive edge.

- Improved market reach and industry visibility - Companies buy companies to reach new markets and grow revenues and earnings. A merge may expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community: bigger firms often have an easier time raising capital than smaller ones.

That said, achieving synergy is easier said than done - it is not automatically realized once two companies merge. Sure, there ought to be economies of scale when two businesses are combined, but sometimes a merger does just the opposite. In many cases, one and one add up to less than two.

Sadly, synergy opportunities may exist only in the minds of the corporate leaders and the deal makers. Where there is no value to be created, the CEO and investment bankers - who have much to gain from a successful M&A deal - will try to create an image of enhanced value. The market, however, eventually sees through this and penalizes the company by assigning it a discounted share price. We'll talk more about why M&A may fail in a later section of this tutorial.

Varieties of Mergers

From the perspective of business structures, there is a whole host of different mergers. Here are a few types, distinguished by the relationship between the two companies that are merging:

- Horizontal merger - Two companies that are in direct competition and share the same product lines and markets.
- Vertical merger - A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker.
- Market-extension merger **-** Two companies that sell the same products in different markets.

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- Product-extension merger **-** Two companies selling different but related products in the same market.
- Conglomeration - Two companies that have no common business areas.

There are two types of mergers that are distinguished by how the merger is financed. Each has certain implications for the companies involved and for investors:

  - Purchase Mergers - As the name suggests, this kind of merger occurs when one company purchases another. The purchase is made with cash or through the issue of some kind of debt instrument; the sale is taxable.

    Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company. We will discuss this further in part four of this tutorial.
  - Consolidation Mergers - With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

Acquisitions

As you can see, an acquisition may be only slightly different from a merger. In fact, it may be different in name only. Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another - there is no exchange of stock or consolidation as a new company. Acquisitions are often congenial, and all parties feel satisfied with the deal. Other times, acquisitions are more hostile.

In an acquisition, as in some of the merger deals we discuss above, a company can buy another company with cash, stock or a combination of the two. Another possibility,

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which is common in smaller deals, is for one company to acquire all the assets of another company. Company X buys all of Company Y's assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Of course, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

Another type of acquisition is a reverse merger, a deal that enables a private company to get publicly-listed in a relatively short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets. The private company reverse merges into the public company, and together they become an entirely new public corporation with tradable shares.

Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on whether this synergy is achieved.

REASONS FOR MERGER AND AMALGAMATION

The key determinants for success in the global market are the ability to achieve size, scale, integration and greater financial strength and flexibility, in the interests of maximizing overall shareholder value. Whatever is the fundamental objective, mergers must form part of the business and corporate strategies aimed at creating sustainable competitive advantage for the firm. It is believed that mergers and amalgamations are strategic decisions leading to the maximization of a company's
growth by enhancing its production and marketing operations, enhanced competition, breaking of trade barriers, free flow of capital, globalization of business etc.
Further, it has been stated that mergers and acquisitions are intended:
(a) to limit competition,
(b) to utilize under-utilized market power,
(c) to overcome the problem of slow growth and profitability in one's own

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industry, (e) to achieve diversification,

(f) to establish a transnational bridgehead without excessive start up costs to gain access to foreign market,

(g) to utilize under-utilized resources – human and physical and managerial skills,

(h) to displace existing management,

(i) to circumvent Government regulations,

(j) to reap speculative gains attendant upon new security issue or change in P/E ratio

(k) to create an image of aggressiveness and strategic opportunism, empire building and to amass vast economic powers of the company.

[Courtsey : Ansoff H.L. et. Al. Acquisitive Behaviour of U.S. Manufacturing firms 1964-65, Vanderbilt university Press, 1971].

Some of the most common reasons and benefits of mergers and amalgamations include:

(i) maintaining or increasing a company's growth especially where internal growth is restricted due to scarcity of resources;

(ii) increasing or enhancing profitability, through cost reduction resulting from economies of scale, operating efficiencies and synergy.

(iii) diversification of risks.

(iv) Accelerating company's market power and reducing the severity of competition.

(v) reducing tax liability.

Some of the above mentioned reasons and benefits are discussed briefly hereunder.

Improving Economies of Scale

One of the most frequent reason given for mergers is to improve the economies of scale. Economies of scale arise when increase in volume of production leads to a reduction in cost of production per unit. They are generally associated with the manufacturing operations, so that the ratio of output to input improves with the volume of operations. Mergers and amalgamations help to expand the volume of production without a corresponding increase in fixed costs. Thus, the fixed costs are distributed over a large volume causing the unit cost of production to decline. Economies of scale may also be obtained from the optimum utilization of management resources and systems of planning, budgeting, reporting and control. A combined firm with a large size can make the optimum use of the management resources and systems resulting in economies of scale.

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This gives the company a competitive advantage by gaining an ability to reduce the prices to increase market share, or earn higher profits while maintaining a price.

Operating Economics

Apart from economies of scale, a combination of two or more firms may result in reduction of costs due to operating economies. A combined firm may avoid overlapping of function and facilities. Various functions may be consolidated and duplicate channels may be eliminated by implementing an integrated planning and control system. The merger of Sundaram Clayton Ltd. (SCL) with TVS Suzuki Ltd. (TSL) was motivated by operating economies and by virtue of this, TSL became the second largest producer of two wheelers. TSL needed to increase its volume of production but also needed a large manufacturing base to reduce its production costs. Large amount of funds would have been required for creating additional production capacity. SCL was also required to upgrade its technology and increase its production. Both the firms' plants were closely located offering various advantages, the most versatile being the capability to share common R & D facilities.

Market Leadership

Some of the mergers and amalgamations take place with a view to seek additional strength in the market. The amalgamation can enhance value for shareholders of both companies through the amalgamated entity's access to greater number of market resources. With the additional combined market share, a company can afford to control the price in a better manner with a consequent increase in profitability. The bargaining power of the firm vis-à-vis labour, suppliers and buyers is also enhanced.

The merged firm can also export technological breakthrough against obsolescence and price wars. In the case of the amalgamation of Reliance Petroleum Limited with Reliance Industries Limited, the main consideration had been that the amalgamation will contribute towards strengthening Reliance's existing market leadership in all its major products. It was foreseen that the amalgamated entity will be a major player in the energy and petrochemical sector, bringing together Reliance's leading positions in different product categories.

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Financial Benefits

A merger or amalgamation is capable of offering various financial synergies and benefits such as eliminating financial constraints, deployment of surplus cash, enhancing debt capacity and lowering the cost of financing. Mergers and amalgamations enable external growth by exchange of shares releasing thereby, the financial constraint.

Also, sometime cash rich companies may not have enough internal opportunities to invest surplus cash. Their wealth may increase through an increase in the market value of their shares if surplus cash is used to acquire another company. A merger can bring stability of cash flows of the combined company, enhance the capacity of the new entity to service a larger amount of debt, allowing a higher interest tax shield thereby adding to the shareholders wealth. Also, in a merger since the probability of insolvency is reduced due to financial stability, the merged firm should be able to borrow at a lower rate of interest. Apart from this, a merged firm is able to realize economies of scale in floatation and transaction costs related to an issue of capital i.e. issue costs are saved when the merged firm makes a larger security issue.

Acquiring a New Product or Brand Name

A company, for strategic reasons, may wish to produce or market a particular product, but may not have the required production, marketing or managerial facilities for completing a product line or for meeting all the needs of a customer segment. Getting the required know-how from others sources installing and commissioning a plant and then launching the new product may take much time and result in loss of advantages for getting into the associated business. Instead, amalgamation would provide readymade facilities, which would provide a quicker entry for encashing the comparative advantage of the new product before new entrants make the market much more competitive and much less profitable.

Diversifying the Portfolio

Another reason for merger is to diversity the company's dependence on a number segments of the economy. Diversification implies growth through the combination of firms in unrelated businesses. All businesses go through cycles and if the fortunes of a company were linked to only one or a few products then in the decline stage of their product life cycles, the company would find it difficult to sustain itself. The company

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therefore looks for either related or unrelated diversifications and may decide to do so not internally by setting up new projects, but externally by merging with companies of the desired product profile. Such diversification helps to widen the growth opportunities for the company and smoothen the ups and downs of their life cycles.

Synergies

Synergy refers to a situation where the combined firm is more valuable than the sum of individual combining firms (2+2=5). The combination of operations can create a unique level of integration for the amalgamated entity spanning the entire value chain in the line of business. This will enable the amalgamated entity to achieve substantial savings in costs, significantly enhancing its earnings potential. Synergies can be expected to flow from more focused operational efforts, rationalization, standardization and simplification of business processes, productivity improvements, improved procurement, and the elimination of duplication.

Taxation or Investment Incentives

A company, which has incurred losses in the past, can carry such losses forward and offset them against future taxable profits and reduce tax liabilities. Such a company when merged with a company with large taxable profits would help to absorb the tax liability of the latter.

A similar advantage exists when a company is modernizing or investing heavily in plant and machinery, which entitles it to substantial investment incentives, but has not much taxable profits to offset them with. Acquiring or merging such a company with a highly profitable company would help make full use of the investment incentives for the latter.

Survey findings

In the early seventies, the Organization for Economic Cooperation and Development (OECD) published a Report of their Committee of Experts on Restrictive Business Practices, on 'Mergers and Competition Policy'. The report listed twelve motives most often cited for mergers, which may be grouped together under the following categories:

A. Economies of Scale

1 Obtain Real Economies of Scale Related Reasons

2 Acquire Capacity at Reduced Prices

B. Market share Reasons

3 Increase market power

4 Expand production without price reduction

5 Build an empire

6 Rationalize production

C. Financial Synergy

7 Obtain Tax advantages Related Reasons

8 Obtain monetary economies of scale

9 Use complementary resources

10 Gain promotional profits

D. Diversification of Risk

11 Spread risks by diversification Related Reasons

12 Avoid firm's failure

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Lecture-3

Introduction to Corporate restructuring

CORPORATE restructuring involves restructuring the assets and liabilities of corporations, including their debt-to-equity structures, in line with their cash flow needs in order to,

- Promote efficiency,
- Restore growth,
- And minimize the cost to tax payers.

Corporate governance refers to the framework of rules and regulations that enable the stakeholders to exercise appropriate oversight of a company to maximize its value and to obtain a return on their holdings. Fundamental cultural and institutional changes are required if a new corporate governance structure is to be established with arm's-length, transparent relations between corporations, government, and banks. Changing corporate governance, however, is a long-term process Global enterprises may be motivated to reorganize their worldwide tax and legal structure for a variety of reasons. For example,

- To fully realize the value anticipated from a strategic merger or acquisition, a global enterprise must quickly reorganize and integrate its combined business operations from a tax and legal perspective.
- On the other hand, a fully integrated global enterprise may be forced to quickly realign its worldwide structure in order to effect a strategic spin-off or disposition of business operations that the management no longer deems desirable or essential.
- Finally, a global enterprise may wish to reorganize its worldwide structure to accommodate a down-sizing or transformation of its existing business operations or simply to generate tax and legal efficiencies that will contribute to its overall earnings per share. Whatever the objective, to be truly successful, a global reorganization must be structured in a manner that not only,
- Optimizes the ultimate tax position of the enterprise,
- But also addresses a multitude of legal issues that arise as a result of the restructuring.

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Lecture - 4

Corporate failures.

Business failures

Before we understand the physiology of restructuring let us understand the causes for corporate failures.

"God, but its hard making predictions!........ Especially about the future" – Alphonse Allais.

"The future, sadly, is not any more what it used to be" – Paul Valery.

The result is increased number of corporate failures.

Business failure and reorganization

Business failure occurs due to different reasons. While few firms fail within first year or two of life, few others grow, mature and fail much later. The failure can occur in a number of ways and also from different reasons. Business failure can be considered from,

- Economic and,
- Financial view point.

Why business firms fail

Let us try understand the different reasons why corporate often fail

- An imbalance of skills within the top echelon.
- A chief executive who dominates a firms operations without regard for the inputs of peers
- An inactive board of directors. The board of Directors lack of interest in the financial position of the company may lead to insolvency.
- A deficient finance function within the firm's management.
- The absence of responsibility for the chief executive officer.

Apart from the above mistakes the firm usually is vulnerable to several mistakes,

- Management may be negligent in developing effective accounting system
- The company may be unresponsive to change

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- Management may be inclined to undertake an investment project that is disproportionately large relative to firm size. If the project fails the probability of insolvency is greatly increased.
- Finally the management may rely heavily on debt financing that even a minor problem can place the firm in a dangerous position.

Symptoms of bankruptcy or failure

Having understood the causes for a firm's sickness, the next important question is – is it possible to with reasonable accuracy predict a firm's failure using some modeling technique. Research shows that as a company enters the final stage prior to failure - a pattern may develop in terms of - changing financial ratios which prove to be useful indicators of an impending disaster. *Altman* has developed a statistical model and found the statistical ratios best predicting bankruptcy. Based upon *Altman'*s sample of bankrupt firms the study yielded an equation that used five ratios to predict bankruptcy. Accordingly,

Bankruptcy score = 1.2X 1+ 1.4X2 + 3.3X3 + 0.6X4 + 0.999X5

Where,

X1 = Networking Capital / Total assets

X2 = Retained earnings / Total assets

X3 = Earnings before interest and taxes / total assets

X4 = Total market value of stock / book value of total debt

X5 = Sales / total assets

The Analysis: The Z-score was developed from an analysis of 33 – Bankrupt manufacturing companies with average assets of $6.4 million, and, as controls, another 33 companies with assets between $1 million and $25 million.

Atman's Z-score calculates 5 ratios,

1 return on total assets

2 sales to total assets

3 working capital to total assets

4 retained earnings to total assets

These ratios are then multiplied by a predetermined weight factor and the results are added together. The final number--the Z-score--yields a number between -4 and +8. The

research showed that Financially-sound companies show Z-scores above 2.99, while those scoring below 1.81 are in fiscal danger, maybe even heading toward bankruptcy. Scores that fall between these ends indicate potential trouble. In Altman's initial study of 33 bankrupt companies, Z-scores for 95 % of these companies pointed to trouble or imminent bankruptcy. Although the numbers that go into calculating the Z-score (and a company's financial soundness) are sometimes influenced by external factors, it provides a good quick analysis of where the company under study stands compared to the competition, and provides a good tool for analyzing the ups and downs of the company's financial stability over time.

The Altman Z-Score Analysis - 5 Ratios

RATIO FORMULA WEIGHT FACTOR WEIGHTED

RATIO

Return on Total

Assets

Earnings Before

Interest and Taxes

Total Assets

x. 3.3 -4 to +8.0

Sales to Total Assets

Net Sales

Total Assets

x 0.999 -4 to +8.0

Equity to Debt

Market Value of

Equity

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Total Liabilities

x 0.6 -4 to +8.0

Working Capital to

Total Assets

Working Capital

Total Assets

x 1.2 -4 to +8.0

Retained Earnings to

Total Assets

Retained Earnings

Total Assets

x1.4 -4 to +8.0

Practice questions

1. why business firms fail
2. enumerate few symptoms of business failure
3. explain altmans bankruptcy score

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Lecture -4

The physiology of business failure

In an economic sense business failure is associated with success in business relates to firms that earn adequate return on their investment. Similarly business failure is associated with forms that cannot earn adequate returns on their investments. What is important is whether a business failure is permanent or temporary. In fact the appropriate course of action depends on whether the business failure is permanent or temporary. Thus if the failure is temporary the firm may have to be liquidated and if the failure is permanent the firm may have to take steps to the speed the company's return to business.

Types of business failure

Insolvency

A firm may fail if its returns are negative or even low. A firm that consistently reports losses at operational level would experience decline in market share and eventual closure.

Technical insolvency

A firm is said to be facing technical insolvency when it is unable to pay its liabilities as they become due. Thus when a firm faces technical insolvency its assets are still greater than the liabilities but the firm is confronted with liquidity crisis.

Bankruptcy

When a firm has technical insolvency some of its assets could be converted to cash to escape complete failure. If this is not done at right time, the firm may have to face a more serious type of failure – Bankruptcy. It occurs when firm's assets are less than the liabilities. A bankrupt firm has a negative shareholder's equity. Although bankruptcy is a more obvious form of business failure courts treat technical insolvency and bankruptcy in the same way.

The challenge

When a firm faces severe problems, either the problems must be resolved or the firm must be liquidated. At such point an important question has to be answered – ***"is the***

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firm worth more dead or alive" The decision to continue operating has to be based upon - *The feasibility and fairness of reorganizing the firms as opposed to the benefits of liquidating the business.* When technical insolvency occurs management must either modify the operating financial conditions or terminate the firm's life If a decision is made to alter the company in the hopes of revitalizing its operations, Either voluntary agreements with the investors, or A formal court arranged reorganization must be used. If on the other hand the difficulties are believed to be insurmountable, then liquidation will take place either by assignments of assets to an independent party for liquidation or by formal bankruptcy proceedings.

Voluntary remedies to Insolvency

Once a firm begins to encounter these difficulties the firm's owners and management have to consider the alternatives available to failing business. Such a firm has two remedies,

- Attempt to resolve its difficulties with its creditors on voluntary or informal process.
- Petition the courts for assistance and formally declare bankruptcy.

The company creditors also may petition to courts and get the company involuntarily declared bankrupt.

To reorganize or liquidate

Regardless of whether a business chooses informal or formal methods to deal with its difficulties eventually the decision has to be made whether to reorganize or liquidate the business. Before this decision can be made both the business liquidation value and its going concern value has to determine.

Liquidation value: equals the proceeds that would be received from the sale of the business less its liabilities.

Going concern value: equals the capitalized value of the company's operating earnings less its liabilities. Normally,

If the going-concern value exceeds the liquidation value the company needs to be reorganized otherwise it should be liquidated.

However in practice the determination of the going concern and liquidation values is not easy due to following reasons,

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- Uncertainty as to estimating the price the company's assts will bring at auction.
- The company's future operating earnings
- Appropriate discount rate at which to capitalize the earning may be difficult to determine.
- Management understandably is not in a position to be completely –objective, about the above values.

Informal alternatives for failing business

Regardless of exact reasons why a business begins to experience difficulties the result is often same – Cash flow problems Frequently,

- The first step taken by troubled company involves stretching its payable. In some occasions this can keep the company busy for several weeks of needed time before creditors take action. If the difficulties are more than just minor and temporary the company may turn to its bankers with request for additional working capital loans.
- Another possible action is the company bankers and creditors take up to restructure the company's debt. Restructuring of debt by bankers can be quite complex. However debt restructuring basically involves either
- Extension,
- Composition, or
- A combination of both above.

In *Extension* – The failing company tries to reach an agreement with its creditors that will permit it to lengthen the time for meeting its obligations.

In *composition* – The firm's creditors accept some percentage amount lees than their original claim and the company is permitted to discharge its debt obligations by paying less than the full amounts and are protected from any further actions on part of creditors while it attempts to work out a plan of re-organization.

What to do with the failing firm

Another important aspect of the bankruptcy procedures involves what to do with the failing firm. Just as in case of informal alternatives a decision has to be made about whether a firm's value as a going concern is greater than its liquidation value. Generally

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if this is so a suitable plan of reorganization can be formulated and the firm is reorganized otherwise it is liquidated.

Reorganization

If a voluntary remedy such as an extension or composition is not workable a company can declare or be forced by its creditors into bankruptcy. As a part of this process a firm is either reorganized or dissolved. Reorganization is similar to an extension or composition, the objective being to revitalize the firm by changing its capital structure – like,

- Reduction of fixed charges by substituting equity and limited income

securities in place of fixed income securities, etc. Corporate restructuring can occur in myriad ways. Mergers, takeovers, divestitures, spin-offs, and so on referred to collectively as corporate restructuring have become a major force in the financial and economic environment all over the world.

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Lecture – 5

Dynamics of restructuring

In an incisive study on corporate restructuring covering a number of companies over an extended period of time **Gordon Donalson** examined the dynamics of corporate restructuring. He tried to look at issues like why corporate restructuring occurs periodically, what conditions or circumstances induce corporate restructuring and how should corporate governance be reformed to make it more responsive to the needs of restructuring. The key insights of this study are as below,

• Even though the environmental change which warrants corporate restructuring is a gradual process, corporate restructuring is often an episodic and convulsive exercise. Why? Typically an organization can tolerate only one vision of future, articulated by its chief executive and it takes time to communicate that vision and mobilize collective commitment. Once the strategy and structure that reflect that vision are in place, they acquire a life of their own. A constituency develops with a vested interest in that strategy and structure which resists change unless it becomes inescapable.

• Hence Gordon Donalson says "hence resistance to change often preserves the status quo well beyond its period of relevance so that when change comes the pent up forces like an earthquake capture in one violent moment a decade of gradual change.

• The conditions or circumstances which seem to enhance the probability of voluntary corporate restructuring but not necessarily guarantee same are, persuasive evidence that the strategy and structure in place have substantially eroded the benefits accruing to one or more principal corporate constituencies a shift in the balance of power in favor of the disadvantaged constituency availability of options to improve performance Presence of leadership which is capable of and willing to act.

• Corporate restructuring occurs periodically due to an on going tension between the organizational need for stability and continuity on one hand and economic compulsion to adapt to changes on the other. As Gordon Donaldson says, " the 'wrongs' that develop during one period of stable strategy and structure are never permanently rightened because each new restructuring becomes the platform on which the next era of stability and continuity is constructed.

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Lesson - 6

Historical background from Indian perspective

In earlier years, India was a highly regulated economy. To set-up an industry various licenses and registration under various enactments were required. The scope and mode of corporate restructuring was, therefore, very limited due to restrictive government policies and rigid regulatory framework. Consequent upon the raid of DCM Limited and Escorts Limited launched by Swaraj Paul, the role of the financial institutions became quite important. In fact, Swaraj Paul's bids were a forerunner and constituted a 'watershed' in the corporate

history of India. The Swaraj Paul episode also gave rise to a whole new trend. Financially strong entrepreneurs made their presence felt as industrialists – Ram Prasad Goenka, M.R.Chabria, Sudarshan Birla, Srichand Hinduja, Vijay Mallya and Dhirubhai Ambani and were instrumental in corporate restructuring. The real opening up of the economy started with the Industrial Policy, 1991 whereby 'continuity with change' was emphasized and main thrust was on relaxations in industrial licensing, foreign investments, and transfer of foreign technology etc. For instance, amendments were made in MRTP Act, within all restrictive sections discouraging growth of industrial sector. With the economic liberalization, globalization and opening up of economies, the Indian corporate sector started restructuring to meet the opportunities and challenged of competition.

Present Scenario

Today, a restructuring wave is sweeping the corporate sector over the world, taking within its fold both big and small entities, comprising old economy businesses conglomerates and new economy companies and even the infrastructure and service sector. Mergers, amalgamations, acquisitions, consolidation and takeovers have become an integral part of new economic paradigm. Conglomerates are being formed to combine businesses and where synergies are not achieved, Demergers have become the order of the day. With the increasing competition and the economy, heading towards

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globalization, the corporate restructuring activities are expected to occur at a much larger scale than at any time in the past, and are stated to pay a major role in achieving the competitive edge for India in international market place. The process of restructuring through mergers and amalgamations has been a regular feature in the developed and free economy nations like Japan, USA and European countries with special reference to UK where hundreds of mergers take place every year. The mergers and takeovers of multinational corporate houses across the borders has become a normal phenomenon. Corporate restructuring being a matter of business convenience, the role of legislation, executive and judiciary is that of a facilitator for restructuring on healthy lines. The stand of the Government is that monopoly is not necessarily bad provided market dominance is not abused. In this era of hyper competitive 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.

Global Scenario

The sweeping wave of economic reforms and liberalization, has transformed the business scenario all over the world. The most significant development has been the integration of national economies with '**Market-oriented Globalized Economy'**. The multilateral trade agenda and the World Trade Organization (WTO) have been facilitating easy and free flow of technology, capital and expertise across the globe. Globalization gives the consumer many choices – technologies are changing, established brands are being challenged by value – for money products, the movement of goods across countries is on the rise and entry barriers are being reduced. As markets consolidate into fewer and larger entities, economies become more concentrated. In this international scenario, there is a heavy accent on the quality, range, cost and reliability of product and services. Companies all over the world have been reshaping and repositioning themselves to meet the challenges and seize the opportunities thrown open by globalization. The management strategy in turbulent times is to focus on core competencies – selling loss making companies and acquiring those, which can contribute to profit and growth of the

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group. The underlying objective is to achieve and sustain superior performance. In fact, most companies in the world are merging to achieve an economic size as a means of survival and growth in the competitive economy. There has been a substantial increase in quantum of funds flowing across nations in search of restructuring and takeover candidates. UK has been the most important foreign investor in USA in recent years with British companies. In telecom, the biggest deals include AT&T- TCI, SBC-Ameritech etc. There have been huge oil sector mergers, the biggest being Exxon-Mobile, BP-Amoco and Total-Pretrofina. It is estimated that one-in-four US workers have been affected by the wave of mergers and acquisition activity. In the Japanese context, mergers and acquisitions are less relevant as they believe in alliances and joint ventures than mergers and acquisitions. Also, research has shown that Japanese are least preferred merger partner/acquirer. The reason being - incompatible on language.

National Scenario

The unleashing of Indian economy has opened up lucrative and dependable opportunities to business community as a whole. The absence of strict regulations about the size and volume of business encouraged the enterprises to opt for mergers and amalgamations so as to produce on a massive scale, reduce costs of production, make prices internationally competitive etc. Today Indian economy is passing through recession. In such a situation, corporates which are capable of restructuring can contribute towards economic revival and growth. Despite the sluggish economic scenario in India, merger and amalgamation deals have been on the increase. The obvious reason is – as the size of the market shrinks, it becomes extremely difficult for all the companies to survive, unless they cut costs and maintain prices. In such a situation, merger eliminates duplication of administrative and marketing expenses. The other important reason is that it prevents price war in a shrinking market. Companies, by merging, reduce the number of competitors and increase their market share.

In the words of Justice Dhananjaya Y.Chandrachud, ***Corporate restructuring is one of the means that can be employed to meet the challenges which confront business.***

Let us understand the techniques of restructuring. Before that it needs to be understood that - Corporate restructuring can take several forms,

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- Mergers and acquisitions
- Portfolio restructurings
- Financial restructurings.

Restructuring may also be classified into following forms,

- Financial restructuring
- Technological restructuring
- Organizational restructuring

The most commonly applied tools of corporate restructuring are

- Amalgamation
- Merger
- Demerger
- Slump sale
- Acquisition
- Joint venture
- Divestment
- Strategic alliance
- Franchises

Organizational restructuring exercise:

Many firms have begun organizational exercises for restructuring in recent years to cope with heightened competition. The common elements in most organizational restructuring and performance enhancement programmes are described below,

• Regrouping of business: firms are regrouping the existing businesses into a few compact strategic business units which are often referred to as profit centers. For example L&T ahs been advised by Mckinsey Consultants to
regroup its twelve businesses into five compact divisions

• Decentralization: to promote a quicker organizational response to dynamic environmental developments, companies are resorting to decentralization, de- layering, and delegation aimed at empowering people down the line. For example, Hindustan lever Ltd., has embarked on an initiative to reduce

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Portfolio restructurings

Mergers, asset purchases, and takeovers lead to expansion in some way or the other. They are based on the principle of synergy which says 2 +2=5 ! Portfolio restructuring, on the other hand, involves some kind of contraction through a Divestiture or a De-merger is based on the principle of "synergy" which says 5 -3 = 3!

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Lesson - 7

Corporate strategy

Towards reorganizing themselves companies need to develop a strategy. The conditions companies must satisfy if they are to conserve their essential characteristics over time may be summed up as –

- Consistency between their strategy, and
- The characteristics of the external environment in which they operate.

Owing to technological change and evolution as well as owing to heightened competitive pressures following,

- Market globalization and,
- Deregulation,

Companies increasingly have to cope with altered conditions of competition. In response they are forced to change their strategic framework. Companies also need to change the way they compete and also the basic assumptions underlying the planning criteria that they adopt for their more general strategic design/architecture and those that govern the ways in which they interact with the external environment.

These changes have a bearing on,

- The companies ability to control environment variables
- The degree of company dependence on the external environment
- The very nature of the variability to be controlled.

Uncertainty has become the central element of competitiveness and business environment. In a world defined by turbulence surprise and a lack of continuity predictions are increasingly erroneous and therefore dangerous. This turbulence is being caused by,

- Acceleration of technological process
- The globalization of competition
- The restructuring of capitalism on a global scale.
- The slowing down of growth in some key sectors
- The political changes
- The high growth rates of Asian countries
- The large imbalance in global economy.

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In a world, where prediction is becoming less reliable, decision-making and management models are perennially evolving, successful companies are organizing to become progressively "ready for anything".

They are equipping themselves to be able to seize unexpected opportunities and retreat rapidly from bad risks. This evolution is centered on,

- Improvement of strategic analysis and thinking in terms of scenarios
- The anticipated development of additional capabilities in key resources
- Increased speed of action and reaction through efficient process of learning

and change.

Precisely organizations are restructuring themselves to meet changing environment. For three decades after world war two most economies around the world witnessed historically unparalleled progress. However after the early 1970s growth in most of industrialized economies began to slow down, affecting much of the developing world particularly adversely during the 1980's and 1990's. There were a variety of causes of this change in the trajectory of growth some of a macro economic nature and others rooted in the structure of corporate organization and in inter-firm linkages. The response to these pressures has been a significant change in macroeconomic policies amongst countries. Throughout the world there has been a surge toward deregulation and a feeling of barriers to the global flow of many resources. For some countries this has resulted in significant enhancement to economic growth but for others globalization has done little to enhance living standards and security. Thus the gains from globalization is not automatic they depend on response of producers to the changing competitive environment. One critical area of change is to be found in organization of production. To cope with new competitive pressures firms have to deliver not just low-priced goods and services but also products of greater quality and diversity. This requires in the first instance that they reorient their internal organization, changing production layout, introducing new methods of quality assurance and instituting processes to ensure continuous improvement.

But these changes in themselves are not sufficient. They need to be complemented by alterations in the relationship amongst firms particularly with firms.

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Lecture-8

What we mean by Strategies

Introduction

The term 'strategies' has been defined by J.L.Thompson as "means to an end. The end concerns the purpose and objectives of the organization. There is a broad strategy for the whole organization and a competitive strategy for each activity. Functional strategies contribute directly to the competitive strategy". The word 'strategy' is used to describe the direction that the organization chooses to follow in order to fulfill its mission. Another famous strategy thinker, Henry Mintzberg has enunciated 5 Ps of strategy viz.-

(i) A Plan i.e. strategy is a consciously intended course of action which a firm chooses to follow after careful deliberations on the various options available to it. It is not the first alternative that came to the chief executive's mind like a flash or a dream.

(ii) A Ploy i.e. it is a specific manoeuvre which is intended to outwit an opponent or a competition. It is a trick, a device, a scheme or a deception to gain advantageous position before engaging into the combat of marketing warfare.

(iii) A Pattern i.e. it is not one decision and one solitary action; it stands for a stream of decisions and actions to guide and tend the future course of the enterprise until it reaches its predetermined corporate objectives.

(iv) A Position i.e. it is a means of locating the firm in an environment full of external factors pulls and pushes. On most of those factors, enterprise has little control and whatever influence it can exercise is constrained by its organizational capabilities.

(v) A Perspective i.e. it is an ingrained way of perceiving the world around the organization and its business operations. It is greatly influenced by the mindset of people who form the dominant interest group and are involved in taking decisions affecting the future course that the firm takes.

The above may also be visualized as five uses of strategy. However, they are all linked together and each organization must explore its own uses with respect to its business, internal competencies and external environments. With competition for markets and market share becoming more intense, managers responsibilities are increasing. They must devise suitable strategies to gain an edge over its competitors at a cost which it deems

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reasonable, strategy is a game plan of the company to outwit and outmanoeuvre its competitors.

Levels of Strategies

Strategies can be visualized to operate at three different levels viz. Corporate level, divisional or business level and operational or functional level. Strategies at corporate level focus on the scope of business activities i.e. what product portfolios to build, to expand and to consolidate. The growth and diversification strategy has to be spelt out in terms of functions and structures- should it be in the form of multi divisions of the same corporation or should it be a holding group having a number of legally independent companies and how resources have to be allocated to various alternative and competing options. Such strategies are known as grand, overall or root strategies. If these are to succeed, they have to take into account political, economical technological environments and in accordance with the societal and national priorities without ignoring the organizational paradigm and dominant stakeholders' expectations. Their time frame is usually the longest usually five years or more. Strategies at divisional or business level are directly concerned with the future plans of the profit centers which are divisionalized in large enterprises. These are the sub-strategies as they devolve from the grand strategies and have market orientation because these deal with the current and future product lines and current and future markets including overseas businesses. Strategies at operational or functional level target the departmental or functional aspects of operations and look at the functional strategies of marketing, finance, human resources, manufacturing, information systems etc. and devise ways and means of increasing their contribution to the other levels of strategies. It must be noted that success of strategies at business or corporate level is largely dependent upon the strategic decisions regarding activities at the operation level. A good strategy results in effective aligning of the organization with its environment. A company needs to tune its vision continually to the requirements of a constantly changing business environment. Every company, influenced by the cause and effect of its environment, draws resources from the environment and provides value-added resources back to the environment. The effectiveness of the manner in which a

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company draws resources and delivers back to the environment depends on its strengths and weaknesses. Strategy is a major focus in the quest for higher revenues and profits, with companies pursuing novel ways to 'hatch' new products, expand existing businesses and create the markets of tomorrow. The global economic environment has been posing both threats and opportunities to companies. If a company's response is weak to the environment, the latter posses a threat to the former. On the other hand, if a company's response is strong to the environment, the latter unfolds numerous opportunities. As such, strategic management is the continuous process of coordinating the goals of a company with the economic environment at a macro level, in an effective manner, to reap the opportunities and overcome the threats, considering its strengths and weaknesses.

Strategic Planning

The environment in which business organizations operate today is becoming uncertain. In the emerging fast-changing competitive global environment, a company can neither save its way to prosperity nor afford to remain at a standstill if it to avoid stagnation; it must grow on its own, or be absorbed into a growing entity. Profitable growth constitutes one of the prime objectives of most of the business organizations. Different organizations may have to use different growth strategies depending on the nature of complexity and quantum of work involved. The top management of the organization ordinarily provides the direction as to which of the strategies would be the most appropriate for a particular company. This will depend upon several factors, including the corporate objectives of the organization. The strategic alternative, which an organization pursues, s crucial to the success of the organization and achievement of established goals. However, many times these are influenced by factors externals to the organization over which the management has limited control. Strategic planning is a management tool, used to help an organization do a better job to assess and adjust the organisation's direction in response to a changing environment. Strategic planning is a disciplined effort to produce fundamental decisions and actions that shape and guide what an organization is, what it does, and why it does it, with a focus on the future at the same time. A strategic plan is visionary, conceptual and directional in nature. Though there is no prescribed single 'silver bullet' for corporate success, there is a continuous need for strategic planning. However, management must understand the holistic nature of strategy, and have the determination to adhere to it

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steadily and steadfastly by using strategic planning as a guide in times of uncertainty. In order to derive the maximum benefit of strategic planning, the companies must recognize that the methodology requires sustained commitment, an understanding of its complexity and the ability to harness its strategic opposites.

Importance of Strategic Planning

Strategic planning encourages, managers to take a holistic view of both the business and its environment. The strength of strategic planning is its ability to harness a series of objectives, strategies, policies and actions than can work together. Managing a company strategically means thinking and accordingly taking suitable action on multiple fronts. Due to involvement of multiple operations objectives, strategies, policies or actions may, on the surface, appear contradictory and mutually exclusive, but in reality they can work together. Strategic planning provides the framework for all the major business decisions of an enterprise-decisions on business, products and markets, manufacturing facilities, investments and organizational structure. In a successful corporation, strategic planning works as the path finder to various business opportunities, simultaneously it also serves as a corporate defense mechanism helping the firm avoid costly mistakes in product market choices or investments. Strategic planning has the ultimate burden of providing a corporation with certain core competencies and competitive advantages in its fight for survival and growth. It is not just a matter of projecting the future. It seeks to prepare the corporation to face the future. Its ultimate burden is influencing the corporation's mega environs in its favor, working into the environs and shaping it instead of getting carried away by its turbulence or uncertainties. The success of the efforts and activities of the enterprise depends heavily on the quality of strategic planning i.e. the vision, insight, experience, quality of judgment and the perfection of methods and measures.

Features of Strategic Planning

The salient features of strategic planning are as under:

1. It is an inclusive, participatory process in which the Board and staff take on a 'shared ownership'
2. It is a key part of effective management
3. It prepares the firm not only to face the future but even shape the future in its favor.
4. It is based on quality data

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5. It draws from both intuition and logic.
6. It accepts accountability to the community
7. It builds a shared vision that is value-based.
8. It helps to avoid haphazard response to environment.
9. It ensures best utilization of firm's resources among the product-market opportunities.

Strategic planning is not a substitute for the exercise of judgment by leadership. So the date analysis and decision-making tools of strategic planning do not make the organization work – they can only support the intuition, reasoning skills, and judgment that the personnel contribute to their organization.

Strategic Planning and Long-Range Planning

Although these terms are frequently used interchangeably strategic planning and long-range planning differ in their emphasis on the concept of "assumed" environment. Long-range planning is generally considered to mean the development of a plan for accomplishing a goal or set of goals over a period of several years, with the assumption that current knowledge about future conditions is sufficiency reliable to ensure the plan's reliability over the duration of its implementation. On the other hand, strategic planning assumes that an organization must be responsive to a dynamic, changing environment (as against the stable environment assumed for long-range planning). Strategic planning, also emphasizes on the importance of making decisions that will ensure the organization's ability to successfully respond to changes in the environment.

Once an organization's mission has been affirmed and its critical issues identified, it is necessary to figure out the board approaches to be taken (strategies), and the general and specific results to be sought (the goals and objectives). Strategies, goals and objectives may come from individual inspiration, group discussion, formal decision-making techniques, or otherwise – but the bottom line is that, in the end, the management agrees on how to address the critical issues. In strategic planning it is crucial to formally consider the manner in which an organization will accomplish its goals. The solution to this encompasses formulation of a strategy. Strategy is a plan or course of action which is of vital, pervasive or continuing importance to the organization as a whole. Whereas management is defined as the conducting or supervising of something (as a business) especially the executive function of planning, organizing, directing, controlling and

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supervising any industrial or business project or activity with, responsibility for results. (Websters Third New International Dictionary). In light of this strategic management can be defined as the formulation and implementation of plans and the carrying out of activities relating to matters which are of vital, pervasive or continuing importance to the total organization. In other words, strategic management is the application of strategic thinking to the job of leading an organization and has four basic doctrines.

(i) matching business requirements with internal capabilities,

(ii) having strategically balanced portfolio,

(iii) achieving and sustaining competitiveness, and

(iv) Developing long-term internal and core competencies.

Strategic planning is useful only if it supports strategic thinking and leads to strategic management

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Lecture - 9

Competitive Advantage and Core Competencies

Companies should strive to develop unique resources in order to gain a lasting competitive advantage. Competitive advantage, whatever is source, can ultimately be attributed to the ownership of valuable resources that enable the company to perform activities efficiently at comparatively lower costs than its competitors. Superior performance will therefore be based on developing a competitively distinct set of resources and deploying them in a well-conceived strategy. Companies should abandon the areas of operations and dispense with activities where they do not possess a competitive advantage and concentrate their resources where they could attain competitive strength, so as to focus on improving productivity and increased efficiency.

The concept of 'core competency' is central to the resource-based perspective on corporate strategy. The resource-based view of strategy is that sustainable competitive advantage arises out of a company's possessing some special skills, knowledge, resources or competencies that distinguish it form its competitors. Core competency is a bundle of a specific knowledge; skills, technologies, capabilities and organization which enables it to create value in a market those other competitors cannot do in the short term. The resources could be, for example, manufacturing flexibility, responsiveness to market trend and reliable service. The main concept about core competencies was developed by C.K.Prahalad and G.Hamel in 1990. The idea is that, over time, companies may develop key areas of expertise, which are distinctive to that company and crucial to the company's long term development. These areas of expertise may be in any area but are mot likely to develop in the critical, central areas of the company where most value is added to its products. While in the case of a manufacturer this could be in the routine and processes at the heart of the production process, for a software company the key skills may be in the initial conceptualization process or alternatively in the high quality of code writing they have achieved. Core competencies are not fixed and codified but flexible and evolving over time and changing in response to changes in the company's environment. As the company evolves and adapts a new circumstances and opportunities, so its core competencies will also adapt and change. In this way the company will be able to make the most of its given resources and apply them to new opportunities.

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Prahalad and Hamel suggest three factors to help identify core competencies in a company.

(i) Core competence provides potential access to a wide variety of markets.

(ii) Core competence should make a significant contribution to the perceived customer benefits of the end product.

(iii) core competence should be difficult for competitors to imitate. Companies can use their core competencies to expand into other markets and add to the customer benefits.

Strategy Formulation and Execution

One of the purposes of corporate restructuring is to have an optimum business portfolio, by deciding whether to retain, divest or diversify the business. Business portfolio restructuring can be done in a variety of ways like amalgamations, merger, demerger, slump sale, takeover, disinvestment, joint venture, foreign franchises, strategic alliance, etc. The ultimate choice of strategy by the organization would depend upon its growth objectives, attitude towards risk, the present nature of business and technology in use, resources at its command, its own internal strengths and weaknesses, Government policy, etc.

Amalgamation

In amalgamation, two or more existing companies merger together or form a new company keeping in view their long term business interest. The transferor companies lose their existence and their shareholders become the shareholders of the new company. Thus, amalgamation is a legal process by which two or more companies are joined together to form a new entity or one or more companies are to be absorbed or blended with another and as a consequence the amalgamating company loses its existence and its shareholders become the shareholders of the new or amalgamated company.

Merger

A merger has been defined as 'the fusion or absorption of one thing or right into another'. A merger has also been defined as an arrangement whereby the assets of two (or more) companies become vested in, or under the control of one company (which may or may not be one of the original two companies), which has as its shareholders, all or

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substantially all, the shareholders of the two companies. In merger, one of the two existing companies merges its identify into another existing company or one of more existing companies may forma a new company and merge their identities into the new company by transferring their business and undertakings including all other assets and liabilities to the new company (hereinafter referred to as the merged company). The shareholders of the company whose identity has been merged (i.e. merging company) get substantial shareholding in the merged company. They are allotted shares in the merged company in exchange for the shares held by them in the merging company according to the shares exchange ratio incorporated in the scheme of merger as approved by all or prescribed majority of the shareholders of the merging companies and the merged companies in their separate general meetings and sanctioned by the Court as per the agreed exchange ratio.

Demerger

Demerger in relation to companies, the demerged company sells and transfers one or more of its undertakings to the resulting company for an agreed consideration. The resulting company issues its shares at the agreed exchange ratio to the shareholders of the demerged company. Demerger is a relatively new phenomenon in the Indian corporate sector.

Slump Sale

In a slump sale, a company sells or disposes of the whole or substantially the whole of its undertaking for a lump sum predetermined consideration. In a slump sale, an acquiring company may not be interested in buying the whole company, but only one of its divisions or a running undertaking on a going concern basis. The sale is made for a lump sum price, without values being assigned to the individual assets and liabilities transferred. The business to be hived-off is transferred form the transferor company to an existing or a new company. A "Business Transfer Agreement" (Agreement) is drafted containing the terms and conditions of transfer. The agreement provides for transfer by the seller company to the buyer company, its business as a going concern with all immovable and movable properties, at the agreed consideration, called "slump price".

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Take Over

Takeover is a strategy of acquiring control over the management of another company – either directly by acquiring shares or indirectly by participating in the management. The objective is to consolidate and acquire large share of the market. The regulatory framework of take over listed companies is governed by the Securities and Exchange Board of India SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

Disinvestment

The Disinvestment Policy of the Government of India in the area of privatizing the public sector undertakings, refers to transfer of assets or service delivery from the government to the private sector. For this purpose, the Disinvestment Commission was established on 23rd August 1996 as an independent non-statutory, advisory body to make its recommendations on the public sector enterprises referred to it. The concept of disinvestment takes different forms – from minimum government involvement to partnership with private sector where the government is the majority shareholder.

The salient features of the procedure evolved by the Department of Disinvestment include (i) proposals in accordance with the prescribed policy to be placed before the Cabinet Committee on Disinvestment (CCD); (ii) selection of advise after clearance of proposal; (iii) issue of advertisement in leading newspapers inviting Expression of Interest (EOI); (iv) short-listing of bidders on the basis of laid down criteria; (v) drafting of Share Purchase Agreement and Shareholders' Agreement; (vi) finalization of Share Purchase Agreement and Shareholders' Agreement after negotiations; (vii) Inter-Ministerial Group (IMG) meeting to approve the proposal and agreements and (viii) evaluation by the Comptroller and Auditor General (CAG) of India after the transaction is completed.

Joint Venture

Joint venture means a foreign equity formed, registered or incorporated in accordance with the laws and regulations of the host country in which the Indian party makes direct investment. It is a strategic business policy whereby a business enterprise for profit is

formed in which two or more parties share responsibilities in an agreed manner, by providing risk capital, technology, patent/trade mark/brand names and access to market. Joint ventures with multinational companies contribute to the expansion of production capacity, transfer of technology and penetration into the global market. In joint ventures, assets are managed jointly. Skills and knowledge flow both ways. If it is a joint venture between foreign and domestic firm, the respective combinations usually are for example domestic firm provides labour and foreign firm provides technology.

Franchising

Franchising aims primarily at distributing goods and services that have a high reputation in the market and involves servicing the customers and end users. Franchisers support, train and to an extent control franchisees in selling goods and rendering services. The most popular form of franchising is the product distribution franchise it becomes more complicated when the franchisee has to market the product that has to be prepared, treated, assembled, processed or serviced in a specified way, the franchiser being very reputed and associated with that style of servicing. Franchising may be defined as a contract, either expressed or implied, written or oral, between two persons or parties by which franchisee is granted the

right to engage in the business of offering, selling, distributing goods and services prescribed in substantial part by franchiser. Operation of franchisee's business is substantially associated with franchiser's trademark, service mark or logo or advertisement or commercial symbol. Franchisee pays directly or indirectly the fees to the franchiser. The franchising may cover the entire system or a specified territory or a specified retail outlet. Usually franchisers have standard agreements for all their franchisees because uniformity and conformity is considered very important.

Strategic Alliances

Any arrangement or agreement under which two or more firms cooperate in order to achieve certain commercial objectives is called a strategic alliance. Strategic alliances are often motivated by considerations such as reduction in cost, technology sharing, product development, market access to capital. Strategic alliances facilitate a market entry strategy, which maximizes the potential for high return while mitigating economic risks and other exposures. Strategic alliance is gaining importance in infrastructure sectors,

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more particularly in areas of power, oil and gas. The basic idea is to pool resources and facilitate innovative ideas and techniques while implementing large projects, with the common objective of reduction of cost and time, and sharing the resultant benefits, in proportion to the contribution made by each party in achieving the targets. For detail regarding strategic alliances students may refer Study XI 'Alliances'. Strategy formulation is thus a sequential process which consists of strategic situation analysis and strategic choice analyses. Strategic situation analysis is self examination of the corporation's existing strategic posture, whereas strategic choice analysis is forward looking scenario building approach to the firm's future strategic posture. The strategic choice to be made by a firm will depend on its assessment of its competitive strengths and weaknesses and to match these against the opportunities and threats posed by the market forces.

Corporate restructuring strategies

Corporate managers face an ever-changing environment. Similarly managers have a variety of strategic options when evaluating the choices to be made in responding to such a situation. We try to discuss here the various forms of possible organizational and financial options available to a corporate managers. The fact that there are a number of options indicates that there are an array of options and as well no one-size-fit all approach exists. Below is presented a general framework for corporate restructuring and reorganization.

General framework for corporate restructuring and reorganization.

- reorganization of assets and ownership

- asset sale

- equity carve outs

- spin-offs

- reorganizing financial claims

- debt-equity exchange offer

- dual-class recapitalization

- leveraged recapitalizations

- financial reorganizations

- liquidation

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- other strategies

- alliances and joint ventures
- ESOP and MLPs
- Going-private and leveraged buyouts
- Using international markets
- Share repurchase programs.

Let us try to define each of the above methods,

- asset sale:

an asset sale is defined as the sale of a division subsidiary product line or other assets directly to another firm. In an asset sale the transferred subsidiary or division is absorbed within the organizational structure of the buying firm. The payment in this form of divestiture is usually cash although the payment in some asset sales is in form of stock of the buying firm.

- equity carve-out

it is defined as the offering of a full or partial interest in a subsidiary to the investment public. In effect an equity carve out is an IPO of a corporate subsidiary or a split-off IPO. This mode of restructuring creates a new publicly traded company with partial or complete autonomy from the parent firm.

- spin-off

a spin-off is defined as a pro rata distribution of shares in a subsidiary. No cash is generated by the parent in this form of divestiture although the debt allocation between the parent and subsidiary has capital structure implications. This form of restructuring creates a new and publicly traded company that is completely separate from the former parent firm. In addition to the above three main forms of restructuring there are variations present in an interrelated form with the main restructuring methods.

- split-up:

it is defined as the separation of the company into two or more parts. This term is applied where the firm is not merely divesting a piesce of the firm but is instead strategically breaking up the entire corporation body. The break up process is accomplished with one or more equity carve outs or spin-offs.

- tracking stock:

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- it is a separate class of common stock of the parent corporation. The value of the stock is based on the cash flow of the specific division. Tracking stock was first issued in 1984 as part of the acquisition of EDS by general motors.

- exchange offer

it is defined as a distribution of the ownership of the subsidiary in which shareholders have a choice to retain the parent shares or exchange their existing shares for the new shares in the subsidiary. An exchange offer resembles a spinoff in that shares are issued in a separate, publicly traded company. The difference is that the shares in the new firm are received only by those holders who opt to trade in the shares in the parent.

Motives for restructuring

Practical experiences sugest that a firm may restructure in many ways. Further the variety of divestiture methods suggest that a firm can restructure in many ways. The variety of divestiture methods also suggest that many motives can exit for corporate restructuring. Corporate focus often is sited as a prime reason for corporate restructuring. However recent examples suggest that even a focused company periodically reviews strategic alternatives in response to changing conditions in product
markets. Research shows that in general firms restructure to remain competitive and to respond to the change forces in the economy. To further analyze the causes and effects of corporate restructuring we may need also to review and analyze,

- why might divestitures create wealth
- why do divestitures occur.

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Lecture - 10

DIVESTITURES

A divestiture involves the sale of a division or plant or unit of one firm to another. From the seller's perspective, it is a form of contraction; from the buyer's point of view it represents expansion. For example, when Coromandel Fertilisers Limited sold its cement division to India Cements Limited, the size of Coromandel Fertilizers contracted whereas the size of India Cements Limited expanded. Hence a divestiture is the obverse of a purchase. It is important to recognize that companies often achieve external expansion by acquiring an operating unit – plant, division, product line, subsidiary, etc – of another company. In such a case the seller generally believes that the value of the firm will be enhanced by converting the unit into cash or some other more productive asset. The selling of some of a firm's assets is called divestiture. Unlike business failure, the motive for divestiture is often positive; to generate cash for expansion of other product lines, to get rid of a poorly performing operation, to streamline the corporation, or restructure the corporation's business consistent with its strategic goals. There is a variety of methods by which firms divest themselves of operating units. One involves the sale of a product line to another firm. These outright sales can be accomplished on a cash or stock swap basis using the procedures described later in this chapter. A second method that has become quite popular in recent years involves the sale of the unit to existing management. This sale is often achieved through the use of leveraged buyout (LBO), Sometimes divestiture is achieved through a spin-off, which results in an operating unit becoming an independent company. A spin-off is accomplished by issuing shares in the operating unit being divested on a prorata basis to the parent company's shareholders. Such an action allows the unit to be separated from the corporation and to trade as a separate entity. Like outright sale, this approach achieves the divestiture objective, although it does not bring additional cash or stock to the parent company. The final and least popular approach to divestiture involves liquidation of the operating unit's individual assets. Regardless of the method used to divest a firm of an unwanted operating unit, the goal typically is to create a more lean and focused operation that will enhance the efficiency as well as the profitability of the enterprise and create maximum value for shareholders. Recent divestiture seems to suggest that many operating units are worth much more to other than

to the firm itself. Comparisons of post divestiture and pre divestiture market value have shown that the "breakup value" of many firms is significantly greater than their combined value. As a result of market valuations, divestiture often creates value in excess of the cash or stock received in the transaction. Unlike LBOs, the use of divestitures in corporate restructuring is expected to remain popular.

Motive for Divestiture: Divestiture decisions are prompted by a variety of motives. The more important ones are discussed below:

- **Raising Capital:** A Common motive for divestiture is to raise capital. Cash strapped firms seem to resort to divestiture to shore up their liquidity. CEAT, for example, sold its Nylon Tyre cord plant at Gwalior to SRF for Rs. 3250 million so that it could settle its out standings and raise funds to concentrate on tyre manufacturing.
- **Curtailment of losses:** A prominent reason for divestiture is to cut losses. More broadly it may imply that the unit that is proposed to be divested is earning a sub-normal rate of return.
- **Strategic realignment:** The seller may divest a unit which no longer fits with its strategic plan. Often such a unit tends to be in an unrelated line and may demand a lot of managerial time and attention. After divestment, the seller can concentrate on its core business. ICI appears to be a good example. It sold its fiber division to Terene Fibres India, fertilizers division to Chand Chap Fertilizers and Chemicals, and seeds division to Hysum India. These divestitures, ICI believes will enable it to focus on paints and industrial chemicals, in line with its parent's global strategy.
- **Efficiency gain**: A divestiture results in an efficiency gain when the unit divested its worth more as part of some other firm or as a stand-alone business. This happens when there is a reverse synergy, sometimes referred to as 'synergy'. This means that the value of the parts is greater than the whole. In simple arithmetic, it implies that 5-3 = 3! Remember that a merger is motivated by the possibility of synergistic benefit, where the whole is expected to be more valuable than the sum of the parts: 2 +3 = 6!

FINANCIAL EVALUATION OF A DIVESTITURE

Typically, when a firm sells a division (or plant) to another company, it transfers the assets of the division along with the liabilities of the division, with the concurrence of the creditors. This means that the selling firm (referred to hereafter as the parent

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firm), in essence, transfers its ownership position in that division. To assess whether it is worth doing so from the financial point of view, the following procedure may be followed:

Step 1: Estimate the divisional post-tax cash flow: The parent firm should estimate the post-tax cash flow relating to the operations of the division and the rest of the operations of the parent firm. The relevant issue in this context is: What happens to the post-tax cash flow of the parent company with the division and without the division? The difference between the two represents the post-tax cash flow attributable to the division.

Step 2: Establishment the discount rate for the division. The discount rate applicable to the post-tax cash flow of the division should reflect its risk as a stand-alone business. A suggested procedure is to look at the cost of capital of some firm (or a group of firms) engaged solely or substantially in the same line of business and that is about the same size and use it as proxy for the division's cost of capital.

Step 3: Calculate the division's present value: Using the discount rate determined in Step 2 calculates the present value of the post-tax of the post-tax cash flow developed in Step 1. This represents the current worth of the cash flow generating capability of the division.

Step 4: Find the market value of the division-specific liabilities: The market value of the division specific liabilities is simply the present value of the obligations arising from the liabilities of the division. Remember that the market value of the division specific liabilities will be different from the book value of the division-specific liabilities if the contracted interest rates on these liabilities are different from the current interest rates.

Step 5: Deduce the value of the parent firm's ownership position in the division. The value of the ownership positive (VOP) enjoyed by the parent firm in the division is simply:

Present value of the division's Market value of the division-specific

Cash flow -------- liabilities

(Step 3) (Step 4)

Step 6: Compare the value of ownership position (VOP) with the divestiture proceeds (DP). When a parent firm transfers the assets of a division along with its liabilities, it

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receives divestiture proceeds (DP) as compensation for giving up its ownership position in the division. So, the decision rule for divestiture would be as follows:

DP > VOP Sell the division

DP = VOP Be indifferent

DP < VOP Retain the division

MANAGING DIVESTMENTS

Since divestments are becoming common place, corporates should approach them systematically and rationally. Here are some basic guidelines for managing divestments.

Regard Divestments as a Normal part of Business Life Divestments are motivated inter- alia by the following features of business life: (i) A company's disposition toward a given activity may change over its life-cycle. What may appear as highly desirable and appealing at one stage may strike as unattractive and unappealing at another stage.

(ii) Decisions are based on judgments which are sometimes right and sometimes wrong – this is a fact of business life. Hence, regard divestments as a normal process for all organizations, not just sick and unsuccessful organizations. As Leonard Vignola Jr. says "A company lives by expanding and contracting by growing and changing, by acquiring and divesting. These are the actions of a healthy, vital company, not a sick, dying company"

Consider Divestment as one of the Many Responses to a Situation There are several options available when a business or division is under-performing. It may be continued as it is; it may be shut down till business conditions improve; new product lines may be added; an aggressive cost reduction program may be initiated; manufacturing and / or distribution arrangements may be strengthened. When none of these alternatives seem feasible or desirable, consider divestment seriously. Since divestment is one of the many responses, it must be considered as an integral part of the regular planning process. The planning group should be assigned responsibility for initiating divestment moves.

Approach Divestments Positively View a divestment as an opportunity, not a catastrophe. As Vignola says: "Difficulties abound and optimum divestment is not overly easy to accomplish. Yet divestment ought to be viewed as a chance to turn a less than favorable situation into a future benefit to the divesting company" Announce divestment decisions candidly and create an impression that the company has the ability to deal with

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a problem realistically and sensibly. As Leonard Vignola, Jr says: "The decision to divest should be presented as a firm aggressive, positive step on the part of the divesting company."

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Lecture-11

De-mergers

A De-merger results in the transfer by a company of one or more of its undertakings to another company. The company whose undertaking is transferred is called the Demerged company and the company (or the companies) to which the undertaking is transferred is referred to as the resulting company.

DEMERGER

Companies often have to downsize or 'contract' their operations in certain circumstances such as when a division of the company is performing poorly or simply because it no longer fits into the company's plans or give effect to rationalization or specialization in the manufacturing process. This may also be necessary to undo a previous merger or acquisition which proved unsuccessful. This type of restructuring can take various forms such as demergers or spin offs, split offs, etc. Large entities sometimes hinder entrepreneurial initiative, sideline core activities, reduce accountability and promote investment in non-core activities. There is an increasing realization among companies that demerger may allow them to strengthen their core competence and realize the true value of their business. 'Demerger' is often used to describe division or separation of different undertakings of a business, functioning hitherto under a common corporate umbrella. "A scheme of demerger, is in effect a corporate partition of a company into two undertakings, thereby retaining one undertaking with it and by transferring the other undertaking to the resulting company. It is a scheme of business reorganization" Justice N.V. Balasubramaniam J in Lucas TVS Ltd. in Re. CP No. 588 and 589 of 2000 (Mad-Unreported). Such a split or division may take place for various reasons e.g. a conglomerate company carrying out various activities might transfer one or more of its existing activities to a new company for carrying out rationalization or embarking specialization n the manufacturing process. Also, such a transfer might be of a less successful part of the undertaking to a newly formed company. The new company and transferee, need not be the subsidiaries of the parent company which has affected/undergone such split or division. The term "Demerger" has not been defined in

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the Companies Act, 1956. However, it has been defined in Sub-section (19AA) of Section 2 of the Income-tax Act, 1961. According to the said Sub-section, "demerger" in relation to companies, means transfer, pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956, by a demerged company of its one or more undertakings to any resulting company in such a manner that –

i. all the property of the undertaking being transferred by the demergedcompany, immediately before the demerger, becomes the property of the resulting company in such a manner that

ii. all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of resulting company of virtue of the demerger.

iii. the property and the liabilities of the undertaking, being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;

iv. the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis;

v. the shareholders holding not less than three fourths in value of the share in the demerged company (other than shares already held therein immediately before the demerger or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger,

vi. the transfer of the undertaking is on a going concern basis;

vii. the demerger is in accordance with the conditions, if any, notified under Sub section (5) of Section 72A of the Income Tax Act 1961 by the Central Government in this behalf.

Explanation 1-For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

Explanation 2 – For the purposes of this clause, the liabilities referred to in subclause (ii), shall include:

(a) the liabilities which arise out of the activities or operations of the undertaking;

(b) the specific loans or borrowings (including debentures) raised, incurred and utilized solely for the activities or operations of the undertaking; and

(c) in cases, other than those referred to in clause (a) or clause (b), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

Explanation 3 – For determining the value of the property referred to in subclause (iii), any change in the value of assets consequent to their revaluation shall be ignored.

Explanation 4 – For the purposes of this clause, the splitting up or the reconstruction of any authority or a body constituted or established under a Central, State or Provincial Act, or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be, shall be deemed to be a demerger if such split up or reconstruction fulfills such conditions as may be notified in the Official Gazette, by the Central Government. From the above, the following points emerge about demergers:

1. Demerger is essentially a scheme of arrangement under Section 391 to 394 of the Companies Act, 1956 requiring approval by:

(i) majority of shareholders holding shares representing three-fourths value in meeting convened for the purpose; and

(ii) sanction of High Court.

2. Demerger involves 'transfer' of one or more 'undertakings'.

3. The transfer of 'undertakings' is by the demerged company, which is otherwise known as transferor company. The company to which the undertaking is transferred is known as resulting company which is otherwise known as 'transferee company'.

Demerged company

According to Sub-section (19AAA) of Section 2 of the Income-tax Act, 1961, "demerged company" means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company.

Resulting company

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According to Sub-section (41A) of Section 2 of the Income-tax Act, 1961 "resulting company" means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and, the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger. The definition of 'resulting company' has clearly brought out three important requirements while establishing its relationship with demerging company. They are –

1. Consideration for transfer of undertaking would be by issue of shares only by resulting company.
2. Such consideration would be paid only to the shareholders of demerged company.
3. Resulting company can also be a subsidiary company of a demerged company.

RECONSTRUCTION

The expression "reconstruction" has been used in Section 394 of the Companies business of a company to one or more other companies, specially formed for the purpose. The old company goes into liquidation and its shareholders, instead of being repaid their capital are issued and allotted equivalent shares in the new company. Consequently, the same shareholders carry on almost the same undertaking or enterprise in the name of a new company. Halsbury's Laws of England defines reconstruction thus:

"While an undertaking being carried on by a company is in substance transferred, not to an outsider, but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company, there is a reconstruction. It is also reconstruction, where, after the transfer of a part of the company's undertaking, the stockholders in the new company comprise a majority in number, but less than half in value of the shareholders in the original company." Thus "reconstruction" involves the winding up of an existing company and the transfer of its assets and liabilities to a new company formed for the purpose of taking over the business and undertaking of the existing company. Shareholders in the existing company become shareholders in the new company. The business, undertaking and shareholders of the new company are substantially the same as those of the old company. The new company may have a

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different capital structure from that of the old one, or have different objects, or be incorporated in a different country, but an essential feature of a reconstruction is that the new company's ,membership is substantially the same as that of the old company. A company may, if its memorandum of association permits, carry out reconstruction following the procedure laid down in Section 494 of the Companies
Act, 1956 by incorporating a new company specifically for that purposes.

This is a well recognized method of reorganization and restructuring of a company. Where the shareholders of a company approve of such a method of reconstruction or reorganization of a company, it cannot be said that the directors of the company were actuated by any sinister motive in doing so. *United Bank of India Ltd. v. United India Credit & Development Co. Ltd.* (1977) 47 Comp. Cas. 689 (Cal.) The Supreme Court in Textile Machinery Corporation Ltd. v. CIT (1977) 107 ITR
195 (SC) held that "reconstruction" of business involves the idea of substantially the same persons carrying on substantially the same business. There, it was explained, in the context of the expression "reconstruction of business already in existence", as used in Section 15C of the then Indian Income-tax Act, 1922, corresponding to Section 80J of the income-tax Act, 1961, that a new activity launched by an assessee by establishing a new plant and machinery by investing substantial funds may produce some commodities of the old business or it may produce some other distinct marketable produces or even commodities which may feed the old business. The products may be reconsumed by the assessee in his old business kor may be sold in the open market. Such an undertaking cannot be said to have been formed by the reconstruction of the old business and denied the benefit of Section 15C merely because it goes to expand the existing business of the assessee in some directions.

Simply stating, a company is reconstructed when a new company is formed, and the existing company is dissolved after the business, assets and liabilities of the dissolved company are taken over the new company under a scheme of arrangement, between the existing company and the new company (known as the reconstructed company), duly approved by all or a majority of the shareholders of both the companies and sanctioned by the court.

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The reconstructed company will have substantially the same shareholders and
pay the purchase price of the assets and properties of the dissolved company to the shareholders of the dissolved company by issue of its own equity shares at the agreed exchange ratio as per the approved scheme of arrangement.

Procedure to be followed for reconstruction

- The company should ensure that its Memorandum of Association contains a clause authorizing reconstruction.
- For the purpose of reconstruction, the company should form another company
for transferring its own undertaking, assets and liabilities.
- The Board of directors of the company should hold a meeting after due notice to:

(a) discuss and decide on reconstruction;

(b) majority of the directors of the company should make a declaration of solvency under Section 488 of the Act, which should be verified by an affidavit. It should be to the effect that they have made a full inquiry into the affairs of the company, and that, having done so, they have formed the opinion that the country has no debts, or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. The declaration should be made within five weeks immediately preceding the date of the passing of the resolution for winding up of the company under Section 484 of the Act and should be delivered to the Registrar of Companies for registration before that date.

(c) Approve notice for calling a general meeting of the company for passing a special resolution under Section 484(2) of the Companies Act:

(i) for voluntary winding up of the company;

(ii) for appointment of a liquidator under Section 490 and fixing his remuneration.

(iii)For conferring on the liquidator either a general authority to receive, by way of compensation or a part compensation for the transfer or sale, shares, policies, or other like interests in the transferee company, for distribution among the
members of the transferor company; or enter into any other arrangement whereby the members of the transferor company, may, in lieu of receiving cash, shares, policies or

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other like interests or in addition thereto, participate in the profits of, or receive any other benefit form the transferee company; and

(d) Authorize the company secretary to issue notice for the meeting. - Simultaneously send copy of the notice to the stock exchanges where the shares of the company are listed.

- Hold the general meeting of the shareholders of the company and pass resolution as contained in the notice.

- File Form No.23 and a certified true copy of the special resolution passed, with the Registrar of Companies along with the prescribed filing fee.

- Give notice of appointment of the liquidator to the Registrar within ten days of the appointment [Section 493].

The company should, within fourteen days of the passing of the resolution of the transferor company, the liquidator will transfer the assets etc. of the transferor company to the transferee company and the transferee company shall allot its shares to the shareholders of the transferor company according to the scheme of reconstruction.

DIFFRENCE BETWEEN DEMERGER AND RECONSTRUCTION

As discussed above, "demerger" means transfer, pursuant to a scheme of arrangement under Sections 391 to 394 of the Companies Act, 1956, by the demerged company of its one or more undertakings to a new company formed for the purpose, known as the resulting company, in such a manner that all the property of the undertaking, being transferred by the demerged company becomes the property of the resulting company by virtue of the demerger; all the liabilities relatable to the undertaking, being transferred by the demerged company become the liabilities of the resulting company by virtue of the demerger; the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger.

In the case of reconstruction, a new company (hereinafter referred to as 'transferee company') is formed, the existing company (hereinafter referred to as transferor company') is dissolved by passing a special resolution for members voluntary winding up and authorizing the liquidator to transfer the undertaking, business, assets and liabilities of the transferor company to the transferee company. The transferee company pays the

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consideration by issue and allotment of its shares to the shareholders of the transferor company in accordance with the pre-determined
share exchange ratio. In this process, the old company with substantially the same shareholders, same undertaking and business.

The difference between the two terms comes to the fore only when a scheme of arrangement is framed for sanction by the court. Demerger forms part of a scheme of compromise or arrangement within the ambit of Sections 391 to 394A of the Companies Act, 1956. In addition, demergers which envisage the reduction of share capital, will attract other provisions of the Companies Act, 1956 including Sections 100 to 104. The company will have to pass a special resolution for reduction of its share capital, which is subject to confirmation by the Court as per Section 101 of the Companies Act, 1956.

The articles of association of the company should have a provision permitting reduction of share capital and its memorandum of association should provide for demerger, split, etc. Secion 390(b) of the Companies Act, 1956 interprets 'arrangement' appearing in Sections 391 to 393 including 'division' of shares into shares of different classes. The expression 'reconstruction' on the other hand has been used in Section 394 of the Companies Act along with the term amalgamation.

One of the methods achieving a demerger is through a scheme of reconstruction. A demerger represents a milestone and is not the final step on the process of corporate restructuring. After the demerger, companies can pursue theirseparate strategies to enhance shareholder value and further streamline their respective portfolios.

SPLITS/DIVISIONS

Demerger, division, split or spin off may take place when a new company is formed for the purpose, *inter alia,* of taking over the residual division of one or more of existing companies, on the same being spun off in pursuance of a joint venture agreement between the existing company and another company and a scheme of arrangement is formulated in furtherance of such joint venture agreement.

In a split-off, some of the shareholders in the parent company are given shares in a division of the parent company, (usually a subsidiary) which is split-off in exchange for their shares in the parent company.

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Split-off can also be used as one mode to defend against hostile takeovers.

Companies may choose to split off divisions to make it less attractive to takeover bidders. Defensive split-offs are however, a drastic takeover defence. The most recent example is the plan of the management of Larsen & Toubro (L&T) to split off its cement division to make it difficult for Grasim Industries to take it over.

Steps to be taken for Demerger

1. *Preparation of scheme of demerger*

(i) Prepare a scheme of demerger in consultation with all interested parties and have the same approved in principle by the Board of Directors of the company at a meeting.

(ii) Appoint an expert for valuing the shares to determine the share exchange ratio.

(iii) Engage an advocate for the preparation of scheme and for appearing Subsequently before the High Court.

(iv) In case of listed companies, the stock exchanges where the shares are Listed should be intimated.

2. *Application to court for direction to hold meetings of members/creditors*
3. *Obtaining court's order for holding meetings of members/creditors*
4. *Notice of the meetings of members/creditors*
5. *Holding meeting(s) of members/creditors*
6. *Reporting the result of the meeting by the Chairman to the court*
7. *Petition to the court for sanctioning the scheme of demerger*
8. *Obtaining order of the court sanctioning the scheme*
9. *Court's order on petition sanctioning the scheme of demerger*

TAX ASPECTS OF DEMERGERS

The business and economic environment of the country has, enhanced the need for rationalization of laws relating to business reorganization, restructuring of production system and better utilization of resources. This has become necessary with the view to enable the Indian Industry to rearrange itself to become gloabally competitive.

In order to incorporate the recent structural amendments new provisions relating to demerger of companies were introduced by the Finance Act, 1999 which became effective from 01-04-2000. These amendments were introduced so as to enable the Corporate Bodies to ensure mainly that-

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(a) Demergers should be tax neutral and should not attract any additional liability to tax.

(b) In demergers, tax benefits and concessions available to any undertaking should be available to the said undertaking on its transfer to the resulting company.

(c) Tax benefits to such business reorganizations should be limited to the transfer of business as a going concern and not to the transfer of specific assets which would amount to the sale of assets and not a business organizations.

(d) The accumulated losses in a demerger should be allowed to be carried forward by the resulting company if these are directly relatable to the undertaking proposed to be transferred.

However, if it is not possible to relate these to the undertaking, such losses and depreciation should be apportioned between the demerged company and the resulting company in a reasonable manner.

The benefits available for demergers have been extended to authorities or Board set up by the Central or State Governments.

The Income-tax Act, 1961 provides for the following tax reliefs to the demerged company, the shareholders of the demerged company, who are issued and allotted shares in the resulting company in the exchange for the shares held by them in the demerged company and the resulting company which emerges as a result of a demerger.

Tax reliefs to the resulting company

The resulting company is eligible for tax reliefs if:

(a) the demerger satisfies all the conditions laid down in Section 2(19AA) of the Income-tax Act, 1961; and

(b) the resulting company is an Indian company

INDIAN SCENARIO WITH RESPECT TO DEMERGER AND RECONSTRUCTION

In India, the law relating to reconstruction through demerger or division or spin off or split is the same as it is with respect to reconstruction through amalgamation, merger, absorption, etc. Almost eighty per cent of the private sector companies in the country are family managed companies, where the heads of the family promote the companies by their ability, expertise, knowledge, experience and dedication. In some of these large

groups, family partitions have taken place, the large companies have been split and the management has been handed over to the family members.

Another type of split that has taken place is the hiving off or unrelated subsidiary activities of a company to specialize in a particular process or product line. Thus, ITC Ltd. divested its hotel divisions by incorporating a separate company. Also, demerger has been through restructuring of existing companies. Thus, the Tata group transferred their investments in TOMCO (Tata Oil Mills Co. Ltd.) under a scheme of arrangement with Hindustan Lever Ltd. The objective was to concentrate on their core competencies and exit from the consumer products such as soap, oil, etc.

REVERSE MERGER

It must be understood at the outset that amalgamation and merger are corporate restructuring methods. Both the terms are synonymous. The procedure to be adopted for both is the same and the consequences of both are also the same. For achieving amalgamation as well as merger, an existing company (which is referred to as the "amalgamating or merging or transferor company"), under a scheme of amalgamation or merger, loses its own legal identity and is dissolved without being would up and its assets, properties and liabilities are transferred to another existing company (which is referred to as the "amalgamated or merged or transferee company"). Generally, a loss making or less profit earning company merges with a company with track record, to obtain the benefits of economies of scale of production, marketing network, etc. This situation arises when the sick company's survival becomes more important for strategic reasons and to conserve the interest of community.

In a reverse merger, a healthy company merges with a financially weak company. The main reason for this type of reverse merger is the tax savings under the Income-tax Act, 1961. Section 72A of the Income-tax Act ensures the tax relief, which becomes attractive for such reverse mergers, since the healthy and profitable company can take advantage of the carry forward losses/of the other company. The healthy units loses its name and surviving sick company retains its name. In the context of the Companies Act, there is no difference between a merger and a reverse merger. It is like any amalgamation. A reverse merger is carried out through the High Court route.

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A De-merger may take the form of a spin-off or a split-up. In a spin-off an undertaking or division of a company is spun off into an independent company. After the spin-off, the parent company and the spun off company are separate corporate entities. For example, the Information Technology, Division of WIPRO Limited was spun off a separate company in the late 1980s. In a split-up, a company is split up into two or more independent companies. As a sequel, the parent company disappears as a corporate entity and in its place two or more separate companies emerge. For example, the Ahmedabad Advanced Mills was split up into two separate companies. viz., New Ahmedabad Advance Mills and the Tata Metal Strips. Though spin-offs and split-ups are different in form, their economic substance is the same.

Rationale Spin-offs and split-up are regarded as devices for enhancing corporate values by raising efficiency and performance. The principle sources of efficiency gain and performance improvement are as follows:

Sharper focus

A spin-off may facilitate a sharper business focus by removing a poor business "fit". For example, when Itek Corporation of US spun off its vision products division, Itek's management said:

*"With the separation of vision products, **Itek** is once again a high technology company. While the separation of vision products was costly, we are now in a position to totally dedicate our efforts and resources where Item has expertise and leadership".*

Improved incentives and accountability:

A spin-off strengthens managerial incentives and heightens its accountability. For example, the President's letter in 1980 Annual Report of Peabody International describes the effects of Peabody's spin-off of GEO International: "Speaking from personal experience, one of the most exciting benefits has been a rekindling of the entrepreneurial spirit and initiative within both Peabody and GEO. Managers in both companies now feel that their individual efforts can make a significant difference in bottom line results".

Tax Aspects of De-merger The Income Tax Act stipulates the following conditions for a transaction to be recognized as a De-merger:

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- All the assets and the liabilities of the undertaking are transferred from the Demerged company to the resulting company.
- The transfer is effected on a going concern basis and at book value.
- Shareholders holding not less than 75 per cent in value of the shares in the Demerged company become shareholders of the resulting company or companies by virtue of the De-merger.
- In consideration of the De-merger, the resulting company issues its shares to the shareholders of the De-merged company on a proportionate basis. When a transaction satisfies the above conditions, the following tax provisions are applicable.
- Tax benefits and concessions available to any undertaking should be available to the said undertaking on its transfer to the resulting company.
- Accumulated losses and unabsorbed depreciation can be carried forward from the De-merged company to the resulting company.
- Neither the companies nor the shareholders are subject capital gains tax.
- Expenses incurred wholly for the purpose of De-merger are allowed as a deduction in five annual installments of 20 per cent each.

The above benefits, however, will not apply should there be another De-merger of the resulting company within a period of ten years from the date of De-merger.

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Lesson - 12

CATEGORIES OF MERGER

The following is the broad classification of mergers:

(a) *Horizontal merger*

This class of merger is a merger between business competitors who are manufactures or distributors of the same type of products or who render similar or same type of services for profit. It involves joining together of two or more companies which are producing essentially the same products or rendering same or similar services or their products and services directly compete in the market with each other. It is a combination of two or more firms in similar type of production/distribution line of business. Horizontal mergers result in a reduction in

the number of competing companies in an industry, increase the scope for economies of scale and elimination of duplicate facilities. However, their main drawback, is that they promote monopolistic trend in the industrial sector as the number of firms in an industry is decreased and this may make it easier for the industry members to collude for monopoly profits.

(b) *Vertical merger*

Vertical mergers occur between firms in different stages of production operation. In a vertical merger two or more companies which are complementary to each other e.g. one of companies is engaged in the manufacture of a particular product and the other is established and expert in the marketing of that product or is engaged in production of raw material or ancillary items used by the other company in manufacturing or assembling the final and finished product join together. In this merger the two companies merge and control the production and

marketing of the same product. Vertical merger may take the form of forward or backward merger. When a company combines with the supplier of material, it is called a backward merger and where it combines with the customer, it is known as

forward merger. A vertical merger may result into a smooth and efficient flow of production and distribution of a particular product and reduction in handling and inventory costs. It may also pose a risk of monopolistic trend in the industry. As a

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whole the efficiency and affirmative rationale of vertical integration rests primarily on costliness of market exchange and contracting.

(c) *Conglomerate merger*

This type of merger involves coming together or two or more companies engaged in different industries and/or services. Their businesses or services, are neither horizontally nor vertically related to each other. They lack any commonality either in their end product, or in the rendering of any specific type of service to the society. This is the type of merger of companies which are neither competitors, nor complimentaries nor suppliers of a particular raw material nor consumers of a particular product or consumable. A conglomerate merger is one which is neither horizontal nor vertical. In this, the merging companies operate in unrelated markets having no functional economic relationship. Mergers may further be categorized as:

Cash Merger

A merger in which certain shareholders are required to accept cash for their shares while other shareholders receive shares in the continuing enterprise.

Defacto Merger

Defacto merger has been defined as a transaction that has the economic effect of a statutory merger but is cast in the form of an acquisition of assets.

Down Stream Merger

The merger of parent company into its subsidiary is called down stream merger.

Up Stream Merger

The merger of subsidiary company into its parent company is called an up stream merger.

Short-form Merger

A number of statues provide special company rules for the merger of a subsidiary into its parent where the parent owns substantially all of the shares of the subsidiary. This is known as a short form merger. Short form mergers generally may be effected by adoption of a resolution of merger by the parent company, and mailing a copy of plan of merger to all shareholders of subsidiary and filing the executed documents with the prescribed authority under the statue. This type of merger is less expensive and time consuming than the normal type of merger.

Triangular Merger

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Triangular merger means the amalgamation of two companies by which the disappearing company is merged into subsidiary of surviving company and shareholders of the disappearing company receive shares of the surviving company.

MERGERS AND ACQUISITIONS MERGER

A merger occurs when two or more firms are combined and the resulting firm maintains the identity or one of the firms. Usually, the assets and liabilities of the smaller firms are merged into those of the larger firms. Merger, a form of external expansion, should be undertaken only when they are expected to enhance share value.

A merger may take the legal form of either a statutory merger or a purchase of assets (and often assumption) of the target firm.

Statutory merger: In statutory merger, so called because it is executed under the statutes of the state of incorporation, the stock of the target firm is directly exchanged for stock of acquiring firm, and the legal existence of the target firm automatically ceases. Although the legal form implies a stock –for-stock exchange, the acquiring firm may purchases the stock of the target for cash or by exchanging other securities and then, as the sole stockholder of the target, exchange the stock in a statutory merger.

Purchase of assets: The acquiring firm might purchase the assets and usually, assume the liabilities of the target firm. The purchase may be for cash or securities of the acquiring firm. After the purchase, the sole assets of the acquired firm are the cash and/or securities received in the exchange. After any liabilities not assumed by the acquiring firm are paid, the acquired firm is liquidated by distributing its assets (cash and/or securities of the acquiring firm) to its stock holders in liquidating dividend. Then the acquired corporation is formally dissolved.

Regardless of the legal form used, holders of a stipulated majority of the equity of the acquired firm must approve the merger. Depending on its character, approval of holders of a majority of the stock of the acquiring firm may or may not be required.

TYPES OF MERGERS

The four types of mergers are the (horizontal merger, (2) Vertical merger, (3) congeneric merger and (4) conglomerate merger. A horizontal merger results when two firms in the same line of business are merged. An example would be the merger of two machine-tool manufacturers. This form of merger results in the expansion of a firm's

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operations in a given product line and at the same time eliminates a competitor. A vertical merger occurs when a firm requires a supplier or a customer. For example, the merger of a machine-tool manufacturer with its supplier of castings would be a vertical merger. The economic benefit of this type of merger systems from the form's increased control over the acquisition of raw materials or the distribution of finished goods.

A congeneric merger is achieved by acquiring a firm that is in the same general industry but neither in the same line of business nor a supplier or customer.

An example is the merger of a machine-tool manufacturer with the manufacture of industrial conveyor systems. The benefit of this type of merger is the resulting ability to use the same sales and distribution channels to reach customers of both businesses. A conglomerate merger involves the combination of firms in unrelated business. The merger of a machine-tool manufacturer with a chain of fast-food restaurants would be an example of this kind of merger. At first glance it would appear that such a combination could not provide any operating synergism; admittedly, synergism would be relatively small compared to that of most vertical or horizontal combinations. But if the operating profit patterns of the various acquired firms differ as economic changes occur, a portfolio effect might be achieved. This would make the operating risk of the combination smaller than the risk of the firms standing by themselves. If risk is reduced while the combination of cash flows is unchanged, the value of the combination may exceed that of its individual components. There also may be some favorable effects resulting from flexibility of personnel and transfer of technology, even though the firm appears to be engaged in different lines of business. In this sense operating synergy may result from conglomerate growth.

Acquiring versus Target companies

The firm in a merger transaction that attempts to acquire another firm is commonly called the **acquiring company.** The firm that the acquiring company is pursuing is referred to as the **target company**; Generally, the acquiring company identifies, evaluates, and negotiates with the management and/or shareholders of the target company. Occasionally, the management of a target company initiates its acquisition by seeking to be acquired.

Friendly versus Hostile takeovers

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Mergers can occur on either a friendly or a hostile basis. Typically, after isolating the target company, the acquirer initiates discussions with its management. If the target management is receptive to the acquirer's proposal, it may endorse the merger and recommend shareholder approval. If the shareholders approve the merger, the transaction is typically consummated either through a cash purchase of
the shares by the acquirer or through an exchange of the acquirer's shares, bonds or some combination for the target firm's shares. This type of negotiated transaction is known as a friendly merger. If on the other hand, the takeover target's management does not support the proposed takeover for any of a number of possible reasons, such as two low an offering price, a desire to maintain the firm's autonomy, or a "poor fit". It can fight the acquirer's actions. In this case the acquirer can attempt to gain control of the firm by buying sufficient shares of the target firm in the marketplace. This is typically accomplished by using tender offers (i.e. a formal offer to purchase a given number of shares at a specified price). This type of unfriendly transaction is commonly referred to as **a hostile merger**. Clearly, hostile mergers are more difficult to consummate because the target firm's management acts to deter rather than facilitate the acquisitions. Regardless, hostile takeovers are sometimes successful.

STRATEGIC VERSUS FINANCIAL MERGERS

Mergers are undertaken for either strategic or financial reasons. Strategic mergers involve merging firms to achieve various economies of scale by eliminating redundant functions, increasing market share, improving raw material sourcing and finished product distribution, and so on. In these mergers the operations of the
acquiring and target firms are somehow combined to achieve economies and thereby cause the performance of the merged firm to execute that of the premerged firms. An interesting variation of the strategic merger involves the purchase of specific product lines (rather than the whole company) for strategic reasons. Financial mergers, on the other hand, are based on the acquisition of companies that can be restructured to improve their cash flow. These mergers involve the acquisition of the target firm by an acquirer, which may be another company or a
group of investors often the firm's existing management. The objective of the acquirer is to drastically cut costs and sell of certain unproductive or noncompatible assets to

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increase; the firm's cash flows. The increased cash flows are used to service to the sizable debt that is typically incurred to finance these transactions. Financial mergers are not based on the firm's ability to achieve economies of scale, but rather on the acquirer's belief that through restructuring, the firm's hidden value can be unlocked. The ready availability of junk bond financing throughout the 1980s fueled the financial merger mania during that period in the global market. With the collapse of the junk bond market in the early 1990s, financial merger have fallen on relatively hard times. The heavy debt burdens involved in many of the glamour financial merger of the 1980s caused many of them to subsequently file for bankruptcy. As a result, the strategic merger, which does not rely as heavily on debt, tends to dominate today.

MOTIVES FOR MERGING

Firms merge to fulfill certain objectives. The overriding goal for merging is the maximization of the owner's wealth as reflected in the acquirer's share price. Specific motives, which included growth or diversification, synergy, managerial skill or technology, tax considerations, increased ownership liquidity, and defense against takeover, should be pursued when they are believed to be consistent with owner wealth maximization.

GROWTH OR DIVERSIFICATION

Companies that desire rapid growth in size or market share or diversification in the range of their products may find that a merger can be used to fulfill the objective. Instead of going through the time-consuming process of internal growth or diversification, the firm may achieve the same objective in a short period of time by merging with an existing firm. In addition, such a strategy is often less costly than the alternative of developing the necessary production capability and capacity. If a firm that wants to expand operations in existing or new product area can find a suitable going concern, it may avoid many of risks associated with the design, manufacture, and sale of additional or new products. Moreover, when a firm expands or extends its product line by acquiring another firm, it also removes a potential competitor.

SYNERGISM

The nature of synergism is very simple. Synergism exists whenever the value of a combination is greater than the sum of the values of its parts. In other words,

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synergism is “2 + 2 = 5”, But identifying synergism and evaluating it may be difficult; in fact, sometimes its implications may be vary subtle. As broadly defined to include any incremental value resulting from business combination. Synergism is the basic economic justification of merger. The incremental value may derive from increases in either operational or financial efficiency.

Operating Synergism

Operating synergism may result from economies of scale, some degree of monophony) power, or increased managerial efficiency. The value may be achieved by increasing sales volume in relation to assets employed (operating asset turnover), increasing profit margins, or decreasing operating risk. Although operating synergy usually is the result of either vertical or horizontal integration, some synergistic effects also may result from conglomerate growth or the integration of technology and/or personnel into a more deficient unit. In addition, sometimes a firm may acquire another to obtain patents, copyrights, technical proficiency, marketing skills, specific fixed assets, customer relationships, or managerial personnel. Operating synergism occurs when these assets, which are intangible, may be combined with the existing assets and organization of the acquiring firm to produce an incremental value.

Although that value may be difficult to appraise, it may be the primary motive behind the acquisition.

Financial Synergism

As we are broadly interpreting the term, synergism may include financial advantages as well as operating ones. Among these are incremental values resulting from complementary internal funds flows more efficient use of financial leverage, increase external financial capability, and income tax advantages.

Complementary internal funds flows: Seasonal or cyclical fluctuation in funds flows sometimes may be reduced or eliminated by merger, if so, financial synergism results in reduction of working capital requirements of the combination compared to those of the firms standing alone.

More efficient use of financial leverage: Financial synergy may result from more efficient use of financial leverage. The acquiring firm may have little debt and wish to use the high debit of an acquired firm to lever earnings of the combination. Or the

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acquiring form may borrow to finance an acquisition for cash of a low-debt firm, thus providing additional leverage to the combination. The financial leverage advantage must be weighed against the increased financial risk.

Increased External Financial capability: Many mergers, particularly those of relatively small firms into large ones, occur when the acquired firm simply cannot finance its operations. Typical of this situation is a small growing firm with expanding financial requirements. The firm has exhausted its bank credit and has virtually no access to long-term debt or equity markets. Sometimes the small firm has encountered operating difficulty, and the bank has served notice that its loans will not be renewed. In this type of situation, a large firm with sufficient cash and credit to finance the requirements of the smaller one probably can obtain a good buy by making a merger proposal to the small firm. The only alternative the small firm may have is to try to interest two or more larger firms in proposing merger to introduce completion into their bidding for the acquisition.

The smaller firm's situation might not be so bleak. It may not be threatened by nonrenewable of a maturing loan. But its management may recognize that continued growth to capitalize on its markets will require financing beyond its means. Although its bargaining position will be better, the financial synergy of the acquiring firm's strong financing capability may provide the impetus for the merger.

Sometimes the financing capability is possessed by the acquired firm. The acquisition of a cash-rich firm whose operations have matured may provide additional financing to facilitate growth of the acquiring firm. In some cases, the acquiring firm may be able to recover all or part of the cost of acquiring the cash-rich firm when the merger is consummated and the cash then belongs to it.

A merger also may be based upon the simple fact that the combination will make two small firms with limited access to the capital markets large enough to achieve that access on a reasonable basis. The improved financing capability provides the financial synergy.

Income tax advantages:

In some cases, income tax consideration may provide the financial synergy motivating a merger, for example, assume that firm has earnings before taxes of about Rs. 10 crore per year and firm B, now breaking even, has loss carry forward of Rs. 20 crore

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accumulated from unprofitable operations of previous years. The merger of A and B will allow the surviving corporation to utilize the loss carry forward, there by eliminating income taxes in future periods, as shown in table – 1 in effect, such a merger will increase the net after-tax income of firm A by Rs 4 crore (67 per cent) for each of the next two years. The financial synergism reflects the fact that the combined firm can use the tax-loss carry forward whereas firm B might never be able to use it. However, this is permissible under section 72A of Income tax Act relating to merger of only sick industrial companies of India.

COUNTER SYNERGISM

Certain factors may oppose the synergistic effect contemplated from a merger.

Often another layer of overhead costs and bureaucracy is added. Do the advantages outweigh this disadvantage? Sometimes the acquiring firm agrees to long-term employment contracts with the managers of the acquired firm. Such contracts often are beneficial but they may be opposite. Personality or policy conflicts may develop that either hamstring operations or require buying out such contracts to remove personnel from position of authority.

TABLE – 1

Advantages of Merger Utilizing Tax-Loss Carry forward

(In ’00,000)

Year

1 2 3

Without

merger

Earnings

before taxes

Rs.

1,0

00

Rs.

1,0

00

Rs.
1,0
00
Income taxes
@ 40%
40
0
40
0
40
0
Net income to
shareholders
Rs
60
0
Rs
60
0
Rs.
60
0
With merger
Earnings
before taxes
Rs.
1,0
00
Rs.
1,0
00

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Rs.

1,0

00

Loss carry

forward

1,8

00

1,0

00

-0-

Net taxable

income

-0-

-0-

Rs.

1,0

00

Income taxes

@ 40%

-0-

-0-

Rs.

40

0

Net Income

to

shareholders

Rs.

1,0

00

Rs.

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1,0

00

Rs.

60

0

Particularly in conglomerate mergers, management of the acquiring firm simply may not have sufficient knowledge of the business to control the acquired firm adequately. Attempts to maintain control may induce resentment by personnel of the acquired firm. The resulting reduction of efficiency may eliminate expected operating synergy or even reduce the post merger profitability of the acquired firm. The list of possible counter-synergistic factors could go on endlessly; the point is that mergers do not always produce the executed results. Negative factors and the risks related to them also must be considered in appraising a prospective merger.

OTHER MOTIVES FOR MERGER

Mergers may be motivated by two other factors that perhaps should not be classified under synergism. These are the opportunity for an acquiring firm to obtain assets at a bargain price and the desire of shareholders of the acquired firm to increase the liquidity of their holdings.

Purchase of Assets at Bargain Price: Mergers may be explained by the opportunity to acquire assets, particularly land, mineral rights, plant, and equipment, at lower cost than would be incurred if they were purchased or constructed at-current market prices. If market price of many stocks have been considerably below the replacement cost of the assets they represent, expanding firm considering constructing plants, developing mines, or buying equipment often have found that the desired assed could be obtained cheaper by acquiring a firm that already owned and operated the asset . Risk could be reduced because the assets were already in place and an organization of people knew how to operate them and market their products.

Many of the mergers can be financed by cash tender offers to the acquired firm's shareholders at price substantially above the current market. Even so, the assets can be acquired for less than their current costs of construction. The basic factor underlying this apparently is that inflation in construction costs not fully reflected in stock prices because

of high interest rates and limited optimism (or downright pessimism) by stock investors regarding future economic conditions.

Increased Managerial Skill or Technology:

Occasionally, a firm will have good potential that it finds itself unable to develop fully because of deficiencies in certain areas of management or an absence of needed product or production technology. If the firm can not hire the management or develop the technology it needs, it might combine with a compatible firm that has the needed managerial personnel or technical expertise, of course, any merger, regardless of the specific motive for it, should contribute to the maximization of owner's wealth.

Increased Ownership Liquidity:

The merger of two small firms or a small and a larger firm may provide the owners of the small firm(s) with greater liquidity.

This is die to the higher marketability associated with the shares of larger firms.

Instead of holding shares in a small firm that has a every "thin" market, the owners will receive shares that are traded in a broader market and can thus be liquidated more readily. Not only does the ability to convert shares into cash quickly have appeal, but owning shares for which market price quotations are readily available provides owners with a better sense of the value of their holdings. Especially in the case of small, closely held firms, the improved liquidity of ownership obtainable through merger with an acceptable firm may have considerable appeal.

Defense against Takeover: Occasionally, when a firm becomes the target of an unfriendly takeover, it will as a defense acquired another company. Such a strategy typically works like this; the original target firm takes an additional debt to finance its defensive acquisition; because of the debt load, the target firm becomes too large and too highly levered financially to be of any further interest to its suitor. To be effective, a defensive takeover must create greater value for shareholders than they would have realized had the firm been merged with its suitor.

In addition, the stockholder-managers of the acquired firm may be offered attractive management contracts and/or seek the opportunity to rise to positions of

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greater responsibility in the acquired firm than would be possible within their small one.

LEVERAGED BUYOUTS AND DIVESTITURES

Before addressing the merger negotiation process and mechanics of merger analysis, it is important to understand two topics that are closely related to mergers – LBOs and divestitures. An LBO is a method of structuring a financial merger, whereas divestitures involve the sale of a firm's assets.

LEVERAGED BUYOUTS (LBOs)

A popular technique that was widely used during the 1980s to make acquisitions is the leveraged buyout (LBO), which involves the use of a large amount of debt to purchase a firm. LBOs are clear-cut-examples of financial merger undertaken to create a high-debt private corporation with improved cash flow and value. Typically in the LBO 90 percent or more of the purchase price is financed with debt. A large part of the borrowing is secured by the acquired firm's assets, and the lenders, because of the high risk, take a portion of the firm's equity. Junk bonds have been routinely used to raise the large amounts of debt needed to finance LBO transactions. Of course, the purchasers in an LBO expect to use the improved cash flow to service the large amount of junk bond and other debt incurred in the buyout.

The acquirers in LBOs are other firms or groups of investors that frequently include key members of the firm's existing management.

An attractive candidate for acquisition through leveraged buyout should possesses three basic attributes:

1. It must have a good position in its industry with a solid profit history and reasonable expectations of growth.

2. The firm should have a relatively low level of debt and a high level of "bankable" assets that can be used as loan collateral.

3. It must have stable and predictable cash flow that are adequate to meet interest and principal payments on the debt and provide adequate working capital. Of course, a willingness on the part of existing ownership and management to sell the company on a leveraged basis is also needed.

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Lecture-13

THE MERGER NEGOTIATION PROCESS

Mergers are often handled by investment bankers – financial intermediaries hired by acquirers to find suitable target companies and assist in negotiations. A firm seeking a potential acquisition can hire an investment banker to find firm meeting its requirements. Once a target company is selected, the investment banker negotiates with its management or investment banker. Frequently, when management wishes to sell the firm or a division of the firm, it will hire an investment banker to seek out potential. In the event that attempts to negotiate with the management of Target Company break down, the acquiring firm, often with the aid of its investment banker, can make direct appeal to shareholders by using **tender offers**. The investment banker is typically compensated with a fixed fee, a commission tied to the transaction price, or with a combination of fees and commission. A desirable merger candidate usually receives more than a single offer. Normally certain non financial issues relating to the disposition and compensation of the existing management, product-line policies, financing policies and the independence of the targets firm must be resolved. Although the negotiations are generally based on the expectation of a merger, sometimes negotiations will break down.

TENDER OFFERS

When management negotiations for an acquisition break down, tender offers may then be used to negotiate a "hostile merger" directly with the firm's shareholders. A tender offer is a formal offer to purchase a given number of shares of a firm's stock at a specified price. The offer is made to all the shareholders at a premium above the market price. Occasionally, the acquire will make a two-tier offer in which the term offered are more attractive to those who tender shares early. For example, the acquirers offer to pay Rs. 25 per share of the first 60 per cent of the outstanding shares tendered and only Rs 23 per share for the remaining shares. The shareholders are advised of a tender offer through announcements in financial newspapers or through direct communications from the following firm. Sometimes a tender offer is made to add pressure to existing merger negotiations. In other cases the tender offer may be made without warning as an attempt at an abrupt corporate takeover.

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FIGHTING HOSTILE TAKEOVERS

If the management of a target firm does not favour a merger or considers the price offered in a proposed merger too low, it is likely to take defensive actions toward off the hostile tender offer. Such actions are generally developed with the assistance of investment bankers and lawyers who, for generally sizable fees, help the firm to develop and employ effective takeover defenses. Numerous strategies such as informing shareholders of the alleged damaging effects of a takeover, acquiring another company (discussed earlier in the chapter), or attempting to sue the acquiring firm on antitrust or other grounds for fighting hostile takeovers where developed. In addition, many other defenses (some with colourful names) exist – white knight, poison pills, greenmail, leveraged recapitalization, golden parachutes, and shark repellents. We now take a brief look at each of these strategies.

The **white knight** strategy involves the target firm finding a more suitable acquirer (the "white knight") and prompting it to compete with the initial hostile acquire to takeover the firm. The basic premise of this strategy is that if being taken over is nearly certain; the target firm ought to attempt to be taken over by the firm that is deemed most acceptable to its management.

Poison pills typically involve the certain of securities that give their holders certain rights that become effective when a takeover is attempted. The "pil" allows the shareholders to receive special voting rights or securities that, once issued, cause the firm to be much less desirable to the hostile acquirer, **Green mail** is a strategy by which the firm repurchased through private negotiation a large block of stock at a premium from one or more shareholders to end a hostile takeover attempt by those shareholders. \clearly greenmail is a form of corporate black mail by the holders of a large black of shares.

Another hostile takeover defense involves the use of a **leveraged recapitalization,** which is a strategy involving the payment of a large debtfinanced cash dividend . This strategy significantly increases the firm's financial leverage, thereby deterring the takeover attempt. In addition, as a further deterrent the recapitalization is often structured to increase the equity and control of the existing management. **Golden parachutes** are provisions in the employment contracts of key executives that provide them with sizable compensation if the firm is taken over. Golden parachutes deter hostile takeovers to the

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extent that the cash outflows required by these contracts are large enough to make the takeover unattractive to the acquirer. Another defense is use of **shark repellents,**which are antitakeover amendments to the corporate charcter to corporate charter that constrain the firm's ability to transfer managerial control of the firm as a result of a merger. Although this defense could entrench existing management, many firms have had these amendments ratified by shareholders.

Because takeover defenses tend to insulates management from shareholders, the potential for litigation is great when these strategies are employed. Lawsuits are sometimes field against management by dissident shareholders. In addition, governments frequently intervene when a proposed takeover is deemed to be in violation of law.

VALUING THE TARGET COMPANY

Whether a firm is planning to acquire a target firm for cash or through a stock swap, it must first determine the target firm's value. The value would then be used, along with a proposed financing scheme, to negotiate the transaction-on a friendly or hostile basis. The value of the target would be estimated by using the capital budgeting techniques whether the target firm is being acquired for its assets or as a going concern.

Acquisition of Assets: Occasionally, a firm is acquired not for its income-earning potential but as a collection of assets (generally fixed assets) that the acquiring company needs. The price paid for this type of acquisition depends largely on which assets are being acquired; consideration must also be given to the value of any tax losses. To determine whether the purchase of assets is financially justified, the acquire must estimate both the costs and benefits of the target assets. This is capital budgeting problem, since an initial cash outlay is made to acquire assets and, as a result, future cash inflows are expected.

Acquisitions of Going Concern: Acquisitions of target companies that are going concerns are best analysed by using capital budgeting techniques similar to those used for asset acquisitions. The basic difficulty in applying the capital budgeting approach to the acquisition of going concern is the estimation of cash flows and certain risk considerations. The methods of expected cash flows from an acquisition are similar to those used in estimating capital budgeting cash flows. Typically pro forma income statements reflecting the post merger revenues and cost attributable to the target company

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are prepared. They are then adjusted to reflect the expected cash flows over the relevant time period. Whenever a firm considers acquiring a target company that has different risk behaviors, it should adjust the cost of capital appropriately before applying the appropriate capital
budgeting techniques.

Stock Swap transactions

Once the value of the target company is determined, the acquirer must develop a proposed financing package. The simplest, but probably least common, case would be a pure cash purchase. Beyond this extreme case there are virtually an infinite number of financing packages that use various combinations of cash, debt, preference shares, and equity shares. Here we look at the other extreme – stock swap transactions in which the acquisition is paid for using an exchange of equity shares. The acquiring firm exchanges its shares for shares of the target company according to a pre determined ratio. The ratio of exchange of share of is determined in the merger negotiations.

This ratio effects the various financially yardsticks that are used by existing and prospective shareholders to value the merged form's shares.

Ratio of Exchange: When one firm swaps its stock for the shares of another firm, the firms must determine the number of shares of the acquiring firm to be exchanged for each share of the target firm. The first requirement, of course is that the acquiring company have sufficient shares available to complete the transaction. Often a firm's repurchase of shares is necessary to obtain sufficient shares for such a transaction. The acquiring firm generally offers more for each share of the target company than the current market price of its publicly traded shares. The actual ratio of market price of the acquiring firm. It is calculated in this manner because the acquiring firm pays the target firm in stock, which has a value equal to its market price.

Effect on Earnings Per Share: Ordinarily, the resulting earnings per share differ from the pre merger earnings per share for both the acquiring firm and the target firm. They depend largely on the ratio of exchange and the pre merger earnings per share of each firm. It is best to view the initial and longrun effect of the ratio of exchange on earnings per share (EPS) separately.

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When the ratio of exchange is equal to 1 and both the acquiring firm and the target firm have same pre merger earnings per share, the merged firm's earnings per share will initially remain constant. In this rate instance, both the acquiring and target firms would also have equal price/earnings (P/E) ratios. In actually the earnings per share of the merged firm are generally above the pre merger earning per share, of one firm and below the pre merge earnings per share of the other after the necessary adjustment has been made for the ratio of exchange.

Effect on Market Price Per Share: The market price per share does not necessarily remain constant after the acquisition of one firm by another. Adjustments occur in the marketplace in response to changes in expected earnings, the dilution of of ownership, changes in risk, and certain other operating and financial changes. Using the ratio of exchange, ratio of excnhange in market price can be calculated. It indicates the market price per share of the acquiring firm paid for market price per share of the target firm. The ratio the MPR, is defined by:

$$MPR = \frac{MP\ acquiring \times RE}{MP\ target}$$

Where

MPR = Market price ratio of exchange

MP acquiring = market price per share of the acquiring firm

MP target = market price per share of the target firm

RE = ratio of exchange

The post merger earnings per share of owners of the acquiring and target companies can be explained by comparing the price/earnings (P/E) ratio. By paying more than its current value of earnings to acquire the earnings (P/E paid > P/E of acquiring company), the acquiring firm transfers the claim on a portion of its pre merger earnings to the owners of the target firm. Therefore on a post merger basis the target firm's EPS increases, and the acquiring firm's EPS decrease. Note that this outcome is almost always the case, since the acquire typically pays a 50 per cent, on average premium above the target firm's market price, thereby resulting in the P/E paid being much above its own P/E. If acquiring company were to pay less than its current value of earnings to acquire

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the earnings (P/E paid < P/E of acquiring company), the opposite effects would result. The long run effect of merge on the earnings per share of the merged company depends largely on whether the earnings of the merged firm grow. Often although a decrease in the per-share earnings of the stock held by the original owners of the acquiring firm is expected initially, the long run effects of the merger on earnings per share are quite favorable. Since business firms generally expect growth in earnings, the key factor enabling the acquiring company, which initially experiences a decrease in EPS, to experience higher further EPS than it would have without the merger is the fact that the earnings attributable to the target company's assets grow at a faster rate than those resulting from the acquiring company's pre merger assets. The ratio of exchange in market price is normally greater than 1, which indicates that to acquire a firm, the acquire must pay a premium above its market price. Even so, the original owners of the acquiring firm may still gain because the merged firm's stock may sell a price/earning ratio above the individual pre merger ratios. This results from the improved risk and return relationship perceived by shareholders and other investors. The financial manager must recognize that, only the proper management of the merged enterprise can its market value be improved. If the merged firm can not achieve sufficiently high earnings in view of its risk, there is no guarantee that its market price will reach the forecast value. Nevertheless, policy of acquiring firms with low P/E can produce favorable results for the owners of the acquiring firm. Acquisitions are especially attractive when the acquiring firm's stock price is high. Since fewer shares must be exchange to acquire a given firm.

TERMS OF MERGERS

Naturally, both firms in the proposed merger/acquisition will seek the best terms possible for their respective shareholders. This involves a negotiation to divide the value between the two sets of shareholders. The ratio of exchange canbe determined by a comparison of the two companies in fiveareas: 1. earnings, 2: growth in earning, 3: dividends; 4, market price; and 5: book value.

It is clear that if we distribute securities in the new firm in proportion to any one of these basis, there will be a conflict with a distribution that uses any other of the basis except in any extremely fortuitous case. Such a conflict suggests the question of what weight is to be attributed to each of these bases of comparison. Before we examine the interplay of

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the different bases of valuation of a firm at a practical level, we must emphasize that if the merger is synergistic, the value of both companies for their owners will rise. Thus in a merger negotiation there is always discussion of: 1. the improvement of total receipts that can be anticipated beyond the sum of he separate earnings; 2. The savings or cost reduction expected from the fusion; and 3. The impact of both of these factors on the market value of the securities that would result from the merger. To illustrate the complexity of the problem, even if there were no increase in earnings by fusion and no cost savings, it is quite possible that the merger would result in a price earnings ratio higher than the separate price earnings ratio of the two companies, for example, due to off setting risks. Hence we see that historical earnings or price earnings ratios are usually inadequate as the principle of merger.

It flows, then that much of the popular analysis of mergers is based on faulty assumptions, namely, that (1) the past record and valuation of each separate entity is indicative of its separate future records and (2) the future record and valuation of the fusion is the sum of the separate(even future) records and valuation of the separate firms. Let us assume that it is agreed that future valuation of the fused firms is what is to be divided. We might propose that this value should be divided between the two firms in proportion to the present value of each firm (or the market value ratio). But such a proposal assumes that each firm contributes to an improvement in the total value of the new proportion to its separate market value.

Actually one or the other of the merging companies may have more opportunities to merger at high values with other companies. This is sometimes described on bargaining power and it effects not only the division of the increment of the fused value over the sum of the value of the two separate result of the ratio of shares in the fused firms.

ILLUSTRATION OF THE PROBLEM OF MERGER TERMS

The quantities data most readily available and most frequently used to evaluate merger terms in the practical world are earnings, dividends, market value, book value, and net current assets. Assuming the data given in Table-2. It is apparent that computations on a per share basis are convenient and this is the customary procedure. A look at the data suggests that company A is a so-called growth company and company B is mature. If an exchange of one for one were to occur and if the market were to place no higher value of

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the fused operation then on its two separate parts and Company B were the surviving company, the result might be those given in Table-3.

***Net current assets is the same as net working capital i.e., current assets minus current liabilities.**

One thing immediately apparent is that all of the per share figures are the arithmetic means of the separate company figured but that the new price earnings ratio is not an average of old price earnings ratio. Price and theearnings ratio is determined by the price and earnings; price is not determined by the price-earning-ratio and earnings.

TABLE – 3

Possible Results of One for One merger of Company A into Company B

Total Earnings Rs. 70,000

Shares of equity 20,000

Earnings per-share Rs. 3.50

Price earnings ratio 12.80

Market value per share Rs. 45.00

Dividends per share Rs. 2.10

Book value per share Rs. 14.00

Net Current assets per share Rs. 1.75

Notice also that none of the single factor exchange rate is one or greater. The exchange rate of one for one cannot be arrived at by some weighting of the several factors set out. However, in many cases after the exchange rate is established the result can be arithmetically equated to a number of different weighting systems applied to the several factors.

We can determine how long this time period will be by solving the following equation for it;

$E1 (1 + g1) N = E2 (1+g2) N$

Where **E1** and **g1** are the earnings and growth rate before merged and **E2** and **g2** are the earnings and growth rate after merger and is the break-even number of years. The growth rate after merger is the average of the separate growth rates, weighted by the total earnings of each company. In our case **g2** is [0.10 (20,000) +

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0.05 (50,000)] / 70,000 of 6.43 per cent. The company B is trading a current earnings of Rs 5 per share with a growth rate of 5% for current earnings of Rs. 3.50 per share and a growth rate of 6.43 per cent. Conversely, company A is tracing current earnings of Rs 2 per share with a growth rate of 10% for a current earnings of Rs. 3.50 per share and a growth rate of 6.43.

Substituting in this equation, N turns to be 26.4 years for company B and 17 years for company A. Thus as to company B, the decline in earnings in the merger from Rs. 5 per share to Rs 3.50 per share will be equalized after 26.4 years. Where the earnings have risen to Rs 18.13 per share [computed as log 5 + 26.4(log 1.05) or log 3,5 + 26.4(log 1.0643)]. Similarly the increase from Rs 2 per share to Rs. 3.5 per shares or company A in the merger will be equalized after 17 years when earnings will be at Rs 10.10 per share [computed as log 2 + 17(log 1,1) or log 3.5 + 17 (log 1,0543)].*

FACTORS DOMINATING SITUATIONS

Situations in which each of the five factors is likely to dominate are listed before:

Market value

Market value will dominate when there are dissenter problems. Great deviation from market value threatens to result in litigation beyond the problem of receiving the cash needed for dissenters. However, when 'market' value represent a thin or even a supported market, only the naïve company will be trapped into reorganizing market value.

Book Value

Book value is likely to dominate first in the case where liquidity carries a premium. This might occur, for example, at any time when the capital market and/or the economy as a whole have slowed down and new securities of any kind are difficult to market at any thing approximating a reasonable price. A second situation where book value will be dominant is where the market value of the assets of one company is well above the market value of its shares.

Dividends

Dividend rates of the two companies are not likely to influence the terms of the merger but can be expected to affect the form of securities used. Dividend depends on earnings and policy as to payout. But in a merger every effort will be spent to use a type of security which will preserve existing cash dividends for shareholders of the acquired

company. The payout policy of fused operation can not be readily determined in advance except where the policies of both companies have been nearly the same, thus creating an expectation that the same pattern will continue.

Earnings

Earnings are sometime stated to be the dominant single factor, and 'earnings' in such a statement means historical earnings. The relevant earnings, however, are expected further earnings and these are reflected in market value. Variability of
earnings is a factor to be considered, but his is reflected in market value and appears in the price-earnings ratios, which reflect risk as well as growth prospects.

DISSENTING SHAREHOLDERS

Although a combination generally depends only upon the approval of a required majority of the total number of shares outstanding, minority shareholders can contest the price paid for their share, if a dissenting shareholder and the company fails to agree as to just settlement on a voluntary basis, the shareholder can take his case to court and demand an appraisal of his shares and a settlement in cash. After a fairmarket price has been established by the court the dissenting shareholders receives payment in cash for his shares. If the number of dissenting shareholders is large, they can cause considerable trouble. If the transaction is in share, the demands for cash payments on the part of these shareholders may put a severe financial strain on the combination. Thus, most combinations depend not only upon obtaining approval of a required majority of shareholders but also upon minimizing the number of dissenting shareholders by making the offer attractive to all. Dissenting shareholders may be able to block the combination if they suspect that fraud is involved, even through the required majority of shareholders has approved it.

BENEFITS AND COSTS

The manager's objective is to maximize the current wealth of A's shareholders. Consequently he will go-ahead with the merger if he can negotiate a deal that makes them richer. Certain difficulties have to be disposed off before beginning any substantive discussion. In the first place, it is sometimes hard to tell who is purchasing whom, the law makes a distinction between mergers, which are purchased by A of company B's share or

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assets, and consolidation, in which A and B continue to form a new company, which survives. In the later case buyers and sellers are not legally identified.

The benefits of a merger can be defined as the difference between (1) the total present value of the merged firms and (2) the sum of their values if they do not merge.

If V represents a present value, then

Benefit = . V = VAB – VA - VB ------ (1)

The implied question is, "what aspects of the proposed merger make the two firms worth more together than apart?"

If this definition of benefit is accepted, then cost must be defined as the difference between the amount paid for the acquired firm and the amount it is worth as a separate entity. If B's owners receive case for their shares, for example, then

Cost = Cash - VB ------ (2)

Defining benefits in this way focuses attention on the economic value of merger. Estimating this value is indeed just like a capital budgeting problem.

Estimating cost, however, requires consideration of how the benefits of merger are shared between A and B's owners. As we will see later that cost can depend on how the merger is financed.

Firms should go ahead with mergers for which benefit exceeds cost. If the merger is financed by cash, this requires that

Benefit – Cost = . V – (Cash – VB) > 0 ------ (3)

It may not be obvious that A's shareholders gain when equation (3) holds. If not, consider the following. If there is no merger, then the aggregate value of their shares is Va If the merger goes through, their position is VAB – Cash. Their net gain is exactly as given by equation (3)

Net Gain = VB - Cash V A

= . V + VA + VB - Cash VA

= . V – (Cash – VB).

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Lecture-14

Cost of merger

ESTIMATING THE COST OF A MERGER

Cost is the difference between the amount paid for the acquired firm and what it is worth as a separate entity. Estimating cost is straight forward as long as the merger is financed by cash. However, it is useful to distinguish between IB, the "intrinsic" value of the acquired firm as a separate entity and MVB, the aggregate market value of the firm as observed around the time of the merger, since MVB, may be affected by information about the merger.

We can rewrite equation (2) as

Cost = (cash – MVB) + (MVB – IB) (4)

= Premium paid over Difference between observed market observed market value value of B of B and what it is worth on its own

ESTIMATING THE COST WHEN THE ACQUISITION IS FINANCED BY EQUITY

Estimating cost is tricker when mergers are financed by an exchange of shares. Suppose that firm A offers 25,000 shares, worth Rs 100 per share before the merger announcement, instead of Rs 25,00,000 cash. MVB is Rs 20,00,000 as before. The apparent cost of the merger is:

Apparent cost = Rs 100(25,000) – Rs. 20,00,000 = Rs 5,00,000

However, this is not likely to be the true cost, for three reasons. First, firm B's real value may not be Rs. 20,00,000 Second A's shares may not be valued correctly at Rs 100. Third, and most important, portion of the benefits generated by the merger will accrue to B's shareholders – they will be partners of the merged firm. The true cost is therefore

Cost = . VAB - VB

Where . is the proportion of the merged firm that B's shareholders end up owning.

Continuing with out example, consider again A's 25,000 share offer, B's shareholders will end up with one-fifth of the merged firm:

25,000 1

. = ------------- = ----

1,00,000 + 25,000 5

Suppose the market value before the merger announcement accurately reflect the firm's separate values. Also the merger generates benefit worth Rs. 1,00,000 so VAB = VA + VB + V = Rs. 1,00,00,000 + Rs 20,00,000 + Rs 10,00,000 = 1,30,000 Then the merger's true cost to A's shareholders is 1/5 VAB – VB or Cost = (Rs 1,30,00,000) – Rs. 20,00,000 = Rs. 6,00,000

The implication is that A's shareholders are as well of offering rs. 26,00,000 cash as they are offering shares worth Rs 25,00,000 before the merger announcement.

The larger the benefits generated by the merger, the greater the true cost of the 25,000 – share offer.

In making these calculations management is essentially attempting to estimate what B's share will be worth after the merger agreement is sealed and announced.

When this happens, the price of the 50,000 firm B shares will immediately jump to Rs. 52.00 a Rs 12.00 capital gain over their initial Rs 40.00 price (This assumes the market agrees with the Rs 10,00,000) estimate of merger benefits). If A's management could wait until the merger terms are announced, estimating cost would be easy.

Cost = Rs. 52(50,000) – Rs. 10,00,000 = Rs. 6,00,000

Why not just announce, tentative merger terms, and then sit back to see how the market reacts before completing the merger negotiations? Would that not avoid these somewhat complicated calculations? The flow in this strategy is that observed market prices will be extremely difficult to interpret if the market knows that the announced terms are tentative and that further negotiations are pending.

CASH VERSUS EQUITY FOR FINANCIAL MERGERS

The key distinction between cash and stock as means of financing mergers is that, if cash is offered, the ultimate pay off to B's shareholders is independent of the success or failure of the merger. Cost can be estimated without reference to the merger's benefits. If share is offered, cost depends on benefits, because they must be shared with B's owners.

It is hard to generalize about whether other financing instruments should be treated like cash or share. For practical purposes, bonds or preference share issued by A will probably

be treated like cash. The value of the bonds given to B's shareholders will be essentially independent of the success or failure of the merger, providing A is a good credit risk to start with. Convertible bonds (or convertible preference share) introduced the same problems that equity shares do. The option to convert gives B's shareholders the chance to share in merger benefits. In order to estimate cost, A's management must estimate the bond issue's value once the final merger terms and benefits are known to the market.

What are the consequences of financing mergers with equity rather than cash?

Other things being equal, the greater the merger benefits, the greater the cost of equity financing. Also, equity financing mitigates the effect of over-or undervaluation of the acquired firm. If, for example, A's management mistakenly offers more shares for B than that firm is really worth, then the inevitable bad news will fall partly on B's shareholders' shoulders. Finally, equity financing is less advantageous than cash. If A's equity is undervalued by the market. It is observed, then equity financing is cheap. Note, however, there is no necessary connection between high or low price- earnings ratio and over-or undervaluation. A high price-earnings does not mean that equity financing is cheap.

Our analysis of merger costs gives no explanation for the observed association between merger activity and bull markets for share capital. A rapid increase in prices does not imply that shares are generally overvalued. Even if it did, it would not explain a merger wave. Buy B's would gain by financing mergers with over valued shares but lose by acquiring firms that are also overvalued. Mergers can be explained only by assuming differences in valuation errors made by buyers and sellers. No doubt hindsight can supply some instances where this has happened, but it is a weak theory for explaining merger cycles. Unfortunately, other theories are weak also, which means that responsible management must approach mergers on a case-by case basis, without any presumption that "the odds are with us."

THE CONSOLIDATION

A consolidation is the combination of two or more firms into a newly created corporation. For example, firms A and B are combined into a new firm C. This usually is accomplished by the exchange of the equity shares of A and B for those of firm C. The assets and liabilities of B and A are transferred to C, and the old

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corporations. A and B, cease to exit. Consolidation has not been very widely used in recent years. Its principal disadvantages, as compared to a merger, are that a new corporation must be formed, consent of a stated majority (usually simple or two-thirds) of the shareholders of each combining corporation is required, and there is no possibility of using "pooling of interests" accounting or utilizing tax-loss carry forwards.

THE HOLDING COMPANY

The holding company is a firm which controls one or more other companies (called subsidiaries) through ownership of the subsidiary firm's equity shares. The holding company structure permits the parent firm (the holding company) to control substantial assets with a small investment and also provide earnings that are highly levered. Because of this leverage, the company holding can be a relatively risky enterprise with the opportunity for extraordinary gains it the subsidiaries prosper and large losses if the subsidiaries do poorly.

The difference between the holding company technique for combination and merger and consolidation can be summarized as follows. There are no dissenter rights for minority holders when a holding company gains control. At the same time, there is relatively easy means for the holding company to dispose of the shares where there is a desire to switch investment. Thus an operating company in a declining industry may first turn itself into an investment company and then become an operating company in another industry over several decades as it recovers depreciation on its plant and phases out its operation.

Advantages of holding companies

The primary advantage of the holding company arrangement is the leverage effect that permits the firm to control a large amount of assets with a relatively small investment. In other words, the owners of a holding company can control significantly larger amount of assets than they could acquire through mergers. The following example illustrates the leverage effect. Suppose, for simplicity, that there are five operational companies each with a Balance Sheet given in Table-4,

TABLE – 4

Balance Sheet of Each Operating Company

Liabilities Assets

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Current Operating assets Rs.

10,00,000

Liabilities Rs. 2,00,000

5 per cent bonds 3,00,000

6 per cent preference share 2,00,000

Equity share capital 1,00,000

Surplus 2,00,000

--------------- ------

Total liabilities Rs.10,00,000 Total assets

Rs.10,00,000

And net worth

Assume that the after-tax income of each operating company is Rs. 2,12,000 of which Rs.12,000 is due to preference shares. Assume that the equity shares can be brought at book value. Control may require buying at most 51 per cent of the equity. If we create a new company whose assets are the controlling shares of the five operating companies and finance the acquisition with bonds and preference as well as equity shares?

TABLE – 5

Balance sheet of Holding company

Liabilities Assets

7 percent bonds Rs. 3,50,000 Investment in operating

companies

(Rs. 1,50,000 of equity in

each

of 5 operating

companies)

8 per cent

preference share 1,00,000

Equity share capital 3,00,000

Rs. 7,50,000

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Total liabilities and Rs. 7,50,000 Rs.

7,50,000

net worth

The Balance sheet might be given in table – 5 assuming we acquire 50 per cent of the equity shares of ech operating company at book value, Now with Rs 1,50,000 of the holding company's share capital we control Rs. 50,00,000 in assets of the operating companies and claimed Rs. 50,00,000 of earnings of the operating companies (assuming they pay out 100 per cent of earnings). Of the Rs. 5,00,000 we apply Rs. 24,500 to holding company bonds and Rs. 8,000 to the preference shares (both of which carry higher rates than these securities of the operating companies because their income depends on the equity shares earnings of the operating companies.) Of the holding company owns 80 per cent or more of the operating company's voting shares, no income tax is due because the intercompany dividends are exempt, but here we own only 50 per cent, and hence only 85 per cent of the intercompany dividends are exempt. At a tax rate of 48 per cent the effective tax rate on the holding company receipts is 0.48 x 0.15 or 7.2 per cent. Here 15 per cent of Rs. 5,00,000 is taxable, or Rs. 75,000. But since the bond interest of Rs. 24,500 of the holding company is deductible Rs. 50,500 is taxable. This derives the effective tax rate below 7.2 per cent in this case. Where the equity share capital of the operating companies earns 66 per cent (Rs. 2,00,000) of Rs 3,00,000), the equity of the holding company earns 150 per cent (Rs. 4,49,760 on Rs. 3,00,000) We have considered the use of only one level of holding company. Above this level leverage increases. The high leverage obtained through a holding company arrangement greatly magnifies earnings and losses for the holding company. Quite often, a pyramiding of holding companies occurs when one holding company controls other holding companies, thereby causing an even greater magnification of earnings and losses. The greater the leverage, the greater the risk involved. The risk return tradeoff is a key consideration in the holding company decision. Another commonly cited advantage of the holding company arrangement is the risk protection resulting from the fact that the failure of one of the companies does not result in the failure of the entire holding company. Since each

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subsidiary is a separate corporation, the failure of one company should cost the holding company, at maximum, no more than its investment in that subsidiary. Other advantages include the following: (1) certain state tax benefits may be realized by each subsidiary in its state of incorporation; (2) Lawsuits or legal actions against a subsidiary will not threaten the remaining companies; and (3) it is generally easy to gain control of a firm, since shareholder or management approval is not generally necessary. Besides the advantages of avoiding dissenters' rights, minimizing the investment needed for control, and achieve leverage, the holding company presents two other advantages: (1) selective insulation of risks and (2) facility in financing. Both of these advantages are not clear cut. If there are inter-company transactions in the systems, the courts may easily refuse to recognize the d distinction of the corporations. But if the distinction between holding company and the operating companies is maintained, the decline of one operating company may not affect holding company as seriously as it affects the operating company. Facility in financing may follow from the superior standing of the system compared to the lesser status the individual operating companies would have. A major disadvantage of the holding company arrangement is the increased risk resulting from the leverage effect. When general economic conditions are unfavorable, a loss by on subsidiary may be magnified. Another disadvantage is

double taxation before paying dividends a subsidiary must pay taxes on its earnings.

Moreover, the holding companies are generally high cost of administration resulting from maintaining each subsidiary company as a separate entity. A merger, on the other hand, would likely result in certain administrative economies of scale. The need for coordination and communication between the holding company and its subsidiaries may further elevate these costs. Finally, the fact that holding companies are difficult to analyze is another disadvantage. Security analysts and investors typically have difficulty in understanding holding companies because of their complexity. As a result these firms tend to sell low multiples, of earnings (P/Es).

This means that the shareholder value of holding companies may suffer.

The operating economies that might come from a system would also be available to other forms of combinations.

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ACCOUNTING POLICIES: PURCHASE VERSUS POOLING OF INTERESTS

There are two general accounting methods for handling mergers and acquisitions. One is called the purchase method, the other the pooling of interest, and they have considerably different effects on post combination Eps Goodwill, which occurs when the purchase price of the selling company exceeds its book value, is treated substantially different under the two methods. Under the purchase method the excess of the selling company's purchase price over book value is first assigned, to the extent possible, to tangible assets, the remainder is defined as goodwill. Goodwill is depreciable for investor reporting purposes but not for tax purposes. This means that there will be a depreciation charge against earnings each year for goodwill but no commensurate depreciation tax shield. Under the pooling of interest method the books of the combining companies are simply combined or pooled as there is no goodwill created and, consequently, no depreciation of goodwill that will reduce reported earnings. Another aspect of pooling of interest that make it appear favorable was the previously sanctioned accounting practice regarding acquired assets. Assets acquired at book value under pooling could be resold at market value, and the difference would be reflected in higher profits and earnings. These apparent earnings advantages led to widespread preference for the pooling method along with widespread abuses of the method. The accounting profession has attempted to eliminate what are largely artificial advantages of the pooling method by eliminating some of the obvious enticements and by making it more difficult for pooling of interest.

Example – 1

Company XYZ offers Rs. 12,00,000 for Rs. 4,00,000 of ABS's stock at book value. ABC has Rs. 1,00,000 debt. How much goodwill arises? If XYZ has Rs. 20,00,000 equity and Rs. 5,00,000 debt itself, what is the combined balance sheet using the purchase method ?

Solution: Rs. 8,00,000 goodwill (Rs. 12,00,000 – Rs.4,00,000) Balance sheets are as follows:

(per lakh of Rs.)

Purchase method Pooling of interests

method

Debt 6 Assets 30 Debt 6 Assets

30

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Equity 32 Goodwill 8 Equity 24 Goodwill

0

------ ----- -----

Total 38 Total 38 Total 30 Total

30

EARN-OUTS

The deferred payment plan, which has come to be called an earn-out, represents a relatively recent approach to merger financing. The acquiring firm agreed to make a specified initial payment of cash or stock and, if it can maintain or increase earnings, to pay additional compensation.

An earn-out has several benefits for the acquiring organization. These are tested below:

(1) It provides a logical method of adjusting the difference between the amount of stock the purchaser is willing to issue, and the amount the seller is agreeing to accept for the business.

(2) The merging company will immediately be able to report higher earnings per share because fewer shares of equity will become outstanding at the time of the acquisition. In addition the acquiring company is provided with downside protection in the event that the merged business does not fulfill its earnings expectations.

(3) The earn-out diminishes the guesswork in establishing a equitable purchase price, because the price is based upon the actual performance of the prospective acquisition after the merger. Even though several advantages exist for earn-outs, potential problems must also be recognized these are:

(1) The required corporation must be capable for being operated as an autonomous business entity.

(2) The acquiring firm must be willing to allow freedom of operation to the management of newly acquired business.

(3) The acquiring firm must be willing to contribute towards the future growth of acquiring company, realizing that only by working together with the two firms attain success.

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Numerous types of earn-outs have been devised; the various arrangements are limited only by the imagination of the management of the two firms involved.

However, the base-period-earn-out may be used as any illustration. Under this plan the shareholders of the acquired company are to receive additional shares in each future year if the firm improves its earnings above the base period profits – that is, earnings in the last year before the acquisition. The amount of the future payments will be determined by three factors:

(1) The amount of earnings in the forthcoming years in excess of the base-period profits.

(2) The capitalization rate (discount rate) agreed upon by the parties.

(3) The market value of the acquiring organization at the end of each year. For example, the compensation in shares in future years might be computed by using the following formula:

Excess earnings x price/earnings multiple

Equity market price

To illustrate, company X acquired company Y in 1999 which had base period earnings of Rs. 8,00,000. At the time of the merger, company Y shareholders received 3,00,000 shares if cinoabt X equity. Annual profits, subsequent to the merger have been Rs. 8,75,000, Rs 9,50,000, Rs 10,50,000 and Rs 9,00,000. The market value of company X's equity is Rs 25 per share and the price/earnings ratio is 10. Based upon the formula above, the additional shares to be paid to company

stockholders would be:

Rs. 75,000 x 10

2002: ---------------------- = 30,000 shares

Rs. 25

Rs. 1,50,000 x 10

2003: ---------------------- = 60,000 Shares

Rs. 25

Rs. 2,50,000 x 10

2004: ------------------------= = 1,00,000 shares

Rs. 25

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Rs. 1,00,000 x 10

2005: -------------------------- = 40,000 shares

Rs. 25

Total = 2,30,000 shares

Therefore, in addition to the down payment of 3,00,000 company X shares company Y shareholders would receive a total of 2,30,000 shares during the ensuing four years.

The foregoing example is oversimplified, since other variables must also be recognized in the development of an earn-out plan. Such factors include

(1) A specified limitation as to the maximum amount of share that can be transferred in any year.

(2) an established range for the share price employed in the computations;

(3) The recognition of yearly earnings increments over the prior year.

(4) The determination of an equitable down payment; and

(5) The succinct definition of earnings for the earn-out computations.

In conclusion, the earn-out technique provides a means by which acquiring business can eliminate part of the guesswork involved in purchasing a firm. In essence, it allows the acquiring management the privilege of hindsight.

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Lecture- 15

METHODS OF MERGER/AMALGAMATION

A merger or amalgamation may be effected by various methods; e.g.,

(i) Merger under a scheme of compromise or arrangement;

(ii) Merger by purchase of shares;

(iii) Merger in public interest under orders of the Central Government;

(iv) Merger through holding company;

(v) Merger by a scheme of winding up; or

(vi) Merger by exchange of shares followed by winding up

PRELIMINARY STEPS IN MERGERS

The process of screening and selecting the right companies for mergers and amalgamations should proceed in a systematic manner-from general to the more specific. The process starts by identifying the general domains of potential industries to the specific selection of companies to be evaluated and approached for merger or acquisition. The process of screening is generally as follows:

Identifying Industries

First a set of industries is selected which meet the strategic conditions outlined by the company for the merger. This may be in terms of size. For instance, a company I wanting to acquire a medium scale investment will leave out the large investment I industries such as petrochemicals, shipbuilding, etc.

Selecting Sectors

A broad group of acceptable sectors are then identified. For each of these sectors, data with respect to the sales turnover and growth, return on investment (or sales), market shares, competition and asset turnover etc. is collected for the various J companies. On the basis of this comparison, the more desirable sectors are chosen.

Choosing Companies

Potential companies are carefully looked at with respect to the competitive environment in which they operate. Specific attention is paid to the competitive strengths of these companies in their sectoral environment. Comparable sizes are favourable to the chances of success of the merger.

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Generally sales turnover and the asset level, which in turn determines the cost level of acquisition, characterize the size of companies. A common rule of thumb I followed is to consider companies, which are 5 to 10 per cent in size of the bidding companies.

Comparative Cost and Returns

The next step is to consider the financial obligations associated with merger and \ amalgamation on the basis of which the potential companies are reduced further on the basis of their likely return. The companies are listed and compared with respect to their return on investments and the future expected returns are also developed on the basis of different market scenarios. The risks and uncertainties are incorporated to (determine the possible variations in returns. Finally, the various companies are ranked on the basis of their position against each of the identified objectives.

The regulator examines the request keeping in view the statutory, regulatory and other prudential requirements and the need for compliance with the various provisions of the statute and approves the same with or without conditions.

For example, in the case of the application for merger of ICICI Ltd. with ICICI Bank Ltd. submitted to the Reserve Bank of India (RBI) for regulatory approvals, the Reserve Bank approved the merger subject to certain conditions.

Approvals of Respective High Court(s):

Approval of the respective High Court(s) of both the companies confirming the scheme of amalgamation are required. The court issues orders for winding up of the amalgamating companies without dissolution on receipt of the reports from the official liquidator and the Regional Director that the affairs of the amalgamating companies have not been conducted in a manner prejudicial to the interests of its members or to public interest.

Integration Stage:

The structural and cultural aspects of the two organizations, if carefully integrated in the new organization will lead to the successful merger and ensure that expected benefits of the merger are realized. The above aspects are discussed in detail in this lesson.

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LEGAL ASPECTS OF MERGER/AMALGAMATION

MERGER OR AMALGAMATION UNDER THE COMPANIES ACT, 1956—SALIENT FEATURES

The Companies Act, 1956 has provided for a set of provisions specially dealing with amalgamation of companies, to facilitate the transactions. The statutory provisions relating to Merger and Amalgamations are contained in Sections 390 to 396A of the Companies Act, 1956.

While Section 390 interprets the expressions company, arrangement and explains unsecured creditors, as used under Sections 391 and 393, Section 391 lays down in detail the power to make compromise or arrangements with creditors and members. Under this Section a company can enter into a compromise or arrangement with its creditors or its members, or any class thereof without going into liquidation. Section 392 lays down the power of the High Court to enforce compromise and arrangements while Section 393 specifies the information as to compromise or arrangements that is to be sent with every notice calling the meeting. The provisions for facilitating reconstruction and amalgamation of companies are contained in Section 394. Section 395 prescribes the power and duty of the transferee company to acquire shares of shareholders dissenting from scheme or contract approved by majority. Powers of Central Government to provide for amalgamation of companies in national interest is laid down under Section 396 and Section 396A specifies provisions for preservation of books and papers of amalgamated company.

The salient features of Sections 391 and 394 are —

There should be a scheme of compromise or arrangement for restructuring or amalgamation. &

— An application must be made to the court for direction to hold meetings of shareholders/creditors.

— Court may order a meeting of shareholder/creditors.

— Holding of meeting(s) of shareholders/creditors as per court's order.

— Scheme of compromise or arrangement must be approved by 3/4'" in value of creditors, class of creditors, members, class of members.

- Another application must be made to court sanctioning the scheme of

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compromise or arrangement.

- An approved scheme duly sanctioned by court is binding on all shareholders/ creditors/company(ies).
- Court's order takes effect only after a certified copy has been filed with the Registrar of Companies.
- Copy of court's order should be annexed to every copy of memorandum of association of the company.
- Court may stay commencement or continuation of any suit or proceeding against the company after application has been moved in the court.
- Court's order is appealable in a superior court.

Therefore, merger or amalgamation under a scheme of arrangements as provided under Sections 391-394 of the Act is the most convenient and .most common method of obtaining a complete merger or amalgamation between the companies. There is active involvement of the Court and an amalgamation is complete only after the Court sanctions it under Section 394(2) and takes effect when such order of court is filed with the Registrar of Companies. In fact, Sections 391 to 394 of the Act read with Companies (Court) Rules, 1959 serve as a complete code in themselves in respect of provisions and procedures relating to sponsoring of the scheme, the approval thereof by the creditors and members, and the sanction thereof by the Court.

Accordingly, amalgamation can be effected in any one of the following ways:

(i) *Transfer of undertaking by order of the High Court (Section 394 of t'he Companies Act)*

Under Section 394 of the Companies Act, the High Court may sanction a scheme of amalgamation proposed by two or more companies after it has been approved by a meeting of the members of the company convened under the orders of the court with majority in number of shareholders holding more than 75 percent of the shares who vote at the meeting, approve the scheme of amalgamation, and the companies make a petition to the High Court for approving the Scheme. The High Court serves a copy of petition on the Regional Director, Company Law Board and if he does not object to the amalgamation, the Court sanctions it. Once the Court sanctions the scheme, it is binding on all the members of the respective companies.

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(ii) *Purchase of Shares of One Company by another Company (Section 395 of the Companies Act)*

Under Section 395 of the Companies Act, 1956, the undertaking of one company can be takenover by another company by the purchase of shares. This section obviates the need to obtain the High Court's sanction. While purchasing shares, the company which acquires shares should comply with the requirements of SEBI (Substantial Acquisition of Shares and Takeovers)

Regulations, 1997 and Section 372A of the Companies Act, 1956. This Section also provides the procedure for acquiring the shares of dissenting members,

(iii) *Amalgamation of Companies in National Interest (Section 396)*

Where the Central Government is satisfied that an amalgamation of two or more companies is essential in the public interest, then the Government may, by an order notified in the Official Gazette, provide for the amalgamation of those companies into a single company. The amalgamated company shall have such constitution, property, powers, rights, interest and privileges as well as such liabilities, duties and obligations as may be specified in the Government's order.

(iv) *Amalgamation of Companies under Section 494*

Amalgamation of two companies is also possible under Section 494 of the Companies Act, where the liquidator of a company transfers its assets and liabilities to another company.

Section 394 of the Companies Act, 1956 contains provisions for facilitating reconstruction and amalgamation of companies. The provisions apply to mergers also.

The Bombay High Court has held in *Sadanand S. Varde* v. *State of Maharashtra* [(2001) 30 SCL 268 (Bom.)] that the fasciculus of Sections 391 to 394 of. the Companies Act constitutes a complete code of the subject of amalgamation. The court has no special jurisdiction under Article 226 of the Constitution to sit in appeal over an order made under Section 391 of the Companies Act, 1956 which has become final, binding and conclusive. The court cannot sit in judgement over the correctness of an order made under Section 391 by the Court which has become final, conclusive and binding.

Section 394(1) lays down that where an application is made to the Court under

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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 Court –

(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 referredto as "the transferee-company");

the Court 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 persons who within such time and in such manner as the Court 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.

Condition with regard to amalgamation — report from CLB (Central Government or HOC)

The first proviso to Sub-section (1) of Section 394 of the Act lays down 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 court unless the court 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;

The second proviso lays down that no order for the dissolution of any transferor company under clause (iv) shall be made by the Court unless the Official Liquidator has, on scrutiny of the books and papers of the company, made a report to the Court that the affairs of the company have not been conducted in a manner prejudicial to the interests of its members or to public interest.

Sub-section (2) of Section 394 lays down that 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.

Filing of certified copy of Court's order with ROC

Sub-section (3) of Section 394 provides that 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 of Companies for registration. If default is made in complying with this sub-section, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees.

Moreover, according to Sub-section (3) of Section 391 the court order shall not have effect unless a certified copy of the order has been filed with the Registrar.

Sub-section (4) of Section 391 also lays down that 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.

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Application to Court under Section 391 for direction to hold meetings of shareholders/creditors

A compromise or arrangement is effected by and between two or more companies by entering into an arrangement, which comes within the purview of Section 391 of the Companies Act, 1956.

Section 391 (1) provides that 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 Court 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 Court directs.

Sanctioned arrangement binding on all concerned parties

According to Sub-section (2) of Section 391, 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, agree to any compromise or arrangement, the compromise or arrangement shall, if sanctioned by the court, be binding on all the creditors, or 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 company which is being wound up, on the liquidator and contributories of the company.

Disclosure of material facts is a pre-condition for court order

The sub-section further provides that the court shall pass an order sanctioning any compromise or arrangement only when it is satisfied that the company or any other person by whom an application has been made under Sub-section (1) has disclosed to the court, by affidavit or otherwise, all material facts relating to the company, such as the latest financial position of the company, the latest auditors' 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.

Scope of Section 391

Section 391 deals with the rights of a company to enter into a compromise or

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arrangement (i) between itself and its creditors or any class of them and (ii) between itself and its members or any class of them. The arrangement contemplated by the section includes a reorganisation of the share capital of a company by consolidation of its shares of different classes or by sub-division of its shares into shares of different classes or by both'these methods.

Once a compromise or arrangement comes within the ambit of the section, it may be sanctioned by the court, even if it involves certain acts for which a particular procedure is specified in other sections of the Act e.g., reduction of share capital of a company may form part of a compromise or arrangement and when the court sanctions the compromise or arrangement as a whole, reduction of share capital is also sanctioned without the company following the procedure laid down in Section 100 of the Act. The court can refuse to sanction a scheme of merger or amalgamation or reconstruction if it is satisfied that the scheme involves any fraud or illegality.

Once the reduction of share capital of a company is a part of a compromise or arrangement, the requirements of the Companies Act as regards reduction of share capital are not applicable because the court is empowered to sanction reduction of share capital as a part of the compromise or arrangement.

The section also applies to compromise or a management entered into by companies under winding up. Therefore, an arrangement under tnis section can take a company out of winding up.

Once a compromise or arrangement under this section is approved by statutory majority, it binds the dissenting minority, the company and also the liquidator, if the company is in winding up,

ALLIED MATTERS

The companies are required to obtain following approvals in respect of the scheme of amalgamation:

(I) Approval of Board of Directors

- The first step in carrying out amalgamation is approval of scheme of amalgamation by the Boards of both the companies.

- Board resolution should, besides approving the scheme, authorise a Director/ Company Secretary/other officer to make application to court, to sign it and other

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documents and to do everything necessary or expedient in connection therewith, including changes in the scheme.

(ii) Approval of Shareholders/Creditors

Members' and creditors' approval to the scheme of amalgamation is *sine qua non* for Court's sanction. Without that the Court cannot proceed. This approval is to be obtained at specially convened meetings held as per court's directions [Section 391(1)]. However, the court may dispense with meetings of members/creditors. Normally, creditors' meetings are dispensed with subject to certain conditions. For instance, members' meeting may be dispensed with if all members' individual consent is obtained.

***(iii)* Approval of Financial Institutions**

The approval of the Financial Institutions, trustees to the debenture holders and banks, investment corporations would be required if the Company has borrowed funds either as term loans, working capital requirements and/or have issued debentures to the public and have appointed any one of them as trustees to the debenture holders.

(iv) Approval from the Land Holders

If the land on which the factory is situated is the lease-hold land and the terms of the lease deed so specifies, the approval from the lessor will be needed.

(v) Approval of the High Court

Both the companies (amalgamating as well as amalgamated) are required to seek approval from the respective High Courts in accordance with the provisions of Sections 391-394 of the Act, In this regard, the following points are worth noting:

An application under Sections 391 and 394 to High Court for an order convening a meeting of members and/or creditors, is the first step to seeking Court's sanction to amalgamation.

Every amalgamation, except those which involve sick industrial companies, requires sanction of High Court ' which has jurisdiction over the State/area where the registered office of a company is situated. [Section 391].

If transferor and transferee companies are under the jurisdiction of different High Courts, separate approvals are necessary.

If both are under jurisdiction of one High Court, joint application may be made.

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(Mohan Exports Ltd. v. *Tarun Overseas P. Ltd.* (1994) 14 CLA 279 (Del) dissenting from *Re Electro Carbonium P. Ltd..* (1979) 49 Comp Cas 825 (Kar) wherein it was held that a joint application cannot be made.]

-Determination of Cut off Date

Amonst others, the foremost requirement is the determination of cut off date from which all properties, movable as well as immovable and rights attached thereto etc. are required to be transferred from amalgamating company to the amalgamated company. The date may be called transfer date or appointed date and generally it is the first day of preceding financial year for which the audited accounts are available with the company. Another requirement is the determination of a date on which all the required approvals under various statutes are obtained on which the transfer and vesting of the undertaking of amalgamating company with the amalgamated company would take effect. It is common to fix an appointed date as effective date in respect of scheme of amalgamation. A scheme of amalgamation normally contains conditions to be satisfied for the scheme to become effective. It becomes, therefore, essential to consider whether or not the transfer or appointed date should be different from the effective date.

The scheme of amalgamation may provide for merger to be effective from the appointed date. But finally the scheme becomes effective only after a certified copy of the order of the High Court is filed with the concerned office of the Registrar of Companies.

The Supreme Court in *Marshal Sons & Co. (India) Ltd. v. ITO* (1977) 1 Comp. LJP.1 observed that "it is true that While sanctioning the scheme, it is open to the court to modify the said date and prescribe such date of amalgamation/transfer as it thinks appropriate in the facts and circumstances of the case. If the court so specified a date, there is little doubt that such date would be the date of amalgamation/date of transfer. But where the court does not prescribe any specific date but merely sanctions the scheme presented to it-as has happened in this case -it should follow that the date of amalgamation/date of transfer is the date specified in the scheme as 'the transfer date'. It cannot be otherwise."

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Arrangements with Secured and Unsecured Creditors

It is also important to lay down clearly the arrangements with secured and unsecured creditors including the debenture holders. The Exchange Ratio, at which shareholders of amalgamating company will be offered shares in the amalgamated company, will have to be worked out based on the valuation of shares of the respective companies as per the accepted methods of valuation, guidelines and the audited accounts of the company. The value of each share of amalgamating company is fixed keeping in view the value of each share of amalgamating company to be allotted in exchange for the former shares. The Exchange Ratio must be certified by the auditor. Share exchange ratio based on financial position of both Companies on a date later than appointed date is not objectionable since date of negotiations between two Companies cannot be ignored. *[fie. Sumitra Pharmaceuticals Ltd.* (1997) 25 CLA 142 (AP)]. When the
shares of amalgamating company are held by the amalgamated company or its
subsidiaries, the scheme must provide the reduction of share capital to that extent and the manner in which the compensation for shares held in the amalgamating company shall be given. The scheme should also provide for things like transfer of whole or part of the undertaking to the amalgamating company, continuation of legal proceedings against the amalgamating and amalgamated companies, absorption of employees of amalgamating company, obtaining the consent of dissenting shareholders etc.

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Lecture – 16

Procedural aspects under various laws

PROCEDURAL ASPECTS, INCLUDING DOCUMENTATION FOR MERGER/ AMALGAMATION

The procedure commencing with an application for seeking directions of the _ Court for convening, holding and conducting meetings of creditors or class of creditors, members or class of members, as the case may be, to the stage of the court's order sanctioning the scheme of compromise or arrangement is contained in Sections 391 to 395 of the Companies Act, 1956 and rules 67 to 87 of the Companies (Court) Rules, 1959. The Rules also prescribe Forms for various purposes relating to compromise or arrangement:

Authority to amalgamate, merge, absorb, etc.

The memorandum of association of most of the companies contain provisions in their objects clause, authorising amalgamation, merger, absorption, take-over and other similar strategies of corporate restructuring. If the memorandum of a company does not have such a provision in its objects clause, the company should alter the same

The procedural aspects of mergers and amalgamations Observing Memorandum of Association of Transferee Company

It has to be ensured that the objects of the Memorandum of Association of the transferee company cover the objects of the transferor company or companies; if not it will be necessary to follow the procedure for amendment of objects by passing a special resolution at an Extraordinary General Meeting convened for this purpose. It has been held by various decisions of the courts that there is no necessity to have special power in the object clause of the Memorandum of Association of a company for its amalgamation with another company. It has been laid down that to amalgamate with another company is power of the company and not an object of the company.

Since the amalgamation will involve issue of shares by the transferee company to the shareholders of the transferor companies, a general meeting convened for the purpose of the amendment of the Object Clauses of the Memorandum of Association of the

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transferee company to incorporate the object of the transferor company, should also cover resolutions relating to the increase of authorized capital, consequential changes in the Articles of Association and resolution under Section 81(1-A) of the Companies Act, 1956 authorizing the Directors to issue shares of the shareholders of the transferor companies without offering them to the existing shareholders of the company. It is also a normal practice that alongwith the special resolution for amendment of the Object Clause, special resolution is also passed under Section 149(2-A) of the Companies Act, 1956 authorizing the transferee company to commence the business of the transferor company or companies as soon as the amalgamation becomes effective.

Convening a Board Meeting

A Board Meeting is to be convened and held to consider and approve in principle, amalgamation and appoint an expert for valuation of shares to determine the share exchange ratio.

Consequent upon finalisation of scheme of amalgamation, another Board-?
Meeting is to be held to approve the scheme.

Preparation of Valuation Report

Simultaneously, Chartered Accountants are requested to prepare a Valuation
Report and the swap ratio for consideration by the Boards of both the transferor and transferee companies and if necessary it may be prudent to also obtain confirmation from merchant bankers on the valuation to be made by the Chartered Accountants.

Preparation of scheme of amalgamation or merger

All the companies, which are desirous of effecting amalgamation of or merger must interact through their authorised representatives who should report the result of their interaction to their respective Board of directors. The Boards of the involved companies should discuss and determine details of the proposed scheme of amalgamation or merger and prepare a draft of the scheme of amalgamation or
merger. If need be they can obtain opinion of experts in the matter. The drafts of the scheme finally prepared by the Boards of both the companies should be exchanged and discussed in their respective Board meetings. After such meetings a final draft scheme will emerge. The scheme must define the "effective date" from which it shall take effect subject to the approval of the High Courts.

Contents of Amalgamation Scheme

Any model scheme of amalgamation should include the following:

Transfer Date: This is usually the first day of the financial year preceding the financial year for which audited accounts are available with the companies. In other words, this is a cut-off date from which all the movable and immovable properties including all rights, powers, privileges of every kind, nature and description of the transferor-company shall be transferred or deemed to be transferred without any further act, deed or thing to the transferee company.

Effective Date: This is the date on which the transfer and vesting of the undertaking of the transferor-company shall take effect i.e., all the requisite approvals would have been obtained.

Arrangement with secured and unsecured creditors including debenture-holders.

Arrangement with shareholders (equity and preference): This refers to the exchange ratio, which will have to be worked out based on the valuation of shares of the respective companies as per the audited accounts and accepted methods and valuation guidelines.

Cancellation of share capital/reduction of share capital: This will be necessitated when the shares of the transferor-company(ies) are held by the transferee-company and/or its subsidiary(ies) or vice versa. Pending receipt of the requisite approvals to the amalgamation, the transferorcompany(ies) possesses the property to be transferred and to carry on the business for and on behalf and in trust for the transferee-company.

The Scheme should suitably provide for.

1. Brief details of transferor and transferee companies.
2. Appointed date.
3. Main terms of transfer of assets and liabilities from transferor to transferee, with power to execute on behalf or for transferee, the deed/documents given to transferee.
4. Effective date of the scheme.
5. Details of consequences of the scheme coming into effect on effective date.
6. The terms of carrying on the business activities by transferor between 'appointed date' and 'effective date'.
7. Details of share capital of transferor and Transferee Company.

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8. Proposed share exchange ratio, conditions attached thereto, fractional certificates to be issued to transferee company, approvals and consent required etc.

9. Conditions about payment of dividend, ranking of equity shares, prorata dividend declaration and distribution.

10. Status of employees of transferor companies and various schemes or funds created for their benefit, from the effective date.

11. Agreement between transferor and transferee companies towards making applications/petitions under Section 391 and 394 and other provisions to the respective High Courts.

12. Impact of various provisions covering income tax dues, contingencies and other accounting entries deserving attention.

13. Statement to bear costs, expenses etc. in connection with the scheme by transferee company.

14. Qualifications attached to the Scheme, requiring various approvals and sanctions etc.

Approval of Scheme

- It would be necessary to convene a Board Meeting of both the transferor and transferee companies for approving the Scheme of Amalgamation,

Explanatory Statement under Section 393 and the Valuation Report including the swap ratio. Notice has to be given to the regional Stock Exchanges and other Stock Exchanges where shares of the Company are listed under the listing requirements at least two days before the Board Meeting is proposed to be held for purpose of approving the Amalgamation. immediately after the Board Meeting, the Regional Stock Exchange and all other Stock Exchanges are required to be given intimation of the decision of the Board as well the swap ratio before such information is given to the shareholders and the media.

Application **to High Court seeking direction to hold meetings**

Rule 67 of the Companies (Court) Rules, 1959 lays down that an application under Section 391(1) of the Companies Act, 1956 for an order seeking direction for convening meeting(s) of creditors and/or members or any class of them shall be by a Judge's summons supported by an affidavit. A copy of the proposed scheme should be annexed to the affidavit as an exhibit thereto. The summons should be moved *ex parte* in Form No. 33. The affidavit in support of the application should be in Form No. 34.

Jurisdiction of High Court

As explained earlier if the registered offices of both the companies are situated in the same State, a joint application or separate applications should be moved to the High Court having jurisdiction over the State in which registered offices of the companies are situated. However, if the registered offices of the companies involved are situated in different States, they should make separate applications to their respective High Courts.

Accordingly, an application should be made to the concerned High Court under Section 391(1) of the Companies Act, 1956 in accordance with the provisions of rule 67 of the Companies (Court) Rules. 1959, for an order directing convening of meeting(s) of creditors and/or members or any class of them, by a Judge's summons supported by an affidavit.

Normally, an application under Section 391 of the Act is made by the company, but a creditor or a member may also make the application. Although a creditor or a member or a class of creditors or a class of members may move an application under Section 391(1) of the Act, yet, such an application may not be accepted by the court because the scheme of compromise or arrangement submitted to the court along with the application will not have the approval of the Board of directors of the company or of the company in general meeting. However, the court has the discretion to give such directions as it may deem proper.

Where the company is not the applicant

Rule 68 lays down that where the company is not the applicant, a copy of the summons and of the affidavit shall be served on the company, or, where the company is being wound up on the liquidator not less than 14 days before the date fixed for the hearing of the summons.

Where an arrangement is proposed for the merger or for the amalgamation-of two or more companies, the petition must pray for appropriate orders and directions under Section 394 of the Act for facilitating the reconstruction or amalgamation of the company or companies.

Obtaining order of the court for holding class meeting(s)

On receiving a petition the court may order meeting(s) of the members/creditors to be called, held and conducted in such manner as the court directs. Once the ordered

meetings are duly convened, held and conducted and the scheme is approved by the prescribed majority in value of the. members/creditors, the court is bound to sanction the scheme.

The court looks into the fairness of the scheme before ordering a meeting because it would be no use putting before the meeting, a scheme containing illegal proposals which are not capable of being implemented. At that stage, the court may refuse to pass order for the convening of the meeting.

According to Rule 69 of the said Rules, upon hearing of the summons, or any adjourned hearing thereof, the judge shall, unless he thinks fit for any reasons to
dismiss the summons, give directions as he may think necessary in respect of the following matters:

(i) determining the members/creditors whose meeting or meetings have to be held for considering the proposed scheme of merger or amalgamation;

(ii) fixing time and place for such meetings;

(iii) appointing a chairman or chairmen for the meetings;

(iv) fixing quorum and procedure to be followed at the meetings including voting by proxy;

(v) determining the values of the members/creditors, whose meetings have to be held;

(vi) notice to be given of the meetings and the advertisement of such notice; and

(vii) the time within which the chairman of the meeting or chairmen of the j
meetings are to report to the Court the result of the meeting or meetings as the case may be. The order made on the summons shall be in Form No. 35 of the said rules, with such variations as may be necessary. Draft Notice, Explanatory statement under Section 393 of the Companies Act, 1956 and form of proxy are required to be field and settled by the concerned High Court before they can be printed and dispatched to the shareholders.

After obtaining the court's order containing directions to hold meeting(s) of members/creditors, the company should make arrangement for the issue of notice(s) of the meeting(s). The notice should be in Form No. 36 of the said Rules and must be sent by the person authorized by the court in this behalf. The person authorized may be the person appointed by the court as chairman of the meeting, or if the court so directs by the company or its liquidator if the company is in liquidation, or by any other person as the

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court may direct. The court usually appoints an advocate to be the chairman of such a meeting.

Holding meeting(s) as per Court's direction

The meetings are to be held as per directions of the Court under the chairmanship of the person appointed by the Court for the purpose. Normally the Court appoints a Chairman and alternate Chairman of each meeting.

Convening of General Meeting

- At the General Meeting convened by the High Court, resolution will be passed approving the scheme of amalgamation with such modification as may be proposed and agreed to at the meeting. The Extraordinary General Meeting of the Company for the purpose of amendment of Object Clause (Section 17),, commencement of new business [Section 149(2A)], consequent change in Articles (Section 31) and issue of shares [Section 81(1A)] can be convened on the same day either before or after conclusion of the meeting convened by the High Court for the purpose of approving the amalgamation.

Following points of difference relating to the holding and conducting of the meeting convened by the High Court may be noted:

Proxies are counted for the purpose of quorum;

(b) Proxies are allowed to speak;

(c) The vote must be put on poll [Rule 77 of the Companies (Court) Rules].

In terms of Section 391, the resolution relating to the approval of amalgamation has to be approved by a majority of members 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 by proxy. The resolution will be passed only if both the criteria namely, majority in number and three fourth in value vote for the resolution.

The minutes of the meeting should be finalized in consultation with the Chairman of the meeting and should be signed by him once it is finalized and approved. Copies of such minutes are required to be furnished to the Stock Exchange in terms of the listing requirements.

Report by the Chairman on meeting(s)

The Chairman or Chairmen, as the case may be, are to submit their report on the meeting(s) to the Court. The report shall state accurately the number of creditors

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or class of creditors or the number of members or class of members, as the case may be, who were present and who voted at the meeting either in person or by proxy, their individual values and the way they voted. The report shall be in Form No. 39 [Refer Rule 78 of the said Rules]. The report shall be filed within the time fixed by the court or within 7 days of conclusion of the meeting.

Petition to court for confirmation of scheme

When the proposed scheme of compromise or arrangement is agreed to, with or without modifications, as provided in Section 391(2) of the Act, a petition must be made to the court for confirmation of the scheme of compromise or arrangement. The petition must be made by the company and if the company is in liquidation, by the liquidator, within seven days of the filing of the report by the chairman. The petition is required to be made in Form No. 40 of the said rules. On hearing the petition the Court shall fix the date of hearing and shall direct that a notice of the hearing shall be published in the same newspapers in which the notice of the meeting was advertised or in such other papers as the court may direct, not less than 10 days before the date fixed for hearing. (Rule 80) The court also directs that notices of petition be sent to the concerned Regional Director, Registrar of Companies and the official liquidator.

Obtaining order of the court sanctioning the scheme

An order of the court on summons for directions should be obtained which will be in Form No. 41 (Refer Rule 69),

Filing of copy of Court's order with ROC

According to the provisions of Section 391(3) and Section 394(3) of the Companies Act, a certified copy of the order passed by the Court under both the subsections is required to be filed with the concerned Registrar of Companies. This is required to be filed with Form No. 21 as prescribed in the Companies (Central Government's) General Rules and Forms, 1956.

Conditions precedent and subsequent to court's order sanctioning scheme of arrangement

The court shall not sanction a scheme of arrangement for amalgamation, merger etc. of a company which is being wound up with any other company or companies unless it has received a report from the Company Law Board (Central Govt. acting through Regional

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Director) or the Registrar of Companies to the effect that the affairs of the company have not been conducted in a manner prejudicial to public interest. When an order has been passed by the court for dissolution of the transferor company, the transferor company is required to deliver to the Registrar a certified copy of the order for registration within thirty days and the order takes effect from the date on which it is so delivered,

Copies of the order of High Court are required to be affixed to all copies of Memorandum and Articles of Association of the transferee company issued after certified copy has been filed as aforesaid. The transferor company or companies will continue in existence till such time the court passes an order for dissolution without winding up, prior to which it must receive a report from the official liquidator to the effect that the affairs of the company have not been conducted in a manner prejudicial to the interest of the members or to public interest. The practice in India is that in certain High Courts the Order on amalgamation is passed only after the Report of the Official Liquidator is received, whereas in certain cases the order of dissolution is passed after which amalgamation is approved by the concerned High Court.

The above sets out briefly the procedure relating to merger and amalgamation in India. It will be obvious from the foregoing that considerable amount of paper work and documents are required to be prepared during the course of the process of merger. Since the law requires approval of the shareholders both in majority in number and three-fourth in value, it has to be ensured that adequate number of shareholders, whether in person or by proxy attend the meeting so that the resolution can be passed by the requisite majority as mentioned above.

Normally the time frame for such merger will depend on the opposition, if any, to the proposed merger from shareholders or creditors but in normal case it may take anything between six months to one year to complete the merger from the time the Board approves the scheme of amalgamation till the merger becomes effective on filing of the certified copies of the Court's Order.

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Reverse merger

Reverse merger takes place when a healthy company merges into a financially weak company. However, in the context of the Companies Act, there is no distinction between a merger or a reverse merger because in either case one company merges with another company irrespective of the fact whether the merging or the amalgamating company is weaker or stronger. Reverse merger like any amalgamation or merger is carried out through the High Court route under the provisions of Sections 391 to 394 of the Companies Act, 1956. However, if one of the companies in this exercise is a sick industrial company, its merger or reverse merger

AMALGAMATION OF COMPANIES BY AN ORDER OF THE CENTRAL GOVERNMENT (SECTION 396)

Special Power of Central Government to Order Amalgamation

Section 396 of Companies Act, 1956 confers on the Central Government special power to order amalgamation of two or more companies into a single company, if the Government is satisfied that it is essential in the public interest that two or more companies should amalgamate.

This power is unaffected by, and can be exercised, notwithstanding anything contained in Sections 394 and 395 but subject to the provisions of Section 396. But this exclusion is only in respect of Sections 394 and 395 (including Section 392), and not any other provision of the Act.

However, in the case of amalgamation of two or more banking companies, the Central Government must consult the RBI before passing any order under Section 396 [Section 44A(7) of the Banking Regulation Act].

Manner in which Central Government should Exercise Power under Section 396

The power under Section 396 should be exercised by the Central Government only where the Government is satisfied that it is essential in the public interest that two or more companies should amalgamate.

If the Government is so satisfied, it may pass an order providing for the amalgamation of those companies into a single company.

The Central Government may exercise the power under Section 396 of its own motion without any application being received from the companies intending to amalgamate.

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There is no bar to the exercise of that power by the Government on such application.

The order of the Central Government under this section may provide for such constitution: such property, powers, rights, interests, authorities and privileges; and such liabilities, duties, and obligations *as* may be specified in the order.

The order passed by the Government must be published in the Official Gazette. The order aforesaid may also provide for the continuation by or against the transferee company or 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.

If the Government decides to order amalgamation of companies' under this section, it must ensure that the following requirements are complied with in regard to the proposed order:

(a) a copy of the proposed order has been sent in draft to each of the companies concerned;

(b) the time for preferring an appeal under Sub-section (3A) has expired, or where any such appeal has been preferred, the appeal has been finally disposed off; and

(c) 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. [Section 396(4)].

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 396(5)].

Interest and Rights of Members and Creditors

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. [Section 396(3)].

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If 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. [Section 396(3)].

The prescribed authority for this purpose is Joint Director (Accounts), Department of Company Affairs [Rule 12A, Companies (Central Government's) General Rules and Forms, 1956].

The assessment of compensation shall be published in the Official Gazette, [Section 396(3)].

The compensation so assessed shall be paid to the member or creditor concerned by the company resulting from the amalgamation. [Section 396(3)].

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Lecture – 17

Financial aspects of Merger/Amalgamation

FINANCIAL ASPECTS OF MERGER/AMALGAMATION INCLUDING VALUATION OF SHARES

In any merger or amalgamation, financial aspects of the transaction are of prime importance. It denotes the benefits in terms of financial benefits, i.e., increase in productivity, improved profitability and enhanced dividend paying capacity of the merged or the amalgamated company, which the management of each company involved in this exercise would be able to derive.

Each amalgamation or merger is aimed at the following financial aspects:

(a) To pool the resources of all the companies involved in the exercise of amalgamation or merger so as to achieve economies of production, administrative, financial and marketing management.

(b) To secure the required credit on terms from financial institutions, banks, suppliers, job workers etc.

(c) To cut down cost of production, management, marketing etc. by effecting savings in all spheres with the combined strength of qualified and competent technical and other personnel.

(d) To reinforce the united research and development activities for product development to ensure a permanent, dominant and profit making position in the industry.

(e) To improve productivity and profitability in order to maintain a regular and steady dividend to the shareholders.

(f) To concentrate on the core competence of the merged or the amalgamated company.

(g) To consolidate the resource base and improve generation, mobilization and utilization of physical, financial, human, knowledge, information and other important tangible and intangible resources.

Valuation of shares

Valuation of shares of each company involved in amalgamation, merger or share-forshare takeover is imperative. This is made on the basis of a number of relevant factors which affect the value of shares. Among the important factors on the basis-whereof the shares of a company may be valued are —

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(i) Net worth of the company,

(ii) Earning capacity.

(ii) Quoted price of the snares in the stock market,

(iv) Profits made over a number of years.

(v) Dividend paid on the shares over a number of years.

(vi) Prospects of growth enhanced earning per share, etc.

Need *and purpose of valuation of shares*

In mergers and amalgamations, valuation of shares of all the companies involved in the transaction is required to be done for determining the exchange ratio of shares for the purpose of issuing shares in the merged or the amalgamated company (transferee company) to the shareholders of the merging or the amalgamating company (transferor company) in lieu of their shareholdings in the transferor company.

Factors influencing valuation

The valuation of shares of a company is based, *inter alia,* on the following factors:

(i) Current stock market price of the shares,

(ii) Profits earned and dividend paid over the years.

(iii) Availability of reserves and future prospects of the company.

(iv) Realizable value of the net assets of the company.

(v) Current and deferred liabilities for the company,

(vi) Age and status of plant and machinery of the company,

(vii) Net worth of the company.

(viii) Record of efficiency, integrity and honesty of the Board of directors and other managerial personnel of the company.

(ix) Quality of top and middle management of the company and their professional Competence,

(x) Record of performance of the company in financial terms.

Methods of valuation of shares

Certain methods have come to be recognized for valuation of shares of a company, viz., (i) open market price; (ii) stock exchange quotation; (iii) net assets basis; (iv) earning per share method; (v) yield or return method; (vi) net worth method; (vii) break-up value, etc.

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Ideal Valuation method

The various methods of valuation of shares of a company as mentioned above have their individual merits and demerits. Therefore, it has been universally recognized that while, valuing the shares of a company, it is advisable not to depend upon any single method but to resort to a combination of three well-recognized methods, viz, market value method, yield or return on investment method and net assets value method, for arriving at a fair and reasonable shares exchange ration .

While doing this, due weightage should be given to each method based on the company's performance and future prospects.

Valuation by experts

Valuation of shares of a company is a technical job and should preferably be done by financial experts without taking into account the figures given in the latest balance sheets of a company, because more often than not, the corporate balance sheets disclose less and hide more. The valuation of shares of a company should be done keeping in view the above factors and with the best of judicious approach uninfluenced by extraneous factors. The productivity and profitability of the company, easy availability of raw materials and ready market for the end products of the company do affect the valuation of shares of the company. Valuation does not depend entirely an mathematical calculation. Certain intangible assets like goodwill, patent, trademark or a licence under a patent or a trade mark carry more value than some tangible assets, which must go into the valuation of the shares of a company.

Valuation of shares in different situations – Judicial Pronouncements Supreme Court in CWT V.Mehedeo jalan

In CWTv. Mahadeo Jalan (1972) 86 ITR 621 (SC) the Supreme Court observed:

"An examination of the various aspects of valuation of shares in a limited company would lead us to the following conclusion:

(1) Where the shares in a public limited company are quoted on the stock exchange and there are dealings in them, the price prevailing on the valuation date is the value of the shares.

(2) Where the shares are of a public limited company which are not quoted on a stock exchange or of a private limited company, then value is determined by reference to the

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dividends, if any reflecting the profit earning capacity on a reasonable commercial basis. But , where they do not, then the amount of yield on the basis will determine the value of the shares. In other words, the profits which the company has been making and should be making will ordinarily determine the value.

The dividend and earning method or yield method are not mutually exclusive: both should help in ascertaining the profit earning capacity as indicated above. If the results of the two methods differ, an intermediate figure may have to be computed by adjustment of unreasonable expenses and adopting a reasonable proportion of profits.

(3) In the case of a private limited company also where the expenses are incurred out of all proportion to the commercial venture, they will be added back to the profits of the company in computing the yield. In such companies the restriction on share transfers will also be taken into consideration as earlier indicated in arriving at a valuation.

(4) Where the dividend yield and earning method break down by reason of the company's inability to earn profits and declare dividends, and if the set back is temporary, then it is perhaps possible to take the estimate of the value of the shares before set back and discount it by a percentage corresponding to the proportionate fall in the price of quoted shares of companies which have suffered similar reverses.

(5) Where the company is ripe for winding up, then the break-up value method determines what would be realized by that process. In setting out the above principles, we have not tried to lay down any hard and fast rule because ultimately the facts and circumstances of each case, the nature of the business, the prospects of profitability and such other considerations will have to be taken into account as well as applicable to the facts of each case. But, one thing is clear, the market value, unless in exceptional circumstances to which we have referred, cannot be determined on the hypothesis that because in a private limited company one holder can bring into liquidation, it should be valued as on liquidation, by the break-up method. The yield method is the generally applicable method while the break-up method is the one resorted to in exceptional circumstances or where the company is ripe for liquidation but nonetheless is one of the methods."

Therefore, generally, in case of amalgamation, a combination of all or some of the well-accepted methods of valuation may be adopted for determining the exchange

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ratio of the shares of two companies.

The valuation of company shares is a highly technical matter which requires considerable knowledge, experience and expertise in the job. A ratio based on valuation of shares of both the companies done by experts, approved by majority of the shareholders of both the companies and sanctioned by court is an ideal exchange ratio.

Supreme Court in Miheer H. Mafatlal v. Mafatlal Industries Ltd.

The law on the subject has been well settled by the Supreme Court in *Miheer H. Mafatlal* v. *Mafatlal Industries Ltd.* (1996) 4 Comp LJ 124 (SC) where it was held that once the exchange ratio of the shares of the transferee company to be allotted to the holders of shares in the transferor company has been worked out by a recognized firm of chartered accountants who are experts in the field of valuation, and if no mistake can be pointed out in the said valuation, it is not for the court to substitute its exchange ratio, especially when the same has been accepted without demur by the overwhelming majority of the shareholders of the two companies or to say that the shareholders in their collective wisdom should not have accepted the said exchange ratio on the ground that it will be detrimental to their interest.

Supreme Court in Hindustan Level Employees Union v. Hindustan Lever Ltd.

In *Hindustan Lever Employees Union v, Hindustan Lever Ltd.,* (1994) 4 Comp LJ 267 (SC) the Supreme Court held that it is not the part of the judicial process to examine entrepreneurial activities to ferret out flaws. The court is least equipped for such oversights, nor indeed is it a function of the judges in our constitutional scheme. It cannot be said that the internal management, business activity or institutional operation of public bodies can be subjected to inspection by the court. To do so is incompetent and improper and, therefore, out of bounds.

Nevertheless, the broad parameter of fairness in administration, bona fides in action and the fundamental rules of reasonable management of public business, if breached, will become justiciable. *(The court's obligation is to satisfy that the valuation was in accordance with the taw and the same carried out by an independent body).*

The Supreme Court had explained that the nature of jurisdiction by the court, while considering the question of sanctioning a scheme of arrangement or compromise, is of sentinel nature and is not of appellate nature of examine the arithmetical accuracy of

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scheme approved by majority of shareholders. While considering the sanction of a scheme of merger, the court is not required to ascertain with mathematical accuracy the terms and target set out in the proposed scheme. What is required to be evaluated is general fairness of the scheme.

The contention Braised was that the High Court in exercise of the sentinel nature of jurisdiction in company matters is expected to act as a guardian of interest of the companies, the members and the public, complaint was made in the appeal that the High Court had failed to exercise its jurisdiction in that way but was swayed by considerations which were neither legal nor relevant. In making this contention with great vehemence, it was pointed out that exchange ratio was not correctly determined by placing before the court comparative figures of the assets of the two companies their market value, their holdings in the market, etc. Rejecting the plea the Supreme Court said:

"But what was lost sight of was that the jurisdiction of the court in sanctioning a scheme of merger is not to ascertain with mathematical accuracy if the determination satisfied the arithmetical test. A company court does not exercise an appellate jurisdiction. It exercises a jurisdiction founded on failures. It is not required to interfere only because the figure arrived at by the valuer was not as better as it would have been if another method would have been adopted. What is imperative is that such determination should not have been contrary to law and that it was not unfair for the shareholders of the company which was being merged. The court's obligation is to be satisfied that valuation was in accordance with law and it was carried out by an independent body."

On the facts of the case the court found that the proposed scheme was approved by more than 99% of the shareholders and the grievance voiced by the objector was not shared by them. The objection was raised by the objector on the availability of same facts which were with other shareholders. The same explanatory statement at once was sent to the objector and on the basis of which he had taken inspection of all the relevant documents; the court took notice of the fact that the explanatory statement was approved by the Registrar as a relevant factor. The Supreme Court observed:

"In the facts of this case, considering the overwhelming manner in which the shareholders, the creditors, the debenture holders, the financial institutions who had 41% shares in TOMCO, have supported the scheme and have not complained about any lack

of notice or lack of understanding of what the-scheme was about, we are of the view, it will not be right to hold that the explanatory statement was not proper or was lacking in material particulars."

In the matter of Carron Tea Co. Ltd.

Although the question of valuation of shares and fixation of exchange ratio is a matter of commercial judgment and the court should not sit in judgment over it, yet the court cannot abdicate its duty to scrutinize the scheme with vigilance. It is not expected of the court to act as a rubber stamp simply because the statutory majority has approved the scheme and there is no opposition to it. The court is not bound to treat the scheme as a fait accompli and to accord its sanction merely upon a casual look at it. It must still scrutinize the scheme to find out whether it is a reasonable arrangement which can, by reasonable people conversant with the subject, be regarded as beneficial to those who are likely to be affected by it. Where there is no opposition, the court is not required to go deeper. However, when there is opposition, the court not only will but must go into the question and if it is not satisfied about the fairness of the valuation, it would be justified in refusing to accord sanction to the scheme as was held by the court *[Carron Tea Co. Ltd.* (1966) 2 Comp LJ: 278 (Cal).

In the matter of Bank of Baroda Ltd. v. Mahindra Ugine Steel Co. Ltd.

The jurisdiction of the court in inquiring into the fairness of the exchange ratio cannot be ousted by vote of majority shareholders on the ground that valuation of shares is a matter of commercial judgement - *[Bank of Baroda Ltd.* v. *Mahindra Ugine Steel Co. Ltd.* (1976) 46 Comp Gas 227 (Guj.)]

1. The Group Company submitted the High Court Order for Adjudication under the Bombay Stamp Act, to the Collector of Stamps, Pune with details of lands and buildings owned by the Transferor Company.

2. The Collector thereafter adjudicated the necessary stamp duty as Rs. 17, 04, 612.00 at 7% on determining the true market value of the immovable property at Rs. 2,43,51,600.00. The same was paid and the Order was registered with the Sub-Registrar of Assurances where the lands and buildings are located.

Lecture– 18

Taxation aspects

TAXATION ASPECTS OF MERGERS AND AMALGAMATIONS

Meaning of Amalgamation

The word 'amalgamation1 or 'merger' is not defined any where in the Companies Act, 1956. However Section 2(1 B) of the Income Tax Act, 1961 defines 'amalgamation' as follows:

"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 amalgamating company or companies and the company with which they merge or which is formed as 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 the 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 the amalgamation;

shareholders holding not less than three-fourth in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by or by a nominee for, the amalgamated company or it 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 the distribution of such property to the other company after the winding up of the first mentioned company.

Thus, for a merger to qualify as an 'amalgamation' for the purpose of the Income Tax Act, the above three conditions have to be satisfied.

Carry Forward and Set off of Accumulated Loss and Unabsorbed Depreciation

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Under Section 72A, a special provision is made which relaxes the provisions relating to carrying forward and set off of accumulated business loss and unabsorbed depreciation allowance in certain cases of amalgamation. Where there has been an amalgamation of a company owning an industrial undertaking or a ship with another company, then, notwithstanding anything contained in any other provision of the Act, the accumulated loss and the unabsorbed depreciation of the amalgamating company shall be deemed to be the loss or, as the case may be, allowance for depreciation of the amalgamated company for the previous year in which the amalgamation was effected, and other provisions of this Act relating to set-off and carry forward of loss and allowance for depreciation shall apply accordingly.

It is to be noted that as unabsorbed losses of the amalgamating company are deemed to be the losses for the previous year in which the amalgamation was .effected, the amalgamated company will have right to carry forward the loss for a period of eight assessment years immediately succeeding the assessment year relevant to the previous year in which the amalgamation was effected.

However, the above relaxations shall not be allowed in the assessment of the amalgamated company unless the amalgamated company—

(i) holds continuously for a minimum period of five years from the date of amalgamation at least three-fourths in the book value of fixed assets of amalgamating company acquired in a scheme of amalgamation.

(ii) continues the business of the amalgamating company for a minimum period of five years from the date of amalgamation.

(iii) fulfills such other conditions as may be prescribed to ensure the revival of the business of the amalgamating company or to ensure that the amalgamation is for genuine business purpose.

It further provides that in case where any of the above conditions are not complied with, the set off of loss or allowance of depreciation made in any previous year in the hands of the amalgamated company shall be deemed to be the income of amalgamated company chargeable to tax for the year in which such conditions are not complied with.

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For the purposes of these provisions "accumulated loss" means so much of the loss of the amalgamating company under the head "Profits and gains of business or profession" (not being a loss sustained in a- speculation business) which amalgamating company would have been entitled to carry forward and set off under these provisions if the amalgamation had not taken place. Similarly, "unabsorbed depreciation" means so much of the allowance for depreciation of the amalgamating company which remains to be allowed and which would have been allowed to the amalgamating company under the provisions of this Act, if the amalgamation had not taken place.

Capital Gains Tax

Capital gains tax is leviable if there arises capital gain due to transfer of capital assets. The word 'transfer' under Section 2(47) of the Act includes the sale, exchange or relinquishment of the asset or the extinguishment of any right therein or the compulsory acquisition there of under any law. Under Section 47(vi) and (vii), transfer does not include any transfer in a scheme of amalgamation of a capital asset by the amalgamating company to the amalgamated company if the latter is an Indian company. From the assessment year 1993-94 any transfer of shares in an Indian company held by a foreign company to another foreign company in pursuance of a scheme of amalgamation between the two foreign companies will not be regarded as 'transfer' for the purpose of levying tax on capital gains. This provision will apply only if at least twenty five percent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company and such transfer does not attract .tax on capital gains in the country in which the amalgamating company is incorporated.

Further, the term transfer also does not include any transfer by a shareholder in a scheme of amalgamation of a capital asset being a share or shares held by him in the amalgamating company if the transfer 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. Even in the absence of Section 47(vii) of the Act, a shareholder is not liable to pay any capital gains tax since an amalgamation does not include exchange or relinquishment of the assets. Amalgamation does not involve an exchange or relinquishment of shares by amalgamating company as held in *CIT\j. Rasik Lai Manek*

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Lai {1975)95 ITR 656). However, no benefit will be available under Section 47 (vil) if the shareholders of malgamating company are allotted something more than share in the amalgamated company viz. Bonds or debentures *(CIT* v. *Gautam Sarabhai Trust* (1988) 173 ITR 216 (Guj.).

Amortisation of Preliminary Expenses

The benefit of amortisation of preliminary expenses under Section 35D are ordinarily available only to the assessee who incurred the expenditure. However, the benefit willnot be lost in case of the undertaking of an Indian company which is entitled to amortization is transferred to another Indian company in a scheme of amalgamation within 10 years / 5 years period of amortization. In that event the deduction in respect of previous year in which the amalgamation takes place and the following previous year within the 10 years / 5 years period will be allowed to the amalgamated company and not to the amalgamating company.

Capital Expenditure on Scientific Research

In the case of an amalgamation, if the amalgamating company transfers to the amalgamated company, which is an Indian company, any asset representing capital expenditure on scientific research, provisions of Section 35 would apply to the amalgamated company as they would have applied to amalgamating company if the latter had not transferred the asset.

Expenditure on Acquisition of Patent Right or Copyright

Where the assessee has purchased patent right or copyrights he is entitled to a deduction under Section 35A for a period of 14 years in equal instalments. The amalgamated company gets the right to claim the unexpired instafments as a deduction from its total income.

The deduction under this section is however available for expenditure incurred before 1st April, 1998 only.

Expenditure on Amalgamation

Section 35DD provides that where an assessee being an Indian company incurs any expenditure, on or after the 1s' day of April, 1999, wholly and exclusively for the purposes of amalgamation, the assessee shall be allowed a deduction of an amount equal

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to one-fifth of such expenditure for each of the five successive previous years beginning with the previous year in which the amalgamation takes place.

Expenditure on Know-how

Section 35AB(3) of the Income-tax Act provides that where there is a transfer of an undertaking under a scheme of amalgamation and the amalgamating company is entitled to a deduction for expenditure incurred in acquiring know-how, then the amalgamated company shall be entitled to claim deduction under this section 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 such amalgamation not taken place.

'The deduction under this section is however available for any lump sum consideration paid in any previous year relevant to the assessment year commencing on or before 1.4.98.

Expenditure for obtaining Licence of Operate Telecommunication Services (Section 35ABB)

The provisions of the Section 35ABB of the Income Tax Act relating to deduction of expenditure, incurred for obtaining license to operate telecommunication services shall, as far as may be, apply to the amalgamated company as they would have applied to the amalgamating company if the latter had not transferred the license.

Tax Aspects on Slump Sale

Section 293 of the Companies Act empowers the Board of Directors of a company, after obtaining the consent of the company in general meeting to sell lease or otherwise dispose off the whole or substantially the whole of the undertaking(s) of a company.

The transaction in this case, is normally of either of the following type:

(a) Sale of a running concern.

(b) Sale of a concern which is being wound up.

Sale of a Punning Concern

This type of sale as a going concern provides for the continuation of the running of the undertaking without any interruption. But there is always a problem of fixing a

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value in the case of a running concern for all tangible and intangible assets including fixing a value for the infrastructure and other environmental facilities available. In view of all this, the seller normally fixes a lump sum price called 'slump price'.

The noun 'slump' means 'a gross amount, a lump'. Similarly, 'slump sum' means a 'lump sum' [Chambers Twentieth Century Dictionary, 1983 Edn., p 1220). A slump sale transaction would, therefore, mean a sale or a transaction which has a lump sum price for consideration.

Sale in the Course of Winding up

On the other hand a sale in the course of winding up, is nothing but a realisation sale aimed at collecting the maximum price for distributing to the creditors and the balance to the coniributories (the shareholders). By the very nature of the transaction, this is a piece meal sale and not a slump sale. In this case, there will be liability to tax as per the provisions of the Income-tax Act. Slump sale as defined under Section 2(42C) of the Income-tax Act, 1961 means the transfer of one or more undertaking as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales. In other words, it is a sale where the assessee transfers one or more undertaking as a whole including all the assets and liabilities as a going concern. The consideration is fixed for the whole undertaking arid received by the transferor. It is not fixed for each of the asset of the undertaking. The assessee may also transfer a division instead of the undertaking as a whole by way of such sale. Thus it may be noted that the undertaking as a whole or the division transferred shall be a capital asset.

Tax Aspects for a Slump Sale

Normally, any sale of a capital asset will give rise to a capital receipt and any profit derived may give rise to capital Gains in certain cases. This is true in the case of sale of an undertaking also.

In *Doughty* v. *Commissioner of Taxes,* the Privy Council laid down the following principles: The sale of a whole concern engaged in production process, e.g. dairy farming or sheep rearing, does not give rise to a revenue profit. The same might be said of a manufacturing business which is sold with the lease holds and plant, even if there are added to the sale piece goods in stock and even if these piece goods form a very substantial part of the aggregate sold. Where, however, business consists entirely in

buying and selling, it is difficult to distinguish for income tax purpose between an ordinary and realization sale, the object in either case being to dispose of the goods at a profit. The fact that the stock is sold out in one sale does not render the profit obtained any different in kind from the profit obtained by a series of gradual and smaller sales. In the case of such a realization sale, if there is an item which can be traced as representing the stock-in-trade, though it is in conjunction with the sale of the whole concern and a transfer of all the assets for a single unapportioned consideration, there cannot be said to be any revenue profit realised on the sale of the stock-in-trade which is sold with all the other assets, although the business of the concern may consist entirely in buying and selling.

The Supreme Court, based on the above decision held in the following two cases that the price received on the sale of industrial undertaking is a capital receipt.

CITv. West Coast Chemicals and Industries Ltd. - 46 ITR 135 - Where a slump price is paid and no portion is attributable to the stock-in-trade, it may not be possible to say that there is a profit other than what results from the appreciation of capital. The essence of the matter, however, is not that an extra amount has been gained by the selling out or the exchange but whether it can fairly be said that there was a trading was a trading, from which alone profit can arise in business.

CIT v. *Mugneeran Bangur and Co.* - 57 ITR 299 - In the case of a concern carrying on the business of buying land, developing it and then selling it, it Is easy to distinguish a realisation sale from an ordinary sale, and it is very difficult to attribute part of the slump price to the cost of land sold in the realization sale. The mere fact that in the schedule the price of land was stated does not lead to the conclusion that part of the slump price is necessarily attributable to the land sold.

The same view was also reiterated by the Gujarat High Court in the following cases:

1. *Sarabhai M. Chemicals Pvt. Ltd.* v. *P.M. Mittat, Competent Authority* — 126 ITR1.
2. *Artex Manufacturing Co.* v. *CIT*- 131 ITR 559.

At the same time, the Gujarat High Court also recognized that when an undertaking as a whole is sold as a going concern there will be liability under the head Capital Gains, In 126 ITR 1 the Gujarat High Court stated as follows:

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It is well settled that business is property and the undertaking of a business is a capital assets of the owner of the undertaking. When an undertaking as a whole is transferred as a going concern together with its goodwill and all other assets, what is sold is not the individual itemised property but what is sold is the capital asset consisting of the business of the undertaking and any tax that can be attracted to such a transaction for a slump price at book value would be merely capital gains tax and nothing else but capital gains tax. Plant or machinery of any fixture or furniture is not being sold as such. What is sold is the business of undertaking for a slump price. It the capital assets, namely, the business of the undertaking, has a greater value than its original cost of acquisition, then, capital gains may be attracted in the ordinary case of a sale of an undertaking.

The Bombay High court also recognised that there will be a capital gains tax when a sale of business as a whole occurs (Refer *Killic Nixon and Co.* v. *CIT* 49 ITR 244).

Transfer of shares by shareholders of amalgamated **company**

The term "transfer" has been defined in Section 2 (47) of the Income-tax Act, 1961.
The given definition is not exhaustive but inclusive. It hints at sale, exchange, relinquishment of an asset, extinguishment of any right therein , compulsory acquisition thereof etc. Therefore, other modes of transfer as are understood in particular contexts or in their ordinary sense are also liable to capital gain subject to the other conditions regarding taxability under the head "Capital gains".

However, Section 47 of the Income-tax Act, 1961 contains a large number of transactions which are not regarded as transfer for the purpose of taxability under the head "Capital gains". Sub-section (vii) of Section 47 specifically exempts from taxability of any transfer by a shareholder, in a scheme of amalgamation, of a capital asset being a share or shares held by him in the amalgamating company, if—

(a) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company, and

(b) the amalgamated company is an Indian company. **No exchange or relinquishment involved**

It has been held in C/7v. *Rasiklal Manektal* (HUF) (1989) 177 ITR 198 (SC) that in the event of amalgamation of companies, transfer of shares by the shareholders of the

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amalgamating company and allotment of shares in their names by the amalgamated company does not involve "exchange" or "relinquishment".

THE HUMAN ASPECTS OF MERGERS AND AMALGAMATIONS

The merger is a period of great uncertainty for the employees of the merging organisations. The uncertainty relates to job security and status within the company leading to fear and hence low morale among the employees. It is natural for employees to fear the loss of their revenue or change in their status within the company after a merger since many of these employees literally invest their whole lives in their jobs. Hence the possibility of a change in their position is likely to be viewed with fear and resentment. The possibility of change in compensation and benefits also creates a feeling of insecurity and unease. The influx of new employees into the organization can create a sense of invasion at times and ultimately leads to resentment. Further, the general chaos which follows any merger results in disorientation amongst employees due to ill defined role and responsibilities. This further leads to frustrations resulting into poor performance and low productivity since strategic and financial advantage is generally a motive for any merger. Top executives very often fail to give attention to the human aspects of mergers by neglecting to manage the partnership in human terms. By failing to give attention to the problems faced by their employees, they fail to fully develop their companies' collaborative advantage.

The successful merger demands that strategic planners are sensitive to the human issues of the organisations. For the purpose, following checks have to be made constantly to ensure that:

- sensitive areas of the company are pinpointed and personnel in these sections carefully monitored.
- serious efforts are made to retain key people.
- a replacement policy is ready to cope with inevitable personnel loss.
- records are kept of everyone who leaves, when, why and to where.
- employees are informed of what is going on, even bad news is systematically delivered. Uncertainly is more dangerous than the clear, logical presentation of unpleasant facts.

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- training department is fully geared to provide short, medium and long term training strategy for both production and managerial staff.
- likely union reaction be assessed in advance.
- estimate cost of redundancy payments, early pensions and the like assets.
- comprehensive policies and procedures be maintained for employees related issues such as office procedures, new reporting, compensation, recruitment and selection, performance, termination, disciplinary action etc.
- new policies to be clearly communicated to the employees especially employees at the level of managers, supervisors and line manager to be briefed about the new responsibilities of those reporting to them.
- family gatherings and picnics be organized for the employees and their families of merging companies during the transition period to allow the employees get off their inhibitions and breed familiarity.

The classic examples of effective human resource management is the acquisition of Wellcome group by Glaxo. Wellcome and Glaxo were profoundly different companies, both structurally as well as culturally. WeHcome was more of an academic culture and Glaxo more of a commercial, business driven culture. Everything was different between the companies, from finance to information technology, the structure of sales resentatives to legal side. Less diplomatic Gtaxo staff saw Wellcome as an over-centralised organisaion with employees who were unrealistic in their expectations for the business's financial success. Academia- like penny-pitching officials had saddled Wellcome with out-of-date information technology. Wellcome staff, in contrast, saw Glaxo as overly commercial mercenaries assaulting their worthy enterprise and driven by cash. They argued, in its enthusiasm for the latest high-tech research gadgetry. The Glaxo officials refused to study tropical diseases, where sufferers could not afford western prices.

To try to combat such sentiments, management declared that both old companies were history and decreed that a new company was to be built in its place. But, the most difficult aspect of merger was to lay off staff both on account of closing down of certain manufacturing units as well as to cut down on excess costs. To overcome the difficulties, management offered a very lucrative package. The solution was expensive but

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unavoidable, given that Glaxo management was trying not to give the impression that it was steamrolling Wellcome.

In France, the company established an organization called Competence Plus, comprising employees who had been made redundant. They were guaranteed up to 15 months on full salary and given training courses on everything from "networking" to new skills. They were also the first to be interviewed for any vacancies that arose within the new group during that period. Employees hired by other companies for trial periods had their salaries paid by Glaxo-Wellcome. For those who remained, there were improvements too. Glaxo staff worked a 39-hour week, whereas Wellcome did 37 hours. Now Glaxo-Wellcome people work 37 hours. "We were concerned not tomake mistakes in the social sphere," said Mangeot, the Chairman of Glaxo-Wellcome, France.

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Lecture – 19

Funding the merger process

Funding of Mergers

Growth is essential for sustaining the viability, dynamism and value enhancing capability of a company. A company can expand and/or diversify its markets internally or externally. If it can not grow internally due to lack of physical and managerial resources, it can grow externally by mergers and acquisitions in a convenient and inexpensive manner. However, mergers and acquisitions involve cost and can be an expensive mode if the company pays an excessive price for merger. It should be borne in mind that benefits should exceed the cost of acquisition. It is necessary that price may be carefully determined and negotiated so that merger enhances the value of shareholders. The benefits of a merger can be defined as the difference between

(i) the total present value of the merged firms and

(ii) the sum of their values if they do not merge. If V represents the present value, and A and B as two firms willing to continue to form a new company :

Benefit = AV =VAB - VA - VB

Cost may be defined as the difference between the amount paid for the acquired firm and the amount it is worth as a separate entity. If B's owners receive cash for their shares then:

Cost = Cash - VB.

If the merger is financed by cash, attempt should be made so that

Benefit - Cost = AV - (Cash - VB) > O.

If there is no merger, aggregate value of their shares is VA for firm A. If merger goes through, their position is VB - Cash. Net gain is given by:

Net gain = VB- Cash- VA.

= AV + VA + VB- Cash - VA - AV - (Cash - VB) Cost however will depend on how a merger is funded or financed.

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Lesson 20

PROCESS OF FUNDING

Funding of merger or takeover involves payment of consideration money to the acquirer for acquiring the undertaking, assets and controlling voting power of shareholders as per valuation done and exchange ratio arrived at. Form of payment may be selected out of any of the modes available such as cash payment, issue of equity shares, mix of equity and cash, debt or loan stock, preference shares, convertible securities, junk bonds etc. Care should be taken to ensure that the financial package chosen should suit the financial structures of both the acquirer and acquiree companies, and it should also provide a desirable gearing level and prove economical to acquirer.

Mergers and takeovers may be funded by a company (i) out of its own funds, comprising paid up equity and preference share capital, for which shareholders are issued equity and preference shares or (ii) out of borrowed funds, which may be raised by issuing various financial instruments. A company may borrow funds through the issue of debentures, bonds, deposits from its directors, their relatives, business associates, shareholders and from public in the form of fixed deposits, external commercial borrowings, hybrids, loans from Central or State financial institutions, banks, rehabilitation finance provided to sick industrial companies under the Sick Industrial Companies (Special Provisions) Act, etc.

Well-managed companies make sufficient profits and retain them in the form of free reserves, and as and when their Boards propose any form of restructuring, they are financed from reserves, i.e. internal accruals.

Where their own funds are found to be inadequate for funding of mergers, takeovers, etc. they may seek financial assistance from financial institutions and banks depending upon the quantum and urgency of their requirements. They may issue further equity or preference shares, debentures, or may raise public deposits or even resort to external commercial borrowings etc. Some companies raise funds through private placement of their shares, debentures and other loan instruments. Although adequate foreign investments are flowing into the country yet most companies in India depend on domestic credit for their financial requirements.

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Ordinarily, a cash rich company may use its surplus funds in different ways.
Companies are now increasingly using their surplus funds also for taking over the control of other companies, often in the same line of business, to widen their product range and to increase market share.

FUNDING THROUGH EQUITY SHARE CAPITAL

Equity share capital can be considered the permanent capital of a company.
Normally it is always available unless the company goes into liquidation or till any time before that stage, the Board resolves for capital restructuring. Moreover, equity needs no servicing as a company is not required to pay to its equity shareholders any fixed amount of return in the form of interest etc. When the profits of a company permit, the Board at its discretion, may resolve to pay them a suitable amount as dividend, after approval by the shareholders. Therefore, equity capital is the best suited source of funding a merger or a takeover.
Merger provides additional assets in the form of plant, machinery, buildings and other infrastructure for additional and diversified industrial production. In this case, equity instrument plays a dominant role as the assets of the merging companies are taken over by the merged company and in return the merged company issues its equity to the shareholders of the merging companies.
Also, a merger needs no deployment of additional funds, either from internal accruals or from outside agencies, like the financial institutions, banks etc. Therefore, no additional interest burden is involved. The additional equity which is issued to the shareholders of the merging companies needs no servicing. When the company makes adequate profits and the Board of Directors, in their discretion, recommend the declaration of dividend, the shareholders get dividend on their shareholdings.
At times acquirer's shareholders are also interested in obtaining payments in equity shares rather than cash due to tax liability immediately devolving upon them in the eventuality of receipt of cash consideration, whereas in case of equity, capital gains tax is deferred till the time of realisation of shares in cash. The only disadvantage to the shareholders of the merged company is the resultant temporary dilution in earnings per share (EPS) due to the issuance of additional shares.
In the normal life of a company, equity capital is costlier than the borrowed

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capital, because interest on borrowed capital is a charge on the profits of the company whereas dividend on equity shares is paid out of the net profits of the company.

FUNDING THROUGH PREFERENCE SHARE CAPITAL

Another source of funding a merger or a takeover may be through the issue of preference shares, but unlike equity capital, preference share capital involves the payment of fixed preference dividend or a fixed rate of dividend. Therefore, before deciding to raise funds for this purpose, by issue of preference shares, the Board of directors of a company has to make sure that the merged company or the target company would be able to yield sufficient profits for discharging the liability in respect of payment of preference dividend.

Preference share capital

According to Section 85 of the Companies Act, 1956, preference shares represent that part of the share capital of a company, which fulfills both the following requirements, namely:

(a) that as respects dividends, it carries or will carry a preferential right to be paid, a fixed amount or an amount calculated at a fixed rate, which may be either free of or subject to income-tax; and

(b) that as respects capital, it carries or will carry, on a winding-up or repayment of capital, a preferential right to be repaid the amount of the capital paid-up or deemed to have been paid-up, whether or not there is a preferential right to the payment of either or both of the following amounts, namely:

(i) any money remaining unpaid, in respect of the amounts specified in clause (a), upto the date of the winding-up or repayment of capital; and

(ii) any fixed premium or premium on any fixed scale, specified in the memorandum or articles or the company.

Burden of preference dividend

A company funding its merger or takeover proposal through the issue of preference shares is required to pay dividend to such shareholders as per the agreed terms. While raising funds through this mode, the management of the company has to take into

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consideration the preference dividend burden, which the profits of the company should be able to service.

BUY-BACK OF SHARES

Buy-back is generally resorted to by companies, which have more funds than their present and near future requirements and in the prevailing cash market they cannot deploy those surplus funds in other gainful activities. Therefore, they resort to buy-back. After the buy-back of shares by a company, availability of its shares in the market gets reduced and the balance available stock of shares commands more price and respect. It also suits promoters of the company as their stake in the company increases in proportion to the bought back shares. Buy back of shares is also used as a takeover defence.

Companies empowered to buy-back

Section 77A of the Companies Act, 1956, provides that notwithstanding anything contained in that Act, but subject to the provisions of Sub-section (2) of the Section and Section 77B, a company may purchase its own shares or other specified securities out of:

its free reserves; or

the securities premium account; or

the proceeds of any shares or other specified securities. However, no buyback of any kind of shares of other specified securities can be made out of the proceeds of an earlier issue of the same kind of shares or other specified securities [Refer Sub-section (1)].

Conditions for buy-back

According to Sub-section (2) of Section 77A no company can purchase its own shares or other specified securities under Sub-section (1) unless:

(a) such a buy-back is authorised by its articles;

(b) a special resolution has been passed in general meeting of the company authorising the buy-back;

However, where the buy-back is or less than ten per cent of the total paid up equity capital and free reserves of the company, then such buy-back can be authorised by the Board by means of a resolution passed at its meeting. No offer of buy-back should be made within a period of 365 days from the date of the preceding offer of buy-back.

(c) the buy-back is or less than twenty-five per cent of the total paid-up capital and free reserves of the company. Provided that the buy-back of equity shares in any financial year should not exceed twenty-five percent of its total paid equity capital in that financial year.

(d) the ratio of the debt owed by the company is not more than twice the capital and free reserves after such buy-back. However, the Central Government can prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies.

(e) all the shares or other specified securities for buy-back are fully paid-up.

(f) the buy-back of 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.

HYBRIDS

The term "hybrid" does not find a mention anywhere in the Companies Act or the rules and regulations framed thereunder. It is also not a term used in business, trade and industry.

The dictionary meaning of the term "hybrid" is "anything derived from heterogeneous sources or composed of elements of different or incongruous kinds."

In the context of funding of mergers and takeovers through various types of financial instruments, viz., equity share capital, preference shares capital, debentures, bonds, external commercial borrowings, global depository receipts, employees' stock option scheme, sweat equity, non-voting shares or shares with differential voting rights, take over finance, derivative contracts, etc., the expression "hybrid" means a combination of financial instruments which may enable a company to raise funds for financing a merger or takeover.

Therefore, depending on the nature of transaction and the convenience of shareholders, a company may fund its programme of merger or takeover by resorting to issuing a variety of financial instruments in order to collect sufficient finance for successfully implementing its proposal.

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FUNDING THROUGH EMPLOYEES STOCK OPTION SCHEME

The share capital that may be raised through a scheme of employees' stock option can only be a fraction of the entire issue. Hence no company can imagine of funding any scheme of merger or takeover entirely through this route. Merits and demerits of funding of merger or takeover through the equity issue have already been discussed earlier under the heading "Funding of merger or takeover through equity issue".

Employees' stock option scheme is a voluntary scheme on the part of a company to encourage its employees to have a higher participation in the company. Stock option is the right (but not an obligation) granted to an employee in pursuance of a scheme, to apply for the shares of the company at a pre-determined price. Suitable percentage of reservation can be made by a company for its employees or for the employees of the promoter company or by the promoter company for employees of its subsidiaries, as the need may arise. Equitable distribution of shares among the employees will contribute to the smooth working of the scheme.

Only bona fide employees eligible for shares under this scheme

The offer of shares to the employees on preferential basis has been misused by some companies by allotting shares to non-employees or in the joint names of employees and non-employees. The companies have, therefore, been advised to ensure that the shares reserved under the employees' quota be allotted only to the bona fide employees, subject to the SEBI guidelines issued in this regard and the shares remaining unsubscribed by the employees may be offered to the general public through prospectus in terms of the issue, if any [Press release dated 30.1.1996]. The option granted to any employee is not transferable to any person.

SEBI Guidelines

The Securities and Exchange Board of India (SEBI) has issued the Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999, which are applicable to companies whose shares are listed on any recognized stock exchange in India.

As per the guidelines, no employee stock option scheme (ESOS) shall be offered unless the company constitutes a compensation committee for administration and

superintendence of the ESOS. The Compensation Committee has to be a committee of the Board of Directors consisting of a majority of independent directors.

The lock in period and rights of the option holder are as specified in the guidelines.

The Board of Directors have to inter alia, disclose either in the Directors' Report or in the annexure to the Directors' Report, the details of the ESOS, as specified in the regulations.

As a safeguard the regulations provide that no ESOS can be offered to the employees of a company unless shareholders of the company approve the ESOS by passing a special resolution in a general meeting.

Issue of Sweat Equity Shares

A company whose shares are listed on a recognized stock exchange can also issue sweat equity shares in accordance with the provisions of Section 79A of the Companies Act, 1956 and the Securities and Exchange Board of India (Issue of Sweat Equity) Regulations, 2002 which were notified on 24th September 2002.

These regulations are not applicable to an unlisted company. However, an unlisted company coming out with an initial public offering and seeking listing of its securities on the stock exchange, pursuant to issue of sweat equity shares, is required to comply with the SEBI (Disclosure and Investor Protection) Guidelines, 2000.

The Sweat Equity Shares are subject to a lock in for a period of three years from the date of allotment.

FUNDING THROUGH EXTERNAL COMMERCIAL BORROWINGS

External Commercial Borrowings are regulated by the ECB Guidelines issued by the External Commercial Borrowings Division, Department of Economic Affairs, Ministry of Finance, Government of India as modified from time to time.

External Commercial Borrowings (ECB) are defined to include commercial bank loans, buyers' credit, suppliers' credit, securitized instruments such as Floating Rate Notes and Fixed Rate Bonds, etc., credit from official export credit agencies and commercial borrowings from the private sector window of Multilateral Financial Institutions such as International Finance Corporation (Washington) ADB, AFIC, CDC, etc.

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ECBs are permitted by the Government as a source of finance for Indian corporates for expansion of existing capacity as well as for fresh investment.

The policy seeks to keep an annual cap or ceiling on access to ECB, consistent with prudent debt management. The policy also seeks to give greater priority for projects in the infrastructure and core sectors, such as power, oil exploration, tele-communication, railways, roads and : bridges, ports, industrial parks and urban infrastructure etc. and the export sector.

Development financial institutions, through their sublending against the ECB approvals are also expected to give priority to the needs of medium and small scale units.

Applicants are free to raise ECB from any internationally recognised source such as banks, export credit agencies, suppliers of equipment, foreign collaborators, foreign equity-holders, international capital markets etc. Offers from unrecognised sources are not entertained. Similarly, trusts/non-profit making organisation are ineligible to raise ECBs.

Average Maturities for ECB

ECBs have the various minimum average maturities for raising different amount of external commercial borrowings.

The average maturity of ECBs for the purpose of ECB guidelines is the weighted average of all disbursements taking each disbursement individually and its period of retention by the borrower.

ADR/GDR

A Depository Receipt is a negotiable certificate that usually represents a company's publicly traded equity or debt. Depository Receipts are created when a broker purchases the company's shares on the home stock market and delivers those shares to the Depository's local custodian bank, who then instructs the depository bank, to issue Depository Receipts.

Global Depository Receipt (GDR)

A GDR is a dollar denominated instrument tradeable on a stock exchange in Europe or U.S.A.

The concept of GDR, original to the developed countries, now has gained popularity even in developing countries like India. They were originally designed as instruments to

enable investors in USA to trade in securities that were not listed in the Stock Exchanges in USA. The major benefit that accrues to an investor from GDR is the collection of issue proceeds in foreign currency which may be utilized for meeting foreign exchange component of project cost, repayment of foreign currency loans, meeting commitments overseas and similar purposes.

The other benefits accruing to an investor from GDR issue are firstly, that investor does not have to bear any exchange risk as a GDR is denominated in US dollar with equity shares comprised in each GDR denominated in Rupees. Secondly, investor reserves the right to exercise his option to convert the GDR and hold the
equity shares instead. It facilitates raising of funds of market related prices of minimum cost as compared to a domestic issue and permits raising of further equity on a future date for funding of projects like expansion or diversification through mergers and takeovers etc. It also helps to expand investor base with multiple risk preferences, improves marketability of the issue, and enhances prestige of the company and credibility with international investors.

American Depository Receipts (ADRs)

An ADR is a negotiate certificate that represents a non-US company's publicly traded shares or debt. ADR's trade freely like any other US security as they are priced and quoted in US dollars. They can be traded on either an exchange or over the counter market and settle according to US standards. ADR's can also trade in markets outside US and can be used to raise capital in US or in markets outside US. ADR is a tradeable instrument, equivalent to a fixed number of shares, which is floated on overseas markets. ADR issues can be made at four levels depending on the preference of the company. The norms for each level differ and the based on the specific criteria to be satisfied by the issuer. The features of ADRs are as follows:

1. This instrument permits the foreign investor to access non-US market investment thereby 'insulating him from exchange risk as and ADR denominated in dollars and dividends are also paid in dollars.

2. ADRs are listed on the New York Stock Exchange or Over the Counter Exchange in the USA. ADR's attract a much wider investor base than the GDRs, since pensions funds and individual investors are permitted to invest in them.

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3. The size of the ADR issue can be expanded or contracted according mand as depository banks can, issue or withdraw corresponding shares in the local market. GDR is a one time issue and can be contracted in size only if investors decide to redeem.
4. ADR issue is more expensive than a GDR issue as the spread for the underwriter on an ADR issue is 7-8 per cent as compared to
5. 5-6 percent for a GDR issue.
6. ADR issue requires drawing up the accounting statements in accordance with the stringent requirements of the Securities and Exchange Commission and US GAAP.

Utilisation of proceeds of GDR issue

Vide Press Note dated 11.5.1994 issued by Ministry of Finance, it was stipulated that GDR issues would be permitted only for the following end-use to be incurred within one year from the date of issue.

1. Financing capital goods imports.
2. Financing domestic purchase/installation of plant, equipment and buildings.
3. Prepayment or scheduled repayment of earlier external borrowing.
4. Making investments abroad where these have been approved by competent authorities.
5. A margin of 15 per cent of the total proceeds of an issue for the other general corporate restructuring uses.

Companies would be required to submit quarterly statements of utilisation of funds duly certified by their auditors. The issuer companies would be required mandatorily to retain the Euro issue proceeds abroad to be repatriated as and when expenditure for the approved end uses (including 15% earmarked for general corporate restructuring purposes) are incurred. ADR's and GDR's are identical from a legal, operational, technical and administrative standpoint.

FUNDING THROUGH FINANCIAL INSTITUTIONS AND BANKS

Funding of a merger or takeover with the help of loans from financial institutions, banks etc. has its own merits and demerits. The advantage in this method of funding is that the period of such funds is definite which is fixed at the time of taking such loans. Therefore, the Board of the company is assured about continued availability of such funds for the pre-determined period. On the negative side, the interest burden on such

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loans, which is quite high in India, must be kept in mind by the Board while deciding to use borrowed funds from financial institution. Such funding should be thought of and resorted to only when the Board is sure that the merged company or the target company will, as per plan, give adequate returns to service such loans, i.e., timely payment of periodical interest on such loans and re-payment of the loans at the end of the term for which such loans have been taken.

However, in the developed markets, funding of merger or takeover is not a critical issue. There are various sources of finance available to an acquirer. In the Indian market, it was not easy to obtain takeover finance from financial institutions and banks because they are not forthcoming to finance securities business. Takeover involves greater risk. There is no other, organized sector to provide finance for takeover by a company.

In the context of lack of institutional funding for takeovers, the reconvened Justice P.N. Bhagwati Committee on takeovers in its reports of May 2002 has recommended that banks/financial institutions should be encouraged to consider financing takeovers. The committee has suggested that SEBI could take up the matter with the Reserve Bank of India for facilitating such funding.

Merger as a corporate strategy is now finding favour with corporates in India as a form of corporate restructuring. There have been many instances of this form of corporate restructuring. Merger of the Shipping Credit and Investment Corporation of India (SCICI) with its parent corporation, the Industrial Credit and Investment Corporation of India Ltd. (ICICI) is one such instance.

Encouraged with the success of the experiment, certain financial institutions and banks have decided to fund takeovers and mergers; in the initial stages. Funding may be only of those companies, where the element of risk is negligible. Funding of mergers and takeovers will assure the funding institutions safe deployment of their funds in attractive, profitable and non-risky ventures.

FUNDING THROUGH REHABILITATION FINANCE

Rehabilitation finance is not available for mergers and takeovers by healthy companies. Merger or takeover may be provided for in a scheme of rehabilitation

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under the Sick Industrial Companies (Special Provisions) Act, 1985. Under the Act, rehabilitation finance may also be provided for in a rehabilitation scheme prepared by an operating agency on the direction of the Board for Industrial and Financial Reconstruction (BIFR) in the case of a sick industrial company, which is regulated by the Sick Industrial Companies (special Provisions) Act, 1985.

The Act provides for the reference' to the BIFR in respect of a sick industrial company conduct of inquiry by BIFR, nomination of an operating agency for determination of measures necessary for rehabilitation of the sick company, preparation of a rehabilitation scheme, which may provide, inter alia, for

(i) rehabilitation finance for the sick company;

(ii) merger of the sick company with a healthy company or merger of a healthy company with the sick company;

(iii) takeover of the sick company by a healthy company;

(iv) such other preventive, ameliorative and remedial measures as may be appropriate.

The scheme is prepared by the operating agency, and after the same is sanctioned it becomes operative and binding on all the concerned parties including the sick company and the other companies — amalgamating or merging or the amalgamated or the merged companies. These mergers normally rank in category of leveraged buyouts i.e. takeover affected with high degree of borrowing as the
financial package approved by BIFR for rehabilitation of sick unit acquired by
healthy unit involves further borrowings from financial institutions and banks by
acquirer company.

LEVERAGED AND MANAGEMENT BUYOUTS

There are various options available for the revival of a 'sick company. One is
buyout of such a company by its employees. This option has distinct advantages over Government intervention and other conventional remedies. Buyout by employees provides a strong incentive to the employees in the form of personal stake in the company. The employees become the owners of the company by virtue of the shares that are issued and allotted to them. Moreover, continuity of job is the greatest motivating force which keeps them on their toes to ensure that the buyout succeeds. Such a buyout saves mass unemployment and unrest among the working class. Relations between the

worker management and the employees are expected to be cordial without any break, strike or other such disturbing developments. Hence chances of success are more. However, such a buyout can be successful only if necessary financial support is extended by the Government or the financial institutions and banks.

In *Navnit R. Kamaniv. R.R. Kamani,* two schemes of rehabilitation came before the BIFR for consideration and approval. One of the schemes was presented by a shareholder holding 24% shares in the company and the other scheme was submitted by the workmen's union of the company. When the two schemes were viewed in juxta-position, there was no doubt that the scheme presented by the applicant shareholder appeared in a rather poor light. The BIFR sanctioned the scheme which was presented by the workers' union because, in the opinion of the BIFR, that scheme was more suited for the revival of the company.

The matter went to the Supreme Court. Turning to the merits of the scheme presented by the workers and sanctioned by BIFR, it was considered to be feasible and economically viable by experts. It envisaged the management by a Board of directors consisting of fully qualified experts and representatives of banks, Government and of the employees. The scheme had the full backfng of the nationalised banks and the encouragement from the Central and State Governments which had made commitments for granting tax concessions. The backing and the concessions were forthcoming essentially because it was a scheme framed by the employees who themselves were making tremendous wage-sacrifice and trying to salvage the company which has been almost wrecked by others.

The above decision of the Supreme Court brought about a significant change in workers' attitude towards their own role in the revival and rehabilitation of sick industrial companies, a change from collective bargainers to collective performers. However, in the case before the Supreme Court, the facts were quite favourable for the workers of the company. Though the workers can, through collective effort, achieve the objective of reviving sick industrial units, their own stakes being no less, yet they need all the help and encouragement from the Government, financial institutions and banks for sustained efforts for revival and rehabilitation. Change in attitude of workers' unions in such an endeavour is all the more important.

Leveraged Buyout (LBO) is defined as the acquisition by a small group of investors, financed largely by borrowing. This acquisition may be either of all stock or assets, of a hitherto public company. The buying group forms a shell company to act as the legal entity making the acquisition. This buying group may enter into stock purchase deal or asset purchase deal. Under the stock purchase device the shareholders sell their stock in the target company to the buying group and then the two firms may be merged. Under the asset purchase mode, the target company sells its assets to the buying group. This exercise aims at generating enormous increases in the market value and value gains for shareholders both who own the firm before the restructuring and after the restructuring.
The leveraged buyouts differ from the ordinary acquisitions in two main ways:
firstly, a large fraction of purchase price is debt financed through junk bonds and
secondly, the shares of LBOs are not traded on open markets. In a typical LBO
programme, the acquiring group consists of a small number of persons/organisations/ sponsored by buy out specialists ,etc. This group, with the help of certain financial instruments like high yield high risk debt instruments, private placement instruments, bridge financing etc. acquire all or nearly all of the outstanding shares of the target" firm.
An attractive candidate for acquisition through leveraged buyout should possess three basic attributes:

1. It must have a good position in industry with sound profit history
2. The firm should have a relatively low level of debt and high level of 'bankable' assets
3. It must have stable and predictable cash flows and adequate working capital.

The buyout group may or may not include current management of the target firm. If the group does *so,* the buyout may be regarded as 'management buyout' or MBO. In other words, when the managers buy their company from its owners
deploying debt, leveraged buyout is called management buy out.

A Management Buyout (MBO) is simply a transaction through which the incumbent management buy outs all or most of the other shareholders. The management may take on partners, it may borrow funds or it can organize the entire restructuring, on its own. An MBO begins with arrangement/raising of finance. Thereafter, an offer to purchase all or nearly all of the shares of a company not presently held by the management has to be

made which may necessitate a public offer and even delisting. Consequent upon this, restructuring may be affected and once targets have been achieved, then the company can go public again.

FUNDING THROUGH PUBLIC DEPOSITS

A company may fund its proposal for a merger or a takeover through term deposits. Deposits, like loans from financial institutions, banks etc. or like the debentures carry interest burden at the agreed rate. Therefore, the Board of directors of the company proposing to adopt this route must make sure that the merged company or the target company would give adequate returns, as projected, for timely and regular payment of interest on deposits and timely re-payment of the principal amount of the deposits raised for the purpose.

Funding through DEBENTURES

Issue of Debentures

A company may meet the cost of its proposed scheme of merger or takeover by issuing debentures. This route involves a burden of interest, which the company would be required to pay to the depositors in quarterly, six-monthly or annual instalments according to the terms and conditions of issue. The Board must resort to this route of funding if it is confident that after the proposed merger, the merged company would be able to meet its commitment of timely payment of interest and repayment of the principal amount of the debentures on redemption. If the company takes over another company, the Board of directors must be quite sure that the target company would be able to give adequate returns for the payment of interest and for redemption of the debentures on maturity. If the company is proposed to be merged with the acquirer company, then the merged company should be able to service the debentures as above.

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Lesson – 21-23

VALUAION OF SHARES AND BUSINESS INTRODUCTION

Valuation is a device to assess the worth of the enterprise which is subject to merger or takeover *so* that the consideration amount can be quantified and price of one enterprise for the other can be fixed. Such valuation helps in determining the
value of shares of the acquired and acquiring company to safeguard the interest of the shareholders of both the companies. The share of any member in a company is a movable property and can be transferred in the manner provided in the articles. A share represents a bundle of rights like right to elect directors, to vote on resolutions of the company, share in the surplus, if any, on liquidation etc. Valuation of shares in an amalgamation or takeover is made on a consideration of a number of relevant factors, such as stock exchange prices of the shares of the two companies, the dividends paid on the shares, relevant growth prospects of the companies, values of the net assets and even factors which are not evident from the face of the balance sheet like quality and integrity of the management, present and prospective competition, yield on comparable securities, market sentiments etc. Valuation has to be tempered by the exercise of judicious discretion and judgment as it is a very crucial and complicated issue.

Need and purpose

There are a number of situations which trigger the need to know the value of a business — strategic partnerships, merger or acquisition of a business, employee stock ownership plans (ESOPs), joint ventures, etc. From the perspective of a valuer, a business owner, or an interested financial party, a valuation provides a useful base to establish a price for a business or to help increase a company's va|ue and attract capital. The necessity for valuation of shares arises *inter alia,* in the following circumstances:

Assessments under the Wealth Tax Act;

Purchase of a 'block of shares', which may or may not give the holder thereof a controlling interest in the company;

(iii) Formulation of schemes of amalgamation, etc.;

(iv) Acquisition of interest of dissenting shareholders under a scheme of reconstruction;

(v) Conversion of shares;

(vi) Advancing a loan on the security of shares.

For transactions involving a relatively small number of shares, which are quoted on the stock exchange, normally the price prevailing on the stock exchange is accepted. However, valuation by experts is called for when the parties involved in the transaction/deal/scheme, etc. fail to arrive at a mutually acceptable value or the agreements or Articles of Association, etc., provide for valuation by experts. The valuation by *a* valuer becomes necessary when:

(i) Shares are unquoted;

(ii) Shares relate to private limited companies;

(iii) Courts so direct;

(iv) Articles of Association so provide;

(v) Relevant agreements so provide;

(vi) Statute so requires.

Valuation can serve many purposes --to establish a price, to help increase value, to attract capital and to meet governmental requirements.

The significance of valuation is however, different in different areas. Valuation is necessary for the decision making by shareholders to sell their interest in the company in the form of shares. Self evaluation may be done by the company being merged with another but it must be satisfied with the value of the shares, it's shareholders should get in the form of shares of the merging company for effecting merger. Such satisfaction is necessary to weigh the over-valuation of shares of acquirer and/or under valuation of shares of the acquired or *vice-versa.* Therefore, to enable shareholders of both the companies, to take decision in favour of amalgamation; valuation of shares is needed and once they are satisfied and have approved it with requisite majority, the court approves the same while sanctioning their scheme of amalgamation, because it is the interest of shareholders which will suffer in the event of wrong valuation.

The value of a firm can be directly related to the decisions it makes — on which project it undertakes, on how it finances them and on its dividend policy. Understanding this relationship is the key to making value-increasing decisions and sensible financial restructuring. Valuation is the central focus in -fundamental analysis. The underlying theme in fundamental analysis is that the true value of the firm can be related to its

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financial characteristics — its growth prospects, risk profile and cash flows. A deviation from this value is a sign that a stock is under or over valued.

Valuation plays a *significant part in acquisitions*

Valuation of the target in an acquisition is an important part of the process of determining the consideration to be offered to the target shareholders. The value that the bidder places on the target sets the maximum or 'walk away' price that the bidder can afford to offer the target shareholders. The value of the target from the bidders point of view is the sum of the pre-bid stand alone value of the target. On the other hand, target companies may be unduly optimistic in estimating value, especially in hostile takeovers, as their attempt is to convince the shareholders that the offer price is too low. Valuation of shares also depends on who the buyer is. A low-profile company can extract high price if a big company like Microsoft eyes the new profile company as a takeover proposition.

Factors influencing valuation

Many factors have to be assessed to determine fair valuation for an industry, a sector, or a company. The key to valuation is finding a common ground between all of the companies for the purpose of a fair evaluation. Determining the value of a business is a complicated and intricate process. Valuing a business requires the determination of its future earnings potential, the risks inherent in those future earnings, Strictly speaking, a company's fair market value is the price at which the business would change hands between a willing buyer and a willing seller when neither are under any compulsion to buy or sell, and both parties have knowledge of relevant facts. The question that then arises is "How do buyers and sellers arrive at this value?" Arriving at the transaction price requires that a value be placed on the company for sale. The process of arriving at this value should include a detailed, comprehensive analysis which takes into account a range of factors including the past, present, and most importantly, the future earnings and prospects of the company, an analysis of its mix of physical and intangible assets, and the general economic and industry conditions.

The other salient factors include:

(1) The stock exchange price of the shares of the two companies before the commencement of negotiations or the announcement of the bid.

(2) Dividends paid on the shares.

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(3) Relative growth prospects of the two companies.

(4) In case of equity shares, the relative gearing of the shares of the two companies. ('gearing' means ratio of the amount of Issued preference share capital and debenture stock to the amount of issued ordinary share capital.)

(5) Net assets of the two companies.

(6) Voting strength in the merged (amalgamated) enterprise of the shareholders of the two companies.

(7) Past history of the prices of shares of the two companies.

Also the following key principles should be kept in mind:

(1) There is no method/of valuation which is absolutely correct. Hence a combination of all or some may be adopted.

(2) If possible, the seller should evaluate his company before contacting potential buyers. Infact, it would be wiser for companies to evaluate their business on regular basis to keep themselves aware of its standing in the corresponding industry.

(3) Go for a third party valuation if desirable to avoid over—valuation of the company which is a common tendency on the seller's part.

(4) Merger and amalgamation deals can take a number of months to complete during which time valuations can fluctuate substantially. Hence provisions must be made to protect against such swings.

Valuation/Acquisition Motives

An important aspect in the merger/amalgamation/takeover activity is the valuation aspect. The valuation of business, however, depends to a great extent on the acquisition motives. The acquisition activity is usually guided by strategic behavioural motives. The strategic reasons could be either purely financial taxation, asset-stripping, financial restructuring involving an attempt to augment the resources base and portfolio-investment) or business related (expansion or diversification). The behavioural reasons have more to do with the personnel ambitions or objectives (desire to grow big) of the top management. The expansion and diversification objectives are achievable either by building capacities on one's own or by buying the existing capacities. This would effectively mean a "make (build) or buy decision" of capital nature. The decision criteria in such a situation would be the present value of the differential cash flows. These differential cash flows would,

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therefore, be the limit on the premium which the acquirer would be willing to pay. On the other hand, if the acquisition is motivated by financial considerations (specifically taxation and asset-stripping), the expected financial gains would form the limit on the premium, over and above the price of physical assets in the company. The cashflow from operations may not be the main consideration in such situations. Similarly, a merger with financial restructuring as its objective will have to be valued mainly in terms of financial gains. It would, however, not be easy to determine the level of financial gains because the financial gains would be a function of the use of which these resources are put finally, the pricing of behaviorally motivated acquisitions is not really guided by the financial considerations. Since the acquisitions are not really the market driven transactions, a set of non-financial considerations will also affect the price. The price could be affected by the number and the motives of other bidders. The value of a target is effected not only by the motive of the acquiring company, but also by the target company's own objectives. The motives of the target company could also be viewed as to be strategic, financial'or behavioural.

Valuation of private companies

While the principles of valuation of private companies are the same as for public companies, an important difference is that for private company targets we do not have the benchmark valuation provided by the stock market. And also that a public company is often widely researched by investment analysts, information about the private target may be sparse. Forecasting the future cash flows is thus a more difficult exercise. Offsetting this disadvantage is the fact that private company bids are almost always friendly, with easier access to the target's management information.

Valuation of listed companies

Shares of listed companies, which are traded, are quoted on the stock exchange and are freely available. These shares can be sold or bought at the stock exchanges. The market price of the shares reflects their value.

However, there cannot be complete reliance on the market value of shares because of two short comings viz. firstly, at times, correct information about a company is not available to the investors, and, secondly, due to insider trading, there are distortions, which are reflected in the market price of shares.

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Valuation of unlisted companies

The P/E ratio cannot be calculated in the case of unlisted companies, as the market price of the shares is not available. Hence, a representative P/E ratio of a group of comparable quoted companies can be taken after suitable adjustments.

Generally, for private limited companies or small companies, which are not quoted and are closely held, a discount is applied for valuation to the prevalent P/E ratio of comparable listed company. The other factors to be taken into consideration while following earning approach to valuation of an unlisted company are:

1. Company analysis - - shareholding pattern, voting powers, rights and obligations of shareholders in addition to other data.

2. Industry analysis - - whether it is high or low growth industry, natureindustry and influence on it of seasonal, volatile orcyclical business fluctuations, major competitors and their market share, etc.

Methods of valuation

The cardinal rule of commercial valuation is, that the value of something cannot stated in an abstract form; all that can be stated is the value of a thing in a particular place, at a particular time, in particular circumstances.

Valuation of the target requires valuation of the totality of the incremental cash flows and earnings.

Valuation of a target is based on expectations of both the magnitude and the timing of realisation of the anticipated benefits. Where, these benefits are difficult to forecast, the valuation of the target is not precise. This exposes the bidder to valuation risk. The degree of this risk depends on the quality of information available to the bidder, which, in turn, depends upon whether the target is a private or a public company, whether the bid is hostile or friendly, the time spent in preparing the bid and the pre-acquisition audit of the target.

There are four main value concepts namely:

- owner value
- market value
- tax value and
- fair value.

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Owner value determines the price in negotiated deals and is often led by a proprietor's view of value if he were deprived of the property.

The basis of market value is the assumption that if comparable property has fetched a certain price, then the subject property will realize a price something near to it.

The fair value concept in essence, is the desire to be equitable to both parties. It recognizes that the transaction is not in the open market and that vendor and purchaser have been brought together in a legally binding manner.

Tax valuation has been the subject of case law since the turn of the century. There are concepts of value that impunge upon each of these main areas; namely, investment value, liquidation value, and going concern value.

I. Valuation based on assets

This valuation method is based on the simple assumption that adding the value of all the assets of the company and subtracting the liabilities, leaving a net asset valuation, can best determine the value of *a* business. However, for the purposes of the amalgamation the amount of the consideration for the acquisition of *a* business may be arrived at either by valuing its individual assets and goodwill or by valuing the business as a whole by reference to its earning capacity. If this method is employed, the fixed assets of all the amalgamating companies should preferably be valued by the same professional value on a going concern basis. The term 'going concern' means that a business is being operated at not less than normal or reasonable profit and value will assume that the business is earning reasonable profits when appraising the assets. If it is found when all the assets of the business, both fixed and current, have been valued that the profits represent more than a fair commercial return upon the capital employed in the business as shown by such valuation the capitalized value of the-excess (or super profits) will be the value of the goodwill, which must be added to the values of theother assets n arriving at the consideration to be paid for the business. This method" may be summarized thus: The procedure of arriving at the value of a share employed in the equity method is simply to estimate what the assets less liabilities are worth, that is, the net assets lying for a probable loss or possible profit on book value, the balance being available for shareholders included in the liabilities may be debentures, debenture

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interest, expenses outstanding and possible preference dividends if the articles of association stipulate for payment of shares in winding up.

However, although a balance sheet usually gives an accurate indication of short-term assets and liabilities, this is not the case of long-term ones as they may be hidden by techniques such as "off balance sheet financing". Moreover, a balance sheet is a historical record of previous expenditure and existing liabilities. As a valuation is a forward looking exercise, acquisition purchase prices generally do not bear any relation to published balance sheet. Nevertheless a company's net book value is still taken into account as net book values have a tendency to become minimum prices and the greater the proportion of purchase price is represented by tangible assets, the less risky it's acquisition is perceived to be.

Valuation of a listed and quoted company has to be done on a different footing as compared to an unlisted company. The real value of the assets may or may not reflect the market price of the shares; however, in unlisted companies, only the information relating to the profitability of the company as reflected in the accounts is available and there is no indication of the market price. Using existing public companies as a benchmark to value similar private companies is a viable valuation methodology.

The comparable public company method involves selecting a group of publicly traded companies that, on average, are representative of the company that is to be valued. Each comparable company's financial or operating data (like revenues, EBITDA or book value) is compared to each company's total market capitalization to obtain a valuation multiple. An average of these multiples is then applied to get company value. An asset-based valuation can be further separated into four approaches:

Book value

The tangible book value of a company is obtained from the balance sheet by taking the adjusted historical cost of the company's assets and subtracting the liabilities; intangible assets (like goodwill) are excluded in the calculation.

Statutes like the Gift Tax Act, Wealth Tax Act, etc., have in fact adopted *book value* method for valuation of unquoted equity shares for companies other than an investment company. Book value of assets does help the valuer in determining the

useful employment of such assets and their state of efficiency. In turn, this leads the valuer to the determination of rehabilitation requirements with reference to current replacement values.

In all cases of valuation on assets basis, except book value basis, it is important to arrive at current replacement and realization value. It is more so in case of assets like patents, trademarks, know-how, etc. which may posses value, substantially more or less than those shown in the books.

Using book value does not provide a true indication of a company's value, nor does it take into account the cash flow that can be generated by the company's assets.

2. Replacement cost

Replacement cost reflects the expenditures required to replicate the operations of the company. Estimating replacement cost is essentially a make or buy decision.

3. Appraised value

The difference between the appraised value of assets, and the appraised value of liabilities is the net appraised value of the firm.

This approach is most commonly used in a liquidation analysis because it reflects the divestiture of the underlying assets rather than the ongoing operations of the firm.

4. Excess earnings

In order to obtain a value of the business using the excess earnings method, a premium is added to the appraised value of net assets. This premium is calculated by comparing the earnings of a business before a sale and the earnings after the sale, with the difference referred to as excess earnings.

In this approach, it is assumed that the business is run more efficiently after a sale; the total amount of excess earnings is capitalized (e.g., the difference in earnings is divided by some expected rate of return) and this result is then added to the appraised value of net assets to derive the value of the business.

II. Open market valuation

Open market value refers to a price of the assets of the company which could be fetched or realized by negotiating sale provided there is a willing seller, property is freely exposed to market, sale could materialize within a reasonable period, orders will remain static throughout this period and without interruption from any purchaser giving

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an extraordinarily higher bid. Each asset of the company is normally valued on the basis of liquidation as resale item rather than on a going-concern basis. The assets of the company, which are not subject to regular sale, could be assessed on depreciated or replacement cost. Besides, intangible assets like goodwill are also assessed as per normal practices and recognized conventions.

III. Valuation based on earnings

The normal purpose of the contemplated purchase is to provide for the buyer the annuity for his outlay. He will expect yearly income, return great or small, stable or fluctuating but nevertheless some return which is commensurate with the price paid therefore. Valuation based on earnings based on the rate of return on capital employed is a more modern method being adopted. From the last earnings declared by a company, items such as tax, preference dividend, if any, are deducted and net earnings are taken.

An alternate to this method is the use of the price-earning (P/E) ratio instead of the rate of return. The P/E ratio of a listed company can be calculated by dividing the current price of the share by earning per share (EPS). Therefore, the reciprocal of P/E ratio is called earnings - price ratio or earning yield.

Thus P/E = P

EPS

Where P is the current price of the shares.

The share price can thus be determined as

P = EPS x P/E ratio

MERGER NEGOTIATIONS:

SIGNIFICANCE P/E RATIO AND EPS ANALYSIS

In practice, investors attach a lot of importance to the earnings per share (EPS) and the price-earnings (P/E) ratio. The product of EPS and P/E ratio is the market price per share.

Exchange Ratio

The current market values of the acquiring and the acquired firms may be taken as the basis for exchange of shares. The share exchange ratio (SER) is given as follows:

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Share Exchange Ratio = Share price of the acquired firm

Share price of the acquiring firm

SER = Pb

Pa

The exchange ratio in terms of the market value of shares will keep the position of the shareholders in value terms unchanged after the merger since their proportionate wealth would remain at the pre-merger level. There is no incentive for the shareholders of the acquired firm, and they would require a premium to be paid by the acquiring company. Could the acquiring company pay a premium and be better off in terms of the additional value of its shareholders? In the absence of net economic gain, the shareholders of the acquiring company would become worse-off unless the price-earnings ratio of the acquiring company remains the same as before the merger. For the shareholders of the acquiring firm to be better

off after the merger without any net economic gain either the price-earnings ratio will have to increase sufficiently higher or the share exchange ratio is low, the price-earnings ratio remaining the same. Let us consider the example in Illustration given below:

Illustration. Enterprise is considering the acquisition of Enterprise. The following are the financial data of two companies:

Profit after tax (Rs.) Number of shares EPS (Rs.) Market value per share (Rs.) Price earnings ratio

Shyama Enterprise is thinking of acquiring Rama Enterprises through exchange of shares in proportion of the market value per share. If the price-earnings ratio is expected to be

(a) pre-merger P/E ratio of Rama i.e. 7.5

(b) pre-merger P/E ratio of Shyama i.e.15,

(c) weighted average of pre-merger P/E ratio of Shyama and Rama i.e. 13.75, what would be the impact on the wealth of shareholders after merger?

Solution:

Since the basis of exchange of shares is the market value per share of the acquiring (Shyama Enterprise) and- the acquired (Rama Enterprises) firms, then

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Shyama would offer 0.25 of its shares to the shareholders of Rama:

Pb = 30 = 0.25

Pa 120

In terms of the market value per share of the combined firm after the merger, the position of Rama's shareholders would remain the same; that is, their per share value would be: 120 x .25 = Rs. 30. The total number of shares offered by Shyama (the acquiring firm) to Rama's (the acquired firm) shareholders would be:

No. of shares exchanged = SER x Pre-merger number of shares of the acquired firm.

= (Pb/Pa)Nb

= 0.25 x 8000 = 2,000

and the total number of shares after the merger would be: Nb + (SER) Nm = 20,000 + 2,000 = 22,000. The combined earnings (PAT) after the merger would be: Rs. 80,000 + Rs. 16,000 = 96,000 and EPS after the merger would be:

Post-merger combined EPS = Post -merger combined PAT

Post - merger combined shares

PATa+PATb

Na+(SER)Nb

= 80,000 + 16,000

20,000 +(0.25)8000

= 96,000 = 4.36

22,000

The earnings per share of Shyama (the acquiring firm) increased from Rs.4 to Rs.4.36, but for Rama's (the acquired firm) shareholders it declined from Rs. 2 to Rs.4.36x.25 = Rs.1.09.

Given the earnings per share after the merger, the post-merger market value per share would depend on the price-earnings ratio of the combined firm. How would P/E ratio affect the wealth of shareholders of the individual companies after the merger?

The shareholders of both the acquiring and the acquired firms neither gain nor lose in value terms if post-merger P/E ratio is merely a weighted average of premerger

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P/E ratios of the individual firms. The post-merger weighted P/E ratio is calculated as follows:

Post-merger weighted P/E ratio:

(Pre-merger P/E ratio of the acquiring firm) x (Acquiring firm's pre-merger earnings + Post-merger combined earnings) + (Pre-merger P/E ratio of the acquired firm) x (Acquired firm's pre-merger earnings H- Post merger combined earnings).

P/EW = (P/EJ (PATa/PATc) + (P/Eb) x (PATb/PATc) ...(4)

Using Equation (4) in our example we obtain:

(30) x (80,000/96,000) + (15) (16,000/96,000) = 25 + 2.5 = 27.5

The acquiring company would lose in value if post-merger P/E ratio is less than the weighted P/E ratio. Any P/E ratio above the weighted P/E ratio would benefit both the acquiring as well as the acquired firms in value terms. An acquiring firm would always be able to improve its earnings per share after the merger whenever it acquires a company with a P/E ratio lower than its own P/E ratio. The higher EPS need not necessarily increase the share price. It is the quality of EPS rather than the quantity which would influence the price.

An acquiring firm would lose in value if its post-merger P/E ratio is less than the weighted P/E ratio. Shyama Enterprise would lose Rs.27.30 value per share if P/E ratio after merger was 15. Any P/E ratio above the weighted P/E ratio would benefit both the acquiring as well as the acquired firm in value terms. When the post-merger P/E ratio is 30, Shyama gains Rs.5.40 value per share and Rama Rs.1.35.

Why does Shyama Enterprise's EPS increase after merger? Because it has a current P/E ratio of 30, and it is required to exchange a lower P/E ratio, i.e.

P/E exchanged = SER x Pa ...(5)

EPSb

= 25x120_ = 15

2

Shyama Enterprise's EPS after merger would be exactly equal to its pre-merger EPS if P/E ratio paid is equal to its pre-merger P/E ratio of 30. In that case, given Rama's EPS of Rs.2, the price paid would be Rs.60 or a share exchange ratio of .5.

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Thus Shyama Enterprise would issue .5 x 8,000 = 4,000 shares to Rama Enterprise.

The acquiring firm's EPS after merger would be: Rs.96,000/24,000 = Rs.4. It may be noticed that at this P/E ratio, Shyama's shareholders would have the same EPS as before the merger: .5 x Rs.4 = Rs.2. It can be shown that if the acquiring firm takes over another firm by exchanging a P/E ratio higher than its P/E ratio, its EPS will fall and that of the acquired firm would increase after the merger.

The limitation of this methods is that it is based on past performance whereas for a fair valuation, a reliable estimate of future earnings is necessary.

In view of this, discounted cash flow (DCF) is often a preferred tool to value businesses. What sets this approach apart from other approaches is that it is based on projected, future operating results rather than on historical operating results. As a result, companies can be valued based on their future cash flows, which may be somewhat different from historical results.

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Lecture – 24

DCF METHOD

DISCOUNTED CASH FLOWS

Discounted cash flow analysis consists of projecting future cash flows, deriving a discount rate and applying this discount rate to the future cash flows and terminal value. This detailed analysis depends on accurate financial projections and discount rate assumptions. The resulting company valuation is the sum of discounted future cash flows and the discounted terminal value,

The first step in conducting a discounted cash flow analysis is to project future operating cash flows over projected holding periods. These projections are generally done before debt (but after taxes) to obtain an accurate indication of future free cash flow, without making any assumptions about the company's leverage. The future free cash flow is the cash left over after operating the business and investing in necessary property, plant and equipment, but before servicing debt or paying out any cash to owners.

The second step in the discounted cash flow analysis is to develop a discount rate.

The discount rate is also referred to as the Weighted Average Cost of Capital (WACC) and is best thought of as a percentage, which represents the return, expected by an owner of the company commensurate with the risk associated with the investment.

Thus, a company with little in the way of a demonstrated track record, would receive a higher discount rate than a company with a long history of growth and profitability and more obvious future prospects. Discount rates are generally calculated by deriving the company's cost of equity capital and the company's aftertax cost of debt. These financing costs are weighted and result in a WACC percentage, or discount rate.

The cost of equity capital is generally determined using the capital asset pricing model (CAPM), which is based on three inputs:

1. the risk free rate (the expected return on long term government bonds).
2. the beta, which is a measure of the relative riskiness of the company and
3. the equity risk premium (the expected rate of return on common stocks in the long run)

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The derived discount rate is applied to the projected future cash flows to determine the present value of the future cash flows.

The next step involves calculating a terminal, or residual value. A terminal value calculation combines assumptions used to derive future projections and the discount rate to obtain a current value for a company's long-term future cash flows. The assumption underlying this step is that a company is a going concern and that its value is imbedded in its ability to generate value not just today, but also in the future. A terminal value is calculated by determining the cash flow in the period beyond the last projected period. This predicted future cash flow is then
capitalized by a percentage (represented by the company's discount rate less thepredicted long term growth rate) and this capitalized figure is then discounted back to the present using the discount rate. Together with an analysis of the company's operating history, business, industry and competitive environment, the results from one or more of these valuation methodologies are combined to form the basis of a comprehensive business valuation. To be accurate, this comprehensive business valuation should take into account all aspects of the company's business, including factors which may be difficult to value and that do not show up on financial statements.

Valuation based on super profits

This approach is based on the concept of the company as a going concern. The value of the net tangible assets is taken into consideration and it is assumed that the business, if sold, will in addition to the net asset value, fetch a premium. The super profits are calculated as the difference between maintainable future profits and the return on net assets. In examining the recent profit and loss accounts of the target, the acquirer must carefully consider the accounting policies underlying those accounts. Particular attention must be paid to areas such as deferred tax provision, treatment of extraordinary items, interest capitalisation, depreciation and amortisation, pension fund contribution and foreign currency translation policies. Where necessary, adjustments for the target's reported profits must be made, so as to bring those policies into line with the acquirer's policies. For example, the acquirer may write off all R&D expenditure, whereas the target might have capitalised the development expenditure, thus overstating the reported profits. The Value can be calculated using the following formula:

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V = T + P - rT

Where T = value of net tangible assets P = maintainable

future profits r = normal return expected on assets

c = rate at which super profits are capitalized

Discounted cash flow valuation method

Discounted cash flow valuation is based upon expected future cash flows and discount rates. This approach is easiest to use for assets and firms whose cash flows are currently positive and can be estimated with some reliability for future periods. Discounted cash flow valuation, relates the value of an asset to the present value of expected future cash flows on that asset. In this approach, the cash flows are discounted at a risk-adjusted discount rate to arrive at an estimate of value. The

discount rate will be a function of the riskiness of the estimated cash flows, with

lower rates for safe projects and higher rate for riskier assets. This approach has its foundation in the 'present value' concept, where the value of any asset is the present value of the expected future cash flows on it. Essentially, DCF looks at an acquisition as a pure financial investment. The buyer will estimate future cash flows and discount these into present values. Why is future cash flow discounted? the reason is that a rupee in future is at risk of being worth less than a rupee now. There are some business based real risks like acquired company loosing a contract, or new competitor entering the market or an adverse regulation passed by government, which necessitated discounting of cash flows.

The discounted cash flow (DCF) model is applied in the following steps:

1. Estimate the future cash flows of the target based on the assumption for its post-acquisition management by the bidder over the forecast horizon.
2. Estimate the terminal value of the target at forecast horizon.
3. Estimate the cost of capital appropriate for the target.
4. Discount the estimated cash flows to give a value of the target.
5. Add other cash inflows from sources such as asset disposals or business divestments.
6. Subtract debt and other expenses, such as tax on gains from disposals and divestments, and acquisition costs, to give a value for the equity of the target.
7. Compare the estimated equity value' for the target with its pre-acquisition

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stand-alone value to determine the added value from the acquisition.

8. Decide how much of this added value should be given away to target shareholders as control premium.

In preparation for the forecast of target cash flows under the bidder's management, the historic cash flow statements of the target must be examined. Target cash flows are generally forecast for the next five to ten years. In general, the longer the forecast horizon, the less accurate the forecast. Whatever the forecast horizon, the terminal value of the target at the end of that period based on free cash flows thereafter also needs to be forecast. Often this terminal value is based on the assumption of perpetual free cash flows based on the same level of operations as in the last year of the forecast period. The level perpetual cash flows are then capitalised at the cost of capital to yield the terminal value.

The cost of capital is the weighted average cost of capital (WACC), estimated from the target's pre-acquisition costs of equity and debt.

WACC = *Ke* E/V + (1 - Tc) Kd D/V -:- KPP/V

Where Ke = cost of equity;

Kd = cost of debt;

Kp = cost of preference shares;

E = market value of equity;

D = market value of dept;

P = market value of preference shares;

Tc = corporation tax rate;

V = E +D + P, the value of the firm.

Valuation by team of experts

Valuation is an important aspect in merger and acquisition and it should be done by a team of experts keeping into consideration the basic objectives of acquisition. Team should comprise of financial experts, accounting specialists technical and legal experts who should look into aspects, of valuation from different angles.

Accounting expert has to foresee the impact of the events of merger on profit and loss account and balance sheet through projection for next 5 years and economic

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forecast. Using the accounting data he must calculate performance ratios, financial capacity analysis, budget accounting and management accounting and read the impact on stock values, etc. besides, installing accounting and depreciation policy, treatment of tangible and intangible assets, doubtful debts, loans,- interests, maturities, etc.

Technician has its own role in valuation to look into the life and obsolescence of depreciated assets and replacements and adjustments in technical process, etc. and form independent opinion on workability of plant and machinery and other assets.

Legal experts advice is also needed on matters of compliance of legal formalities in implementing acquisition, tax aspects, review of corporate laws as applicable, legal procedure in acquisition strategy, laws affecting transfer of stocks and assets, regulatory laws, labour laws preparing drafts of documents to be executed or entered into between different parties, etc.

Nevertheless, the experts must take following into consideration for determining exchange ratio.

A. Market Price of Shares

If the offeree and offeror are both listed companies, the stock exchange prices of the shares of both the companies should be taken into consideration which existed before commencement of negotiations or announcement of the takeover bid to avoid distortions in the market price which are likely to be created by interested parties in pushing up the price of the shares of the offeror to get better deal and vice versa.

B. Dividend Payout Ratio (DPR)

The dividend paid in immediate past by the two companies is important as the shareholders want continuity of dividend income. In case offeree company was not paying dividend or its DPR was lower than the offerer's, then it's shareholders would opt for share exchange for the growth company by sacrificing the current dividend income for prospects of future growth in incdme and capital appreciation.

C. Price Earning Ratio (PER)

Price earning ratios of both the offeror and offeree companies be compared to judge relative growth prospects. Company with lower PER show a record of low

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growth in earning per share which depresses market price of shares in comparison to high growth potential company. Future growth rate of combined company should also be calculated.

D. Debt Equity Ratio

Company with low gearing offers positive factor to investors for security and stability rather than growth potential with a geared company having capacity to expand equity base.

E. Net Assets Value (NAV)

Net assets value of the two companies be compared as the company with lower NAV has greater chances of being pushed into liquidation.

Having taken all the above factors into consideration, the final exchange ratio may depend upon factors representing strength and weakness of the firm in the light of merger objectives including the following:

Liquidity, strategic assets, management capabilities, tax loss carry overs, reproduction costs, investment values, market values (combined companies shares) book values, etc.

Valuation by experts : effect

It is well settled that the valuation of shares is a technical matter, requiring considerable skill and expertise. If the same has been worked out and arrived at by experts then the same should be accepted, more so, if the same has the approval of the shareholders. That is to say, where the valuation done by the company's auditors is approved by the majority of shareholders and is also confirmed by eminent experts, who are appointed by the court to examine the valuation so made, as fair, and the valuation is not shown to be patently unfair or unjust, it would be extremely difficult to hold that the valuation so made is unfair, and, then, the court shall have to be slow to set at naught the entire scheme of amalgamation. The court does not go into the matter of fixing of exchange ratio in great detail or to sit in appeal over the decision of the chartered accountant. If a chartered accountant of repute has given the exchange ratio as per valuation made by him and the same is accepted by the requisite majority of the shareholders, the court will only see whether there is any manifest unreasonableness or manifest fraud involved in the matter.

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So, the exchange ratio of shares in the case of scheme of amalgamation, when supported by an opinion of accounting, technicians & legal experts and approved by a very large number of shareholders concerned, is *prima facie* to be accepted as fair, unless proved otherwise by the objectors. It is also well established, that there are number of bases on which valuation or the offered exchange ratio, which ultimately is a matter of opinion, can be founded and final determination can be made by accepting one of amalgamation of various consideration. It is also well settled by the Supreme Court in *Hindustan Lever Employees' .Union* v. *Hindustan Lever Ltd.,* that mathematical precision is not the criterion for adjudging the fair exchange ratio. Thus, now, the law has been well settled by the Supreme Court in *Miheer H.* transferee company to be allotted to the holders of the transferor company has been worked out by a recognised firm of chartered accountants who are experts in the field of valuation, and if no mistake can be pointed out in the said valuation, it is not for the court to substitute its exchange ratio, especially when the same has been accepted without demur by the overwhelming majority of the shareholders of the two companies or to say that the shareholders in their collective wisdom should not have accepted the said exchange ratio on the ground that it will be detrimental to their interest. It is not the part of the judicial process, said the Supreme Court in *Hindustan Lever Employees' Union* v. *Hindustan Lever Ltd.,* to examine entrepreneurial activities to ferret out flaws. The court is least equipped for such oversights, nor indeed is it a function of the judges in our constitutional scheme. It cannot be said that the internal management, business activity or institutional operation of public bodies, can be subjected to inspection by the court. To do so is incompetent and improper and, therefore, out of bounds.

Where the determination of the market price has been entrusted to a reputed valuer, there no reason to doubt his competence unless *mala fides* are established against him. Allegations of *mala fides* are easy to make but difficult to substantiate. Unless the person who challenges the valuation satisfies the court that the valuation arrived at is grossly unfair, the court will not disturb the scheme of amalgamation which has been approved by the shareholders of two companies, who are, by and large well informed men of commercial world. It is difficult to set aside the valuation of experts in the absence of fraud or *mala fides* on the part of the experts.

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Fair value of shares

Valuation can be done on the basis of fair value also. However, resort to valuation by fair value is appropriate when market value of a company is independent of its profitability.

The fair value of shares is arrived at after consideration of different modes of valuation and diverse factors. There is no mathematically accurate formula of valuation. An element of guesswork or arbitrariness is involved in valuation. The following four factors have to be kept in mind in the valuation of shares. These are:

(1) Capital cover,

(2) Yield,

(3) Earning capacity, and

(4) Marketability.

For arriving at the fair value of share, three well-known methods are applied:

(1) the manageable profit basis method (the earning per share method).

(2) the net worth method or the break-up value method, and

(3) the market value method.

The fair value of a share is the average of the value of shares obtained by the net assets method and the one obtained by the yi6ld method. This is, in fact not a valuation, but a compromise formula for bringing the parties to an agreement. The average of book value and yield-based value incorporates the advantages of both the methods and minimizes the demerits of both the methods. Hence, such average is called the fair value of share or sometimes also called the dual method of share valuation.

The fair value of shares can be calculated by using the formula:

Value by net assets method + Value by yield method

Fair Value of shares = ---

2

Valuation of equity shares must take note of special features, if any, in the company or in the particular transaction. These are briefly stated below:

(a) Importance of the size of the block of shares:

Valuation of the identical shares of a company may vary quite significantly at

the same point of time on a consideration of the size of the block of shares under negotiation.

The holder of 75% of the voting power in a company can always alter the provisions of the articles of association; a holder of voting power exceeding 50% and less than 75% can substantially influence the operations of the company even to alter the articles of association or comfortably pass a special resolution.

A controlling interest therefore, carries a separate substantial value.

(b) Restricted transferability:

Along with principal consideration of yield and safety of capital, another important factor is easy exchangeability or liquidity. Holders of shares of unquoted public companies or of private companies do not enjoy easy marketability; "therefore, such shares, however good, are discounted for lack of liquidity at rates, which may be determined on the basis of circumstances of each case.

The discount may be either in the form of a reduction in the value otherwise determined or an increase in the normal rate of return.

(c) Dividends and valuation:

Generally, companies paying dividends at steady rates enjoy greater popularity and the prices of their shares are high while shares of companies with unstable dividends do not enjoy confidence of the investing public as to returns they expect to get and, consequently, they suffer in valuation.

(d) Bonus and rights issue:

Share values have been noticed to go up when bonus or rights issues are announced, since they indicate an immediate prospect of gain to the holder although in the ultimate analysis, it is doubtful whether really these can alter the valuation.

Statutory valuation

Valuation of shares may. be necessary under the provisions of various enactments like the Wealth tax Act, Companies Act, Income-tax Act, etc. e.g. valuation is necessary under the

Companies Act in the case of an amalgamation and under the Income-tax Act for the purposes of

capital gains.

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Some of the other enactments have laid down rules for valuation of shares. The rules generally
imply acceptance of open market price i.e. stock exchange price for quoted shares and asset based
valuation for unquoted equity shares and average of yield and asset methods i.e. fair value, in valuing
shares of investment companies.

Dividend Discount Models

Dividends refer to that portion of a firm's net earnings which are paid out to the shareholders.
Since dividends are distributed out of the profits, the alternative to the payment of dividends is the
retention of earnings/profits. The retained earnings constitute an easily accessible important
source of financing the investment requirements of firms. There is, thus, a type of inverse
relationship between retained earnings and cash dividends: larger retentions, lesser dividends; smaller
retentions, larger dividends. Thus, the alternative uses of the net earnings-dividends and retained
earnings—are competitive and conflicting.
There are, however, conflicting opinions regarding the impact of dividends on the valuation of a
firm. According to one school of thought, dividends are irrelevant so that the amount of dividends
paid has no effect on the valuation of a firm. On the other hand, certain theories consider the
dividend decision as relevant to the value of the firm measured in terms of the market price of the
shares.
The purpose here is, therefore, to present a critical analysis of some important theories

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representing these two schools of thought with a view to illustrating the relationship between
dividend policy and the valuation of a firm.

The basic model for valuing equity is the dividend discount model—the value of a stock is the
present value of expected dividends on it.

Versions of the Model

Since projections of dividends cannot be made through infinity, several versions
of the dividend discount model have been developed based upon different
assumptions about future growth.

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Lecture – 25-26

Other models

Dividend Growth Valuation Model (Gordon Growth Model)

The dividends of most companies are expected to grow and evaluation of share values based on dividend growth is often used in valuation of shares. The Gordon growth model relates the value of a stock to its expected dividends in the next time period, the required rate of return on the stock, and the expected growth rate in dividends.

Value of the stock =

where DPS, = expected dividends one year from now r =

required rate of return for equity investors g =

growth rate in dividends forever

The Gordon growth model can be used to value a firm that is in 'steady state' with dividends growing at a rate that is expected to stay stable in the long term. Thus, though the model's requirement is for the expected growth rate in dividends, analysts are able to substitute the expected growth rate in earnings and get precisely the same result, if the firm is truly in steady state.

Assumptions

Gordon growth model using dividend capitalization is based on the following assumptions:

I. retained earnings represent the only source of financing,

II. rate of return is constant,

III. cost of capital remains constant and is greater than growth rate,

IV. the company has perpetual life.

The implications of the model is that when the rate of return is greater than the discount rate, the price per share increases as the dividend ratio decreases and if the return is less than discount rate it is vice versa. The price per share remains unchanged where the rate of return and discount rate are equal.

Walter's Valuation Model

Prof. Walter's theory was that in the long run the share prices reflect only the present value of expected dividends. Retentions influence stock price only through

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their effect on future dividends. Prof. Walter has formulated this and used the dividend to optimize the wealth of an equity shareholder. His formula in determination of expected market price of a share is given below:

RC

P = Market price of the equity share

D = Dividend per share

E = Earnings per share

(E-D) = Retained earning per share

Ra = Internal rate if return on the investment

Rc = Cost of capital

if Ra is greater than 1, lower dividend will maximize the value per share and vice versa.

Assumptions -

Walters model is based on the following assumptions:

I. all earnings are either distributed as dividends or invested internally immediately,

II. all financing is done through retained earnings and external sources of funds like debt or new equity capital are not used,

III. with additional investment undertaken, the firm's business risk does not change, implying that the firm's internal rate of return and its cost of capital are constant,

IV. the firms are a going concern with an infinite life.

In the long run, the relationship between the rate of return on retained earnings or return on investment and the rate of market expectation is important to the investors. Thus,

I. in a company where the rate expected by investors is higher than market capitalization rate, shareholders would accept low dividends and

II. in a company where return on investment is lower than market capitalization rate, shareholders would prefer higher dividend so that they can utilize the funds so obtained elsewhere in more profitable opportunities.

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Thus, according to this modei, the investment policy of a firm cannot be separated from its
dividend policy and both are inter-related. The choice of an appropriate dividend policy affects the
value of an enterprise. Retentions influence the share price only through their effect on further
dividend.

Modigliani and Miller - Irrelevance Theory

Modigliani and Miller were of the opinion that its basic earnings power and its risk class determine the value of the firm. Hence, the firm value depends on its asset investment policy rather
than on how earnings are split between dividends and retained earnings. According to them, a
firm's dividend policy has no effect on the value of its assets. If the rate of dividend declared by a
company is less, its retained earnings will increase and so also the net worth and vice versa.

Assumptions-

I. there are no stock floatation or transaction costs, II. dividend policy has
no effect on the firm's cost of equity,

III. the firm's capital investment policy is independent of its dividend policy,

IV. investors and managers have the same set of information (symmetric
information) regarding future opportunities.

Modigliani and Miller demonstrated, under a particular set of assumptions, that if a firm pays
higher dividends, then it must sell more stocks to new investors, and that the share of the value of the
company given up to new investors is exactly equal to the dividends paid out. The value of the firm
was not determined by the amount of dividends paid, but rather by the earning power of the

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projects in which the firm invested its money.

According to Modigliani and Miller Model the market price of a share after dividend declared is calculated by applying the following formula

where

P0 - the prevailing market price of a share,

Kc = the cost of Equity Capital,

D, = dividend to be received at the end of period one,

P, = market price of a share at the end of period one, **Dividend Yield method**

The shareholders in a company are entitled to receive dividends as and when declared. Since

investors in company get their return in the form of a dividend the amount of dividend paid out

gives some indication of how valuable the shares will be to the potential buyer. If dividend is one of the

key factors determining how valuable shares are it is possible to look at the relationship between level

of dividend and price in other companies and base a price on what dividend is normally paid.

This concept can be represented as a formula for any individual company compared to an accepted average for similar businesses.

Dividend per share = Total dividend declared

Number of shares

Value per share = Dividend per share

Average dividend per share

Value of business = Value per share x Total number of shares

The same result can be obtained using figures for the business as whole rather than per share if

information is available in that form.

Total value of business = Total dividend

Average dividend per share

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Combination of all or some of the methods of valuation may be adopted

It is thus well settled law that the combination of three well known methods of valuation of
shares, namely, yield method, net asset value method and market value method to arrive at the share
exchange ratio giving due weightage to each method based on the company's performance,
operating losses and future maintainable profits is a fair method to arrive at the average value of
the share and that the fact that at the relevant time the book value of the share of one company was
higher than that of another is not material.

The following principles have emerged from the judicial decisions [see *Shah/bag Enterprises (P)
Ltd. Re.* (1976) 46 Comp.Cas 642 (GUJ)] in the matter of approach to different methods of valuation,
namely -

(1-) The assessment value must be based mainly upon the income yield, but with some regard to
the assets backing in special cases.

(2) Assets backing is of more importance in the case of a majority shareholding
than in a minority shareholding, and is more useful in investment companies
than in trading companies as a check on value determined from earning
capacity.

(3) Earning capacity or maintainable profits are not synonymous with the yield or
return, which is the balance remaining therefrom after providing a reasonable
reserve.

Valuation of securities in a takeover

A takeover, like any other contract of purchase and sale, involves the striking of a bargain between the

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buyer and the shareholders of the seller in regard to the price. With a range between the maximum
price which the buyer is prepared to pay and the minimum price which a sufficient number of the
shareholders of the seller are prepared to accept, the price actually paid will depend on such factors
as (a) the eagerness of the buyer to buy and whether there are competing bidders; (b) the eagerness
of the shareholders of the seller to sell and, in case of share for share offer the willingness of the shareholders of the seller to become the shareholders of the buyer; (c) the skill, judgement and timing of the buyer's campaign, including the persuasivenss with which the buyer's case is expressed in the offer documents and other circulars to shareholders, (d) the willingness of the buyer to structure the offer in the light of the particular financial and tax considerations of the shareholders of the seller; (e) if the directors of the seller resist the bid, the skill, judgement and timing of the defensive campaign and degree of support, they receive from their merchant bankers, associates and other financial institutions; (f) whether the directors of the seller hold a large block of effectively controlled shares or the shares are widely dispersed; (g) fortuitous factors, such as the behaviors during the offer period of the stock exchange in general, economic developments, and sometimes even political events which affect investment sentiment. The decision as to what price the transferee company should be prepared to pay to acquire the transferor company should be determined by precisely the same financial analysis as the decision whether the transferee company should erect a new factory or purchase a large item of plant.

Thus the motivation for buying and selling companies varies considerably, but it is important that both parties understand what they want from one another.

First, what is the buyer looking for? It could be:

- An opportunity to grow faster, with a ready-made market share.

To eliminate a competitor by buying it out.

— Better integration - horizontal or vertical.

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- Diversification with minimum cost and immediate profit.

To improve dividend yield, earnings or book value.

To forestall the company's own takeover by a third party To enjoy the prospect of turning around a sick company.

On the other hand, why are companies available for sale? Some of the reasons are:

- Declining sales or earnings. , .
- An uncertain future.
- Owner wants to slow down or retire with no successor.
- Desire to maximise growth under the umbrella of a larger company.

To raise cash for a more promising line of business.

- Lack of adequate financial and management skills.

To concentrate time and effort on what it can do best.

The stages that have to be gone through in order to conclude a deal, either directly or through an intermediary, include:

- Search and exchange of information about each other.
- Preliminary investigation followed by serious negotiation.
- Contract development and closing the deal.

In the case of a share-for-share takeover (including cases where the consideration consists of loan stock convertible into or with subscription rights for equity capital of transferee company) the value of transferee company's existing operations should be ideally valued on the same basis, so as to determine the maximum number of shares that the transferee company should be prepared to offer.

Non-Financial Considerations in Valuation

Howsoever sophisticated the financial techniques applied to evaluate the worth of a business, and however accurate the assumption, it is more than likely that intangible (and perhaps irrational) factors will ultimately determine the amount the purchaser is prepared to pay. While it is arguable that any acquisition should be justifiable in a financial context, the motives for an acquisition may often be purely defensive, for example, to make the combined company less attractive to acquisition by a third party, to prevent an outsider getting a toe-hold in the industry, to prevent a

competitor from acquiring the same business, or to diversify out of a manifestly declining industry. In such circumstances the financial benefits of the acquisition are much more difficult to quantify. Worse still, the motives may simply involve empire-building or personal aggrandisement on the part of the directors or owners of the acquiring company.

The foreign currency acquisition makes the valuation a still more complex and difficult exercise. It is suggested that the acquisition in another country may be evaluated in that country's currency. In addition, the cost of capital estimate for discounting should also be from the target company's country only. The reason for using the acquirer's cost of capital in the target's country is that the product pricing decisions in the acquired company will have to be based on the local market conditions.

Valuation of Shares in different Situations - Judicial Pronouncements

Supreme Court in *CWTv. Mahadeo Jalan* (1972) 86 ITR 621 (SC) observed:

"An examination of the various aspects of valuation of shares in a limited company would lead us to the following conclusion:

(1) Where the shares in a public limited company are quoted on the stock exchange and there are dealings in them, the price prevailing on the valuation date is the value of the shares.

(2) Where the shares are of a public limited company which are not quoted on a stock exchange or of a private limited company, then value is determined by reference to the dividends, if any, reflecting the profit earning capacity on a reasonable commercial basis. But, where they do not, then the amount of yield on that basis will determine the value of the shares. In other words, the profits which the company has been making and should be marking will ordinarily determine the value.

The dividend and earning method or yield method are not mutually exclusive; both should help in ascertaining the profit earning capacity as indicated above. If the results of the two methods differ, an intermediate figure may have to be computed by adjustment of unreasonable expenses and adopting a reasonable proportion of profits.

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(3) In the case of a private limited company also where the expenses are incurred out of all proportion to the commercial venture, they will be added back to the profits of the company in computing the yield. In such companies the restriction on share transfers will also be taken into consideration as earlier indicated in arriving at a valuation.

(4) Where the dividend yield and earning method break down by reason of the company's inability to earn profits and declare dividends, if the set back is temporary, then it is perhaps possible to take the estimate of the value of the shares before set back and discount it by a percentage corresponding to the proportionate fall in the price of quoted shares of companies which have suffered similar reverses.

(5) Where the company is ripe for winding up, then the break-up value method determines what would be realised by that process.

In setting out the above principles, we have not tried to lay down any hard and fast rule because ultimately the facts and circumstances of each case, the nature of the business, the prospects of profitability and such other considerations will have to be taken into account as will be applicable to the facts of each case. But, one thing is clear, the market value, unless in exceptional circumstances to which we have referred, cannot be determined on the hypothesis that because in a private limited company one holder can bring into liquidation, it should be valued as on liquidation, by the break-up method.

The yield method is the generally applicable method while the break-up method is the one resorted to in exceptional circumstances or where the company is ripe for liquidation but nonetheless is one of the methods."

Therefore, generally, in case of amalgamation, a combination of all or some of the well-accepted methods of valuation may be adopted for determining the exchange ratio of the shares of two companies.

The valuation of company shares is a highly technical mater which requires considerable knowledge, experience and expertise in the job. A ratio based on valuation of shares of both the companies done by experts, approved by majority of the shareholders of both the companies and sanctioned by court is an ideal exchange

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ratio.

Supreme Court in Miheer H.Mafatlal v. Mafatlal Industries Ltd.

The law on the subject has been well settled by the Supreme Court in *Miheer H. Mafatlal v, Mafatlal Industries Ltd.* (1996) 4 Comp LJ 124 (SC) where it was held that once the exchange ratio of the shares of the transferee company to be allotted to the holders of shares in the transferor company has been worked out by a recognised firm of chartered accountants who are experts in the field of valuation, and if no mistake can be pointed out in the said valuation, it is not for the court to substitute its exchange ratio, especially when the same has been accepted without demur by the overwhelming majority of the shareholders of the two companies or to say that the shareholders in their collective wisdom should not have accepted the said exchange ratio of the ground that it will be detrimental to their interest.

Supreme Court in Hindustan Lever Employees Union v. Hindustan Lever Ltd.

In *Hindustan Lever Employees Union v. Hindustan Lever Ltd.,* (1994) 4 Comp LJ 267(SC) the Supreme Court held that the court's obligation is to satisfy that the valuation was in accordance with law and the same was carried out by an independent body.

The Supreme Court had explained that the nature of jurisdiction by the court, while considering the question of sanctioning a scheme of arrangement or compromise, is of sentinel nature and is not of appellate nature to examine the arithmetical accuracy of scheme approved by majority of shareholders. While considering the sanction of a scheme of merger, the court is not required to ascertain with mathematical accuracy the terms and targets set out in the proposed scheme. What is required to be evaluated is general fairness of the scheme.

In the matter of Canon Tea Co. Ltd. : Although the question of valuation of shares and fixation of exchange ratio is a matter of commercial judgment and the court should not sit in

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judgment over it, yet the court cannot abdicate its duty to scrutinise the scheme with vigilance. It is
not expected of the court to act as a rubber stamp simply because the statutory majority has approved
the scheme and there is no opposition to it. The court is not bound to treat the scheme as a fait
accompli and to accord its sanction merely upon a casual look at it. It must still scrutinize the
scheme to find out whether it is a reasonable arrangement which can, by reasonable people conversant
with the subject, be regarded as beneficial to those who are likely to be affected by it. Where there is
no opposition, the court is not required to go deeper. However, when there is opposition, the court
not only will, but must go into the question and if it is not satisfied about the fairness of the
valuation, it would be justified in refusing to accord sanction to the scheme as was held by the
court in *Canon Tea Co. Ltd.* (1966) 2 Comp LJ: 278 (Cal).

Bank of Baroda Ltd. v. Mahindra Ugine Steel Co. Ltd.

In the matter of *Bank of Baroda Ltd.* v. *Mahindra Ugine Steel Co. Ltd.:* The jurisdiction of the
court in inquiring into the fairness of the exchange ratio cannot be ousted by vote of majority
shareholders on the ground that valuation of shares is a matter of commercial judgment - *Bank of*
Baroda Ltd. v. *Mahindra Ugine Steel Co. Ltd.* (1976) 46 Comp Cas 227 (Guj).

Valuation practices in India - Government guidelines

Central Government had come out with guidelines for valuation of shares in 1991. These guidelines are reproduced below. These guidelines were in use by the Controller of Capital Issues

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even before 1978. All India Financial Institutions and banks have been following these guidelines
uniformly. As such, the procedure laid down in these guidelines is followed by the corporate sector
and is in vogue.
These guidelines lay down techniques for calculations of 'fair value' 'Net Assets Value' and
Profit Earning Capacity Value (PECV) and Market Value in the case of quoted shares.

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Lecture – 27

Post merger re-organization

INTRODUCTION

Mergers, amalgamations, acquisitions, takeovers or any other kind of business combinations are undertaken for the purpose of expansion or growth of a business. The fundamental economic rationale for a merger is that the value of the merged entity is expected to be greater than the sum of the independent values of the merging entities. However, there is more to such transactions than joining two legal entities or creating *a* new one. A merger can join two cultures, two sets of procedures and protocols, two sets of policies and change the employment environment and prospects of several hundreds of employees, who have been the bed rock of past successes and the key to future value.

Timely integration of systems, applications and data provide the corporate information needed to achieve the post-merger objectives.

The relevance of Post-merger organisation and integration cannot be overstated. Continuous appraisal and improvement are the basic elements in the success of a merger or an acquisition. Due to the complexity of numerous activities and occurrence of many unanticipated events, it is quite possible-that the process gets off the track and results are not realized. In fact the main reason, why so many mergers either fail or fall short of expectations is a lack of adequate efforts to integrate the purchased company into the buyer's existing operations. It should be realised that once the deal is put through, the 'real' work has only begun. Too often, the buying company underestimates, how long it will take to get the two companies to act as one. Therefore, where importance is placed on whether it is a good idea to purchase a company and figure out the right price, it is equally essential to understand the target company with an eye to post-merger efforts.

'Post-merger reorganisation' is a wide term which encompasses the reorganisation of each and every aspect of the company's functional areas to achieve the objectives planned and aimed at in takeover, merger, amalgamation or demerger. The parameters of post merger reorganisation are to be established by the management team of every amalgamating company differently depending upon its requirements.

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Lecture– 28

Factors in post merger re-organization

1. Gain or Loss to Stakeholders

In mergers and acquisitions it largely depends upon the terms and conditions of the merger and the track record of the transferee oracquirer company. Based on the cardinal principle, every buyer, in other words transferee or acquirer has to pay more than the book value of the transferor or target company. However, the terms and conditions of the transaction depend upon their present operations and past historical records. Some instances of the acquisitions to small shareholders worth mentioning are as under:

1. On the announcement of merger of ICICI Ltd. with ICICI Bank share price jumped from Rs. 47.70 and Rs. 77.00 on 25.9.2001 to Rs. 56.10 and Rs. 98.00 on 24.10.2001 respectively.

2. AV Birla group acquired 14.5% shares of Larsen & Toubro Ltd. (L&T) from Reliance Industries Ltd. at Rs. 309 per share. For increasing the stake up to 34.5% the Birla group's open offer at Rs. 190 per share is under protest by the Investors Grievances Forum and the Financial Institutions (FIs). The L&T script surged to close at Rs. 189 from Rs. 172 on 16.10.2002. FIs collectively hold over 36% shares in L&T. They demanded Rs. 340 per share. The open offer has been stayed and was under review by the SEBI on 18.10.2002. National Association of Small Investors (NASI) said that a section of Grasim shareholders will approach the Supreme Court asking the company to increase the offer price for acquisition of L&T to Rs. 3507- per share. As such, the small shareholders of L&T will be provided with an exit opportunity at a price higher than the ruling market price.

3. AV Birla group open offer for 25.5% shares in Indian Aluminium Ltd. (Indal) at Rs. 1207- per share opened on 14.10.2002 did not receive favourable response in view of Sterlite's offer at Rs. 2217- per share made in 1998 against which the shareholders tendered their shares. There is a good chance for upward revision in the offer price or a strategic deal between Sterlite and AV Birla group. It may also be beneficial to the small

shareholders.

4. The takeover by Mr. Arun Bajoria for Bombay Dyeing provided a golden opportunity to the small shareholders to exit at Rs. 1107- per share against the market price ruling between Rs. 60-75 per share.

5. The takeover bid by Mr. Abhishek Dalmia for the Gesco Corporation resulted in upward revision in offer price to Rs. 457- after acquiring 45% shares at Rs. 277- per share. The Dalmias sold their entire 10.5% stake at Rs. 54 per share to Sheth Mahiaha combine.

6. The takeover bids for Ahmedabad Electricity Company (AEC) by Gujarat Torrent group and the Bombay Dyeing resulted in increasing the offer price from Rs. 657- per share to Rs. 1327- per share and at this price Gujarat Torrent Group acquired AEC; undoubtedly, the small shareholders were benefited prior to acquisition of AEC.

7. Similarly, the takeover bid of Mr. Arun Bajoria for Ballarpur Industries resulted in a surge of the scrip price from around Rs. 507- to Rs. 687- when it was made public.

From the above it is evidently clear that such acquisition attempts cause an increase in share price, which benefits the share holders of the target company. For the post acquisition or merger achievements, reorganisational efforts of the acquirer or merged company are very important. Improving the acquisition integration process is one of the most compelling challenge facing businesses today. The results are dependent on the actions suggested by the consultants and merchant bankers and the actions taken by the finance executives, operational heads, HRD head and legal advisors.

2. Implementation of Objectives

We have so far discussed various objectives, motives, reasons and purposes which are to be achieved and accomplished by implementing them after completion of merger, amalgamation or acquisition. Much of the senior management's attention must be focused on developing a 'post-transaction' strategy and integration plan that will generate the revenue enhancements and cost savings that initially prompted the merger or acquisition. After merger or acquisition, the resources of two or more companies should be put together for producing better results through savings in operating costs

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because of combined management of production, marketing, purchasing, resources etc. These economies are known as synergistic operative economies. Synergy is also possible in the areas of Research and Development function of the combined company for optimum utilization of technological development, which could not be taken up by the separate companies for want of resources.

A key challenge in mergers and acquisitions is their effective implementation as there are chances that mergers and acquisitions may fail because of slow integration. The key is to formulate in advance integration plans that can effectively accomplish the goals of the M&A processes. Since time is money and competitors do not stand still, integration must not only be done well but also done expeditiously.

The takeover or merger of one company with another affects the senior managerial personnel. A cohesive team is required both at the board level *as* well as I at senior executives level. The reorganisation would involve induction of the directors I of the transferor company on the Board of the amalgamating company, or induction I of reputed and influential persons from outside who have expertise in directing and I policy planning to broad base the Board for public image as well as smooth I functioning of the company. Selection of directors, finalising their term of holding the I office as directors, managerial compensation and other payments or reimbursements I of expenses etc. are issues to be sorted out.

At the senior executive level also, changes are required particularly in respect of I compensation depending upon the terms an,d conditions of merger, amalgamation or I takeover and to adjust in suitable positions the top executives of the amalgamated I company to create a congenial environment and cohesive group leadership within the 1 organisation. Understanding different cultures and where and how to integrate them properly is vital to the success of an acquisition or a merger. Important factors to be taken note of would include the mechanism of corporate control particularly encompassing delegation of power and power of control, responsibility towards ! accounting, management information system, to and fro communication channels, interdivisional and intra-divisional harmony and achieving optimum results through changes and motivation.

(iv) Management of financial resources

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(v) Financial Restructuring

Financial restructuring becomes essential in post merger reorganisation.
Financial restructuring is characterised by liquidity crisis, 'abnormal' balance sheets and negative equity. The 'clean-up' must happen fast. Replacement of costlier fundings by cheaper borrowings on a long and short term basis as per requirement is one of the several ways and means of financial restructuring for a company. This being an important aspect concerns most of the top management, creditors, bankers, shareholders, regulatory bodies like stock exchange, SEBI as well as the government where provisions of corporate laws are attracted and their permissions or approvals for planned changes are required. Generally, financial restructuring is done as per the scheme of arrangement, merger or amalgamation approved by the shareholders and creditors but in those cases where takeover or acquisition of an undertaking is made by one company of the other through acquiring financial stake by way of acquisition of shares, e.g. IPCL by RIL, reorganisation of financial structure would be a post-merger event which might compel the company to change its capital base, revalue its assets and reallocate reserves. Decisions have to be made regarding raising owners funds or resorting to borrowed funds as per debt bearing capacity of the company or going in for leasing options. These steps are taken in consultation with the financial consultant and auditors of the company. *(vi) Rationalisation of Labour Cost.*

Post merger reorganisation needs rationalisation of labour cost as it forms the primary factor of prime cost of any product and service. The combined labour force available to the transferee company is to be reviewed in accordance with the requirements of the combined operational functions. With technological upgradation, reduction in labour costs through providing on the job training, motivation, and labour cut by way of voluntary retirement schemes or otherwise forms part of post merger function. This will help in better productivity and higher return on capital employed. The judgement of the Supreme Court of India announced on 30m August, 2002 on the petition of Steel Authority of India Limited (SAIL) has cleared a major hurdle to several Public Sector Undertakings (PSUs) which were not employing contract labour due to the fear of having to' absorb them in regular jobs. The five judges Bench has

relaxed contract labour laws for PSUs by quashing a 1976 notification and held that there will not be automatic absorption of contract labour.

(vii) Production and marketing management

With regard to the size of the company and its operational scale, its product mix should be adjusted during post-merger period. Management has to choose from various alternatives like adding or dropping out products. Decisions are taken on the basis of feasibility studies done by experts covering technoeconomic aspect, costbenefit analysis of production process, identification of market, customers and their preferences, fixing price of product with targeted mark-up, required rate of return and competitive strength. Decisions are generally taken on the recommendations covering economic analysis based on incremental reasoning, fine-perspective, opportunity cost, etc. Another aspect closely related to production is to improve productivity and cost-reduction without affecting product quality. This demands attention to the following aspects:

1. Efficiency of management
2. Degree of technological adaptation

(1) Technological improvements.

To tone up production, it is also necessary that available resources are properl; allocated for sagacious and planned programme for utilisation of scarce and limitet resources available to an enterprise so as to direct the production process to resul into optimal production and operational efficiency. Resource allocation can bt accomplished by a company using the following techniques:

(a) Production function analysis with one or two or more variables;

(b) Input output analysis;

(c) Linear programming when there are more than two variables.

(d) Examining the available options, substitutes and alternative processes.

Revamping of marketing strategy becomes essential, which is accomplished on the basis of market surveys, and recommendation of marketing experts. Marketing surveys may cover both established as well as new products. Pricing policy also deserves attention for gaining competitive strength in the different market segments. Reorganisation of marketing network and rationalisation of marketing strategy is

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equally important.

(viii) Corporate planning and control

Corporate planning to a large extent is governed by the corporate policy. The management's attitude and promoter's inclinations are amply reflected in the expressions directed towards achievement of corporate goals. Corporate policy prescribes guidelines that govern the decision making process and regulates the implementation of the decisions. Corporate planning is to be done in consonance with the corporate policy which might prescribe the broader frame within which activity is to be restricted, minimum returns to be obtained, optimal utilisation of financial, human and material resources is to be made, delegation and de-centralisation of authority is effected, corporate plan made and implemented, and plans and policies formulated prior to the merger or acquisition reviewed.

Other factors to be considered may, *inter alia,* include the existing and prospective market segments, the product and production activity and the nature of demand. All these factors indicate the future of the concern and the commitments to be fulfilled.

The company planning is associated with the management control so that deviations in the planned targets and achievements are recorded and their causes are traced out for remedial measures. In other words, control, as an activity of management, involves comparison of performance with predetermined standards, ascertaining causes for deviations and prescribing corrective action to reinforce the planned programme. In each area of corporate activities whether it is personnel management, material management, real estate management or financial management, planning is associated with control. Control techniques which are used by the corporate units would require changes from traditional to modern control techniques.

The traditional control techniques include (1) Budgeting control; (2) Standard costing; (3) Financial ratios; (4) Internal audit, whereas the modern control techniques are: (1) Performance budgeting; (2) Zero Base Budgeting; (3) Programme Planning & Budgeting System (PPBS); (4) Programme Evaluation and Review Technique (PERT) and (5) Critical Path Method (CPM). All these techniques are now computer based for which softwares are easily available.

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Review of the control techniques could be better done if responsibility centres are defined. In an organisation there may be four responsibility centres viz. Revenue centres, expense centres, profit centres and investment centres. In revenue centres, the output is measured in monetary terms. These centres relate to marketing activities and sales budget focuses main attention on control systems. In expenses centres, inputs are measured in monetary and quality terms. Profit centres which measure both input and output in terms of expenses and revenue respectively, are created when manufacturing and
marketing is done by the same organisation.

These decisions about management structure, key roles, reporting relationships, restructuring, etc. should be made, announced and implemented as soon as possible after the deal is signed. Creeping changes, uncertainty and anxiety that last for nonths are debilitating and start to drain value from an acquisition.

It would be relevant to mention some of the leading common mistakes, made by he corporates, leading to pitfalls in mergers and acquisition:

1. Ego problems on both sides - buyer and seller - rear up very frequently and resulting clashes make bad situations worse. Trying to have two chiefs is a formula for disaster.
2. Attempt to hasten the integration between both the parties raises the likelihood of making serious errors. Sudden and radical changes such as relocating the company's entire production operations should be carefully considered before implementation.
3. Many buyers assert their ownership by moving quickly to convert the acquired company. This does not always work in the right direction.
4. A cautious approach should be applied to competitor end runs. While the company is focused on integration, it furnishes an ideal time for competitors to make a run on the market.
5. Unless the acquired business is in the exact same field, different dynamics might apply.
6. One of the most common and damaging mistakes is to lay off crucial employees from the acquired company. This is a very complicated, delicate]

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matter and even the seller might not have an accurate idea as job titles can j be misleading.

Post Merger Success and Valuation

Every merger is not successful. The factors which are required to measure the success of any merger as can be seen from various studies are briefly discussed below.

1. The earning performance of the merged company can be measured by return on total assets and return on net worth. It has been found that the probability of success or failure in economic benefits was very high among concentric mergers. Simple vertical and horizontal mergers were found successful whereas the performance of concentric mergers was in between these two extremes i.e. failure and success.
2. Whether the merged company yields larger net profit than before, or a higher return on total funds employed or the merged company is able to sustain the increase in earnings.
3. The capitalisation of the merged company determines its success or failure. Similarly, dividend rate and payouts also determines its success or failure.
4. Whether merged company is creating a larger business organisation which survives and provides a basis for growth.
5. Comparison of the performance of the merged company with the performance of similar sized company in the same business in respect of (I)Sales, (ii) assets, (iii) net profit, (iv) earning per share and (v) market price of
share.

In valuing the whole enterprise, one must seek financial data of comparable companies in order to determine definitive ratios that can be used to give an indication of the company being analysed. The data is analyzed to estimate reasonable future earnings for the subject company.

The following information must be made available and analyzed for postmerger valuation: (i) All year-end balance sheets and income statements,
preferably audited,

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for a period of five years and the stub period to the valuation date, (ii) All accounting control information relating to the inventory, sales, cost, and profit contribution by product line or other segment; property cost and depreciation records; executives and managerial compensation; and corporate structure.

(iii) All records of patents, trademarks, contracts, or other agreements, (iv) A history of the company, including all subsidiaries.

Analysis of these items provides data upon which forecasts of earnings, cash flow, etc. can be made.

In general, growth in profit, dividend payouts, company's history, increase in size providing base for future growth and the amount of relative benefits accruing to the interested or associated companies are the factors which help in determining the success or failure of a merged company. Gains to shareholders have so far been measured in terms of increase or decrease in share prices of the merged company. However, share prices are influenced by many factors other than the performance results of a company. Hence, this cannot be taken in isolation, as a single factor to measure the success or failure of a merged company.

6. In some mergers there is not only increase in the size of the merged or amalgamated company in regard to capital base and market segments but also increase in its sources and resources which enable it to utilize them to optimize its end earnings.

7. Fair market value is one of the valuation criteria for measuring the success of post merger company. Fair market value is understood as the value in the hands between a willing buyer and willing seller, each having reasonable knowledge of all pertinent facts and neither being under pressure or compulsion to buy or sell. Such valuation is generally made in pre merger cases.

8. In addition to the above factors, a more specific consideration is required to be given to factors like improved debtors realisation, reduction in non-performing assets, improvement due to economies of large scale production

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and application of superior management in sources and resources available relating to finance, labour and materials.

Conclusion

To sum up, every acquirer or amalgamating company has to pay consideration for the assets and liabilities proposed to be taken up at the real or actual value. In other words, it pays more than the market capitalisation. Such acquisition price always goes in favour of small investors with the intervention of small investors organisations and the market regulatory authority SEBI, as seen in several cases discussed above. Post merger results mostly depend upon the method and manner in which the acquired or amalgamated company is managed. This is clearly depicted in PSUs as every acquirer of a PSU has to face protest and opposition from employees and parties interested therein as happened in Balco's acquisition but efficient and skillful management of the acquired Balco by Sterlite group, made things smoother.. Similar protests were made by the employees and others in due diligence process of Nalco under taken by Grasim before bidding therefor. As such, success and failure of the acquired or amalgamated company depends largely upon post merger reorganisation technique. A successful integration 'melds' not only the various tehcnical aspects of the businesses but also the different cultures. The best way to do so is to get people working together quickly to solve business problems and accomplish results that could not have been achieved before.

There cannot be a set of rules for post-merger reorganisation to make it successful. The management should not only concentrate on profit but also focus on new ideas and techniques. In the words of Mr. Tom Peters, the enterprise should look beyond mergers and acquisitions as a way to grow. By merging and forming a huge enterprise, they scare off the rising entrepreneurial spirit. Raising market share and creating markets are two different things altogether.

The management guru has appreciated that in India there exists a great entrepreneurial spirit partly fostered by disorganisation. Indian's innate spirit probably helps entrepreneurs once may move to other countries. Silicon Valley is a perfect example in his words. General Electric had acquired 1700 companies in 20 years, of which | 99.9% were niche middle-sited companies and they were the best in their fields.

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Thus, the aspect of post-merger reorganisation is not exhaustive and the parameters of the same would have to be established by the management of the companies, depending upon the organisational requirements, corporate policies and plans and the objectives of the merger etc. sought to be met.

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Lecture - 29

MEASURING POST-MERGER EFFICIENCY

The criterion to judge a successful merger differs in different conditions. Different factors may be considered for making value judgements such as growth in profit, dividend, company's history, increase in size, base for growth etc. Several studies suggest different parameters to assess the success of mergers:

(i) Successful merger creates a larger industrial organization than before, survives and provides a basis for growth [Edith Perirose].

(ii) In Arthur Dewing's study, three criteria were considered viz. (a) merger should field a larger net profit than before (b) merger should provide a higher return on total funds (c) there should be a sustained increase in earnings.

(iii) Earnings on capitalization and dividend records determine the success of merger [Shaw L].

(iv) One criteria could be comparison of performance of (20) merging companies for five years prior to merger with their performance in five years after the merger [Killy EM].

During the studies in late 1960s, two types of efficiency improvements weri expected to result from mergers: (1) improvements due to economies of large scale production (2) application of superior management skills to a larger organisation Some other researches in the seventies and eighties, measure efficiency based off stock market measures, labour productivity or total factor productivity etc. These improvements pointed towards market dominance, but for gauging efficient resultant profitability was accepted as a benchmark. In order to ensure progress, a conscious and concerted effort to keep track of several key elements is require alongwith answers to the following questions:

1. What impact is the integration (merger/acquisition) having on key indicators! of business performance? Whether synergies which were hypothesized during the valuation are being realized? •

2. Are the activities and milestones developed with the integration process
target?

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3. What are the major issues emerging during the
integration, requiring
considerable attention?
4. What important facts'have emerged during the merger or acquisition that ca
be used to improve subsequent mergers or acquisition?

Measuring Key indicators

The main purpose of a merger or acquisition is to deliver the expected finand results namely earnings and cash flow. However, there are certain other measun that serve as key indicators and they also need to be measured. The indicators m; be grouped as:

(i) Financial outcomes.

(ii) Component measures of these outcomes namely revenues, costs, working capital and capital investments.

(iii) Organisational indicators such as customers, employees and operations.

All the areas being integrated and both the acquirer and target, or in a merger, both partners, should be brought within the ambit of continuous appraisal. Also, the appraisal should be based on benchmarks to ensure that merger or acquisition are yielding the financial and strategic objective so intended and are not resulting in value leakage. There are broadly four possible reasons for business growth, or expansion which is to be achieved by the merged company. These are (1) Operating economies, (2) Financial economies, (3) Growth and diversification, and (4)ii Managerial effectiveness. These are explained in detail below:

1. Operating Economies

Whenever two or more firms combine, certain economies are likely to be realised as a result of larger volume of operations resulting in economies of scale. These economies may arise due to better utilisation of production capacities, distribution network, engineering services, research and development facilities and so on. The operating economies (economies of scale) would be the maximum in the case of horizontal mergers where intensive utilisation of production capacities will result in benefits for the merged firm.

On the other hand, in the case of vertical mergers, the benefits would accrue from

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better co-ordination of facilities, both backward and forward, reduction in inventory levels and higher market power of the combined firms. Operating economies in the form of reduction or elimination of certain overhead expenses may also arise even in the case of conglomerate mergers. The net result of realising economies of scale would be a decrease in the cost of production. But if the scale of operations or size of the merged firm
becomes too large and unwieldy, then 'diseconomies' of scale would also arise and the unit cost of production would show a rising trend.

2. Financial Economies

Merger of two or more firms brings about the following financial advantages for the merged firm:

(a) Relief under the Income Tax Act

Under Section 72A of the Income Tax Act, 1961 carry forward and setting off of accumulated losses and unabsorbed depreciation of the amalgamating company is allowed against the future profits of the amalgamated company in order to encourage revival of sick units.

(b) Higher Debt Capacity

The merged firm would enjoy higher debt capacity because benefits of combination of two or more firms provide greater stability to the earnings level. This is an important consideration for the lenders since the possibility of default in repayment of loan and interest is reduced to a great extent. A higher debt capacity if utilised, would mean greater tax advantage for the merged firm leading to higher value of the firm.

(c) Reduction in Floatation Costs

Whenever the merged firm raises funds from the market through public issue of shares or debentures, it can reduce the floatation costs as compared to the similar amount being raised independently by the merging firms. Such reduction in the floatation costs represents a real benefit to the merged firm.

Apart from the above, earnings and cash flows are primary financial outcomes that need to be tracked since valuation are built on them. Particular attention should be given to the components of these measures, namely, revenue, costs, investments and net working capital. The extent to which these components show progress will determine

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whether value is being created or not.

3. Growth and Diversification

As stated earlier, merger/amalgamation of two or more firms has been used as a dominant business strategy to seek rapid growth and diversification. The merger improves the competitive position of the merged firm as it can command an increased market share. It also offers a special advantage because it enables the merged firm to leap several stages in the process of expansion. In a saturated market, simultaneous expansion and replacement through merger/takeover is more desirable than creating additional capacities through expansion. A merger proposal has a very high growth appeal, and its desirability should always be judged in the ultimate analysis in terms of its contribution to the market price of the shares of the merged firm.

The merged firm can also seek reduction in the risk levels through diversification of the business operations. The extent to which risk is reduced, however, depends on the correlation between the earning of the merging (combining) firms. A negative correlation between the combining firms always brings greater reduction in the risk whereas a positive correlation leads to less reduction in risk.

The business firm may pursue the objective of diversification with maximum advantage under the following circumstances:

(1) If a firm is saddled with problems which can lead to bankruptcy or jeopardise its very existence, then its merger with another firm can save it from such possible undesirable consequences. Indian industrial sector is faced with the problems of the creation of splintered capacities. As a result, many firms with minimum economic size, such as manufacturers of light commercial vehicles, mini steel plants, mini paper plants, mini dry cell battery plants, mini sponge iron plants, mini cement plants, etc. were created. Many of these units have either closed down or are incurring substantial losses. A few of them, though earning profits today, may fall sick in future due to the increasing competition. In such a situation mergers and takeovers can bring about consolidation of capacities, lead to the revival of sick units and also prevent the occurrence of sickness.

(2) If the shares of one of the combining firms are not traded at the stock

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exchange then creative diversification would be the only feasible route to reduce the level of risk for the investment in these firms.

4. Managerial Effectiveness

It has been pointed out by various studies that incompetency of management has been the most important reason for firms becoming sick. If a sick firm is merged with another well managed company, it will lead to better co-ordination of human resources of both the companies. Managerial effectiveness can also bring substantial gains to the merging firms if two well managed firms combine together to take advantage of valuable human resources.

According to a survey of US manufacturing firms the following motives were identified:

— A desire to utilize competition or to achieve monopoly profits;

— A desire to harness unutilized market power;

— A response to shrinking opportunities for growth and/or profit in one's own industry due to shrinking demand or excessive competition;

— A desire to diversify to reduce risk of business;

— A desire to achieve a large enough size to realise economies of scale of production and/or distribution;

- desire to overcome critical drawbacks in one's own company by acquiring the necessary complementary resources, patents or factors of production;

- A desire to achieve sufficient size to have efficient access to capital markets or inexpensive advertising;

- A desire to utilize more fully particular resources or personnel controlled by the firm, with particular applicability to managerial skill;

- A desire to displace an existing management;

— A desire to utilize tax advantages otherwise not available;

- A desire to reap the promotional or speculative gains contingent upon new security issues, or changed price earning ratios;

- A desire of managers to create an image of themselves as aggressive managers;

- A desire of managers to manage an ever-growing set of subordinates.

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Apart from the above, in the present complex business environment, two more factors have assumed importance viz. Customer reactions and employee reactions.

Customer Reactions

It is necessary to ensure that customers are not adversely affected during a merger or acquisition as losing either profitable customers or a percentage of their business may have a negative impact on earnings and cash flows, especially if the customer represents a large percentage of company's revenues and profits. Several indicators may be deployed such as customer satisfaction, retention, acquisition, market share etc. Keeping track of market value and sales volume, segment by segment is also useful. Often during mergers and acquisitions competitors attempt to disrupt the relationship between an acquirer and its customers. This implies that a company needs to do more than just maintain customer relationships. It has to make an extra effort to ensure that its business does not erode.

Employee Reactions

Employees are capable of having an impact on productivity and customer satisfaction, especially in service business. Employee assessments made at multiple times and with relevant measures may allow better changes to take place. It should be analysed whether employees understand the expected contribution to be made to new organization; the view of employees towards various aspects of organisation and leadership; commitment to the newly formed organization; performance and productivity expected etc.

MERGER AND ACQUISITION TRENDS

Identification of economic or financial motives is not very difficult. When they exist they are usually stated in the annual reports and merger schemes/documents of the companies during the period of merger. They are widely quoted in newspapers. However, there is no objective guideline to measure psychological or motivational factors of the mergers.

In India, what motivates the interested parties to consummate merger between two or more companies has been stated in annual reports, merger schemes and/or media. Motives for mergers in India have been different during icense Raj' and 'Free License Raj' i.e. up to 1991-92 and thereafter as per the Industrial Policy, laws! and

regulations during the last over five decades. It is widely accepted that mergers, I demergers, takeovers or combinations or disinvestments or acquisitions take place I as a vehicle for faster corporate growth. Motives of some companies as stated in the I merger documents or the media are stated hereunder for specific reference.

1. The move of J.K. Industries Ltd. (JK Tyre) for merging its subsidiary Vikrant I Tyres Ltd. with itself seems to be a fall out of Apollo Tyres Ltd. (ATL) decision I to acquire the tyre making facilities of Modi Rubber Ltd. (MRL) which would I add around Rs. 600-800 crores to the top line of ATL from Rs. 1700 crore I making it country's target tyre company ahead of MRF Ltd. Simultaneously, I the JK Tyre also hived off its Sugar and Pharmaceuticals divisions to I concentrate better on its core business of manufacturing and marketing tyres.

2. After the failure in taking over of Indian Aluminium Ltd. in 1998 Sterlite group I has acquired Bharat Aluminium Company Ltd. (Balco), the Chhattisgarh I based aluminium Company from the Government over howls of protests and today, it seems as if it has managed to turn an explosive situation into a win-win thing for the MP State government, shareholders and perhaps, employees, as well. The group has also acquired Hindustan Zinc Ltd. and its ownership has been privatised smoothly. Now, the Sterlite group is interested in National Aluminium Company Ltd. (NALCO), Shipping Corporation of India and Hindustan Copper Ltd.

3. The merger of Reliance Petroleum Ltd. (RPL) with Reliance Industries Ltd. (RIL) from 19.9.2002 has created India's first private sector Fortune 500 company. The merger is effective from 1st April, 2001. The Board of Directors of the merged RIL at its meeting held on 30.9.2002, while approving annual audited accounts for the year ended 31s' March 2002, recommended dividend of 47.5% on the increased capital of Rs. 1396 crores i.e. Rs. 4.75 per share which amounts to a lower dividend in comparison with the dividend paid for the year 2000-2001 to the RPL's shareholders marginally by Rs. 0.75 per share, as the swap ratio of 1 share of RIL for 11 shares of RPL. The objective of this merger as disclosed by the company is of attaining allround leadership in industry peer group in terms of assets, revenue, production volume, market share and maximisation of total shareholder returns. This merger has created RIL, the largest private sector company by turnover of Rs. 57,127 crores and net profit of Rs.

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3,243 crore for the year 2001-02.

4. For the last over five decades Hindustan Lever Ltd. (HLL) operating in India has become a role model not just for FMCG companies but the entire Indian Corporate Sector. Through disinvestment it has acquired Modern Food Industries (India) Ltd. for Rs. 149.4 crores. In mid 80's, Lipton and Brooke Bond were merged with HLL. TOMCO and Lakme were acquired from Tata group. The merger of International Best Food Ltd. and Aviance Ltd. in 2001 with HLL was with the object of achieving greater synergy, elimination *inter se* business overlapping, preventing industrial sickness, and economies in costs—benefits of combined financial, managerial, technical, distribution and marketing expertise. However, it is unfortunate to note from the point of view of the minority shareholders, that the share prices of Brooke Bond, Lipton, Ponds, Tomco and HLL valued separately as five different companies would probably be higher than the current share price of HLL.

5. Having identified the pharmaceutical sector Mr. Ajay G. Piramal had dispensed with the textile business and acquired Nicholas Laboratories Ltd. in 1988. Consequently, Nicholas Piramal India Ltd. (NPIL) was incorporated on 30th November, 1988. In 1995 it acquired Bulk Drug division of Sumitra Pharmaceuticals & Chemicals Ltd. The objective was optimum utilisation of the manufacturing facilities, enhancing profitability and becoming a leading health care company in India. In 1997, Boehringer Mannhein India Ltd. and Piramal Healthcare Ltd. were merged with it for achieving synergistic linkage, profitability and growth in business. In 2001, Rhone-Poulene (India) Ltd., NPIL Fininvest Ltd., Super Pharma Ltd. were merged with it with the same objective of optimum utilisation of the manufacturing, technological and marketing expertise, distribution networks, manpower and other resources.
In 1988, NPIL was then ranked 48 in the industry. Within 14 years it has been ranked as 4th in the Industry. The acquisition led strategy coupled with joint ventures and alliances has registered manifold growth of the company. Its share price has also improved from around Rs. 100A in 1995 to Rs. 250/- in 2002, even though the year was passing through a bearish phase.

6. In 1989, Usha Alloys & Steels Ltd. (UASL) was merged with Usha Martin

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Industries Ltd. (UMIL) with the objective of stable profitability, preventing sickness, achieving economies of scale, reduction of overhead reforms and efficient utilisation of the resources etc. Post merger results were however, not encouraging.

7. In 1989, Tata Fertilisers Ltd. (TFL) was merged with Tata Chemicals Ltd. (TCL) with the objective of unhindered flow of financial, technological and managerial resources for completion of the TFL's project utilisation, of the proven expertise and greatly enhanced financial, technical and managerial potential of TCL. Post merger results proved satisfactory. In 1990-91 and 1995-96 bonus issues were made in the ratio of 1 for 2 and 3 for 5 respectively. The company has been paying dividend continuously on the increased capital at higher rate.

8. With U.K. Corp Limited (formerly Straw Products Ltd.) many companies - M.P. Industries Ltd. (Drycell Battery Project), Dena Bank Ltd. (excluding banking business), Orissa Synthetics Ltd. were merged and it has now hived off its principal Paper undertaking to Central Pulp Mills Ltd. a group company for restructuring of its debts due to Institutions and banks. Its Drycell Plant was closed and Synthetics plant was disposed off to Reliance Industries Ltd. Post merger results however have not been encouraging.

9. In mid 70's Ankur Chemicals Ltd. was merged with J.K. Business Machines Ltd. (now Hifazat Chemicals Ltd.). The merged company has been notified as a sick undertaking and its plant was taken over by Gujarat Industrial Investment Corporation which has also been appointed as the Operating Agency (OA) by the Board for Industrial and Financial Reconstruction (BIFR). Post merger results are unfavourable to the merged company and its stake holders.

10. In 2001, Ciba CKD Biochem Ltd. (CCBL) merged with its promoter company Novartis India Ltd. (NIL) with the objective of business broad base, economies of scale, strategic importance of anti-TB business and preventing sickness.

Thus, core competence seems to be the operative word. Many players who have undertaken M&A blitz are facing serious liquidity and resource crunch, and all grand

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plans have been shelved, in the desperate struggle for survival. Corporate mergers are like bush fires. Their flames travel at lightning speed and they can be very destructive according to the view of Professor Hans Schenk, once described by the Economist as the "internationally most reputable Dutch economist".

In the beginning of the 21s' Century, the disinvestment process of the Public Sector Undertakings (PSUs) has been through a roller coaster ride. However, the disinvestment of two major Companies - Hindustan Petroleum (HPC) and Bharat Petroleum (BPC) had been put off for a short period for the time being. The table gives the details of disinvestments deals which have been completed so far.

Merger of Mahanagar Telephone Nigam Ltd. (MTNL) with Bharat Sanchar Nigam Ltd. (BSNL) was under reconsideration and hence delayed. The Government owns 100% in BSNL and 56.25% in MTNL

The delay in disinvestment process of two major oil PSUs - HPC and BPC and reconsideration on merger of MTNL with BSNL had adversely affected the share prices of these companies and ultimately stock market index.

The disinvestment has clearly slowed down the Merger & Acquisition (M&A) activities in the first half of 2002-2003. The disinvestment alone amounts to Rs. 3,190.5 crore of the total Rs. 16,078 crore worth of M&As logged during the period. According to the data sourced from the Centre for Monitoring Indian Economy (CMIE) a total 640 M&As aggregating Rs. 16,078 crores were announced during April-September 2002 compared to 629 M&As worth Rs. 13,817 crores during the same period in 2001-2002. Most of these deals took place in the chemicals, finance, communication and IT sector including the business process outsourcing (BPO) sector. The M&As volume is higher by 16% due to disinvestment exercise. The privatisation initiated by the Central Government along with the associated open offer for the privatised companies, accounted for higher volume by Rs. 2,261 crores.

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Lecture – 30

Financial restructuring

FINANCIAL RESTRUCTURING

INTRODUCTION

Companies have access to a range of sources from which they finance business. These funds are called 'capital'. The sources of capital can be divided into two categories; internally generated funds and funds provided by third parties. Whichever form of capital is used, it will fall into one of the two categories - debt or equity.

Determination of the proportion of own funds and borrowed funds

Internally generated funds are an important component of a company's capital structure but it would be unusual for a company to grow at a fast pace only through internal generation of funds. The deficit between the funds which a company requires to fund its growth and the funds which are generated internally, is funded by provision of capital from third parties.

Cost of various types of capital

Equity capital is the permanent capital of the company, which does not require any servicing in the form of interest. The ideal capital structure wouJd be to raise money through the issue of equity capital. Debt is essentially an obligation, the terms of which *are, inter alia,* the repayment of the principal sum within a specific time together with periodic interest payments. Perhaps the easiest form of capital for a company to raise is, a loan from a bank. This form of loan capital may be comparatively expensive than equity.

However, as regards servicing of capital there are advantages of issuing debt instruments. Dividend is not a deductible expense when calculating a company's taxable profit; it is on the contrary an appropriation of profits. On the other hand, interest paid by a company on debt finance is an allowable expense when calculating a company's tax, thereby reducing its taxable profit.

Capital gearing

Capital gearing is the relationship of total debt i.e., bank borrowings, debentures, etc. to total equity capital. Equity capital is not debt for the purpose of calculating a company's gearing and does not increase gearing. This has a positive advantage to those who review corporate performance treating gearing as a key indicator. The effort to create securities,

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which achieve the issuer's objective of raising long term capital and reducing gearing i.e. to reduce corporate debt, whilst addressing investor concerns about risk, results in resort to different instruments such as convertible preference shares and bonds.

Broadly speaking, the financial structure of a company comprises of its-

(i) paid up equity and preference share capital;

(ii) various reserves;

(iii) all its borrowings in the form of -

(a) long-term loans from financial institutions;

(b) working capital from banks including loans through commercial papers;debentures;

(c) bonds;

(e) credits from suppliers;

(f) trade deposits;

(g) public deposits;

(h) deposits/loans from directors, their relatives and business associates;

(i) deposits from shareholders;

(j) GDRs and ADRs;

(k) funds raised through any other loan instrument.

A company may require any one or more of the above keeping in view its financial requirements at a particular point of time. A dynamic Board should constantly review the financial structure of the company and effect financial restructuring and reorganisation whenever the need arises.

Need for financial restructuring

A company should always try to seek a balance between its debt and equity in its capital structure and the funding of the resulting deficit. The targets a company sets in striking this balance are influenced by business conditions, which seldom remain constant. When, during the life time of a company, any of the following situations arise, the Board of Directors of a company is compefled to think and decide on the company's restructuring:

(i) necessity for injecting more working capital to meet the market demand for the company's products or services; when the company is unable to meet its current commitments;

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when the company is unable to obtain further credit from suppliers of raw materials, consumable stores, bought-out components etc. and from other parties like those doing job work for the company.

(iv) when the company is unable to utilise its full production capacity for lack of liquid funds. Financial restructuring of a company involves a rearrangement of its financial structure to make the company's finances more balanced.

Restructuring of under-capitalized Company

An under-capitalized company may consider restructuring its capital by taking one or more of the following corrective steps:

(i) injecting more capital whenever required either by resorting to rights issue or additional public issue.

(ii) resorting to additional borrowings from financial institutions, banks, other companies etc.

(iii) issuing debentures, bonds, etc. or

(iv) inviting and accepting fixed deposits from directors, their relatives, business associates and public.

Restructuring of over-capitalized company

If a company is over-capitalized, its capital also requires restructuring by taking following corrective measures:

(i) Buy-back of own shares.

(ii) Paying back surplus share capital to shareholders,

(iii)Repaying loans to financial institutions, banks, etc.

(iv)Repaying fixed deposits to public etc.

(v) Redeeming its debentures, bonds, etc.

BUY-BACK OF SHARES

Not only statute, but also common law, has upheld the 'sanctity' of a company's capital. In 1887, in *Trevor V. Whitworth* (1887) 12 App Cas 409, it was held that a company limited by shares may not purchase its own shares as this would amount to an unauthorized reduction of capital. The rationale for this decision is plain, namely that the creditors of the company make decisions on its credit-worthiness on several grounds, but an important ground is the amount of its share capital. If the courts had not

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established at an early stage that capital was 'sacrosanct1 and could not be returned to shareholders at their whim, then share capital would not have been protected. Without this protection, creditors could find shareholders depleting share capital, with creditors left to carry all the business risks.

In India, the rule in *Trevor* v. *Whitworth* was enshrined in Section 77 of the Companies Act, 1956 which prohibited a company from buying or cancelling its own shares, unless it complied with the provisions and followed the procedure for reduction of share capital under sections 100 to 104 of the Companies Act, 1956 which involved confirmation by the Court.

However, Section 77A of the Companies Act, 1956 which was inserted in the Companies Act by the Companies (Amendment)Act, 1999 with retrospective effect from 31.10.1998 is an exception to the prohibition under Section 77 and Section 100. Section 77A allows companies to buy-back their own shares as well as other specified securities.

CONCEPT OF BUY-BACK

Buy-back of equity shares is one of the prominent modes of capital restructuring. It is a financial strategy that allows a company to buy back its equity shares and other specified securities, including the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

In the fast changing national and international economic scenario, the corporate sector needs freedom in restructuring its debt-equity mix, particularly in times of favourable business environment. Prior to the insertion of Section 77A in the Companies Act, 1956, this type of capital restructuring was achieved through capital reduction process under Section 100 of the Companies Act, 1956, involving the cumbersome procedure of passing a special resolution, subject to confirmation by the Court.

Section 77A has opened up a new method of capital restructuring by companies as and when required. Buy-back being a financial strategy, should not be used for improving controlling interest of the promoters group.

However, improvement controlling interest may occur as a natural consequence of the buy-back strategy. Good corporate management should always aim at creation and

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enhancement of share holders' value. Buy-back offers a straight forward route for reducing equity. When equity is costlier than debt, buy-back helps in reducing the overall capital cost.

When a company has an unsuitable debt-equity ratio and it needs to alter its 'skewed' equity, it has to build free reserves or inject more borrowed funds. In a growth situation, procuring borrowed funds may be possible but otherwise changing the financial structure is quite difficult. Buy-back option may help in rectifying the skewed equity share capital in the existing capital structure of a low 'leveraged' company with stable return.

NECESSITY FOR BUY-BACK

Good corporate governance requires proper utilisation of shareholders' money.

When a company has surplus funds, which it can not, in the given circumstances and in the given state of money market, deploy in a growth process from which it would be able to maintain an average return on capital employed and earning per share, the company's finances need to be restructured by balancing the same.

The Board of Directors of the company has to make a thorough study into the financial structure of the company, the precise reasons for its restructuring and the mode of restructuring which would be suitable to the requirements of the company in the given circumstances.

One of the methods of financial restructuring open to a company is buy-back of its own securities. Buy-back results in the return of the shareholders' money and a reduction of the floating stock of the company's- securities in the market while at the same time creating value for the remaining equity.

In a reconstruction, the reasons for embarking upon a buy-back are varied and could include:

- facilitating reduction of share capital without recourse to the lengthy and time-consuming process of passing a special resolution subject to confirmation by the Court as required under Section 100 of the Companies Act, 1956;
- creation of liquidity in a company's share capital and providing an exit route, where shares are unlisted, or to encourage investment in an unlisted company by agreeing to purchase shares subscribed for at a later date;

- reducing floating stock of the company's securities in the market and improving the net asset value per share attributable to the remaining equity;
- proper and judicious deployment of the company's finances by investing the same in the purchase of its own securities;
- maintaining shareholders' value in a situation of poor state of secondary market by a return of surplus cash to the shareholders; and
- countering hostile take-over.

PROCEDURE AND PRACTICE FOR BUY-BACK OF SECURITIES

Under Section 77A of the Companies Act, 1956 any company limited by shares or a company limited by guarantee and having a share capital can buy-back its own securities, whether it is a private, public, listed or unlisted company.

BUY-BACK PROCEDURE FOR LISTED SECURITIES

The procedure to be followed for buy-back of securities by listed companies is contained in Sections 77A, 77AA and 77B of the Companies Act, 1956 and (referred to as 'the Regulations' hereinafter) the Securities and Exchange Board of India (Buy-back of Securities) Regulations, 1998, which, is detailed below:

[For text of the Securities and Exchange Board of India (Buy-back of Securities) Regulations, 1998, please see Annexure 1].

Funding buy-back

According to Section 77A(1) of the Companies Act, 1956 a company may purchase its own shares or other specified securities (hereinafter referred to as "buyback") out of:

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of any shares or other specified securities.

However, no buy-back of any kind of shares or other specified securities can be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

Thus, the company must have at the time of buy-back, sufficient balance in any one or more of these accounts to accommodate the, total value of the buy-back.

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Conditions for buy-back

As per Section 77A(2), a buy-back must be authorised by the articles of association of the company. It is, therefore, necessary for a company proposing to resort to a buy-back to make sure that such an authority exists in its articles. If the articles do not contain such a provision, the company must follow the procedure laid down in Section 31 of the Companies Act for altering its articles to incorporate such a provision by passing a special resolution and filing a certified true copy of the same along with Form No. 23, with the concerned Registrar of Companies, for registration as required by Section 192 of the Act.

[For specimen of special resolution for alteration of Articles of Association of the company for including an Article authorising buy-back of securities, please see Annexure 2].

In terms of Sub-section (2)(b) of Section 77A, a buy-back must be approved by a special resolution passed in general meeting of the company. However, a special resolution at a general meeting is not necessary where buy-back is or less than ten per cent of the total paid-up equity capital and free reserves of the company and such buy-back has been authorised by the Board of Directors of the company by means of a resolution passed at its meeting.

In such a case, no offer of buy-back can be made within a period of 365 days, reckoned from the date of the preceding offer of buy-back, if any. [proviso to Section 77A(2)(b)].

[For specimen of special resolution for approving buy-back of company's own securities, please see Annexure 3].

Sub-regulation (1) of Regulation 5 of the Regulations, lays down that for the purposes of passing a special resolution under Sub-section (2) of Section *77A* of the Companies Act, the explanatory statement to be annexed to the notice for the general meeting pursuant to Section 173 of the Companies Act shall contain disclosures as specified in Schedule I to the Regulations. Sub-regulation (2) provides that a copy of the resolution passed at the general meeting under Sub-section (2) of Section 77A of the Companies Act, shall be filed with SEBI and the stock exchanges where the shares of the

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company are listed, within seven days from the date of passing of the
resolution. Regulation 5A of the Regulations, provides the following
conditions subject to which a company may buy back its securities when
authorised by a Board resolution pursuant to proviso to Section 77(A)(2) of
Companies Act:

(a) before making a public announcement under Regulation 8(1), a public
notice
shall be given in atleast one English national daily, one Hindi
national daily and a regional language daily all with wide circulation
at the place where the registered office of the company is situated.

(b) the public notice shall be given within 2 days of the passing of the
resolution by the Board of Directors.

(c) the public notice shall contain the disclosures as specified in Schedule
I.

Also, a copy of the resolution, passed by the Board of Directors at its
meeting, authorising buy back of its securities, shall be filed with the
Board and the stock exchanges where the securities of the company are
listed, within two days of the date of passing a special resolution.

Limits upto which securities can be bought back

A buy-back must be equal to or less than twenty-five per cent of the total
paid-up capital and free reserves of the company. However, the buy-back of
equity shares in any financial year should not exceed twenty-five per cent of
its total paid-up equity capital in that financial year [Section 77A(2)(c)].

Maintenance of post buy-back debt-equity ratio

The ratio of the debt owed by the company must not be more than twice the
capital and free reserves after such buy-hack. However, the Central Government may
prescribe a higher ratio of the debt than that specified under this clause for a class or
classes of companies. "Debt" includes all amounts of unsecured and secured debts
[Section 77A(2)(d)].

All the shares or other specified securities for buy-back must be fully
paid-up [Section 77A(2)(e)].

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The buy-back of shares or other specified securities listed on any recognised stock exchange must be in accordance with the SEBI regulations in this behalf [Section 77A(2)(f)].

The buy-back in respect of shares or other specified securities which are not listed on any recognised stock exchange must be in accordance with the guidelines as may be prescribed [Section 77A(2)(g)].

Methods of buy-back

According to Sub-section (5) of Section 77A, a buy-back may be made:

(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 recognised stock exchange, is smaller than such market 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.

According to Regulation 4 of the Regulations, a company may buy back its own securities by any one of the following methods:

(a) from the existing security-holders on a proportionate basis through the tender offer;

(b) from the open market through:

(i) book-building process,

(ii) stock exchange

(c) from odd-lot holders.

Buy-back from existing Security-holders

According to Regulation 6 of the Regulations, a company may buy back its securities from its existing security-holders on a proportionate basis in accordance with the provisions of the Regulations.

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CASE STUDIES

The purpose of this study lesson is to focus on the case studies so as to illustrate and analyse the historical factors, situations leading to mergers, takeovers or amalgamations, strategies involved and assess the restructuring benefits to the companies involved; including the reverse merger processes, so as to enable the students to understand, the practical aspects of corporate restructuring. Names and ancillary information in some case studies have been changed.

Case Study 1: HLL - TOMCO MERGER

(30th June 1993 - Rationale for Arrangement)

Industry Scenario (1989 - 1992)

The soap and detergents industry in India today has matured into an amalgam of market niches
with fast changing consumer loyalties. It has always been a high volume low margin business
requiring massive advertising expenditure. The per capita consumption of soaps and detergents in
India at that time (1989-1992) was 0.3 kgs per annum for soaps and 1.6 kgs for detergents.
Compared to the other developing countries, the consumption figures were extremely low, as
the comparative figures were 0.6 to 1 kgs for soaps and 4.5 kgs for detergents. However, with increase
in population, spread of education and rising levels of income and consumption, the soaps and
detergents industry was poised for a major breakthrough. The overall growth rate of the industry
in the country was expected to be about 15 percent per annum. The Working Group on the 7th Plan
had estimated that the demand for fabric wash products will grow from about 2.2 million tonnes in

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1990 to 4.3 million tonnes in 2000. The consumption of toilet soap was increasing at 6.7% per
annum and more particularly the consumption in the rural areas was likely to grow at more than
12%. However, the growth of this industry had been hampered by factors like scarcity of raw
materials and lopsided tax structure. The major raw material for detergents, linear alkyl benzene, had
to be imported on a large scale due to inadequate availability within the country.
In the early 80s the small scale sector entered the detergents segment of the industry, although it
remained to be dominated by the large scale soap manufacturing giants. The leaders in the detergents
segment of the market were Nirma and HLL. The total turnover of the detergent bars in 1992 was Rs.
1,016 crores of which Nirma had 24.2%, HLL had 44.6% and others had 31.2%. In the detergents
powder market the total turnover was Rs.1,117 crores of which Nirma had 39.5%, HLL had 37.3%,
P&G had 3.2% and others 20%. The detergent segment of the industry was bustling with brands at
the lower end of the market, but the top end was dominated by Ariel and Surf Ultra. Currently this
premium segment which was created by P&G was worth Rs.120 crores, and it was estimated
that the growth in this segment will surpass the average annual growth of 10 percent projected for
the entire industry. This segment of the market was considered to be very lucrative and other
multinationals were planning to enter this segment - Colgate with its international brands, Spic with

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a German collaboration and Tata Chemicals with an ethnic brand were likely to compete
with the
Ariel and Surf. A new segment had emerged within
the detergents market, viz. washing machine powders which market sources
predicted would constitute 25% of the total detergent? market in the next decade. The
then estimated demand for fabric wash products, comprising of the synthetic
detergents and washing soaps is given below:

Year Total FWP Synthetic Detergents Washing
Soaps
(Lakh Tonnes)

8

1

21

7

The toilet soap segment of the industry was valued at Rs. 1,800 crores in 1992,
and HLL was leading with a 70.2% share, Godrej had 10.1%, Nirma had 4.6% and
others, 15.1%. The toilet soap market was divided into a popular segment which
comprised 87 percent and a premium segment of 13 percent, based on price and
quality. The demand for toilet soaps was expected to touch 9.14 lakh tonnes in 2000
AD.

HINDUSTAN LEVER LIMITED — The Company

Hindustan Lever, (HLL) the largest player in the highly competitive and fast
growing soap and detergents market, was poised to transform itself into an almost
invincible colossus, with the acquisition of one-time arch rival, TOMCO. The
TOMCO acquisition, was a strategic move for Lever, as it came close on the heels of
the much publicised strategic alliance between Lever's global adversary, Proctor &
Gamble with Godrej. The merger and strategic alliance, was scheduled to have a
significant impact on the structure and performance of the soap and detergents
industry in India.

Hindustan Lever's operations were focused on the personal wash and fabric
wash segments of the soap and detergents market, although it was also engaged in

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the manufacture of speciality and bulk chemicals.

Although the company had acquired market leadership with a 59 percent market share in 1992, the decade of the 80s had been one of enormous transition and change. During this decade, HLL transformed from a beleagured giant to a slimmer organisation with brimming bottom lines. In the mid-80s, when inflation and rising raw material costs were eroding the profitability of practically all the players in the industry, the company responded with a quality improvement drive. Quality, in HLL was seen as equivalent to savings in cost and enhancement of productivity. Low cost production options were explored and the excess production capacities of sick units were acquired on lease. The management of the entire supply chain was toned up by working closely with the suppliers in an attempt to bring down inventories. On the production front, HLL expanded its production base from three major factories and a chemical complex in 1980, to about 20 manufacturing locations in 1992 (including an export processing zone). Accordingly, the company was no longer dependent on a single location as compared to 1985 when 60% of its production came from the Bombay factory. The non-availability of raw materials coupled with rising prices made it imperative for the company to have control over key inputs and accordingly it commenced the manufacture of sodium tri-polyphosphate in 1983.

On the marketing front, during the 80s, the company launched several new products, extended
brands and upgraded existing products. HLL launched and made a success of eight to ten brands
in the detergents segments — Wheel, Surfmatic, Rin and Surf Ultra, and in the toilet soaps
segment, Liril cologne and LeSancy were launched. The company's major brands like Lifebuoy, Lux
and Rexona were relaunched in modified versions. In 1992, HLL consolidated its value leadership in
the fabric wash market with the relaunching of improved quality concentrated detergent powder, Surf

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Uitra and Triple Power Rin, which are now strengthening their - market position. The net result of the
above measures adopted by the company in the early 80s, gave it a competitive edge in terms of lower
costs for its products, enabling it to grow ahead of the market and maintain market leadership by
offering competitive prices. HLL's success, in terms of volume growth, could be attributed to
aggressive entry into low-priced products, a proper branding and cost strategy coupled with
maintaining a presence in the entire range of the price continuum both in the toilet soaps and
detergents markets. Further, in terms of financial performance, the year 1992-93 had been rather
impressive^ with the sales value edging towards Rs.600 crores, due to improved price realisations and
larger volume in soaps and detergents group. Its innovative cost control measures, aggressive
marketing, and increased production volumes in diversified locations had been largely responsible
for its remarkable improvement in financial performance.

Organization Culture

HLL had been known for its result oriented, systems driven work environment, where a strong
emphasis is placed on performance. Accordingly, it always has/had and strives for a team of high
performing and high profile executives, carefully selected from the best management institutes.

Discussing product profitability and target achievement is the only language that its managers

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understand. The work culture is very demanding and only the best survive. In fact, about 100
managers at that time from Unilever group companies had quit their jobs, as they were unable to
cope with the demanding work culture.
HLL's size had earlier proved to be its weakness, and accordingly, changes in the
organisation structure were necessary to enable it to respond to a rapidly changing market place.
One of the recommendations of the management committees had been the reduction in the levels of
HLL's managerial hierarchy from 9 to 5. In two years time the levels were reduced to 7 and a new
infotech system was introduced which would facilitate exchange of information and help to
increase the speed of response. In order to stem the tide of the managerial exodus, HLL hiked the
entry level remuneration for management trainees by nearly 40%, still the remuneration was lower
than that of the competitors.
On the industrial relations front, 1988 was an eye opener as the HLL management
declared a lock-out at Sewri, its largest production unit, and the factory was opened a year later,
only when the workers signed on the dotted line giving an assurance for an increase in productivity
in return for salary increases. Inspite of closure for one year, the challenges of market-place Table
1 gives detailed financial information and equity share data for four years from 1989-
1992 for HLL.
TABLE 1

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HINDUSTAN LEVER

LIMITED Balance Sheet

Rs. in crore

For the year

d d 31 t 1. Sources of Funds

Shareholders'

(a) Equity

Share

Capital

(b)

R(a)

Secur

ed

Loans

(b)

Unse

Fixed Assets

(

a

)

Investments

Current

A t (b)

Inventories

(c) Sundry

Debtors

(d) Cash and

Bank

l ( ) *Less:* Current Liabilities and Provisions

(a)

Curr

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ent

Liabi

lities

(b)

HINDUSTAN

LEVER

LIMITED Profit

and Loss Account

For the year ended

31st December

Income

Sales

Other Income

Expenditure

Raw Material Cost

Staff Expenditure

Other Expenses

Depreciation

Interest

1 Profit Before Tax

Taxation

Profit After Tax

Dividend Rate %

Earnings per Share

(EPS) Return on Capital

E l d Market Price -

High

Low

Average

Growth Plans

The growth plans for the company began in the mid 80s with

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the initiation of the liberalization process. After a series of brainstorming sessions and analysis of macro economic trends like inflation, balance of payments position, and growth rates, Mr. S.M. Dutta, the Managing Director, and his team of 11 executives decided to zero in on the fastest growing business, soaps and detergents, which was also an area of existing strengths and competences. The growth plans were designed to achieve production of one million tonnes by 1994, more than double the turnover for the soaps and detergents group from Rs. 400 crores to Rs. 850 crores in 1996, and double profit from Rs. 28 crores to Rs. 55 crores.

In keeping with the trends in the international personal wash market, where there had been a dramatic shift away from soaps and bars to liquids, the company decided to launch products ranging from liquid soaps to shower gels aimed at the upper middle class. In 1991, the dismantling of MRTP and FERA*, prompted the company to review its growth plans and evaluate the feasibility of achieving the growth target through acquisitions rather than expansion. Accordingly in 1992, it identified TOMCO as a prime acquisition candidate in the soaps and detergents industry which was going through a difficult period with escalating raw material costs and rising advertisement expenditures eroding profits. The declining financial performance of TOMCO prompted HLL to consider the merger route as an easier and less expensive method for growth. According to Mr. S.M. Dutta, 'acquisition can provide quicker access to manufacturing capacities, are less expensive than organic growth and also provide fairly strong brands'. This strategy of growth through acquisitions was not new to HLL as evidenced by the acquisition of Union Home Products, Sunrise Chemicals and Shivalik Cellulose. It was also not restricted to the soaps and detergents business as HLL was negotiating for the takeover of two superphosphate fertiliser plants

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which had fallen sick.

TOMCO - The Company

TOMCO, a one time major jewel in the Tata crown, was on the brink of becoming a BIFR case. The 74 year old manufacturer of oil based soaps and synthetic detergents had a token presence in edible oils, vanaspati and animal feeds. Over the years it had never emerged as a market leader and always trailed behind HLL, despite certain intrinsic strengths and a strong, infrastructure. The company had 7 lakh urban and rural outlets and 2,500 stock lists spread all over the country. It had a market presence in almost every segment of the soaps and detergents market. In the premium segment of toilet soaps, it had Moti, which was competing with Liril of HLL and Cinthol of Godrej. In the popular segment, it had Hamam and Jai, which were pitted against Lux and Rexona of HLL. In the economy segment, its OK bar soap had proved to be no competition for the formidable Lifebuoy of HLL. In laundry soaps TOMCO was the largest producer with its 501 bar, which was in direct competition with Sunlight of HLL and Ghavi of Godrej. In the detergents bar market TOMCO's Dubble trailed behind HLL's Rin and in the lower end of this segment, TOMCO had positioned Super 501, in competition with Wheel of HLL and Nirma. In the detergents powder segment, TOMCO's Tej had proved to be no competition for HLL's Surf, In the low priced segment of the detergent powders market TOMCO's OK detergent powder was far behind Nirma and Wheel of HLL. It was only in the detergent powders for washing machines, that TOMCO had a leading presence with its Revel and Revel plus. TOMCO had indigenously developed a detergent concentrate, to compete with Procter and Gamble's Ariel and HLL's Surf Ultra. TOMCO had also launched a shampoo Raindrop, and a tooth paste - Effermint.

TOMCO's financial performance over the period March 1986 to March 1990 had been impressive, with an increase in turnover from Rs. 237 crores to Rs. 335 crores, an increase of 41%. The spectacular

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performance in 1990 could be attributed to a growth in rural markets as well as a Rs. 28 crores export order for detergents to USSR. A tighter control on input costs had also contributed towards better financial performance. However, after 1990, the profit margins were eroded due to increase in prices of soap making oils and fats. In fact in 1991 alone, the prices of oil rose by Rs. 3500 per tonne, accounting for 63 per cent of the raw material cost. With the break up of USSR the company's exports suffered *a* serious setback, and forex

* FERA has been repealed and FEMA has come into existence with effect from 1.6.2000.

Earnings dropped from Rs. 29 crores in 1989-90 to Rs. 8 crores in 1990-91. Although the company achieved a turnover of Rs. 387.22 crores for 1990-91, a rise of 14% over the previous year, its pretax profit dipped by 11% to Rs. 6.55 crores. The high cost of raw materials and an increasing wage bill, coupled with stiff competition further eroded profit margins, in 1992. Currently the company was losing heavily and facing a severe cash crunch resulting in further deterioration of profits. Table 2 gives financial information and shareholding pattern for TOMCO.

TATA OIL MILLS

COMPANY LIMITED

Profit and Loss Account

Rs. in crore

For the year ended

31 D b Income

Sales

Other Income

Expenditure

Material Cost

Staff Expenses

Other Expenses

Depreciation

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Interest

Profit Before Tax

Taxation

Profit After Tax

Dividend Rate %

Earnings per Share

Return on Capital

Market Price —

High

Low

Average

Shareholding Pattern

as on 26 8 93 Directors

Public

Corporate Bodies

Financial

Foreign Holding

100.00

Growth Plans

In July 1987, TOMCO's Chairman, Dr. H.N. Sethna brought in Mr. N.S. Sundarajan as his Managing Director to reverse the company's fortunes. After a careful analysis the management team decided to consolidate in the area of soaps and detergents while diversifying into related and unrelated areas. The increasing prices of soap making oils prompted the management to reduce its dependence on soaps. Also, it decided to enhance the production capacity of detergents, as it did not require the high cost soap - making oils and fats.

In order to achieve its growth plans and consolidate existing brands, the company embarked on an ambitious modernisation-cum-diversification plan. It put up additional facilities of *toilet* soaps and detergents in Sewree, Ghaziabad, Madras and established new facilities at Ghaziabad in the North and Ernakulam in the South. It also implemented a Rs. 62 crore project, Tata Vashisti Detergents Ltd., at Chiplun in -

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Maharashtra, to manufacture soaps and detergents. In order to extend its market coverage, it entered into a joint venture agreement with the West Bengal Industrial Development Corporation and took over Gloria Chemicals. As a part of its backward integration plans it set up fatty acid plants at its major factories which were planned to result in cost savings of Rs. 3000 per tonne of fatty acid. Other plans on the anvil included manufacture of titanium-dioxide, sports shoes and pesticides, and setting up of an export oriented unit (Tata Ceramics) for the manufacture of bone china-ware. Other projects in the pipeline were, a Rs. 10 crore joint venture with Clorox of US at Ratnagiri to manufacture institutional hygiene products, disinfectants and cleaners. With all these plans in place, the company hoped to reduce its dependence on soaps and detergents from 85% of turnover to 50%, with sales turnover expected to touch the Rs. 1000 crore mark in 1995-96. To finance its growth plans, in January 1991, the company issued Rs. 46 crores of convertible debentures, which were due for conversion in 1992. However, the herculean efforts of revitalising the company by the current management team failed and due to lack of thrust in the soaps and detergents business, TOMCO became the least equipped *player with* no unique selling proposition.

Tapping the synergies

TOMCO was a good buy for HLL on two very important considerations — complementary brands and manufacturing locations. Although HLL had a presence in practically every segment of the soap market, it did not have an ethnic brand. TOMCO had 7 manufacturing facilities, and it was comparatively stronger in the South with two facilities at Tatapuram, *Kerala.* It was proposed that the spread of manufacturing facilities would enable the combined entity to substantially reduce the transportation cost and more importantly would facilitate the rapid introduction of new products. The distribution network of over 3000 stockists would be practically doubled with the merger. Also, it was felt that HLL's technological edge could help reduce TOMCO's costs by about 30%.

HLL, with the acquisition of TOMCO, planned to have 75% share of the toilet soaps *market* in volume terms. This could make entry of any competing unit into the industry very costly - even a company like Procter & Gamble had already

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made a loss of Rs. 7 crores in entering the premium segment of the detergents markets with its Ariel. Thus, although HLL stood to benefit tremendously from the ethnic brands and access to supplementary manufacturing capacities, the real advantage was seen to be in the future stream of profits that were beneath the gross mismanagement of TOMCO. At the time in question, TOMCO was an extremely viable company with an operating profit of Rs. 22 crores in 1991-92. The high interest cost had eroded the profits, as large amounts of funds were blocked in outstanding debtors, inventories, and loans and advances. The 5500 strong workforce managed to produce only 1 lakh tonnes of soaps and detergents, while HLL produced 7 lakh tonnes with 7000 employees. It was envisaged that HLL would use its cash profits of about Rs. 120 crores for the year 1992, to pay off TOMCO's huge loans. As on 31.3.-1992 the TOMCO had a total loan of Rs. 180 crores and contingent liabilities of Rs. 30 crores, which had resulted in tremendous interest costs. TOMCO's interest cost were about 4.5% of sales, while HLL stood at 1.5%. It was also expected that the HLL-like efficiency would be put into practice and TOMCO's working capital of Rs.151 crores would be trimmed. On an average, TOMCO's receivables were approximately 3 months, compared to HLL's 5-10 days.

Incompatibilities and Problems

It was felt that the more difficult part would be the management of the two very different work cultures and ethos, after the merger. In TOMCO the employee productivity was only 60% of HLL. It was opined that HLL would have to rationalise TOMCO's work force. HLL itself had launched a voluntary retirement package, in order to get rid of about 500 workers, however only a few resigned. Mr. S.M. Datta had however assured TOMCO employees that their employment conditions were to be protected and service conditions would be honoured. All the employees of TOMCO were to be absorbed as HLL employees. The difference in the productivity levels of TOMCO and HLL employees had been conceded as a point of imbalance. However,

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even within HLL, there were differences in productivity, with the Bombay factory productivity levels being lower than that in other locations. Further, Mr. S.M. Dutta felt that the productivity level in TOMCO could be raised to that of HLL only in 3 years. HLL had also agreed to maintain the market shares of TOMCO brands and pay off its creditors. HLL had entered into an agreement with the Consumer Education and Research Centre to clear the consumer activists' apprehension regarding exploitation of the market by large players through pricing, production restriction, promotion of particular brands or misuse of distribution channels.

Scheme of amalgamation

Considering the advantages and incompatibilities as stated above, on 30th June 1993, 99.97% of the share holders in value terms, of TOMCO and HLL approved the scheme of amalgamation, at an EGM, wherein two shares of HLL were to be allotted for every 15 shares of TOMCO. The approval of the Bombay High Court was proposed to be sought.

In addition, it was decided that Unilever will get a preferential allotment of 347, 84, 29 shares at a premium of Rs. 95 to increase its share holding to 51%.

Case Study 2: NICHOLAS PfRAMAL LIMITED TAKES OVER ROCHE PRODUCTS LTD.

ROCHE PRODUCTS LTD.

Background

Roche Products Ltd. was one of the major manufacturers of Vitamin A products and had strengths in the manufacture of bulk drugs, fine chemicals, diagnostics and non-prescription drugs. Its product range also covered various anti-depressant drugs for psycholeptics and psychoanaleptics. Its well-known brand names are Bactrim, Valium and Becozyme.

The company was jointly promoted by F. Hoffmann La Roche and

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Voltas Ltd. in 1958, with the parent company holding 89% of the share capital and Voltas 11%. In August 1984, in compliance with FERA Regulations* the parent company diluted its equity stake to 74%, by making a public issue of shares.

* FERA has been repealed and FEMA has corne into existence with effect from 1.6.2000.

The company had manufacturing facilities at Balkum, Thane for the manufacture of Vitamin A, high technology bulk drugs and fine chemicals. The company had been constantly improving the performance of its manufacturing facilities by undertaking substantial modernisation based on the latest technology to enable efficient and economic production. A major modernisation was carried out in 1984 at a cost of Rs. 2.45 crores which was financed by the public issue of shares and issue of Rs. 2.43 crores of 15% secured non-convertible debentures redeemable at a premium of 5% after the expiry of 7 years from the date of allotment.

In its 35 years of operations, the company's lacklustre financial performance could be attributed to the rising cost of raw materials, high labour and rigid price controls on the company's products. Since 1989-90, about two-thirds of the company's turnover came from drugs under a DPCO, and accordingly, the sales growth during 1989-92 was very impressive. In 1992-93, the company achieved an increase in sales of 22.5 percent over the previous year, due to the price revisions approved by the Government. Although the company lost production during the year due to transportation bottlenecks and inadequate availability of Vitamin C, (a critical raw material), its profitability more than doubled to Rs.1.5 crores, though in terms of percentage, it was still only 2% of turnover whereas other companies achieved a higher percentage.

In 1993 the company undertook a major project for refurnishing its Vitamin A plant at Thane which was installed 30 years ago and was facing problems including corrosion of structures. This project required an investment of Rs. 4 crores in addition to an amount of Rs. 1 crore needed for compliance with revised statutory requirements of effluent treatment.

The marketing and distribution of the company's products were handled by Voltas Ltd., till early 1993. In March 1993, the company decided to take over the

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marketing and distribution of its pharmaceutical products from Voltas, and started the process.

The company had 1100 employees on its rolls, of which only 200 were in the field. Its large staff coupled with a high salary structure had increased the overheads, resulting in extremely low margins compared to industry norms.

The immediate steps that were required to improve profitability were expansion and improvement of distribution facilities, increasing the capacity of bulk drug plant and enhancing the productivity levels of its work force. The introduction of new products, which were outside the control of DPCO, was an area of prime importance.

NICHOLAS
PIRAMAL
LIMITED

Background

In 1987, Ajay Piramal bought out Aspro - Nicholas pic of U.K. and since then the company created pharmaceutical history by achieving substantial improvements in growth and profitability, despite the constraints of price control. In 1991, it was independently rated as the fourth fastest growing company in the industry.

The Nicholas Group's performance was a success story, as evidenced by an impressive increase in the turnover from Rs.18 crores in 1988 to Rs.103 crores in 1993. The growth of Nicholas Labs prior to Piramal's takeover was extremely slow (please see Annexure I given at the end of this case study). Though, the pharmaceutical business contributed 95% to the company's turnover, no new research based products were introduced and there was not much effort to improve the market share of its over the counter brands Aspro and Cleartone. The Piramal Group had to bring in a sizeable investment for R&D, import of technical know-how and sales promotion. Through a strategy of effective motivation of the existing management of these companies and through some reorganisation, the group was able to improve the

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financial performance of the companies acquired by it viz.
Morajee Gukuldas Mills Nicholas Laboratories and Gujarat
Glass. Nicholas
Laboratories, after the takeover by Piramal in 1988, launched 12 new
products, took
over Gujarat Glass in 1990 and increased net profit 8 times from
1.2croresin 1988 to
10.1 crores in 1993. Besides, it earned Rs. 12.45 per share, in 1993,
95% more than
that in 1987. Consequently, the share price moved up from about Rs.
45 in 1987 to
Rs. 310
in 1993.

The company had strengths in the manufacture of formulations like antacids, cardio-vascuiar drugs and anti-ulcerants. It had also set up a sophisticated formulation plant, at a cost of Rs.12 crore. It had a combined field force of 650 employees, one of the largest in the pharmaceutical industry, which acts as crucial factor for success in any industry.

Although, Nicholas Piramal had emerged as a fast growing, profitable company its growth plans were stymied as it no longer had access to new products from its foreign ex-parent. It is worth mentioning in this regard that Nicholas Piramal had been allowed to use the brand names Aspro and Cleartone which were held by Roche's parent company, in an earlier arrangement. Therefore, the company was on the look out for a possible acquisition in the same industry. It was felt that, there should be realisable synergies in the operations of the target company, and the products should be complementary. Accordingly, since the company had strengths in formulations, its management wanted to increase its presence in bulk drugs. The company was also planning to enter the over-the-counter drugs and skincare market.

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Drugs and Pharmaceutical Industry - Overview of Scenario

The drugs and pharmaceutical industry in India had emerged as one of the largest producers of Pharmaceuticals among the developing countries. However, India's share in world production was still insignificant at 0.3 percent although it accounted for 15 percent of the world population. The production of bulk drugs in 1988-89 was Rs. 630 crores and Rs. 2690 crores of formulations. The demand for drugs was estimated at Rs. 15,996 crores by 1999-2000.

Although the industry had shown a steady rise in sales, most companies found their growth stifled due to the drug price control order which covered 72 drugs. The margins in the industry had been falling due to rising input costs, increase in cost of packaging materials, and escalation in power and fuel costs. Accordingly, the profit margins fell from 15 percent of turnover in 1969-70 to 2 percent of the turnover in 1988-89. Declining domestic profitability had forced companies to change their product mix to include non-controlled drugs and over the counter products which were more lucrative.

The future of the industry was poised for substantial growth both in the domestic and global markets. There was a strong possibility of relaxation of the Control Order (DCPO) and it was assumed India may also be forced to accept the patent related clauses in GATT, paving the way for the transnational to launch a new product in India.

Roche Products Ltd. - Rationale for disinvestment

The parent company F. Hoffmann La Roche had decided to disinvest its equity stake of 74% in Roche Products Ltd. Although the company was the major manufacturer of Vitamin A, the parent company had lost interest in this company due to low profit margins. In the last 17 years not a single new product was introduced and no formal growth plans were made, having an adverse impact on the company's financial performance. The other motivation for the foreign company divesting its equity stake had been the termination of the distribution agreement

with Voltas Ltd. making it necessary for the company to set up its own distribution facilities, involving substantial expenditure.

F. Hoffman La Roche constituted a negotiating team consisting of two representatives from the parent company and 3-4 from Roche Products Ltd. Nicholas Piramal Ltd. had expressed keen interest in buying over the controlling shares in RPL.

Roche Ltd's Mandate (before finalisation of deal)

Get the best price for the company. However, the poor performance of the company and its deteriorating efficiency may be used by the other party to the maximum extent to bid down the price. The future prospects of company can get proper additional finance and good management support like NPL.

This mandate was based on the consideration that, it was only after a long search that a keen buyer had been identified and it was in the company's interest to conclude a deal, because if they failed, it could mean another 2-3 years of frustration, working in a losing company.

Nicholas Piramal Ltd. - Rationale for takeover

Some of the competitors entered into strategic alliances and tie-ups with multinational companies to gain access to new products. After considerable analysis, Roche Products was identified as one of the possible targets, as the parent company had decided to disinvest. Roche filled in well in the strategy for growth as there were realisable synergies in the operations of both the companies and the products were complementary. The company had strengths in distribution which complemented Roche's strength in R&D, as it was a multinational company.

NPL's Mandate (before finalisation of deal)

To negotiate with the management of Roche Products Ltd. and acquire the company at a competitive price. Give a justification for the price that would be offered to Roche.

Accordingly, a meeting was scheduled between the representatives of the two companies to negotiate and conclude the deal.

ANNEXURE 1

NICHOLAS

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PIRAMAL

LIMITED Balance

Sheet

For the year ended 31st

h 1. Sources of Funds

1. Shareholders'

Funds: (a) Equity

Share Capital (b)

Reserves and

Surplus

2. Loan Funds; (a)

Secured Loans (b)

Unsecured Loans

Total

//. *Application of*

Funds 1 . Fixed

Assets (a) Net Block

(b) Capital WIP 2.

Investments 3.

Current Assets (a)

Inventories (b)

Sundry Debtors (c)

Cash and Bank

Balances (d) Other

Current Assets (e)

Loans and

Advances

Less: Current

Liabilities and

Provisions (a)

Sundry Creditors

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(b) Other Current

NICHOLAS

PIRAMAL

LIMITED

Profit and

For the year ended 31st

M h I

n

c

o

Expenditure

Material

Staff

Other

Depreciation

Interest

Profit

Before Tax

Taxation

Profit After

Dividend

Earnings per

Return on

Market Price

High

Low

Average

Financial Highlights

Year ended

30 h Sales and

Profit before

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Profit before

Fixed Assets

Share

Reserves

Earnings per

Book Value

Dividend

R t For revaluation reserves in 1987 of 268.69 lakhs.

ANNEXURE2

ROCHE PRODUCTS

LIMITED Balance

Sheet

(Rs. in crore)

For the year ended

1. Sources of Funds

Sharehold

ers' Funds:

(a) Equity

Share

2. Loan Funds:

(a) Secured

(b) Unsecured

Total

//. Application of

Funds

1 . Fixed Assets

(a) Net Block

(b) Capital

2. Investments

3. Current

(a)

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(b) Sundry

(c) Cash and

(d) Loans and

Less; Current Liabilities and Provisions:

(a) Sundry

(b) Other Current

Net Current

Total

PRODUCTS LIMITED

For the year

Income

Sales

Other Income

Expenditure

Material

Staff Expenditure

Other Expenses

Depreciation

Interest

(Rounded off)

Profit Before Tax Taxation Profit After Tax Dividend Rate % Earnings per Share (EPS)

Return on Capital Employed Market Price—

20.89 14.30

High

Low

Averag

e

Shareholding Pattern as on 05.8.93

Foreign Holding (Roche) 74.00

Public 10.63

Financial \ns\'rtu\ions/Banks 5.93

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Others _______

100.00

22.9 7.84 10.11

Case Study 3: TAKEOVER OF PROFIT

EARNING

COMPANY Background

Hindustan Lever Limited (HLL) had in the last ten years used the takeover route to expand the base of the Company. Average sales growth in the last ten years had been 29.5 per cent, driven partly by successful acquisitions like Kwality, Dollops, TOMCO, Brooke Bond and Lakme. Sans the mergers, HLL would have maintained an average of 18 per cent year-to-year growth per annum. Net profit had grown at a compounded rate of 37 per cent during the same period. HLL acquired TOMCO in early nineties and at the same time acquired 20 per cent shareholding of Indian Perfumes Limited (IPL), a Company closely associated with operations of TOMCO and engaged in the aroma chemical business. TOMCO was merged with HLL in 1994 and IPL became HLLs subsidiary as TOMCO was holding approx. 32.5 per cent in IPL. Subsequently HLL acquired shares of IPL from other Tata companies to take its holding in IPL to 73 per cent. Also as a result of amalgamation with TOMCO, HLL acquired the 21.8 per cent stake in Vashisti Detergents Ltd. (VDL) and subsequently acquired 11 per cent stake of other promoter in VDL. In 1993, HLL acquired shares of Brooke Bond India Limited and with amalgamation of Brooke Bond with Lipton India Limited in 1994, got its holding in Lipton converted to Brooke Bond Shares. Subsequently, Pond's and Brooke Bond Lipton India, both subsidiaries of Unilever, got merged with HLL.

Facts

Takeover of Lakme brands, sales and distribution network was through a complex deal for environmental and fiscal reasons. The sale was done in two stages:

Stage I - In January 1995, the Lakme trademark, technology and related intellectual property was transferred to a 100 per cent subsidiary of Lakme Ltd.-Lakme Brands Ltd. The transfer consideration was determined at Rs. 78 crore. Lakme Brand Ltd.'s capitalization was

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represented by equity capital of Rs. 3.25 crore subscribed by Lakme and optionally fully convertible debentures of Rs. 75 crore subscribed to by Hindustan Lever. At the same time, a new joint venture company Lakme Lever Limited was formed, wherein Hindustan Lever and Lakme both held 50 per cent of the 21 lakh equity shares each. Sales and marketing infrastructure in India as well as abroad owned by Lakme was transferred to the joint venture for a consideration of Rs. 32.39 crore. This included payment for goodwill, net current assets and relevant fixed assets. Also, Hindustan Lever paid Rs. 30 crore (Rs. 25 crore to Lakme Ltd. and Rs. 50 lac to Lakme's wholly owned subsidiary Lakme Exports Ltd.) for non-compete agreement.

For Lakme, entry of Unilever group and other MNCs in the field was imminent, which would have led to heightened competition and decline in margins. Therefore, an alliance with an established MNC was a mutually beneficial arrangement. Further, technological/marketing inputs from Unilever group would give an edge over the competitors and allow the joint venture selling company to cash upon its distribution network.

However, HLL's traditional distribution network, although one of the largest, was not tuned to market cosmetic products which are primarily sold through specialised shops/boutiques. So tie up with Lakme enabled the company to leverage on the Lakme distribution channels also.

Stage II - In 1998, Lakme Limited divested its 50 per cent stake in Lakme Lever Ltd. to HLL for a consideration of Rs. 90.5 crore. The entire stake of Lakme Ltd. in its wholly owned subsidiary Lakme Brands Ltd. was also acquired by HLL. Lakme's manufacturing facility at Deonar was taken over for Rs. 24 crore. The manufacturing plant at Kandla owned by Lakme Exports, the 100 per cent subsidiary of Lakme Ltd. was taken over by HLL for a consideration of Rs. 5.71 crore.

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Statistics

The table given below displays the total consideration involved in the sale of Lakme Lever stake, manufacturing facility and brand by Lakme Ltd.

Consideration paid for Rs. (crore)

Stake in Lakme Lever Ltd. 90.5

Deonar manufacturing facility 24.03

Kandla manufacturing facility (from Lakme Export) 5.71

Trade mark, Designs, Brands, Copyrights (from Lakme Brands Ltd.) 110.05

R&D infrastructure (from Lakme Brands Ltd.) .27

Total 230.56

Benefits Occurring

Lakme Limited utilized part of the proceeds to redeem the Rs.75 crore Optionally Convertible Debentures subscribed to by HLL in Lakme Brands Ltd. in

I 1996. Lakme, sans its cosmetics business then ventured into the retailing I business, utilizing the funds garnered for acquisition of a Department Store I Littlewoods. The entire cosmetic business under the Lakme brand is now owned and I managed by HLL.

Case Study 4: KRONE COMMUNICATION LIMITED—CONDITIONAL EXEMPTION

Krone Communications Ltd., M/s. GenTek Inc., USA (the acquirer company) I entered into a re-construction and restructuring agreement with Jenoptik AG, through I its subsidiary, for the acquisition of its entire shareholding in Krone AG which holds I 51% of the issued, subscribed and paid up equity capital of Krone Communications I Limited (target company). Pursuant to this, it made an application dated July 22, 1999 to the Board seeking exemption from the applicability of the provisions of the SEBI I (Substantial Acquisition of Shares

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and Takeovers) Regulations, 1997 (the 'Regulations') for the said acquisition. The Board forwarded the application to the Takeover Panel which *vide* its report dated August 5, 1999 rejected the application on the ground that in the process of the acquisition of Krone AG, the control over the target company would be shifted in favour of the acquirer company through the holding company i.e. Krone AG and that Regulation 12 would be applicable. During the course of the personal hearing held on September 6, 1999, the acquirer brought to the notice of the Board certain additional facts. It was stated that the purpose of acquisition of Krone AG is not to secure the control of the target company and that it would not lead to an indirect acquisition of the target company by the acquirer. Also it contended that the said acquisition would not bring about any change in the shareholding of the target company and that the controlling stake of Krone AG in the target company i.e. 51% would not alter pursuant to the said acquisition. It was stated that they believed that the acquisition would not result in a change in management or a reconstitution of the Board of Directors of the target company. Therefore the Board referred the case back to the Panel for reconsideration of the case based on the new facts. On consideration of the same as well as the undertaking given by the acquirers that the acquirers were willing to abide with the conditional exemption granted by SEBI to the effect that the shareholders of the target company ratify the change in control by an appropriate resolution passed at the meeting of its shareholders. The Takeover Panel *vide* its report dated January 20, 2000 recommended the grant of exemption as sought by the acquirers subject to the shareholders of the target company passing a special resolution at the meeting of the shareholders permitting voting through postal ballot thereat, ratifying the change in control. Also a further condition was imposed that the notice of such a meeting to the shareholders of the target company should

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accompany an envelope for postal ballot with pre-paid postage stamps affixed. SEBl also noted that the acquisition of the target company was merely an unintended consequence of the global restructuring of Krone AG, and that the controlling stake of the acquirer company would not alter Krone AG pursuant to such acquisition. It was also noted that the acquisition would not constitute an indirect acquisition in terms of the Regulations and that adequate intimation of the acquisition was given to all the shareholders of the target company. On the basis of the same as well as after considering the recommendations of the Panel, SEBI, granted exemption to the acquirers from the applicability of the provisions of the Regulations for the proposed acquisition subject to the ratification by the shareholders of the target company as recommended by the Panel *vide* its report dated January 20, 2000.

Case Study 5: SHARE VALUATION AND DETERMINATION OF SHARE EXCHANGE RATIO IN A MERGER

The Companies

C Limited and S Limited were companies in the business engaged predominantly in manufacturing and trading, the former in Cement Industry and the latter in Sugar and Chemical Products.

C Limited was incorporated during the year 1989-90, with registered office at Hyderabad. It was a profit making and dividend paying company since its inception. C Limited had 600 tpd Mini Cement Plant in Andhra Pradesh. The paid-up capital of C Limited was Rs.7.4 crores, with promoter share holding at 27.44%.

S Limited was incorporated in 1990, with registered office at Secunderabad. The plant was commissioned in March 1992 for

production of Sugar and Molasses with 2500 tpd installed capacity.
The company incurred losses since inception and the total accumulated losses as at March 31, 1997 stood at Rs.19.03 crores. The Paid-up-capital of the company was Rs.14.48 crores, with promoter shareholding at 40.60%. The company was a Sick Company under the Sick Industrial Companies (Special Provisions) Act, 1985.
C Limited and S Limited were listed on both the Bombay and Hyderabad Stock Exchanges. While the shares of C Limited were actively traded, there was not much of trading activity for S Limited shares.

The Industry

While there was steady growth in the cement industry, the sugar industry had to suffer on account of increase in sugar imports and no demand for molasses due to prohibition in the State of Andhra Pradesh.

Financials

Whilst the performance of C Limited was impressive in the last few years, there was negative growth in the case of S Limited, which resulted in negative net worth.

The Merger

The management of both the companies felt that among other reasons, a bigger and stronger company would be able to withstand more solidly the rigors of competition in the field of cement and sugar industries. It was therefore, proposed to merge S Limited into C Limited effective from April 1, 1997 and seek the benefit of set-off of losses of S Limited under Section 72A of the Income Tax Act 1961.

Objective

To value the shares of C Limited and S Limited to determine a suitable exchange ratio for merger of S Ltd. with C Ltd. effective from April 1, 1997.
The valuations as on March 31, 1997 were carried out to determine

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(a) fair value of share of C Limited

(b) fair value of share of S Limited

(c) exchange ratio for merger of S Limited with C Limited

I Valuation Inputs

In carrying out the valuation of shares of both the companies,
the following I information among others, were considered:

(a) Audited accounts of C Limited and S Limited for the years 1994-
95, 1995-96
and 1996-97.

(b) Projected results of C Limited and S Limited

(c) Share quotations of the share price movements of C Limited
and S Limited
during the period October 1, 1996 to September 30, 1997.

I Valuation Methodology

In the case of valuation of shares for the purpose of a merger, the
underlying I assumption has to be made that after the merger the
combined company will I continue to carry on the same businesses as
were individually carried on by the two I companies using the same
assets as were used by the two companies. Valuations I are valid and
can be used only for the specific purpose for a reasonable period of time
after they are done.

In this case the valuation of shares was done to decide the fair value
per share of C Limited and S Limited to arrive at the exchange ratio of
shares for the merger of S Limited with C Limited.

The valuations in this study were done as on March 31, 1997.

In the valuation of the shares of the two companies for the
purpose of determining the exchange ratio, the appropriate
methodology was chosen, which would fairly state the relative values
of the shares of the two companies rather than the absolute values.

Valuation of shares of C
Limited Profit Earning

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Capacity Value (PECV)
In arriving at the future maintainable profits (FMP) of C Limited,
the following were considered:
(a) Profits of C Limited for the years 1994-95, 1995-96 and 1996-97 as per the
audited accounts.
(b) Projected profits for the years 1997-98 to 2001-02.
The profits for the years 1994-95 to 1996-97 were adjusted for
nonrecurring/unusual incomes and expenses.
The adjusted profits for the three years are given below:
Year Profit before tax
(Rs. Lakhs)
'1994-95 829.67
1995-96 1,221.67
1996-97 1,030.79
The average profit works out to Rs.1027.37 lakhs.
The profits were assigned weights starting with a weightage of 1
for the year 1994-95 and going on to a weightage of 3 for the year
1996-97. The weightages assigned represent probabilities with the
most recent year having the highest weightage. The weighted average
profits of C Limited for the period 1994-95 to 1996-97 worked out to Rs.
1060.89 lakhs.
In companies/industries having high growth in profits and
significant increase in equity (including ploughing back of a
significant portion of the profits), the past average profits would not
be reflective of the future maintainable profits. In such circumstances,
it would be appropriate to work out the future maintainable profits
based on 'Return on Equity Funds' as at the valuation date. The future
maintainable profits were, therefore worked out on the basis of Return
on Equity Funds, as follows:
The rate of return on average equity funds employed during the

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year was calculated as follows

Profits before tax Rate of return =

Average Funds Employed

As the merger was effective from April 1, 1997, the weighted average rate of return was then applied to the "funds employed" as on March 31,1997 to arrive at the future maintainable profits.

The average capital employed during the years 1994-95, 1995-96 and 1996-97 were worked out, after adjusting for the period the funds which were employed during the financial years, i.e., after adjustments for issues of capital.

The average returns for the years 1994-95 to 1996-97 worked out to 25% and the weighted average returns for the same period 23.71%.

The FMP based on Adjusted Capital Employed as at March 31, 1997 worked out to Rs.1,254.52 lakhs.

For the purposes of arriving at the 'Profit Earning Capacity Value', the future maintainable profits were considered net of tax. C Limited was not currently enjoying the benefit of a tax holiday for new undertakings. There were, consequently, no significant prominent differences, which required adjustment. Since 'timing differences' did not affect the total incidence of tax (though they may affect cash flows), the same were ignored in determining the appropriate rate of tax.

The rate of tax was considered at 35%, which was the rate likely to be applicable in future years based on the indications.

The Future maintainable profit after tax worked out as under:

Rs. lakhs

Future Maintainable profits before tax 1254.52

Tax @ 35% 439.08

Future Maintainable profits after tax 815.44

The next step in this method of valuation was the selection of the rate at which the future maintainable profit after tax could be capitalised to arrive at the total value of the equity capital of the company. The

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capitalisation factor is the inverse of the price/earnings ratio (P/E). Generally, in order to derive a reasonable capitalisation factor, an analysis of the prices and earnings of "comparable" companies in the same industry, to which, the company, whose share is being valued belongs to, is conducted. Having regard to the steep growth in profits of the company over the last four years, the P/E multiple was determined, which worked out to 8. The P/E ratio of Sgave a capitalisation factor of 12.50% which was considered appropriate, in view of the increase in profits of the company during the last few years although the actual P/E multiple of comparable companies in the same industry were lower on account of (he depressed conditions in the stock market.

The value of C Limited shares based on the PECV method, outlined above, is liven below:

3-

Rs. lakhs

Future maintainable profits after tax 815.44

Capitalised at 12.50% 6523.49

Number of shares 74 lakhs

PECV per share Rs. 88.16

Future **earnings per share**

Under this method the fair value of C Limited shares were determined based on I the value of the future earnings per share. The projected earnings for the five years 1997-98 to 2001-02 were considered I assuming that there would be no increase in share capital during this period.

As the projected earnings were computed based on the constant prices these I were not discounted. Weightages were assigned starting with a weightage of 5 for I 1997-98 and ending with 1 for 2001-02. The weightages represent probabilities with I the most distant future having the lowest weightage.

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The weighted earnings per share worked out to Rs. 8.42.
Applying the same multiple of 8 referred to above, the value of the share worked out to Rs. 67.36.

Net Asset Value (NAV) Per Share

This is the value of the net assets attributable to equity shareholders as on a particular date. In this case, the value of net assets was taken as per the audited balance sheet as at March 31, 1997.

The value of net assets as per the audited balance sheet as at March 31, 1997 was worked out after considering the following:

(a) Value of Insurance premia paid. The premia paid during 1994-95, 1995-96
arid 1996-97 had been charged to the Profit and Loss Account. On maturity
•of the Policy, the proceeds received are in excess of the premia paid.
Consequently, as at March 31, 1997, the value of the premia paid was
considered as an asset and pro-rata share of the appreciation attributable to
the premia paid up to March 31, 1997 net of the present value of the future
tax liability on the pro-rata proceeds.

(b) Timing difference on leased assets - During 1995-96 and 1996-97
depreciation charged in the accounts in respect of assets leased out was
Rs. 47.97 lakhs as against the depreciation claimed for tax of Rs. 605.62
lakhs. The tax applicable on the timing difference of Rs.557.65 lakhs was

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discounted to the present value and deducted from the net asset value.

No adjustments were made for contingent liabilities, as these were unlikely to result into liabilities.

Based on the above, the Net Asset Value of C Limited as on March 31, 1997 worked out to Rs.5291.02 lakhs. The fair value of C Limited share under the Net Asset Value method was:

Fair value (NAV) Rs. 5291.02 lakhs

Number of shares *74* lakhs

Fair value per share Rs. 71.50

Average Market Price of Shares

Under this method the fair value of C Limited share was arrived at based on the market price of the share. In arriving at the market price to be considered, the following factors were considered relevant:

(a) The shares of the company were traded on in the stock exchanges of
Hyderabad and Bombay.

(b) The price data was looked at in conjunction with volumes in order to rule out
any manipulation.

(c) The prices during the months around the merger date were considered rather
than the price as on the effective date of the merger as this would be a more
appropriate indicator of the relative values of the shares of the companies.

Based on the high/low of the share prices during the twelve months ended September 30, 1997, the average market price worked out to Rs. 21.36.

Fair Value of C Limited Shares

The fair value of C Limited share was arrived at after taking into

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account the value arrived at on the PECV method, the Future Earnings per Share method, the NAV method and the Market Price. The 'Yield Value' was determined by assigning weightages to the values arrived at based on the PECV method and the Future Earnings per Share method. The value as per the PECV method was assigned a higher weightage of 2 as this was computed based on actual results whereas the value as per the Earnings per Share method was assigned a lower weightage of 1 as this was computed based on future projections which are subject to uncertainties. Having determined the 'Yield Value' this was assigned a weightage of 2/5ths and weightages of 2/5ths and 1/5ths were assigned to Market Price and NAV respectively. This was in keeping with the principle of giving greater importance to the earning value of the business particularly since it was an existing and profitable business. Further, since the company was quoted on stock exchanges the market price was also given due weightage.

The fair value of C Limited share arrived as above was Rs.55.33. **Valuation of shares of S Limited**

S Limited had been incurring losses. The projections for the years 1997-98 to 2002-03 also did not show profits.

The Net Asset Value (NAV) as at March 31, 1997 even after considering the benefit of waivers of interest on loans and the available tax shield on losses was negative.

The projected profit was considered before depreciation, interest and tax (EBDIT) and capitalised to arrive at the fixed assets value. The value of the business under this method was computed considering the fixed assets value so arrived at together with the net current assets and deducting the existing loans (after concessions). Even under this method, the valuation did not yield a positive value.

Both the Yield Method (based on past and future earnings) and the Net Asset Value method did not reveal any positive value for the shares

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of this company.

The shares of S Limited, quoted on the stock exchanges of Hyderabad and Bombay, were thinly traded and there are no quotes in several months. The share prices revealed the following trends:

Particulars Rs.

Average price for the 6 months ended December 31,1996 1.93

Average price for the 6 months ended September 30, 1996 2.08

Average price for 12 months ended December 31, 1996 2.08

Average price for 12 months ended September 30, 1996 2.08

Average price for 12 months ended September 30, 1997 2.08

Price in April, 1996 2.25

Price in April, 1997 2.50

From the above it appeared that the fair market value of the share of S Limited would be in the range of Rs. 2.25 to Rs. 2.50.

Exchange Ratio

The fair values of shares of C Limited and S Limited thus determined were:

Value of share of C Limited Rs. 55.33

Value of share of S Limited Rs. 2.25 - Rs. 2.50

Having regard to the above values of the shares determined for the merger effective April 1, 1997 the recommended exchange ratio was as follows:

1 share of C Limited for every 25 shares of S Limited

Case Study 6: REVERSE MERGER

Wherever a profit making company merges with a loss making company, the amalgamated company would be entitled to carry forward and set off the accumulated loss and unabsorbed depreciation allowance since in such a case it is the loss and unabsorbed depreciation of the same company which is being carried onward. Whereas, in a case where a loss making unit is merged in a profit making unit the profit

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making unit would seek to carry forward the loss and unabsorbed depreciation not of its own but of another company.

An amalgamated company is not entitled to carry forward the accumulated loss and unabsorbed depreciation allowance of the amalgamating company.

Case:

ABC Ltd., a company engaged in manufacture of textiles, had faced marketing constraints and stiff competition from imported material at cheaper prices.

Financial status

ABC Ltd. had suffered huge losses since commissioning, amounting to Rs.1342

lacs as at 31,12.92 (book loss) against paid up capital of Rs. 534 lacs. I.T. losses of Rs. 2248 lacs. Its term liabilities amounted to Rs.1722 lacs including defaults of Interest payments (Rs. 632 lacs) on account of cash losses. Payments to suppliers (Rs. 334 lacs) remained unpaid due to liquidity constraints.

Case for amalgamation

Prospects for the company's products appeared reasonably good. Revival of the unit was possible provided financial help was forthcoming immediately. Borrowing from outside was impossible on account of financial difficulties. XYZ Limited a healthy unit was found willing for amalgamation with ABC Ltd.

A revival plan for ABC Ltd., was contemplated to which financial institutions and banks had agreed to a package of reliefs and concessions by way of interest concession, funding of interest and rescheduling of term loan repayment.

Incentives

The following incentives were available under the statutes:

(1) The incentive for the healthy unit to take over the assets and liabilities of ABC

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Ltd. was the tax benefit under Section 72A of Income-tax
Act. The total tax
benefit to XYZ Ltd. amounted to Rs.1298 lacs. Since XYZ
Ltd. was incurring
huge tax liability on its profits, the amalgamation resulted
into immediate
improvement in its liquidity on account of ABC Ltd.'s losses.
(2) One of the products of XYZ Ltd. was used as raw material for
the products of
ABC Ltd. Besides assured supplies, the amalgamation gave an
advantage of
savings in cost of raw material to ABC Ltd. because after
amalgamation the
raw material could be given at 'transfer cost',

Approval under Section 72A

The Specified Authority under Section 72A of the Income-tax
Act approved the tax benefits of Rs. 1298 lacs on the basis of the
revival plan for ABC Ltd. as prepared by XYZ Ltd.. The revival plan
comprised
(R
s. Lacs) Revival Investment:
Capital Expenditure 809
Repayment of Loans and Interest 1464
Payment to Creditors 176
Working capital 40
2
489 Sources of Financing:
Tax benefits 1298
XYZ Ltd.'s contribution 435
Cash generation of ABC 756
2489

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Immediate revival steps

(1) ABC Ltd. had suffered in the past on account of uncertainty of supply of raw material. It therefore created storage capacity of about 4 weeks supplies to do away with fluctuations in the supply of raw material.

(2) XYZ Ltd. assessed the needs of capital expenditure required for improving the working of ABCL, which were mainly on account of balancing of capacities, modification and replacements of existing equipment, etc.

Exchange ratio

The exchange ratio of shares was worked out as under:

1. ABC Ltd. had negative net worth as on the amalgamation date. But, since amalgamation envisaged tax benefits to XYZ Ltd. on account of accumulated losses of ABC Ltd. the quantum of tax benefit was added to the net worth of ABC Ltd. to get a positive net worth.
2. Past earnings basis was not considered on account of losses of ABC Ltd.
3. Market price of shares was given due weightage.

Case Study 7 MERGER CREATING LARGEST IT COMPANY IN INDIA

Merger of Pro-Tech Inc. with Techno Inc. proposed to create a Rs. 3,650 crore conglomerate. What is in store for the new entity? Where will it gain and where will it lose? Here is a case study on the implications of the merger considered prior to decision-making.

By virtue of Sick Industrial Companies (Special Provisions) Repeal Bill, 2001; SICA is proposed to be repealed.

Post-Merger Proposals

It was expected that the merger will pose the following benefits and

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demands:

THE NEW PRO-TECH. INC. IN INDIA

(Revenues: Rs. crore)

Techno Pro- New Moon

Moor Inc. Tech Pro- Pte.

Pie. Inc. Tech Ltd. Ltd.

Inc. (Compe- (Competitor) titor)

D

e

Unix servers 2

PC servers 2

Workstation 4

O

t

Services 2

Pac

kag

Software 1

Total 1

9

Pro-Tech. Inc.'s $25-billion acquisition of Techno Inc. (at 0.6325 of one newly-issued Pro-Tech Inc. share for one Techno Inc. share) ushers a new Pro-Tech Inc. at $87 billion, just below Moor Pte. Ltd. at $90 billion. Mr. ABC will remain chairman and CEO of the new entity and Techno Inc.'s Mr. PQR will be the President.

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 Indian Industry.

Pro-Tech Inc. plus Techno Inc. group revenues for last fiscal, including software operations, adds to Rs.3,650 crore, keeping it at number 3 behind the PCL group (Rs.4,413 crore) and the Boon

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group (Rs.4,032 crore).

The system vendor toppers are Tin Ltd. (by total-not just systems -revenues), Techno Inc., Moor Pte. Ltd. Pro-Tech Inc. This now changes to the new Pro-Tech Inc. at number 1, followed by Tin Ltd., Moor Pte. Ltd., and, significantly below, PCL.

• Significantly, the new Pro-Tech Inc. entity, will assume the number 1 slot by revenue in PCs, Unix servers and workstations, PC servers, and printers, and tops by units in alj 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 number 2. However, the product range
was largely there with Pro-Tech Inc. anyway, though Techno Inc. was much stronger in PC servers, and consumer desktops.

— Pro-Tech Inc. gains Techno Inc.'s services business, its distribution network especially for consumer desktops, its handhelds, and of course its business customers.

Product-line synergies stem from services (Techno Inc. gets 23 per cent ol its global revenues from services - 13 per cent in India - with plans to push that up), peripherals (Pro-Tech Inc. is the global leader in printers and is very strong in other devices including scanners), and, to a smaller extent in systems (Techno Inc. is stronger in consumer desktops, with a far better distribution network, both in India and globally). Techno Inc. also brings in the very successful Pocket PC, which could replace the

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Pocket PC in Pro-Tech Inc.'s portfolio.

Techno Inc. has anyway outlined a shift in focus to software and services. Its systems margins have been under pressure in recent times; its PC division has been in the red for seven consecutive quarters now; it lost the number 1 PC slot both globally and in the US market. Pro-Tech Inc., under Mr. ABC, has also been under earnings pressure, aggravated by the slowdown and massive restructuring costs in 2001. Pro-Tech Inc. has been keen to ramp up services and consulting revenue, the reason for its abortive bid to buy consulting firm Y&P earlier.

What do they lose?

Clearly, there will be product lines terminated, and jobs lost, if the "cost synergies" that Mr. ABC has spoken about before the press, have to happen effectively.

There are significant systems overlaps between Pro-Tech Inc. and Techno Inc. Globally, systems (PCs, servers, notebooks) bring in a third of Pro-Tech Inc.'s revenues, and one-half of Techno Inc.'s. Their Unix server businesses are similar. Both have proprietary computer processors and architectures. Both have announced a phase-out of these and a shift to Intel's 64-bit Itanium processor for high-end servers over the next three to five years.

Thus, some of the server product lines will have to converge, as will desktop and portables lines. The trimming could happen from either side. The Pro-Tech Inc. name will dominate, but some strong Techno Inc. brands may stay.

However, PCs would continue to be the largest source of revenue for the new company at a time when prices are plummeting and unit sales are declining. And PCs are where neither has been able to run an operation as efficient and profitable as Deil's.

Also, it will be interesting to see if the resulting organization behaves more like Techno Inc., which has been a fairly aggressive company driven by sales goals, or Pro-Tech Inc., which has been more consensus-driven.

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However, at the top level, there could be some 'complementarity',
among the two CEOs who came on board in July 1999. Mr. ABC is
known for her high-level strategy focus; Michael Capellas, for his handson
grasp of operations and the nitty-gritty.
What does the merger mean for the Indian market? The implications
are far reaching. The merged entity will become the largest IT company
in India, displacing Tin Ltd. We take a look at how the merger will create
ripples in each of the segments the two companies operate.

1. Total Revenue

Techno Inc: Rs. 1,761 crore
Pro-Tech Inc: Rs. 1,540 crore
Post Merger: Rs. 3,301 crore
Analysis: It will become the largest IT company in India displacing Tin
Ltd. (Rs.3,142
crore) and existing number 2 company (Rs. 2,947 crore).

1. Group Revenue

Techno Inc.: Rs.1,945 crore
Pro-Tech Inc.: Rs.1,705 crore
Post Merger: Rs. 3,650 crore
Analysis: It will become the third largest group in India behind PCL (Rs.
4,413 crore)
and Boon's (Rs. 4,032) with 'finger' in virtually every segment including
mainframes,
servers, workstations, PCs, notebooks, printers, storage, application
software,
services, etc.

1. Unix Servers (in units)

Techno Inc.: 394
Pro-Tech Inc.: 530
Post Merger: 924
Analysis: With a total market of 3,970 units, its market share will be more

than 23 per
cent but still way behind Sun whose share was almost 62 per cent.

1. P.C Servers (in units)

Techno
Inc.: 9,702
Pro-Tech
Inc.: 5,500
Post
Merger:
15,202

Analysis: With Proliants and Netservers in its kitty, the merged entity's share will be in excess of 38 per cent - more than double of nearest competitor Moor Pte. Ltd. who had under 17 per cent share-in a market which was slightly less than 40,000 units.

1, Traditional Workstations (in units)

Techno Inc.: 330
Pro-Tech Inc.: 535
Post Merger: 865

Analysis: In a market, which saw sales numbering 4,784 units, its share would
amount to 18 per cent - way behind Sun's 67 per cent share.

1. Personal Workstations (in units)

Techno Inc.: 3,320
Pro-Tech Inc.: 2,300
Post Merger: 5,620

Analysis: In this segment, the merged entity will virtually control the market with
nearly 80 per cent share of the total sales of 7,073 units. Moor Pte. Ltd, the closest
competitor will be left way behind with just 14 per cent market share.

1. PCs (in units)

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Techno Inc.: 1,51,568

Pro-Tech Inc.: 91,200

Post Merger: 2,42,768

Analysis: With several strong sub-brands in its fold - Deskpro, Presario, Brio, Pavilion

- the combined entity will be a formidable force. Its market share would amount to

over 14 per cent as compared to less than nine per cent for HCL, four per cent each

for Moor Pte. Ltd and Wipro - the closest competitiors.

1. Notebooks (in units)

Techno Inc.: 11,216

Pro-Tech Inc.: 750

Post Merger: 11,966

Analysis: In a market numbering 42,864 units, with Armada as the best selling brand,

it would have nearly 28 per cent share closely followed by Moor Pte. Ltd. with its

Thinkpads at 25 per cent and Toshiba at 20 per cent.

Case Study 8 MERGER OF TWO COMPANIES WITHIN THE SAME GROUP

Re: Merger ofXYZ (Acquires) with ABC (Acquirer)

XYZ as on 1.4.1999 had merged with ABC, both belonging to same group aiming at integration of activities of the two companies in order to rationalise the same and obtain benefits of economies of scale.

1. Background of both the companies

ABC, the acquirer Company - ABC, was promoted by Mr. P. with plant located at Shitlapur, for the manufacture of electrical cables and wires with an installed capacity of 77 million core meters. It had an engineering Project Division which undertook turn-key contracts having turnover around Rs.15 crores (26% of turnover of ABC) during the

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current year. ABC had a satisfactory profit record and had been paying dividend. ABC undertook a major modernisation scheme at its existing plant at Shitlapur in 1992 for which it had availed of from the institutions, debt assistance. The analysis of balance sheets and profit and loss account for the last 4 years, the shareholding pattern and the term debt and debenture profiles as on March 31, 2002 of ABC are given in *Annexures 1, 3 and 4* respectively.

XYZ, Acquiree Company - XYZ was also promoted by the same promoters. XYZ is engaged in providing engineering services, such as industrial leak sealing under high pressure in process industries such as, chemicals, petrochemicals, fertilisers, steel, paper, etc. in technical collaboration with U.K. based MNC. It was also engaged in the business of leasing. The profitability of XYZ was in general, satisfactory. Due to its nature of activities (servicing and leasing) the XYZ current ratio was adverse. As on March, 31, 2002, XYZ's equity share capital of Rs.40 lakhs was held by the Indian promoters and associates (64%) and foreign collaborator (36%). Subsequently, in May, 2002, XYZ issued bonus shares to the existing shareholders in the ratio of 1:1. As a result, equity share capital of XYZ now amounts to Rs. 80 lakhs and shareholding pattern remains the same. The analysis of balance sheets and profit and loss account for last 4 years shareholding pattern and term debt profile are given in *Annexures 2 and 5* respectively.

Benefits frem Merger- ABC besides manufacturing of electrical cables and wires, provides engineering services. XYZ also provides engineering services. There was commonality between the clientele of the two companies. Thus, the proposed merger of XYZ with ABC would benefit both the companies by rationalising activities of their respective engineering service divisions by way of economies of scale, reduction in overheads and other expenses, reduction in administrative and procedural work and more productive utilisation of manpower and other resources. The amalgamated company

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would be in *a* better position to withstand fluctuation in activities of any of its divisions, command larger resources and larger capital base and would be able to execute larger projects.

On the basis of projections (given in *Annexure 7 and 8)* and analysis of the given information *(Annexure 1 to* 6), valuation of shares was done (as per *Annexure 9)* and share exchange ratio of 2 fully paid up equity shares of ABC for 3 fully paid up equity shares of XYZ (considering 8,00,000 equity shares of XYZ) was suggested.

A

N

Sum

mary

Fixed Assets

Land and

Plant a.nd

Others

Gross fixed

Less:

Net fixed assets

Investments

Current Assets

Stores

Receivables

Advances

Cash and cash

Current Liabilities

Creditors 2

1

9 Unpaid dividends *7*

Provision for 2

Bank borrowings 2

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Unsecured 1

3

Surplus of Current

Assets over

Current Liabilities 1

Net Tangible 1

Represented by

Ordinary share 4

Reserves 7

Debentures and 5

ICICI —

Banks 9

1

Debt: Equity Ratio 0

.

Current Ratio 0

1 . Includes assets .305 lac in 2001.

2. Includes SOD (secured overdraft) from banks for purchase of

3. By way of bonus issue of 1 :1 during the year.

L

Upto March 31

1

Total income 2

Salaries and wages 2

Consumable stores 3

Repairs and —

Administrative 3

Selling expenses 4

9

Profit before

interest, lease

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and depreciation 1

% of gross profit 6

Lease rentals —

Interest charges 3

Depreciation

52 Operating profit/(loss)

39 % of operating profit to

total income 20.7% % of

operating profit + interest to

capital employed

i Ne

t

pr

ofi

t

Cash

A

N

Equity Shareholding Pattern

Pr P

Ltd

XYZLtd N

o

Indian

7,65,359

Promoters

36.8

0

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D.

Working Results of

Amalgamating Units during

April to December, 2002

ABC

Total income 3552

Profit before interest and 406

Interest 271

Depreciation 61

Net profit 74

AN

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D.

Projected Profitability of

Amalgamating Units during April,

2001 to March, 2002

ABC ***XYZ***

Total income 5695 363

Profit before interest and depreciation 585 190

Interest 395 52

Depreciation 90 107

Net profit 100 31

AN

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RE

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AB

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LT

D.

Consolidated Projected Balance Sheet as on April 1,2002

(Rs. in lacs)

Liabilities

Share Capital

Equity 256

— Preference 55 311

Reserve and Surplus

1244

Debenture

274

Term Loans

— FA 175

— FB 175

— FG 111

— FD 87 548

Unsecured borrowings

392

Bank borrowings for working capital

2098

Current liabilities and provisions

Assets:

Net fixed assets 1904

Investments 339

Current assets 3418

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5

6

6

1

Debt: Equity Ratio 0.53 :1

Current Ratio 1.04

ANN

EXU

RE 9

ABC

LTD

.

Basis of Valuation of Equity Shares of Amalgamating

Companies

(Rs. in lacs)

ABC XYZ

No. of equity shares as on March 31, 1992 20,25,000

4,00,000

Net worth of equity on assets basis

as on March 31, 1992- 656.07 133.05

Break up value per equity share (in Rs.) 32.50 34.76

Net worth of equity on yield basis by capitalising

average profit of last 5 years @ 15% (Rs. in lacs) * 715.09

233.54

Earnings value/equity Share (in Rs.) 35.51 58.39

Fair value (in Rs.) 33.86 46.58

Exchange Ratio In May, 2001 XYZ issued bonus shares

to its existing shareholders

in the ratio of 1:1. As a

result, No. of paid up equity

shares of XYZ increased to

8,00,000. On this basis,
exchange ratio works out to
be 2 fully paid up equity
shares of ABC for every 3
fully paid up equity shares
of XYZ.

ANNEXURE 10

ABC
(AMALGAMA
TED)
(31.3
200 Net worth (Rs. in lacs) 989
No. of equity shares 20,2
Break-up value per equity 48.8
Earning per share (Rs.) 4.93
Debt-Equity Ratio 0.60
Current Ratio 1.14

Case Study 9: SCOPE OF AMALGAMATION

The scope of amalgamation has been discussed in the case of *Telesound India Ltd.* In re (1983) 53 Comp Cas 926 (Del).

The facts of the case are that the schemes of amalgamation of the transferor and transferee companies were under the jurisdiction of two different High Courts. It is not the requirement of law that both the companies should go to same High Court for sanction of schemes. The scope of amalgamation is not restricted to case of companies in financial difficulties.

In a petition under Section 394 in the main winding-up petition filed by S, a financer, a scheme of amalgamation was proposed. The scheme was opposed by S and the landlord of the premises tenanted by the transferor company. The shareholders of both the transferor and the transferee companies had unanimously adopted the scheme of

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amalgamation. Clearance under the MRTP Act was also obtained
from the Central Government. Scheme of amalgamation was also
approved by the appropriate authority for the purpose of the benefit
under Section 72A of the Income-Tax Act. Besides, it was also
approved by a number of financial institutions. From the point of view
of the creditors of the company, the amalgamation offered much
better prospect.

The court had sanctioned the scheme elaborating the requirement
of the law at length. The following are the important explanations
found in the text of court order;-

(1) Once the court approves the amalgamation, the
amalgamation becomes
effective and binding by the transfer to the transferee company
of the whole
or any part of the undertaking, property, rights and liabilities of
the transferor
company by virtue of the provisions of Section 394 of the
Act, which are
intended to facilitate the process of amalgamation.

(2) The transferor company does not die either on
amalgamation or on
dissolution without winding up under Section 394(1). It only
merges with the
transferee company but for all purposes remains alive thriving
as part of the
larger whole and not being wound up on merger as
winding up is
unnecessary.

(3) If the two companies are under the jurisdiction of two
different Courts they
have to move to their respective High Courts for obtaining

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sanction of
scheme. The amalgamation becomes effective only after the
scheme is
sanctioned by both the High Courts respectively.
(4) A compromise or arrangement under Section 391 is either,
between a
company or its creditors, or between a company and its
members. Even
though there may be nothing to prevent a Court in a fit case
to give an
opportunity to the creditors of the transferor company to
express their views
but only the members of the company are entitled to vote on
a proposed
amalgamation.
(5) An examination of scheme of Chapter V and the etymology of
the expression
"liable" would show that it was used to enlarge the scope of
Sections 391 and
393 and was not intended to restrict the provisions to companies
which faced
financial difficulties and in defining the expression
"Company" in Section
390A.
(6) Section 72A of the Income-Tax Act, 1961, provides that on
amalgamation the
amalgamated company would be entitled to take
advantage of the accumulated losses of the transferor company
to reduce its,tax liability, and the definition of 'amalgamation' in
Section 2(1 B) of that Act.
(7) The expression "liable to be wound up under this Act" in Section 390,

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cannot
be restricted to mean that the conditions for the winding up of the
company
have been satisfied, but must be widely construed so as to mean that
the
company was capable of being wound up under the Act, since, if it
were to
mean a company in terms of Section 3, a large number of companies
such
as unregistered companies and foreign companies, would be
outside the
purview of the provisions contained in Chapter V of the Act with
regard to
compromise, arrangement and reconstruction including amalgamation,
even
though these categories of companies would be within the winding-up
sweep
of the Act by virtue of the provisions in Part X of the Act, wherefor
"company"
is redefined in Section 390(a) for the purpose of Sections 391 and 393,
so as
to bring these categories of companies within Chapter V and, *inter
alia,* to
enable these companies to become parties to schemes of
amalgamation,
etc.
(8) The expression "property" and "liabilities" which can be
transferred on
amalgamation under Section 394(1) have been defined in very wide
terms by
Section 394(4)(a), so as to include "rights and powers of every

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description"
and "duties of every description" under a'contract, including *a*
contract of
tenancy which are co-extensive with the property and the right
which the
transferor company has in relation to its assets, but which would not be
wider
than what the transferor company was entitled to enjoy.
(9) As to how much shares have to be allotted by the transferee company
to the
existing members and in what ratio or proportion to their existing
holding,
under a scheme of amalgamation, is a matter entirely between
the
companies and their members. There is no further requirement
of the
Companies Act for the purpose of a valid scheme of
amalgamation. The
court is not concerned with the requirement of Section 72A for the
purpose of
sanction even though it would be desirable that these
requirements are
satisfied. An objection cannot be raised that, under the scheme,
redeemable
cumulative preference shares could be redeemed by the company
after a
specified number of years and in that event the shareholders of the
transferor
company may cease to be the shareholders of the transferee company.
That
they would be members of the company in perpetuity is not the

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requirement.
All that the law requires is that they become shareholders. No
shareholder
can be compelled to remain a member of a company apart from the
peculiar
requirement of redeemable preferential share. Such an eventuality
may
happen at any future time even with regard to equity shareholders.
There is a
right for every shareholder to transfer his shares and there can
be no
restriction. The nature of the provision in the scheme with regard
to the
allotment of shares cannot be held, therefore, to be destructive
of any
necessary characteristic of amalgamation or any of the requirements
of the
Companies Act or of Section 72A of the Income-Tax Act, 1961.
The Court held that:
(i) Th,e scheme of amalgamation deserved sanction. Though there was
scope to improve the scheme of compromise with the creditors so
as to remove certain inequities and to give a better deal to the
depositors among the unsecured creditors of the company, if it was
possible to modify the scheme of compromise with that object in
view, it would be unfair to withhold sanction.
iii) The landlord was clearly outside the scheme of compromise
and his claim for
arrears of rent remained unaffected by the scheme by its very
terms, (iii) Considering the case of S, the court had held that
prima facie he was a creditor, but there were counter-claims
arising out of alleged liability to render accounts. A suit by the

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company was pending and S was yet to seek, his legal remedies against the company. If he was to seek a winding up of the transferee company after his claim has been adjudicated, he would obviously be at a disadvantage in having to invoke the jurisdiction of another Court (under which the registered office of the transferee company was situate), if it was eventually held that one of the two Courts which sanctioned the scheme of amalgamation and compromise had no jurisdiction.
Fortunately, the transferee company had been averse to the entire process of adjudication of his claim taking place in Delhi, which was possible in appropriate proceedings under the Companies Act itself, either under Rule 83 or under the general directive or directory jurisdiction of the Court under Section 392 of the Act, as the court which sanctioned the scheme.
On a consideration of the facts and circumstances of the case, the Court felt it reasonable to make appropriate modifications in the scheme with a view to secure a better deal for the depositors but in such a way that the project prepared by the experts of the transferee company were not drastically disturbed so as to make the project uneconomical or less viable, and, accordingly, made suitable modifications of and gave appropriate directions on the schemes.
In the above case the following cases were referred to *Anand Niwas Pvt. Ltd.* v *Anandji Kalyanji's Pedh* (1965) AIR 1965 SC 414; *Damadi Lai* v. *Parashram* (1976) AIR 1976 SC 2229; *Haji-Mohd., Din* v. *Narain Dass* (1979) AIR 1979 Delhi 186 (FEB); *Hillv. Parsons (C A) and Co. Ltd.* (1971) 3 All ER 1345; *J K (Bombay) P. Ltd.* v. *New Kaiser-l-Hind Spg. and Wvg. Co* (1970) 40 Comp Cas 689 (SC); *Khandelwal Udyog Ltd. and Acme Mfg. Ltd.,* In re (1977) 47 Comp Cas 503 (Bom); *Nokes v. Dancaster Collieries* (1940) 3 All ER 549; (1941) 11 Comp Cas 83 (HL); *Official Liquidator of Globe Associates* v. *Sharma* (HP) (1971)

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1 ILR Delhi 149; *Sailendra*
Kumar Ray v. *Bank of Calcutta Ltd.* (1948) 18 Comp Cas 1 (Cal);
Seksaria Cotton -
Mills Ltd. v. *Naik* (AE) (1967) 37 Comp Cas 656 (Bom); *Traders*
Bank Ltd.. In re.
(1949) (Lah) 48, *Travancore National and Quilon Bank.* In re (1939) 9
Comp Cas 14;
AIR 1939 Mad 318; *Union of India* v. *Asia Udyog Pvt. Ltd.* (1974) 44
Comp Cas 359
(Delhi).

Case studies - 10

There are many reasons why a company may aim to achieve growth rather than remain at the same size. Firms which grow benefit from the economies of scale which eventually lead to a greater profit. Firms aim to maximize their profit as this is the ultimate goal for all firms. Economies of scale give greater technical efficiency, spreading fixed costs, bulk buying, agglomeration and so on. That is, technical efficiency generally increases as the size of the firm increases, MR = MC and profit is maximised. For example, in the mission statement of National Foods Limited (NFL), it aims to achieve "optimal levels of productivity and profitability whilst at the same time ensuring that shareholders' investments are safeguarded through ethical and prudent business practices." ie. maximum technical efficiency. Public companies (the larger ones) also have greater access to capital through share floats and subsequent rights issues that they can offer. This is a benefit of being a large, public company. For example, NFL states, as one of their aims, to maximise returns to shareholders through capital growth and dividends. This is just one example of how important access to capital is. Finance from the public is also preferred to finance in the form of a loan, from a bank as repayments are not legally essential. This is something that only a large

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firm can do. Large firms have a degree of security and stability about them. Generally, there is more security in your job and work environment in a grown, established company rather than in small companies. For example, one of NFL's aims is to achieve "operations which continue to be carried out in a responsible manner within an environment that provides safe working conditions for all employees." Employees whose jobs are not under threat tend to work more efficiently without delays. NFL also aims to achieve job satisfaction by its employees and rewards them appropriately for effort and initiative. Finally, large companies are well known and with their status can exert a lot of power and influence on people. Power and respect is desired by almost everyone and thus firms aim to achieve this. NFL aims to achieve leadership in the industries in which its businesses operate. An example of this kind of business is the yoghurt industry in which one of NFL's company, National Dairies, has recently gained the right to manufacture yoghurt in Australia under the Yoplait brand name. Previously, National Dairies was operating at a loss because no one wanted to buy yoghurt under a name they hadn't heard of but now National Dairies is becoming a market leader in all market sectors because Yoplait is providing a strong "umbrella" brand to the business. With this comes access to international research and product development programs from the owner of the Yoplait brand. Thus influence and brand names can lead to other benefits from having power. One 1995/1996 objective was to achieve status as a world competitive producer.

2) PATHWAYS FOR TAKEOVERS & MERGERS

A takeover occurs when one company secures over 50% of another company. This can be for several reasons such as the benefits of economies of scale (especially with the sharing of management), greater marketing power and complimentary products. An example of a lateral integration is Mercantile Mutual Financial Services Limited (MM)

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currently taking over Pacific Mutual Australia Limited (PMA). MM is offering the shareholders of PMA a cash offer of $2.30 for each ordinary share that they own. In addition, another fully franked dividend of $0.10 per share will be offered by PMA once the offer is declared unconditional. One condition is that MM must receive 90% or more acceptance for PMA's shares. This offer values PMA at $98 million. The board of management of PMA have recommended acceptance to the bid in the absence of a higher offer. MM's aim in acquiring PMA is obviously to expand its company. Whilst it may be considered horizontal growth it can also be argued that this is lateral growth since both companies, whilst offering some similar services, are not entirely the same. MM is a "leading insurance and financial services group" whilst PMA is an
investment management and life company. One of the reasons MM desires to takeover PMA is for greater access to capital. PMA is a large, public company with almost $2
billion in funds under their management including the Armstrong Jones property trusts. The acquisition of PMA will extend MM's operations into listed property trusts. As
PMA also has a share of the New Zealand market in its fund management, MM will be expanding its market by acquiring PMA. Additional growth will occur in their life and funds management businesses. Another example of inorganic company growth is a merger between more than one company. An example of this is was the 1995 SBS IAMA Limited integration of eight independent IAMA businesses and one publicly listed SBS Rural Ltd into one national rural distribution and retail organisation. This integration was spread across nine different companies. It could be argued that it was a horizontal integration as eight of them were very similar in levels of production but it is more likely seen to be a lateral integration. Benefits from this include more access to capital, complimentary (rural) products, a much

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larger brand name (for power marketing purposes) and for some related fixed costs such as management and marketing. The merging of SBS IAMA was considered successful to the point that it was referred to as a "capital raising" activity rather than just a merger.

3) FORMS OF BUSINESS GROWTH

(increased market share; product development; growth of market from external sources; profit growth) Steady growth in profits, assets and income can be used as one form of measurement of business growth. In the 1994/1995 Financial year, Burswood Property Trust (Burswood)'s operating revenue increased by 11.7% from the previous year to $429.1 million. In 1986 operating revenue was $43 million in the first 6 months of trading. Its net income (after tax) increased 19.6% to $52.6 million. Distribution (dividends) increased 27% to 15.5 cents per share. However Burswood attributes this growth in profits to increasing demand from a market which Burswood itself, is gaining a greater share of. This increase in demand and the fact that Burswood has an exclusive casino licence, means that growth of the company has been and will continue to be attributed to growth in demand and the market. The external sources contributing to growth in the market are the geographical proximity of Perth, strong economic growth in Asia and an increase in demand from growing middle class populations for "the quality gaming experience, resort facilities and service which are unique to Burswood". Burswood's share in the Asian market has grown significantly in the past decade and looks set to continue with this growth, despite increase in competition as well. Burswood is not unlike a monopoly here in WA. Whilst other casinos are opening up elsewhere in the country and the region, none are opening in Perth. Burswood also believes it has further developed or rather improved its products and services which have helped prompt an increase in demand. Newly introduced games in the main gaming hall, huge casino "African Safari" promotions and new player incentive programs have all

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increased demand from patrons. Recent awards for tourism
and service excellence give the casino great marketing power and a
good reputation which future patrons may base their visits upon.
Another example of expansion through profit growth is PMA. In the
financial year ending 30 June 1995, PMA recorded increases in profit
after tax (+3%), earnings per share (+1%) and dividend to shareholders
per share (+23%) from the previous financial year. This followed
continuous growth in all three areas since 1992. At the same time, the
amount of shareholder's funds had increased as well from more than
$50 million in 1992 to more than $80 million in 1995. Debts had been
reduced to naught and gross funds under management had increased
from $4.05 billion to $4.3 billion. These excellent results won them a
"Golden Target" award for investor relations, adding prestige to their
name. This shows that as the company grew in size, worth and power,
demand for their services increased as well.

4) SOURCES OF FINANCE FOR BUSINESS GROWTH

There are several ways of raising finance for a company. Determining
which method is used to get it, depends on how much finance is needed
in the first place and the current net assets of the company, how
urgently the finance is needed, whether or not and how long before the
money will be payed backed and other factors. Some companies will
choose to float some shares in their company as a source of finance.
Whilst this is can be useful in that there are no legal obligations for the
company to pay back the shareholders, unlike with a loan from a bank,
it is really only useful when large sources of finance are needed as
marketing of the company is time consuming and expensive as
preparation of prospectuses, share brokers and advertising need to be
organised and paid for. However in the case of Hoyts Cinema Ltd, a
share float appears to be quite appropriate as they seek to gain around
$100 million to fund their expansion. Hoyts is offering 50 million
shares at $2.00 each to give the company a market capitalization of

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around $440 million. Profit growth for Hoyts in 1996 has slowed down from 1994-95 when huge box office successes like Forrest Gump and The Lion King raised a lot of revenue for Hoyts. They now plan to hopefully increase their revenue and thus their profit by expanding with 100 new cinema screens around the world. To do this, finance is being raised from this share float. This is not the first
time for the Hoyts name, the radio group Hoyts Media and Hoyts Entertainment previously floated in 1987 but fell into receivership later on. That was a different float.
However it is posiible for a "second float" to take place in the same company after shareholders have bought their shares. It is still possible for the company to offer more
to the public, for extra finance. A new issue of shares is a rights issue and an example of company which has done this is Petroz NL. Petroz is offering a renounceable rights
issue of one new ordinary share at $0.65 per share for every two ordinary shares that a shareholder currently owns. This is being held to raise approximately $42.60 million. As this is an expensive exercise, after costs of marketing have been taken into account, it will actually raise only $41 million. The price of the rights issue is approximately 20% cheaper than the recent trading price of normal Petroz shares.
Petroz is seeking to gain extra finance to fund "the continuing appraisal of the reserves and reservoir performance of the Bayu – Undan gas/condensate field"; extensive engineering studies; potential development of two oil fields and funding of an active oil exploration program. As the level of risk is relatively high, Petroz seeks to fund these activities from existing cash flow, rather than debt. Thus it has chosen to issue a rights issue in place of a loan from a financial institution with the risk that they may not be able to pay it back.

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