Mergers and Acquisitions

Text and Cases

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To

My beloved mother

Santha

Preface

Mergers and industrial/corporate restructuring have become topics of great importance in the global corporate arena. Mergers and acquisitions (M&A) have become world-wide phenomena to achieve strategic and financial objectives. In the context of a changing business environment, many firms have no other alternative but to merge, acquire or to be acquired. M&A activity has manifested itself in waves which are driven by a combination of various economic, regulatory and technological changes. The M&A wave is different in industry focus, transaction types, capital structures, presence and absence of hostile takeovers, mega deals and favourable economic factors like falling interest rates, booming stock market and the expanding economy.

It is no surprise, therefore, that announced M&A deals hit an all-time-high record in 2006 topping $4 trillion globally. Private equity firms represented nearly a quarter of the deals in 2006. M&A activity slowed worldwide in 2007–08 largely due to uncertainty in the global credit markets and fall in the share market around the world. According to Thomson Reuters, global M&A totalled $3.1 trillion in announced deals during 2007–08. According to the Grant Thornton Report, the total number of M&A deals announced in the year 2008 was 454 with a total announced value of $30.95 billion. Global M&A activity again showed signs of recovery in February 2010, with a 3.8% increase in the number of announced transactions. Due to bigger deals, reported dollar volume jumped by 211% in comparison to that in February 2009, which was the lowest-volume month since 1996.

India has been a late starter in the M&A events due to rigid regulations, but in recent years cross-border deals are happening faster. The increased cross border M&A activity can be seen as the response to globalised competition since 1990s.The period from 2000–2007 saw Indian multinationals engaged in 594 overseas acquisitions with an underestimated value of $51.2 billion. The increased momentum of overseas acquisitions by Indian firms can be attributed to India's higher economic growth, rising foreign exchange reserve, continuing Outward Foreign Direct Investment (OFDI) policy regime, allowing domestic firms access to global financial markets, increasing bilateral trade and investment treaties. In the initial part of the year 2010, there were a total of 134 announced Indian M&A transactions, a 55.8% increase from the prior-year figure. Dollar volume of $15.5 billion represented a dramatic rise from $0.4 billion in January-February 2009, largely due to three billion-dollar-plus deals totaling $13.7 billion.

In this backdrop, the introductory chapter of this book discusses global M&A trends and focuses on the emergence of M&A wave in India. The next chapter explains the significance of economic, financial and strategic perspectives of M&A. The third chapter focuses on economic theories that have provided many possible reasons for why mergers might occur: efficiency-related reasons that often involve economies of scale, attempts to create market power, market discipline, diversification etc. The next chapter discusses various types and characteristics of M&A. The following chapters highlight the importance of due diligence, negotiation, deal structuring and methods of payment in M&A. The chapter on valuation highlights the various valuation models used for M&A process. The eighth chapter focuses on accounting issues for mergers; the chapter on corporate restructuring deals with the various types of restructuring activities. The next chapter discusses the various corporate control mechanisms and types of takeovers. The chapter on 'Post-merger

Integration' attempts to understand different aspects related to the integration process. The regulatory and legal framework of M&A is discussed in the following chapter. Empirical research on M&A has revealed a great deal about their trends and characteristics in the last century. Event studies have demonstrated that mergers create shareholder value, with most of the gains accruing to the target company. The chapter on M&A successes reviews research studies based on these business activities.

This is followed by a section discussing M&A activity in the major sectors in India. The cases* focus on sectors like pharma, banking, IT & BPO, consumer goods, airline, telecom, cement, auto, oil & energy, and metal. It also discusses high-profile deals like Tata's acquisition of Corus and Vodafone's acquisition of controlling stake in Hutchison-Essar. Further, it focuses on the growth strategy of the master acquirer—Cisco—through multiple acquisitions. The other major cases discussed include the Arcelor-Mittal merger and the story of GE acquisitions.

This book will serve as a basic resource for the students, scholars and executives dealing with M&A. It provides a methodological overview of the concepts in M&A and is supplemented by case discussions on real world M&A scenarios. It is my hope that the book will aid students and executives to comprehend more clearly the complexity of the dynamics inherent in the M&A process, as well as the synergies involved in it.

Acknowledgements

I wish to acknowledge the valuable contribution of Miss Kavya Shree and Mr Shiva Kumar in preparing the chapter on accounting for mergers and problems in valuation. I also thank Mr Erlingappa, Librarian at PGDMS, SIT Tumkur, for facilitating the use of resources.

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B Rajesh Kumar

*The case studies included in this book have been prepared for the sole purpose of aiding classroom teaching and discussion. They are not meant to serve as endorsements, or sources of data, or illustrations of effective or ineffective management.

Contents

1 Mergers and Acquisitions: Trends

Chapter Objectives

The aim is to make the reader understand:

- The significance of M&A
- Sectoral M&A activity in India
- Factors driving M&A
- The significance of cross border M&A
- The challenges and reasons for cross border M&A

INTRODUCTION

News regarding mergers, takeovers, restructuring and corporate control make newspaper headlines daily. Mergers and industrial/corporate restructuring have become topics of great importance in the global corporate arena. They represent a major force in modern financial and economic environment. Acquisitions remain the quickest route companies take to operate in new markets and to add new capabilities and resources to existing ones. As markets globalise and the pace at which technology changes continues to accelerate, more and more companies are finding mergers and acquisitions (M&A) to be a compelling strategy for growth. Whether in times of boom or bust, M&As continue to be the preferred option for businesses seeking to grow rapidly and more importantly, they end up changing the rules of the game.

M&A, by which two companies are combined to achieve certain strategic and business objectives, are transactions of great significance not only to the companies themselves but also to all other stakeholders, like employees, competitors, communities and the economy. Their success or failure has enormous consequences for shareholders and lenders as well as the above-mentioned constituents.

Events like M&A are of great significance in the modern political environment. The historic corporate battle between Mittal Steel and its unsolicited hostile bid on Arcelor stirred up passions in Europe, with politicians, ministers and even ordinary citizens joining in the discussion. In this context, France and Luxembourg have been accused of protectionism. Meanwhile, other steel makers like Japan's Nippon Steel, the world's third largest steel company after Mittal Steel and Arcelor have adopted the 'poison pill'* strategy to thwart hostile takeovers in the future.

M&A have happened in waves in the last 100 years. In the wave of the 1990s, the value of M&A deals in the US rose from a mere $200 billion in 1992 to $1.75 trillion in 1999. In 1998 alone, 12,356 deals involving US targets were announced for a total value of $1.63 trillion. The value of M&A deals in Europe, at the height of the merger boom in 1999, was nearly $1.5 trillion. Deal volume during the historic M&A

*A strategy used by corporations to discourage hostile takeovers. With a poison pill, the target company attempts to make its stock less attractive to the acquirer.

wave of 1995 to 2000 totalled more than $12 trillion. The value of global M&A activity amounted to $3.8 trillion in the year 2006. American companies, for instance, created titanic business entities by announcing 74,000 acquisitions and 57,000 alliances from 1996 through 2001**.** It is said that during those six years CEOs signed roughly an acquisition and a partnership every hour each day and drove up the acquisitions' combined value to $12 trillion[1] (Dyer et al., HBR, 2004).

Globally 2,932 M&A deals worth $732.32 billion were undertaken in 2006. According to Bloomberg Data Report 2006, Great Britain was the most preferred destination for bidders, with deals valued at $110.6 billion. The other preferred destinations were the United States ($94.81 billion), Canada ($49.68 billion), Luxembourg ($ 39.20 billion) and France ($23.51 billion). India was the 18th most preferred destination.

Figure 1.1 indicates the global M&A activities during 1995-2006.

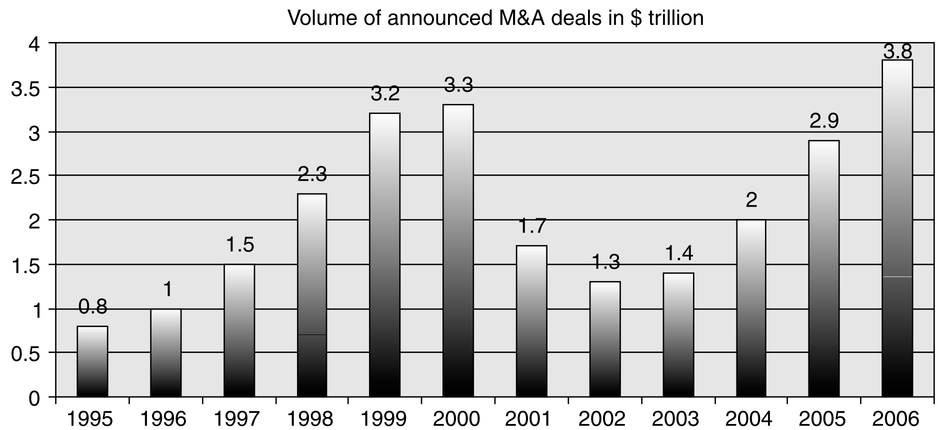

Figure 1.1 *M&A Activity: 1995-2006*

Source: Dealogic; Mckinsey Analysis 2006.

As given in Figure 1.1, in the year 1995, the value of M&A deals was about $0.8 trillion. By 2000, it rose to $3.3 trillion. The value of M&A deals touched $3.8 trillion by the year 2006. The M&A boom in 2006 surpassed the record levels of 2000. It is observed that the value of M&A deals have increased by about 4.75 times in 2006 compared to the year 1995. The global M&A pattern has been showing a cyclic nature during the past 12-year period.

Merger Movement

Mergers have, over the course of the last century, transformed the corporate landscape. A careful examination of the 1,000 largest manufacturing companies of 1950 revealed that 384 of them had disappeared through mergers by 1973. A look at the 100 largest corporations in the United States reveals a mere handful for which mergers did not figure substantially in their growth at one time or another. Exxon, United States Steel and General Motors were spawned in the early merger waves.

The First Wave (1890-1905): The 'great merger movement' was a predominantly US business phenomena that happened from 1890 to 1905. During this period, small firms with little market share consolidated

[1]Jeffrey H Dyer, Prashant Kale and Harbir Singh, 'When to Ally & When to Acquire', Harvard Business Review, July–Aug 2004, pp. 109-115.

with similar firms to form large powerful institutions that dominated their markets. During this period, it is estimated that more than 1,800 firms disappeared due to consolidation. In the 1900s, the value of firms acquired in mergers was 20% of its GDP. This could be quite interesting when compared to the fact that the value was only 3% and from 1998–2000 it was around 10–11% of the GDP. Many of the corporate giants in the US, like General Electric, Eastman Kodak, American Tobacco and Dupont, were formed during the first wave. It is said that approximately 71 important oligopolistic or near competitive industries were converted into near monopolies by mergers. This restructuring of the American industry remained in steady state for the next fifty years.

One of the major short run factors that sparked the 'great merger movement' was the desire to keep prices high. During this period, when the demand declined, firms found it profitable to collude and manipulate supply to counter any changes in demand for the good. This type of cooperation led to widespread horizontal integration amongst firms of the era. In the long run, in order to keep costs low, it was advantageous for firms to merge and reduce their transportation costs, thus producing and transporting from one location rather than various sites of different companies as in the past. In addition, technological changes prior to the merger movement within companies increased the efficient size of plants with capital intensive assembly lines allowing for economies of scale. The merger movement during this period basically consisted of horizontal mergers, which resulted in high concentration in many industries, including heavy manufacturing industries. This merger movement of the turn of century accompanied major changes in infrastructure and production technologies. It followed the completion of the transcontinental railroad system, the advent of electricity and the increased use of coal.

The Second Wave of the 1920s This wave followed the 1903-1904 market crash and the First World War. This was a much smaller wave than the first in terms of relative impact. In totality, it involved less than 10% of the economy's assets. It is estimated that during this wave, characterised by the period of economic growth and stock market boom, about 12,000 firms disappeared. In industries dominated previously by one giant firm, the mergers led to the formation of strong number two companies. In the manufacturing sector, most mergers either resulted in small market share increases for the merging firms or in vertical integration. This merger wave contributed to oligopolistic structure in many industries. The public utilities and banking industry were involved in the merger activity to a greater extent during this period. During this period, about 60% of the mergers occurred in the still fragmented food processing, chemicals and mining sectors. A large portion of the mergers in the 1920s represented product extension mergers, as in the case of IBM, General Foods and Allied Chemicals, market extension mergers in food retailing, department stores, motion picture theatres and vertical mergers in the mining and metal industries. It collapsed due to the stock market crash and depression during 1929-1930.

The Third Wave of the 1960s The merger activity increased after the end of the second world war and peaked during the 1960s. During this period, mostly unrelated mergers took place which were basically aimed at achieving growth through diversification into new product markets. Among the Fortune 500 companies, the percentage of unrelated business category increased from about 4% in 1949 to about 9% in 1960s. The third wave resulted in a massive shift in the business composition of US firms towards greater diversification. This merger period is known as the '*period of conglomerate merger movement*'. The conglomerate firms were diversifying to avoid sales and profit instability, adverse growth developments, adverse competitive shifts and technological obsolescence. Jensen[2] (1983) proposed that most merger activity since mid-1970s had been caused by technological and supply shocks, which resulted in excess productive capacity in many

[2]Jensen M, 1993, 'The Modern Industrial Revolution, Exit and Control Systems', Journal of Finance 48, pp. 831-880

industries. He argued that the mergers were the principal way of removing excess capacity as faulty internal governance mechanisms prevented firms from 'shrinking' themselves.

The Fourth Wave of the 1980s The 1980s witnessed one of the most intense periods of merger activity in the US economic history. This period witnessed the fourth merger wave of the twentieth century. The fourth wave was unique compared with the three prior waves. It specifically featured the hostile takeover and the corporate raider. In addition, in the 1980s, the junk bond market grew into a tool of high finance whereby bidders for corporations obtained access to billions of dollars to finance raids on some of the largest, most established corporations in the US. The period also featured an unprecedented volume of mergers and acquisitions compared with the previous periods. This period also witnessed the rapid growth and decline of the *leveraged buyout* (LBO)—the use of debt capital to finance a buyout of the firm's stock. Mergers and acquisitions in this wave were concentrated in such service industries as commercial and investment banking, finance, insurance, wholesale, retail, broadcasting and healthcare, and in the natural resource area. The RJR Nabisco leveraged buyout at $25 billion in 1988 was the blockbuster takeover for the wave of merger and acquisition activity that began in 1980. Studies[3] have documented that a substantial portion of takeover activity in the 1980s could be explained by industries reacting to major shocks, such as deregulation, increased foreign competition, financial innovations and oil price shocks.

The Fifth Wave of the 1990s The fifth wave that started in the 1990s was distinctly different from the wave that preceded it. The deals of 1990s were not highly leveraged hostile transactions that were common in the 1980s. They could be categorised as strategic mergers. In the 1990s and 2000s, there was significant increase in the volume of European mergers. The fifth wave focussed on core competencies as the source of competitive advantage. The merger activity peaked in the year 2006 with the value of M&A deals touching $3.8 trillion. The fifth wave was characterised by the advancement of new technologies, globalisation of products, services and capital markets. The economic environment saw the emergence of supranational trading blocs, such as the Single Market of the European Union, North Atlantic Free Trade Association, which includes the US, Canada and Mexico, and creation of the World Trade Organisation which facilitated lowering of barriers and capital mobility.

Mega Mergers

The ten biggest deals as of the year 2003 were AOL and Time Warner, Pfizer and Warner- Lambert, Exxon Mobil, Comcast and AT&T Broadband, Verizon and GTE, Travelers and Citicorp, SBC and Ameritech Pfizer and Pharmacia, Nations Bank and Bank of America and Vodafone and Airtouch. Most of these acquisitions were acquisitions of customers.[4] SBC bought Ameritech mainly to reach a huge new group of customers to sell telecommunications services. The most frequent claim for big deals is that they create enormous opportunities for cross selling. When Citicorp merged with Traveler's, Citi was going to sell Traveler's insurance and brokerage services to its millions of customers and Traveler's was going to sell Citi's retail and commercial banking to its customers. When AOL bought Time Warner, each would sell advertisement and subscriptions for the other and Time Warner would deliver AOL over its cable TV systems. Cisco is highly active with its acquisition strategy. For example, during the period 1994–2000, Cisco acquired 51

[3]Mitchell M, Mulherin J, 1996, 'The impact of Industry Shocks on Takeover and Restructuring Activity', Journal of Financial Economics, 41, pp 193-229
[4]Larry Selden and Geoffrey Colvin, 'M&A Needn't be a Loser's Game', Harvard Business Review 2003, pp 5-12

companies. Contributing significantly to Cisco's strategic competitiveness and its ability to consistently earn above average returns is the company's acquisition strategy. The corporate growth for the company is achieved by acquiring firms with products and technologies the firm cannot or does not want to develop internally.[5] During 1996-2000, GE made over 100 acquisitions. In the 1990s, Siemens spent $8 billion on acquisitions. Microsoft buys, on an average, 10 technology companies a year. When Time Inc and Warner Communications combined their two companies in 1989, they created the first giant media conglomerate. They focused on dominating—through size and leverage—all aspects of that market, from print to television to movies and electronic media. The merger of AOL and Time Warner illustrates how innovation that creates rapid market growth can be exceedingly highly valued by the stock market. The market valued the new markets being created by AOL over the older ones being served by Time Warner. The historical setting was when the then new electronic commerce, or e-commerce, had spawned a whole new lot of companies and media industry. The booming stock market of the 1990s had priced most of these new companies exceedingly high. America Online (AOL) was one of these providing service access to the Internet subscribers. In January 1999, it used its very high market value to merge with an older media company, Time Warner.

In 1995, Glaxo PLC's acquisition of Wellcome PLC signified the fact that in pharmaceutical industry, mass was critical in order to compete against the onslaught of generic and branded drug competition. In 1996, two Swiss competitors, Sandoz Ltd. and Ciba Geigy Ltd., were merged to form a new company, Novartis. The merged company became a world leader in many therapeutic areas, including immunology, inflammatory diseases, central nervous system disorders, cardiovascular, endocrine and metabolic diseases.

The key purpose of the acquisition of Atlantic Richfield by BP Amoco was to increase the acquiring firm's market power.

Chrysler has merged with German giant Daimler Benz in a huge trans-Atlantic merger in July 1998. At the time of its announcement, the merger between Daimler Benz and Chrysler Corporation was the world's largest. This horizontal cross border transaction was intended to create market power and generate synergies on which the world's preeminent automotive transportation and services company could be built.

GE Capital was founded in 1933 as a subsidiary of the General Electric Company to provide consumers with credit to purchase GE appliances. Since then, the company has grown to become a major financial services conglomerate with 27 separate businesses. The businesses that generate these returns range from private label credit card services, to commercial real estate financing, to rail car and aircraft leasing. More than half of these businesses became part of GE Capital through acquisitions.

Large size M&A deals also include the purchase by Chevron of Gulf Oil for $13.3 billion, by Philips Morris of Kraft for $12.6 billion, by Texaco of Getty Oil for $10.1 billion, by General Electric of RCA for $6.1 billion, by Eastman Kodak of Sterling Drug for $5.1 billion, and by General Motors of Hughes Aircraft for $5.0 billion.

In the year 2008, Federal Reserve facilitated the takeover of the two largest mortgage lenders in the US, the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation –fondly called Fannie Mae and Freddie Mac. Though Federal Reserve stepped in to save these mortgage lenders, it refused to do anything with Lehman Brothers which had to file for bankruptcy. Fed Reserve, in an attempt to save AIG, pumped in $85 billion to bail out the company. In 2008, Bank of America, the largest bank in the US, took over the country's largest brokerage firm, Merrill Lynch. Barclay's Bank decided to take over the bankrupt Lehman Brothers' investment banking business for $1.75 billion.

[5]Cisco Systems Inc 2000, www.cisco.com

Table 1.1 *Largest Worldwide M&A*

	Effective Year	Acquirer	Target	Transaction Value in $ Billion
1	June 2000	Vodafone Airtouch PLC	Mannesmann AG	$202.8
2	January 2001	American Online Inc	Time Warner	$164.7
3	June 2000	Pfizer Inc	Warner Lambert Co	$89.2
4	November 1999	Exxon Corp	Mobil Corp	$78.9
5	December 2000	Glaxo Wellcome PLC	Smithkline Beecham PLC	$76.0
6	October 1998	Travelers Group Inc	Citigroup	$72.6
7	October 1999	SBC Communication Inc	Ameritech Corp	$62.6
8	May 2000	Shareholders	Nortel Networks Corp	$61.7
9	September 1998	NationsBank Corp	Bank America Corp	$61.6
10	June 1999	Vodafone Group PLC	Air Touch Communications Inc	$60.3

Table 1.2 *Other Mega Mergers*

	Year	Acquirer	Target
1	1999	Qwest Communications	US West
2	1999	Citicorp	Travelers Group
3	1998	BP	Amoco
4	1998	Bell Atlantic	GTE
5	2000	Hewlett Packard	Compaq
6	2004	Royal Dutch Petroleum Co	Shell Transport & Trading Co
7	2001	Comcast Corp	AT&T Broadband & Internet Services
8	2004	Sanofi Synthelabo SA	Aventis SA
9	2002	Pfizer Inc	Pharmacia Corp
10	2004	JP Morgan Chase &Co	Bank One Corp
11	1997	Worldcom	MCI Communications
12	2006	AT&T	BellSouth Corp

Merger Activity in India*

The post independence period saw negotiated mergers between large business groups.[6] The early reported

[6]Under the Industrial Policy Resolution 1948, the Government accepted the concept of mixed economy for India with clearly defined roles for both public and private sectors. One important aspect of the development of the private sector since independence has been the spectacular rise of large business groups in the country. Large business houses developed a web of group companies, investment vehicles and cross shareholdings. The Monopolies Inquiry Commission (1965) found that 75 business houses controlled 1,536 companies. A business group or house was defined to comprise all such concerns which were subject to the ultimate and decisive decision-making power of the controlling interest in the group. The top business groups in the 1960s and 1970s included the Tatas, Birlas, Thapars and Singhanias.

*Also refer to the Appendix 1 given at the end of the book.

mergers in India included the merger of Bengal Iron and Steel Co with Indian Iron & Steel Co Ltd in 1936 and the acquisition of Pukhuri Tea Co Ltd by Bishnauth Tea in 1965.

Globalisation and liberalisation of the Indian economy at the onset of the 1990s paved the way for consolidation towards the end of the decade. During the decade, many business groups undertook restructuring processes to face competition.

Emergence of the M&A Wave in India During the pre-liberalisation licensing era (prior to 1991), several companies indulged in unrelated diversifications based on the availability of licences.[7] The companies thrived in spite of their inefficiencies because the total capacity of the industry was restricted due to the licensing policy. The policy of decontrol and liberalisation coupled with globalisation of the economy exposed the corporate sector to severe domestic and global competition. This was further accentuated by recessionary trends, which resulted in fall in demand, which, in turn, resulted in overcapacity in several sectors of the economy. Prior to 1994, the Murugappa Group[8], the Chabbria Group and the RPG Group sought to build industrial empires through acquisitions. They followed the prevailing industrial practice of building a conglomerate of diverse businesses.

The first wave of corporate deal making lapped Indian shores in the 1980s. This was the era of the first tentative reforms under Mr Rajiv Gandhi (the then prime minister of India) and the birth of large-scale corporate ambition. The first corporate raiders were Swraj Paul, Manu Chhabria and R P Goenka.

The second wave of M&As was largely built on the theme of corporate restructuring during the period 1992-1995. Post liberalisation, conglomerates that had built sprawling and unfocused business portfolios, were forced to sell non-core businesses that could not withstand competitive pressures.

The third wave splashed its way through the corporate landscape during 1997-2002. There was a round of consolidation in key sectors like cement and telecommunications. A new type of deal also made its presence felt–venture capital. Money poured into starts ups, especially in technology and IT services. However, many start ups could not survive leading to M&A activity in the IT arena.

The fourth wave (2004-2006) witnessed a flurry of global deals. Private equity investors and MNCs got bullish about India during this period. Overseas acquisitions by Indian companies also gained prominence.

A significant change happened in 1994 when the necessity for formulating a new takeover code was felt by the regulatory authorities. The policy and regulatory framework governing M&A evolved over the 1990s. Before 1990, an open offer was mandatory for acquiring 25 per cent stake in a company. In 1990, this threshold was reduced to 10 per cent of the company's capital. As a part of the package of reforms and policy liberalisation, the government announced the *New Industrial Policy* (NIP) in July 1991. NIP accorded a more liberal attitude to FDI inflows. Further, FERA restrictions on foreign ownership in Indian companies were abolished and the requirement of prior government approval on M&A was removed. In 1992, the Government of India created the *Securities and Exchange Board of India* (SEBI) with powers to regulate the Indian capital market and to protect investors' interests. In November 1994, with a view to regulate takeovers, SEBI promulgated the *Substantial Acquisition of Shares and Takeover* (SAST) *Regulation Act*, which was modelled closely along the lines of the *UK City Code of Takeovers and Mergers*. The revised SAST Regulation 1997 was amended in 2002, 2004 and 2006. The latest amendment in 2006 was

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[7]The Industries (Development and Regulation) Act was passed in 1951 to implement the Industrial Policy Resolution of 1948. According to the Industrial Licensing Policy, no new industrial unit could be established or substantial extension to existing plants made without a license from the central government, and while granting license for new undertakings, government should lay down conditions regarding location, minimum size, etc., if necessary. Later, through the adoption of Industrial Policy of 1991, industrial licensing was abolished for all projects except for a short list of industries related to security and strategic concerns.

[8]The Murugappa Group has grown through acquisitions. During the period 1980-1993, the group acquired twelve companies in diversified sectors like fertilizers, pesticides, sugar, ceramics, sanitary ware, cutting tools, metal section, chain, plantation and abrasives.

meant to facilitate M&As and help companies to restructure themselves to achieve greater economies of scale, and to compete in the global market.

According to Mckinsey data, by 2005, India emerged as one of the top three markets in Asia, with total deals estimated to have crossed the $20 billion mark, against $10 billion in 2004. Table 1.3 shows the trend of M&A activity during the last three decades.

Table 1.3 *Trends of Mergers and Acquisition in India*

Panel A

Year	Mergers	Acquisitions	Total
1974–79	156	11	167
1980–84	156	15	171
1985–89	113	91	204
1990–94	236	646	882

Panel B*

Year	Total
1995	450
1996	541
1997	636

**On account of non-availability of individual data for mergers and acquisitions, only the total number of M&A is available for the period 1995–97.*

Panel C

Year	Mergers	Acquisitions	Total
1998	80	650	730
1999	193	572	765
2000	294	1,183	1,477
2001	319	1,048	1,367
2002	381	843	1,224
2003	642	1,664	2,306
2004	272	797	1,069
2005	370	867	1,237
2006			1,141

Source: Compiled from Registration and Liquidation of Joint Stock Companies, various issues; Reserve Bank of India Reports; CMIE–Mergers and Acquisitions, SEBI, India/Economics, ABN Amro Data Trends, Sept 2004.

Figure 1.2 shows the M&A trends in India.

During the last 30 years, M&A activity has shown an increasing trend. It can be seen from Table 1.2 that during the earlier period, numbers of mergers were more compared to acquisitions. But post-liberalisation, number of acquisitions are substantially larger compared to mergers, with manifold increase in acquisitions

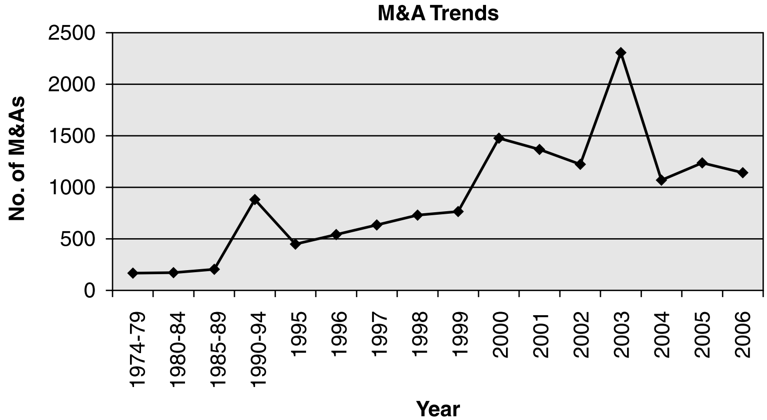

Figure 1.2 *M&A Trends in India*

in the post-1999 period. This can be attributed to the reform aspects in the takeover regulations.[9] The M&A trends given in Figure 1.2 reveal that M&A activities peaked during 2003.

Table 1.4 gives the value of M&A activity in India during the period 1998-2007.

Table 1.4 *Value of M&A Activity*

Year	M&A Value (*Rs in billion)*
1998	151.00
1999	160.43
2000	336.62
2001	351.71
2002	391.62
2003	204.19
2004	513.00
2005	1,042.02
2006	865
2007	1,576

Source: Compiled from Registration and Liquidation of Joint Stock Companies, various issues; RBI Reports; CMIE–Mergers and Acquisitions, SEBI, India/Economics, ABN Amro Data Trends Sept 2004, Business Line, March 7, 2008.

[9]Before 1990, an open offer was mandatory for acquiring 25 per cent stake in a company. In1990, the threshold was lowered to 10 per cent of company's shares. In 1992, the SEBI Act empowered SEBI to regulate takeovers. In 1996, SEBI appointed a committee under the chairmanship of Justice P N Bhagwati to review the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulation 1994. The revised SAST Regulation, 1997 was amended in 2002, 2004 and 2006. The final version covers the issues of applicability of code, public offer, pricing, exemptions and other guidelines.

It is observed that the value of M&A activity increased approximately 7 times in the year 2005 compared to the year 1998. In 2000, the M&A activity increased by approximately 110% with respect to the previous year. The value of M&A activity increased by 151% in 2004 compared to the previous year. The percentage change was 103% in the year 2005 compared to 2004. The value of M&A deals decreased in 2006 compared to 2005. It is observed the value of M&A deals peaked in 2007.

Sectoral Trends In this section, the M&A activities in major sectors have been analysed.

Table 1.5 gives the dominant sectoral M&A activity during the seven-year period, 2000-2007.

Table 1.5 *Major Sectoral M&A Activity*

Year	M&A Activity
2000	Transport, Communication, Food Products
2001	Chemical, IT, Finance
2002	Services, Pharma, Automobiles, Electronics, Power
2003	Food&Beverages, Textiles, Chemicals, Electronics, Automobiles
2004	Food&Beverages, Textiles, Chemicals, Electronics, Automobiles
2005	Telecom, Energy, IT&ITES, Steel, Chemicals and Plastics
2006	IT&ITES, Telecom, Pharma, Energy, FMCG, Media
2007	Telecom, IT, Finance, Cement and Building Materials, Oil and Gas

During the year 2000, domestic mergers took place in several sectors, like transport and communication, food products, finance, computer software, chemicals, plastics and pharmaceuticals. Cross border M&As were reported mainly in the IT sector.

Among the top deals in 2001 were the merger between ICICI Bank and ICICI, Grasim's buyout of 10 per cent stake in L&T and Sterlite Industries buying 51 per cent stake in Balco. In 2001, MNCs accounted for 35 per cent of the total number of deals. Most important deals in 2002 were either due to privatisation of major public sector undertakings or deals struck by major domestic companies and multinational corporations. The biggest merger in the Indian merger history occurred in the year 2002 when intra-group consolidations of Reliance Industries Ltd. (RIL) and Reliance Petroleum Ltd. (RPL) took place.

Around 50 overseas acquisitions, amounting to $1.8 billion, took place in 2003. The largest acquisition in 2003 was in the cement industry: Grasim Industries bought 38.5 per cent stake in L&T Cemco for $354 million.

In 2005, the telecom sector accounted for one-third share of all M&A deal value. Large deals in this sector included Essar Group's acquisition of BPL Communications, Vodafone's investment in Bharti's TeleVentures, Maxis Group's, acquisition of Aircel and VSNL's acquisition of Teleglobe International Holdings.

In the year 2006, IT & ITES was the clear leader as far as sectoral deal values were concerned. This sector garnered $2.9 billion worth of deals. The major deals included EDS's acquisition of majority stake in Mphasis BFL, RR Donnelley's acquisition of Office Tiger, i-Flex's acquisition of Mantas Inc, etc.

In 2007, Telecom sector overtook the IT Industry and dominated the M&A scene with 33 per cent share in the total deal value. The largest deal of the sector was Vodafone acquiring 67 per cent stake in Hutchison Essar, now Vodafone Essar, India's fourth largest telecom player. The Indian financial services sector continued to attract overseas and domestic investments, taking 15 per cent of the total deal flow by value and

19 per cent by number. The largest deals in the sector were the $646 million investment in ICICI Financial Services and the $644 million investment in HDFC Ltd. Cement and building materials sector made up for 7 per cent of the total deal value, out of which 87 per cent was driven by a single acquirer, Holcim. Holcim strengthened its position in India by increasing its holding in Ambuja Cements from 2 per cent to 56 per cent.

The largest deal of the year was India's steel giant, Tata Steel, acquiring Anglo Dutch giant, Corus, which catapulted Tata Steel to become world's sixth largest steel maker.

In 2007, the aviation sector saw consolidation with some large deals. Jet Airways took over Sahara Airline and Kingfisher Airlines acquired a significant stake in Deccan Aviation. The Government of India decided to merge operations of its two state owned carriers, Indian Airlines and Air India.

Strategic Deals

Private equity investors, as a category, have grown globally and have also arrived with a bang in India. Over 100 private equity houses are operating in India and have raised, on an average, about $100 million. They form a major force in the Indian market, resulting in more M&As as they seek to achieve significant value growth within their investment horizon.

According to Grant Thornton report, the total number of deals has increased from 360 in 2004 to 782 in 2006. The number of M&A deals increased by 60 per cent in 2006 compared to 2004. The value of M&A deals also increased by 81 per cent during the period 2004-2006. In 2006, there were more than 40 deals with deal value of over $100 million compared to 25 deals in 2005. In 2007, there were 262 private equity transactions worth Rs 466 billion, a growth of 35 per cent over 2006. The financial services sector accounted for 33 per cent of the total followed by telecoms with 13 per cent and media with 6 per cent. The largest PE deal of the year 2007 was Temasek Holdings along with ICD, Macquarie, AIF Capital, Citigroup and India Equity Partners acquiring 10 per cent stake in Bharti Infratel, a telecom subsidiary of Bharti Airtel, for Rs 41 billion.

Table 1.6 *Strategic Deals in India During 2004–07: Statistics*

	2004	2005	2006	2007
No. of M&A Deals	300	343	480	676
No. of Private Equity Deals	60	124	302	405
Total No. of Deals	360	467	782	1,081
Value of M&A Deals	$11.2 billion	$16.3 billion	$20.3 billion	$51.11 billion
Value of Private Equity Deals	$1.1 billion	$2 billion	$7.9 billion	$19.03 billion
Total	$12.3 billion	$18.3 billion	$28.2 billion	$70.13 billion

Source: Grant Thornton Deal Tracker Annual Issues: 2005/2006/2008

CROSS BORDER M&A

The rise of globalisation has exponentially increased the market for cross border M&A. In 1996 alone, there were over 2,000 cross border transactions worth approximately $256 billion. Cross border acquisitions are complex in nature on account of differences in political and economic environment, corporate organisation, culture, tradition and legal formalities between the countries of the acquirer and the target company.

M&A's share of global FDI have risen from 52 per cent in 1987 to over 83 per cent in 1999. In relation to the world's gross domestic product (GDP), the value of CBA quadrupled from 0.5 per cent in 1987 to 2 per cent in 1999. Cross border acquisitions represented a massive shift of capital and corporate control around the world, with more than 80 per cent of the deals occurring in the US, Europe and Japan.

According to Thomson Financial Reports, US corporations have done 1878 cross border transactions in 2006, which were valued at $186 billion. India stood 23rd on the list in value terms, with 0.7 per cent share.

Table 1.7 *Acquirer –Countrywise Deal Statistics (Data upto 2006)*

Acquirer Nation	Value ($ million)	Market Share (%)	Number of Deals
US	186,347.6	16.8	1,878
Germany	168,825.9	15.2	433
France	110,465.7	9.9	456
UK	103,817.2	9.3	1007
Spain	82,821.5	7.5	196
The Netherlands	68,678.9	6.2	259
Canada	42,961.2	3.9	643
Switzerland	37,352.3	3.4	219
Australia	35,543.4	3.2	450
Brazil	26,906.5	2.4	33
Mexico	20,957.4	1.9	31
Italy	20,634.7	1.9	173
Singapore	16,845.5	1.5	258
Japan	15,484.7	1.4	221
Belgium	13,272.2	1.2	126
China	12,963	1.2	132
Hong Kong	12,529	1.1	365
South Africa	10,902.9	1.0	63
UAE	10,881.8	1.0	40
Norway	10,857.1	1.0	129
Sweden	10,418.5	0.9	283
Denmark	7,745.5	0.7	96
India	7,553.6	0.7	192

Source: Business Today, December 3, 2006, page 69

Factors Influencing Cross Border Acquisitions

- Globalisation of products and service goods market facilitated the trend of convergence of consumer needs, preferences and tastes, which has led to the creation of demand and supply of goods and services in different countries where these companies are located.

- The technological advancement has led to massive investment in R&D, design, marketing and distribution. To achieve economies of scale and recover cost, companies had to adapt globalisation through cross border mergers.
- The economic integration of European Union and the European Monetary System had a huge impact on cross border trade and investment in both product and financial services markets.
- Trends in the equity and bond markets also facilitated the development of cross border acquisitions. Financial innovations and easy availability of capital to finance acquisitions were also contributing factors for the development of cross border M&A activity.
- Economic liberalisation and reforms in developing nations also provided an impetus to the cross border activity. The opening up of markets and removal of regulations with respect to foreign direct investments increased the scope of cross border M&A activity.

Basically an asset exploiting firm seeks to deploy its strategic assets in a new market in order to gain competitive advantage. Firms may also seek to augment resources and capabilities from host countries. The firm could use resources and capabilities of the foreign countries in order to provide competitive advantage.

Growth is probably the most important motive for international mergers. International M&A add a new perspective to the growth process. A profitable firm in a slow growing economy may adopt cross border acquisition as a strategy to invest surplus cash in a fast growing economy in order to grow faster. It may be noted that the bulk of sales of Royal Dutch Shell and Unilever come from outside their home country.

Technological considerations also impact international mergers. A technologically superior acquirer would acquire a target firm in order to exploit its technological advantage. A technologically inferior acquirer may combine with a technologically superior target in order to enhance its competitive position.

Product advantages and product differentiation could also emerge as reasons for international mergers and acquisitions. A firm with a reputation for superior products in the domestic market may find acceptance for its products in the foreign markets. In the 1920s, cars were exported to Europe in large numbers from the US. The competitive advantage in terms of mass production made US cars cheaper despite high foreign tariffs. Later on, the situation reversed with Japanese cars finding acceptance in the US.

Government policy, regulations, tariffs and quotas can affect international mergers and acquisitions in a number of ways. Japan's huge export surplus, which led to voluntary export restrictions, coupled with threats of more binding restrictions, was a major factor in increased direct investment by Japan in the United States. Changes in government policy can make acquisitions more or less attractive.

Foreign exchange rates can also impact cross border acquisitions. The relative strength or weakness of the domestic versus foreign currency can impact the effective price paid for an acquisition, its financing, production costs of running the acquired firm and value of repatriated profits to the parent.

The relative political and economic stability of a nation is another important factor in attracting foreign buyers. Acquirer firms have to evaluate how much government policies would change from one administration to the next. They must assess the likelihood of government intervention on subsidies, tax breaks, loan guarantees, and also at the other extreme, the chances of expropriation.[10]

Barriers to Cross Border M&A

Cross border acquisitions can be considered more riskier than domestic acquisitions due to structural, technical, information and cultural barriers that exist in the target country.

[10]J Fred Weston, K S Chung, Susan E Hoag, 'International Mergers and Restructuring', Mergers, Restructuring and Corporate Control, Chapter 17, PHI, page 426-430.

Structural barriers include both statutory and regulatory barriers. *Statutory barriers* include discriminatory tax laws and monopoly powers of the board to block mergers. *Regulatory barriers* include anti-trust regulation and rules of stock exchange.

Technical barriers consist of management aspects. These include anti-takeover defence mechanisms, like staggered boards and differential voting rights. *Information barriers* include aspects like low compliance with international generally accepted accounting principles (GAAP). Cultural barriers also emerge as a reason for dislike of takeovers. It is important to overcome local language barriers and communication problems due to differences in mentalities and cultures and management styles in an international M&A. [11]

Cross Border M&A in India

India was a late starter in M&A events due to rigid regulations. But, in recent years, cross border deals have been taking place at a faster pace.

Table 1.8 gives the value and volume of cross border and domestic deals during the period 2005–2007.

Table 1.8 *Cross Border & Domestic Deals*

Year	2005		2006		2007	
	No of M&A	M&A in Value ($ million)	No of M&A	M&A in Value ($ million)	No of M&A	M&A in Value ($ million)
Inbound (a)	56	5,173.93	76	5,399.75	112	15,500.95
Outbound (b)	136	4,298.52	190	9,914.15	243	32,759.04
Total Cross Border (a+b)	192	9,472.45	266	15,313.90	355	48,259.99
Domestic (c)	151	6,848.01	214	4,990.87	321	2,852.48
Total (a+b+c)	343	16,320.46	480	20,304.77	676	51,112.47

Source: Grant Thornton Deal Tracker Annual Issue: 2006

During the period 2006–2007, cross border M&A activities increased significantly. The value of inbound cross border M&A activities (foreign companies buying Indian companies) increased marginally from $5,173.93 million in 2005 to $5,399.75 in 2006. But the value of outbound cross border M&A activities (Indian companies buying foreign companies) increased substantially from $4298.52 million in 2005 to $9914.15 million in 2006, representing an increase of 130 per cent. The number of outbound M&A deals were much larger compared to the inbound deals during the two-year period. This fact clearly indicates the emerging trend of Indian companies going on an acquisition spree as a strategic pursuit for growth. The value of domestic M&A deals went down in the year 2006 compared to the previous year though the number of deals increased. The largest outbound deal in 2006 was for $677 million–Tata Tea acquiring 30 per cent stake in Energy Brands (US). The largest inbound deal in 2006 was Kohlberg Kravis Roberts' acquisition of the software business of Flextronics for $900 million.[12]

[11]Sudi Sudarasanam, Cross Border Acquisitions, Creating Value from Mergers and Acquisitions: The Challenges', Chapter 9, Pearson Education, Page 205

[12]Bloomberg, India Business and Investment Report, 2006

The largest outbound deal in the year 2007 was the acquisition of Corus by Tata Steel for $13 billion. The second largest deal involved Hindalco spending $3.33 billion to acquire Atlanta based Novelis, a leading aluminium sheet maker. The third largest outbound deal of 2007 was Suzlon Energy acquiring Germany based Repower for $1.8 billion. Some other large cross border deals included Essar Group's acquisition of Canada based Algoma Steel for $1.6 billion and United Spirits' acquisition of UK based Whyte & Mackay for $1.2 billion.

From early 2000 onwards, Indian Inc has been on an overseas acquisition spree. The value of acquisitions doubled to $9.30 billion in 2004 from $4.5 billion in 2003. The average deal size was $7.5 million in 2002 and it increased to $36.5 million in 2003. In 2003, close to 50 overseas acquisitions took place. In 2005, the total number of outbound deals was 136, generating a total deal value of $4.3 billion. Between January and October 2006, the value of outbound deals was about three and half times more at $15.72 billion. In 2007, 223 deals worth Rs 1,367 billion ($33 billion) registered a massive growth of 300 per cent over the previous year (140 deals worth $8 billion). The average deal size increased from $58 million in 2006 to $150 million in 2007. According to the data compiled by India Advisory Partners, Indian companies paid $209 million and $1.8 billion in 2002 and 2003, respectively, for overseas acquisitions. The value of overseas buyouts by Indian companies increased 164 per cent from $1.7 billion in 2004 to $4.5 billion in 2005. The value of acquisitions doubled to $9.3 billion in the year 2006.

Table 1.9 *Number of Inbound and Outbound Deals in Other Years*

Year	2001	2002	2003
Inbound Deals	1,634	3,204	1,581
Outbound Deals	40	792	599

Source: KPMG Report: Country Perspectives—M&A Activity in India

Indian companies are targeting different geographies for different sectors. For pharma and auto components, Europe is the major destination. Metal and mineral sectors are being targeted in the Asia-Pacific region. IT& ITES and telecom space acquisitions are taking place in the US markets.

The biggest portion of Indian M&A activities have been in Europe (around 40 per cent) and North America (around 34 per cent) highlighting Indian companies' confidence in investing in more developed economies. (Grant Thornton Report 2006)

Following are some of the major outbound deals:

- The top cross border M&As include ONGC's acquisition of Sakhalin Oil & Gas for $1,700 million and Royal Dutch/Shell for $660 million during 2002.
- Two of the most high profile outbound deals came from the pharma sector—Dr Reddy's $571 million acquisition of Germany's fourth largest generic company, Betapharma, in 2006 and Ranbaxy's $324 million acquisition of Romanian pharma company, Terapia.
- Daewoo Electronics was acquired by Videocon for $730 million.
- In 2007, Tata Steel acquired Corus, the UK steelmaker, in an all cash deal for $13 billion. The deal made Tata Steel the world's sixth largest steel manufacturer.

Following are some recent major inbound deals:

- In 2006, US leveraged buyouts giant, Kohlberg Kravis Roberts, acquired US based Flextronics' Indian IT assets for $850 million.
- The Texan major, Electronic Data System, acquired Mumbai based Mphasis BFL for $380 million.
- Aban Lloyd acquired Sinvest ASA for $446 million.
- In the telecommunication sector, Vodafone acquired Hutchison's stake in Essar Telecom for $19 billion.

Why Indian Companies Go Global

The easy availability of dollars as a result of the government's policy of economic liberalisation made it easier for Indian companies to go global. Many regulations and controls binding Indian companies beyond exports were lifted. The changing mindset of Indian corporates for greater exposure and competitiveness facilitated the process of overseas acquisitions. More and more US and other global private equity firms have started funding Indian companies for acquisitions in the West. Tata Group's Tata Tea began the trend when it acquired UK's famous brand, Tetley Tea, for $430 million in 2001.

The number of Indian companies investing aboard has been steadily growing since then. India's private banking system and open capital markets are the foundations on which Indian acquisitions are based and have much more financial discipline. Indian companies' strength lies in their widely acknowledged world class managerial talent. Top line companies are also cash rich.

Indian companies are targeting different geographies for different sectors. For pharma and auto components, Europe is the major destination. Metal and mineral sectors are being targeted in the Asia Pacific region. IT&ITES and telecom space acquisitions are taking place in the US markets.

The IT sector, banking and financial services and pharmaceutical companies have been most active in M&A deals. A host of mid and small cap firms in industries ranging from textiles, consumer durables, fast moving consumer goods and telecom to energy, automobiles, auto components and information technology are participating in the outbound deals.

Indian BPO companies are acquiring overseas companies to focus on high margin niche segments, such as healthcare and market research. These acquisitions focus on technical know how to improve processes and front end teams. Indian IT service providers are acquiring overseas consulting firms for domain expertise and existing overseas customers. The foreign investment activity abroad gained momentum when the Government of India removed the $100 million cap on foreign investments by Indian companies and raised it to the net worth of the companies. The IT sector leads other sectors in acquisition deals.

ICICI Bank's acquisition of the Russian Investitsionno Kreditny Bank, SBI's takeover of Mauritius Bank and the merger of Bank of Punjab with Centurion Bank were some of the important acquisitions in the Banking sector. In the Insurance sector, Standard Life of UK's selling off its 4.9 per cent stake in HDFC to CLSA Merchant Bankers for Rs 1,010 crore was a noted deal. Matrix Lab acquired 22 per cent stake in the Belgium based Docpharma for US$ 263 million. Some other prominent acquisition deals include UCAL Fuels purchase of US based Amtec Precison Products Inc, engaged in manufacturing of auto ancillary products, for $28 million and AV Birla Group's buyout of Canada based pulp plant. Bharat Forge, the Indian maker of steel car bought forges in United States and Germany. Videocon became the third largest colour picture tube manufacturer in the world after it acquired the colour picture tube business of France based Thomson S A for about Rs 1,260 crore. The Thomson acquisition gave Videocon access to the global market. Videsh Sanchar Nigam Ltd (VSNL), the former state monopoly for international telephone calls, paid $130 million for 60,000 km of undersea cables owned by the US gaint Tyco International. Through this acquisition, VSNL got access to trans Atlantic, trans Pacific and inter American cables. VSNL's $239 million buyout of Teleglobe gave the Tata company a foothold in the international voice market, estimated at about 220 billion minutes per annum.

By the year 2005-06, Indian pharma companies had been aggressively making overseas acquisitions for the past two years. DRL, Ranbaxy, Matrix Lab and Torrent Pharma made large acquisitions by taking over generic drug manufacturers in the EU market. Domestic pharma companies view Europe as counterweight to US generic market. In 2006, Ranbaxy acquired three companies. It acquired 96.7 per cent of Romania's largest independent generics drug company, Terapia SA, for $324 million. The combination of Terapia with Ranbaxy's existing activities in Romania created the largest generics company in the country. Ranbaxy's buyout of Terapia gave it clear access to high growth markets, like Romania and Eastern Europe. ONGC invested in 15 assets in 13 countries spread over four continents to secure India's growing need for energy.

According to KPMG, Indian companies shelled out $1.7 billion in 2005 for acquiring about 62 companies.

Tata Coffee's buyout of Eight O Clock, the third largest coffee chain in the US, for an estimated $220 million gave it access to a hundred year old American brand and one of the major coffee retailing firms of the US. Oil drilling major, Aban Lloyd, acquired 33.76 per cent stake in Norwegian drilling company for $446 million (around Rs 2,050 crore).

Indian automobile giants have changed their role from being exporters to overseas investors. Tata Motors has acquired Daewoo Motors. Tata Tea's buyout of Tetley gave it a foothold in the UK market. The deal with Glaceau allowed Tetley to enter the US market and gave Glaceau a chance to tap the US market. In 2006, Suzlon acquired Belgian gearbox maker Hansen for Euro 431.43 million (Rs 2,459.15 crore). The acquisition was funded entirely by debt from the ICICI Bank, the State Bank of India, Deutsche Bank and Barclays Bank.

In the year 2007, the largest deal was Tata acquiring Corus and Hindalco acquiring Novelis. Tata Steel's buyout of Corus made it a global top six players and reduced its risk to fluctuating prices. Other large deals in 2007 included Suzlon Energy acquiring Repower Systems for $1.8 billion, Wipro Ltd acquiring Infocrossing Inc for $557 million and Aban Offshore increasing its stake in Sinvest from 37 per cent to 97 per cent for $774 million. Hindalco had bought out Canada based aluminum maker Novelis for $6 billion while Vijay Mallya of UB Group bought out Glasgow based scotch distiller, Whyte & Mackay, for $600 million.

The slowdown in the US, and probably Europe, would act as a catalyst for the attraction that Indian Companies have towards foreign acquisitions. The slowdown in the US and/or Europe would also make it imperative for companies to become more price competitive. The easy availability of funds have made the acquisitions easier for the acquirer company. Banks and private equity funds are also willing to fund the deals. Evidence shows that companies are capable of turning around their acquisitions. Textile Player Welspun turned around Christy, the terry towel brand in the UK, which was acquired in 2006. Engineering firm Crompton Greaves was able to turn around the Belgium based Pauwels which it took over in May 2005. Indian acquirers are also cash rich firms.

Table 1.10 *Top Cross Border M&As by India Inc.*

Acquirer	Target	Deal Size ($ million)	Region	Sector
Tata Steel	Corus Steel	12,100	UK	Steel
Hindalco	Novelis	3,331	US	Aluminum
Suzlon Energy	Repower Systems AG	1,794	Germany	Energy
United Spirits	Whyte and Mackay	1,177	UK	Liquor
ONGC	Sakhalin Oil & Gas Fields	1,700	Russia	Oil & Gas
Essar Global	Algoma Steel Inc, Canada	1,603	Canada	Steel
ONGC	Oil Field, BC-10 Block	1,400	Brazil	Oil & Gas
Tata Power	PT Kaltim Prima Coal	1,100	—	Energy
Videocon Industries Ripplewood Consortium	Daewoo Electronics	731	Korea	Consumer Electronics
ONGC	Royal Dutch/Shell	660	Angola	Oil & Gas
Tata Tea	Energy Brands Inc	677	US	FMCG
Wipro	Infocrossing	600	US	IT
DRL	Betapharma	570	Germany	Pharma
Sun Pharma	Taro Pharma	454	Israel	Pharma
Aban Loyd	Sinvest ASA	446	Norway	Oil & gas
Tata Tea	Tetley	430	UK	Tea
ONGC (through ONGC Videsh Ltd)	Omimex de Columbia	425	USA	Oil & Gas
Ranbaxy	Terapia	324	Romania	Pharma
Tata Steel	Nat steel	298	Singapore	Steel
Wipro	Unza	275	—	FMCG
Matrix Lab	Docpharma	263	Belgium	Pharma
Bharat Forge	Imatra Kilsta AB,	261	Sweden	Forging
BILT	Sabah Forest	261	Malaysia	Paper
Tata Coffee	Eight O Clock	220	US	Beverages
Reliance	Flag Telecom	211	US	Telecom
Reliance	Flag Telecom	207	Bermuda	Telecom
Bharti Airtel	Zain	10,700	South Africa	Telecom

Source: Collated from various sources.

Table 1.11 *Other Premium Deals*

Acquirer	Target	Value ($ million)	Sector
VSNL	Tyco Global Network	133	US
Reliance Inds	Treveria	103	Europe
Ranbaxy	Aventis	70	France
Infosys	Expert Information	23	Australia
Wipro	Nerve Wire Inc	18.7	US
Amtek Group	Zelter	157.5	Germany
Bharat Forge	CDP	157.5	Germany
Tata Motors	Daewoo Motors	118	Korea
Subex Systems	Azure Solutions	140	UK
Larsen & Toubro	Tamco Switch Gear	108	Malaysia
GHCL	Rosebys	40	UK
Subex Azure	Syndesis	164.50	US
Indian Hotels	Hotel Campton Place	63	US
Himmatsingka Seide	Giuseppe Bellora Spa	21.7	Italy
Ashok Leyland	Defiance Testing	17	US
Jain Irrigation	Dan Irrigation	17.50	Israel

SECTORAL REVIEW OF M&A

In order to give bird's eye view of M&A across major industries, this section critically examines the merger activity that took place across major industrial sectors.

Cement

- The early 1990s saw substantial expansion in cement capacity, far in excess of demand. With recession setting in the late 1990s, a shakeout was inevitable. New and marginal players began to sell out to larger players since only the latter were able to withstand the downturn in demand due to their economies of scale, operational efficiencies, centrally controlled distribution systems and geographical diversification. The takeover of Raasi Cements Ltd and Shri Vishnu Cements Ltd by India Cements Ltd heralded the era of consolidation in the fragmented cement industry.
- In the last four years, due to boom in infrastructure activities, there has been demand backed rise in cement production, eventually resulting in higher revenues for cement companies. Realising the growth potential, top international cement companies, like Lafarge (France), Holcim (Switzerland), Italcementi (Italy) and Heidelberg (Germany) have entered the Indian market in a big way through mergers, acquisitions, joint ventures and green field projects.
- Domestic industry is witnessing a consolidation phase. Small firms are getting merged with bigger players. Almost all major global players are entering Indian market. Mergers and acquisitions will be triggered by the fragmented nature of the industry, where the top six manufacturers control 60 per cent of the market, while the remaining 57 operate with a combined market share of 40 per cent. In

the near future, consolidation of capacities through mergers and acquisitions will be the focus area for major cement players as green field projects require huge capital investments and involve a considerable gestation period. The cyclical nature of this industry has meant that only large players are able to withstand the downturn in demand due to their economies of scale, operational efficiencies, centrally-controlled distribution systems and geographical diversification.

- In the year 2007, the cement sector made up for 7 per cent of the total deal value, out of which 87 per cent was driven by a single acquirer, Holcim. Holcim strengthened its position in India by increasing its holding in Ambuja Cement from 22 per cent to 56 per cent through various open market transactions and an open offer for a total investment of Rs 75 billion. It also staked its stake indirectly by 12 per cent in ACC Cement for Rs 20 billion.

Banking Sector

- In India, over the past 45 years, about 40 banks and non-banking finance companies have been merged.
- The Government of India forced big nationalised banks to adopt M&A as a tool for rescuing ailing banks. Historically, except for a few instances, all M&As in India have been part of crisis management. They have been forced by the regulator–the Reserve Bank of India (RBI)–to protect depositors' money. The notable exceptions were HDFC Bank's takeover of Times Bank and the merger of SCICI, Anagram Finance, ITC Classic, Bank of Madura and ICICI with ICICI Bank, which were all based on market expectations.
- Within a span of 18 months, ICICI announced three mergers—with SCICI, ITC Classic and Anagram Finance. On acquiring ITC Classic, ICICI's own network improved by 10 branches, 12 franchisees and a depositor base of almost seven lakh. Through the merger with Anagram, ICICI gained 50 branches and depositor base of 2,50,000 in Western India. ICICI was attracted by the retail portfolio of Anagram, which was active in lease and hire purchase, car finance, truck finance and consumer finance. With the merger of Bank of Madura, ICICI Bank became richer by almost 260 branches, 2,500 personnel, deposit base of around Rs 37 billion and a strong presence in the southern states. The reverse merger of ICICI with its offspring was aimed at becoming a universal bank which catapulted it into the position of the second largest bank in India. The merger saw ICICI Bank gain critical mass and major thrust on the retail front. The merger between Standard Chartered Bank and Grindlay's Bank created India's largest foreign bank. The Times Bank merger helped HDFC Bank to increase its customer base by 2,00,000 and branches from 68 to 107, and saved costs associated with technology upgradation.
- M&A activities were mostly driven by RBI directives to merge ailing public sector banks with bigger public sector banks. Few private banks have undertaken M&A activity.
- The international banks keen to grow inorganically through local takeovers have been lobbying for a change in the norms governing local acquisitions. The 10 per cent voting rights restriction is a major impediment to grow inorganically. Foreign banks in India have focused more on corporate banking and foreign exchange business and ignored retail finance. Retail finance, mutual fund asset management, wealth management, structured finance, mortgage finance, consumer finance and credit cards are yet to take off in a big way. Most leading banks have established call centres and centralised global back office processing centres in India. Some banks have started to shift their research related work to India to provide fundamental and analytical research inputs to treasury front offices across the globe. Global banks prefer growth through the inorganic route as it is relatively inexpensive and gives quicker access to management control and a wide network of branches and customers.

In the international context, size is increasingly the trend. The fifth largest bank in China is probably bigger than the top five Indian banks put together in terms of assets. To account for thinner net margins, the need for more sophisticated products and low cost technology is being felt. Unless consolidation happens in the banking industry, substantial cut in cost per unit of production cannot be achieved.

Table 1.12 *Mergers and Acquisitions in Banking/NBFC Sector*

Year	Acquirer	Target
1969	State Bank of India	Bank of Behar
1970	State Bank of India	National Bank of Lahore
1971	Chartered Bank	Eastern Bank Ltd
1974	State Bank of India	Krishnaram Baldeo Bank Ltd
1976	Union Bank	Belgaum Bank Ltd
1984-85	Canara Bank	Lakshmi Commercial Bank
1984-85	State Bank of India	Bank of Cochin
1985	Union Bank	Miraj State Bank
1986	Punjab National Bank	Hindustan Commercial Bank
1988	Bank of Baroda	Trader’s Bank Ltd
1989-90	Allahabad Bank	United Industrial Bank
1989-1990	Indian Overseas Bank	Bank of Tamil Nadu
1989-1990	Indian Bank	Bank of Thanjavur
1989-1990	Bank of India	Parur Central Bank
1990-1991	Central Bank of India	Purbanchal Bank
1993-1994	Punjab National Bank	New Bank of India
1993-1994	Bank of India	Bank of Karad
1995-1996	State Bank of India	Kasinath Seth Bank
1996	ICICI	SCICI
1997	ICICI	ITC-Classic
1997	Oriental Bank of Commerce	Bari Doab Bank
1997	Oriental Bank of Commerce	Punjab Coop Bank
1998	ICICI	Anagram Finance
1999	Bank of Baroda	Bareilly Corp Bank
1999	Centurion Bank	20th Century Finance Corp
1999	HSBC	British Bank of Middle East
1999	Union Bank	Sikkim Bank Ltd
2000	HDFC Bank	Times Bank
2000	Standard Chartered Bank	Grindlay’s Bank
2001	ICICI Bank	Bank of Madura
2002	ICICI Bank	ICICI
2002	Bank of Baroda	Benares State Bank
2002	ING Bank	Vysya Bank
2003	Punjab National Bank	Nedungadi Bank
2004	Bank of Baroda	South Gujarat Local Bank
2004	Oriental Bank of Commerce	GTB
2004	IDBI Bank	IDBI

Pharma Sector

- The Indian pharmaceutical sector with more than 20,000 registered units is highly fragmented with severe price competition and governmental price control. The leading 250 pharmaceutical companies control 70 per cent of the market. The pharmaceutical industry in India meets around 70 per cent of the country's demand for bulk drugs, drug intermediates, pharmaceutical formulations, chemicals, tablets, capsules, orals and injectibles.
- The process of consolidation, which has become a generalised phenomenon in the world pharmaceutical industry, has also been reflected in the Indian context. The Indian pharmaceutical companies are increasingly focusing on global acquisitions to enter new markets. This trend is fuelled by the need to explore newer markets and products for future growth in this industry. Pharma companies have been aggressively making overseas acquisitions for the past few years. Dr Reddy's Lab, Ranbaxy, Matrix Lab and Torrent Pharma have made large acquisitions by taking over generic drug manufacturers in the foreign markets.
- The merger of multinational giants Glaxo Wellcome and SmithKline Beecham Plc reflects how important research has become critical for the survival of pharma companies. Before the merger Glaxo Wellcome spent around 15-16 per cent of its turnover on R&D while SmithKline Beecham spent around 10-12 per cent. On an average it takes about 12 years for a new chemical entity to travel from the lab to the market. With the emphasis in research shifting from diseases like tuberculosis to AIDS, the requirement of high tech tools drives up the cost of research. Unlike US, Indian pharma companies spend, on an average, only 1.8 per cent of their sales on R&D.
- In the Indian context there are many reasons for consolidation. On one hand, stiff competition in the generic (that is, off patent) drugs in the US and Europe have brought the profitability of most Indian companies under pressure. On the other hand, steady increase in price control is strangling the domestic market and has actually forced majority of companies to depend on exports. The regulatory authorities in India have also been introducing tighter and more stringent norms since 2005 in order to maintain the high quality of final products. Hundreds of small scale pharmaceutical units are being forced to close down because they cannot afford to meet the regulatory conditions. Industry analysts feel that mid-sized companies with a low promoter holding, with attractions like well-developed production techniques, manufacturing facilities approved by western regulatory authorities or brands that could be leveraged, are likely to become targets for acquisition by larger players.

Food and Beverages Industry

- Activity in this sector was essentially driven by deals struck in the beverages and tobacco industry. The challenge for food industry in India is to create huge volumes with lowest possible cost structure.
- The Williamson Magor Group has built an enviable track record for negotiated mergers, acquisitions and takeovers. The Mcleod Russel acquisition made Williamson Magor Group the world's largest private tea producer.
- The major driving force behind the Tata Tea-Tetley deal has been the fact that Tetley fits perfectly into Tata Tea's globalisation drive. The deal brought together the largest integrated tea company and the largest brand (Tetley), and has resulted in instant expansion of product lines of Tata-Tea Tetley combine.
- There is greater scope for mergers and acquisitions in the fragmented liquor business. There had been international distribution alliances among mid-sized players who wish to remain independent while gaining merger style economies of scale.

- In the early 1990s when India opened its alcoholic beverage industry, a number of global majors entered through joint ventures.
- Breweries Group, the leading player in the Indian spirits market, follows the strategy of inorganic growth for its consolidation in the Indian market.

Oil and Energy

- In the international arena, the oil industry continues to face volatile price swings. Companies with greatest resources and lowest costs would remain in the battle. These industry pressures have resulted in a flurry of M&As, which have forced super major oil companies like Exxon and Mobil, Chevron and Texaco, and Royal Dutch and Shell to merge.
- In the year 2002, RPL merged with RIL, the largest ever merger in Indian corporate industry. The merger has created India's only world scale fully integrated energy company with operations in oil and gas exploration and production (E&P), refining and marketing, petrochemicals, power and textiles. In fact, RIL would probably be the only company in the world that would start with crude oil and end up with saris, shirts and dress materials. This merger can be viewed as in line with global industry trends for enhancing scale, size, integration, global competitiveness and financial strength and flexibility to pursue future growth opportunities in an increasingly competitive global environment.
- Tata Power Company acquired Tata Petrodyne, a private sector oil and gas exploration company for Rs 145 crore. The company is in consortium with global majors like Cairn Energy, Hardy Oil & Gas, ONGC and Hindustan Oil Exploration Company (HOEC) for its gas and oil exploration and development projects in three offshore blocks.
- The major M&A in the domestic oil sector include the merger of IPCL into Reliance and the acquisition of IBP by Indian Oil Corporation.
- Tata Power, the largest private power utility in the country, was formed by the merger of Andhra Power Supply Company and Tata Hydro Electric Power Supply Company.
- The top cross border M&As include ONGC's acquisition of Sakhalin Oil Gas for $1700 million and Royal Dutch/Shell for $660 million in 2002.
- Reliance Group acquired BSES and renamed it as Reliance Energy.
- Indian Oil Corporation acquired 33.58 per cent of the equity of IBP primarily for incremental cash flows. In the north and east, IBP has a strong retail presence and IOC has substantial refining capacity. With the acquisition of IBP, Indian Oil has over 9,000 retail outlets. IOC also acquired 26 per cent stake in the Haldia Petrochemicals Project for Rs 460 crore.
- The merger of Kochi Refinery Ltd into BPCL was meant to provide greater stability to BPCL's earnings in times of higher refining margins and pressures on marketing margins. The merger will also partially resolve the tricky issue of central sales tax for KRL since BPCL buys about 50 per cent of BPCL's production.
- The government's disinvestments initiative suffered a blow with the Supreme Court verdict that Parliamentary approval was necessary for the sell off of Bharat Petroleum Corporation Ltd and Hindustan Petroleum Corporation Ltd.

Media and Entertainment

- The challenging conditions facing the media industry today, like brutal advertising environment, radical change in existing channels of distribution and the unlikelihood that the organic market growth would create value, provide scope for consolidation in this sector.
- The present scope for creating multimedia conglomerates through M&A in India is restricted due to lack of corporatisation in sectors like film production. The problem is further compounded by restrictions

on crossholdings in media and lack of clarity in government policies. For vertical mergers to occur, a film production house should have a stake in distribution as well as exhibition firms to ensure that the company garners maximum returns from the sale of film music, and also recycles film products in theatres and other media sectors, like television and Internet. In India, for instance, most of the content assets, like film and music albums, are written off after the first telecast or hearing, and such assets are not put in the value chain for further promotion.

*Network 18 is growing on buyouts and joint ventures into India's first 360 degree media company. In 1998, TV18 and CNBC Asia entered into a 49:51 joint venture to launch CNBC in India. In 2005, TV18 bought 46 per cent stake in Jagran TV and rechristened it IBN-7. In 2007, Network 18 bought 50 per cent stake in MTV, VH1 and Nickelodeon. The media sector had seen Zee TV acquire stake in ETC networks and Padmalaya Telefilms. Sare gama India Ltd, an RPG company, merged its UK based subsidiary, Sare gama plc, and Mauritius based RPG Global Music Ltd. Nine networks merged into Balaji Telefilms. Hinduja Finance Corporation acquired controlling stake of 51 per cent in Indusind Media and Communications. The acquisition of a 26 per cent stake in the Rajan Raheja owned Hathway Cable & Datacom in 2000 enabled re-entry for Starplus into cable network, which has around one million subscribers. This acquisition was Star's first big investment in distribution of DTH.

The Star group holds around 26 per cent stake in television software producer, Balaji Telefilms.

Zee Telefilms have a joint venture agreement for Turner International distribution. Zee Telefilms hold 76 per cent stake in the distribution company, the balance 26 per cent is with Turner. Zee had hived off its news and cable related businesses into independently listed companies with shareholding proportionate to ZTL. This restructuring included its cable distribution arm, Siti cable, the news and regional language channels and direct to home (DTH) business, Dish TV. Siticable is the country's largest cable network. Dish TV has about one million subscribers. ZTL, which includes the main entertainment channel Zee and Zee Cinema, would continue to have its separate entity and agenda. SAB TV was hived off from the old content company, Sri Adhikari Brothers, to a separate holding company, SAB TV Network, to facilitate the sale of its substantial stake.

The year 2003 was a period of consolidation for major players like Sun and ETV in the southern region. Sun TV took over the Telugu channel Gemini TV. The southern Indian market was dominated by Sun Network. Star's entry into Tamil Nadu through Vijay was aimed at gaining dominance in the southern market.

In 2007, the media sector saw 45 deals and lot of private equity interest, with the largest deal being the investment of Rs 11 billion ($259 million) by Temasek in Inx Media, a TV broadcast company. Other deals included an investment of Rs 7 billion ($166 million) by South Asia Entertainment Holding Ltd. (a group company of Astro All Asia Networks Plc) in Sun Direct TV for 20 per cent stake, and investment of Rs 6 billion ($146 million) by Black stone in Ushodaya Enterprise taking a 26 per cent stake.

Telecommunication Industry

- The telecommunication industry witnessed the first round of merger wave through the Birla–Tata –AT&T consortium.
- Tata's acquisition of VSNL Ltd., the largest ISP subscriber, provided the company NLD licence, 32 earth stations, 12 international gateways and link to five submarine cables, and most importantly, it got assured traffic from the state owned BSNL and MTNL for two years. VSNL later acquired Tyco Global Network for $130 million in an all cash deal which would give it a control over the 60,000 km cable network spanning over three continents.
- Reliance Infocomm bought Flag Telecom to get access to the undersea cable network, to enable them to connect key regions like Asia, Europe and the US.

- The acquisition of Hutchison's stake in Essar by Vodafone was the largest ever consolidation in telecom space, with an enterprise value of $19 billion.

Chemical Industry

- The Indian chemical industry needs to consolidate to upgrade the scale of operations required to compete effectively.
- In the chemical industry, Asian Paints, Tata Chemicals, United Phosphorus and GHCL have made acquisitions in Egypt, Romania, the US and the UK.
- The Clariant and Ciba Specialty Chemicals merger was meant to benefit from increased scales and product range. The merger between BASF India and Cyanamid Agro was meant to strengthen the product portfolio, distribution network, customer focus and cost savings due to operational and management integration.
- Tata Chemicals merger with Hind Lever Chemicals would help the company in reaching out to different geographies as Hind Lever Chemicals have strong presence in the Eastern region, while Tata Chemicals has strong presence in the Western region.

IT & IT Related Services

- The importance of size, pricing pressure and global companies consolidating and building offshore capabilities has made M &A relevant for Indian IT companies.
- Indian IT service providers are also acquiring overseas consulting firms for domain expertise and to acquire existing overseas customers. For instance, Wipro acquired the energy and utilities divisions of AMS and Nerve wire in the US. Cognizant acquired Info pulse in Europe and Ygyan in India. Infosys acquired Expert Systems in Australia. All these acquisitions are positioned as enhancing the geographic footprint, strengthening verticals or solution expertise, or moving up the consulting value chain.
- Starting in 2001, in a span of 18 months, HCL Technologies struck ten deals to acquire companies or set up joint ventures. From 2005 onwards, Wipro acquired 8 companies.
- M&A in the BPO sector has become the order of the day. Indian IT companies acquire BPO companies for quick entry into the BPO space, and for customer acquisition. Indian BPO companies are acquiring overseas companies to focus on high margin niche segments, such as healthcare and market research. These acquisitions essentially focus on the technical know how to improve the processes and front end teams. On the other hand, foreign companies acquire Indian BPOs for their skill and manpower. The ever-growing market for back end jobs is one of the reasons for the acquisitions.

Table 1.13 *Major M&A Deals in Indian ITES –BPO*

Acquirer	Target	Seller	Stake	Detail
Wipro	Spectramind	Chrysalls, HDFC	100%	Deal worth $100 million
Citigroup	Progeon	Infosys	20%	Valued $100 million
HCL Tech	Apollo Contact Center	British Telecom	90%	Valued about $13 million
Oakhil Partners Financial Technology Ventures & Co Mgmt	EXL Service	Conseco Inc, USA	Controlling stake by Oakhil	NA

(*Contd*)

(*Contd*)

ICICI One Source	Customer Asset	Promoters	100%	Deal at $19.3 million
Warbug Pincus	WNS	British Airways	70%	NA
WNS	Town & Country Assistance	Promoters	100%	NA
Optimus (Polaris)	Back office	Global Tech Ventures	Acquisition of Customers & Assets	NA
Household Credit USA	Intellinet	TCS, HDFC	NA	Valued Intellinet at about $100 million
Indian Rayon	Transworks	Chrys Capital	80%	Rs 60 crore ($13 million for mgmt control)
Datamatics Tech	US Parole Mgmt Co	NA	NA	$10 million in all cash deal

Source: Media Companies, Merrill Lynch Report–Economic Times, 29 June 2003

Steel Industry

- The steel industry has witnessed some reasonably large deals by Indian companies to acquire international capabilities. The key cross border deals by Indian companies include the acquisition of Natsteel (Singapore) by Tata Steel, Kremikovtzi (Bulgaria) by ISPAT, Izmir Demir Celic (Turkey) by Global Steel Holding, Maspion Stainless (Indonesia) by Jindal Steel. In 2007, Tata Steel acquired Corus, the UK steel maker, in an all cash deal for $13 billion. The biggest acquisition announcement in 2007 was made by JSW Steel to take over Jindal United Steel Corporation, Saw Pipes and Jindal Enterprises LLC based in US for $940 million.

Automotives Industry

- The automobile industry, especially auto ancillary/component companies, have been at the forefront of the acquisition spree. The reasons for acquiring business abroad are many. It gives the Indian companies easier access to foreign original equipment makers (OEM) and helps to broaden their customer base, capturing more market share.
- The major cross border deals in auto and auto component sectors include Tata Motors acquisition of Daewoo Commercial Vehicle (Korea) and Hispano Carrocera (Spain); Bharat Forge's acquisition of Federal Forge (USA), Carl Dan Peddinghaus & CDP Aluminiumtechnik (Germany) and Amtek Auto's acquisition of GKW Group (UK) and New Smith Jones Inc (USA).
- These acquisitions have opened the window to serve markets like China, Spain, Korea, Italy and Spain. Indian auto majors want to integrate low cost sourcing of components and technical know how to compete successfully in the international market. Sundaram Fasteners took over Dana Spicer, again of UK.
- In 2007, Robert Bosch acquired an additional 9 per cent stake in its subsidiary Motor Industries Co through an open offer for Rs 14 billion ($330 million), increasing its holding to 70 per cent. M&M acquired 63 per cent stake in Punjab Tractors for Rs 14 billion ($340 million) which increased its share in the tractors market to 40 per cent.

Financial Services

There are over 33 mutual funds in the country compared to 7,000 in the US. There has been significant consolidation in the industry in the past few years. Principal Mutual Fund acquired Sun F&C Mutual Fund and PNB Mutual Fund. Through this merger, Principal Mutual Fund attained the traits of scale in the mutual fund business. Franklin Templeton's acquisition of Pioneer ITI helped the company to pole vault to the top slot in the private sector. HDFC AMC gobbled Zurich Mutual Fund and UTI Mutual Fund acquired IL&FS Mutual Fund.

Marico Group Investment Companies merged with Marico Industries Ltd. Pannier Trading merged with Kotak Mahindra Finance Ltd. HDFC merged its wholly owned subsidiary Hometrust Housing Finance with itself. ITC Bhadrachalam Finance Ltd, wholly owned subsidiary of ITC Bhadrachalam Paperboards, merged with ITC Classic Finance Ltd, which later merged into ICICI. Merrill Lynch took 40 per cent equity stake in DSP Securities. GE Caps acquired 50.5 per cent stake in SRF Finance. GE Capital acquired Countrywide Consumer, Escorts Finance, and Maruti Countrywide Auto Finance. Shipping Credit and Investment Company (SCICI) merged into ICICI. Hinduja Finance Corporation merged all its investment companies with itself. Ashok Leyland India merger into HFC was primarily to improve HFC's revenue profile.

In 2007, the largest deal in the sector was the Private Equity (PE) Investment's of 646 million investment in ICICI Financial Services and the $644 million investment in HDFC Ltd. The year also witnessed the separation of several foreign partners from their Indian joint ventures to go solo. Morgan Stanley acquired JM Morgan Stanley's securities business for Rs 20 billion ($480 million) while JM Financial retained the investment banking business for Rs 900 million ($22 million). Similarly, ASK Investment Financial Consultants bought 10 per cent stake in ASK Raymond James Securities India Pvt Ltd from its foreign partner, Raymond James. The securities broking segment was the largest recipient of the investments with 26 per cent share. The other big deals were Citigroup Venture Capital's acquisition of 75 per cent in Sharekhan for Rs 7 billion ($170 million) followed by Orient Global Tamarind Fund acquiring 6.5 per cent stake in India Infoline for Rs 5.6 billion ($135 million) and ICICI Venture and Baring together acquiring 32 per cent stake in Karvy Stock Broking for Rs 5 billion ($122 million).

Other Services Industry

- The hospitality industry saw quite a few deals due to disinvestments drive with Indian Tourism Development Corporation and Hotel Corporation of India selling off key properties across the country.
- The Indian Hotels Company has amalgamated its investment companies, Taj Trade Investments Ltd and Taj Holdings. IHCL has also amalgamated Cove Long Beach Hotels Ltd and Coromandel Hotels Ltd with Oriental Hotels Ltd, which were all part of the Taj Group. These mergers were meant to reduce costs and raise savings by combining resources in different areas of operations.
- Hotel SreeKrishna Ltd merged with GVK Hotels & Resorts Ltd. Kuoni Travel (India), the Indian subsidiary of the Zurich based travel major, has acquired SOTC and merged with Sita. This consolidation made sense, as there were complementarities of strength between two companies in the three travel segments.
- In the healthcare sector, corporate groups like Apollo, Wockhardt, Escorts Hospitals, PD Hinduja National Hospital & Research Center, Fortis Healthcare and Max Healthcare have been involved in mergers and acquisitions. Deccan Hospital merged with Apollo Hospital.

Metal Industry

Hindalco bought out Alcan's 54.62 per cent holdings in Indal for Rs 738 crore. Hindalco buys a part of its alumina needs, sells metal ingots and has minimal presence in the downstream business. Indal exports alumina, buys primary aluminum and manufactures downstream products. Indal always depended on external sources for its metal requirement. The merger will help Birla get 20 per cent stake in the proposed Rs 4,300 crore Utkal Alumina. Hindalco also acquired stake in Indian Aluminum. IndoGulf Corporation Ltd merged with Hindalco Industries Ltd. Carborundum Universal Ltd merged itself with three companies, namely Cutfast Abrasive Tools, Cutfast Polymers Ltd and Eastern Abrasive Ltd. Jindal Vijayanagar Steel merged into JISCO. Tata SSL merged with Tisco, consolidating its steel operations. Annapurna Foils Ltd merged with Indian Aluminum Ltd. Hindustan Zinc was acquired by Sterlite via the disinvestment programme. Advani Oerlikon Ltd merged with Advance Welding Alloys Ltd. Kalinga Tubes Ltd merged with India Metals & Ferro Alloys Ltd. Kalyani Ferrous Industries Ltd merged with Kalyani Steel Ltd. Nasrupura Metals and Navin Alloys merged into Jindal Iron and Steel Company. Tikmani Steel Company merged with Bhuwalka Steel Industries Ltd. Unifort Metallizers Ltd merged with Akar Laminators. Tata Steel has signed a definitive agreement with Singapore based NatSteel to acquire its steel business in an all cash deal amounting to nearly Rs 1,300 crore.

In 2007, the metal sector accounted for 5 per cent of the total deal values. The largest deal in the sector was Vedanta's acquisition of a 71 per cent stake in Sesa Goa, 51 per cent from Mitsui & Co and 20 per cent through an open offer, for a total consideration of Rs 56 billion ($1.4 billion). Another major event was the investment of Rs 13 billion ($320 million) by Aditya Birla Group companies to consolidate their position in Hindalco Industries through preferential allotment.

Textiles Industry

The textile and clothing sector is the largest employer after the agriculture sector. Consolidation and restructuring would be the key to success in the era of post Multi Fibre Arrangement and removal of quantitative restrictions quotas, if India were to achieve $50 billion world textile trade by 2010, according to a study by CII. Post MFA, India is obviously being perceived as a good manufacturing destination, given its skill in the segment, cost of funds and government benevolence. Arvind Mills was the first to move its manufacturing unit from Mauritius to India. The large players are expected to gain most, followed by those who service niche areas and have spare capacity. The SP Oswal Group, promoter of textile companies, Mahavir Spinning Mills and Vardhman Spinning Mills, merged the two yarn manufacturing giants to create an Rs 2,000 crore turnover Textile behemoth.

Table 1.14 *Some Major Textile Mergers*

Target	Acquirer
Ahmedabad Laxmi Cotton Mills	Arvind Mills Ltd
Asoka Mills Ltd	Arvind Mills Ltd
Basanti Cotton Mills	Swan Mills Ltd
Belvedere Jute Mills	Cheviot Co Ltd
Bharat General & Textiles Inds Ltd	Kesoram Industries
Budge Budge Jute Mills Ltd	Delta Jute Mills Ltd
Cheviot Mills Co Ltd	Delta Jute Mills Ltd
Coorla Spinning and Weaving Co Ltd	Swan Mills
Crown Spinning & Mfg Co	Hindoostan Spg & Wvg Mills Ltd

(*Contd*)

(*Contd*)

Davangere Cotton Mills Ltd	Morarjee Goculdas Spg & Wvg Co Ltd
Garden Print Center Pvt Ltd	Garden Silk Mills Ltd
Jayashree Textiles & Inds Ltd	Indian Rayon and Inds Ltd
Jubilee Mills Ltd	Swan Mills Ltd
Kothari Textiles	Kothari Industrial Corpn Ltd
Mafatlal Fine Spg & Mfg Co Ltd	Mafatlal Industries Ltd
Niranjan Mills Ltd	Piramal Spg & Wvg Mills Ltd
Overseas Silk Mills Pvt Ltd	Overseas Synthetics Ltd
P A Spg Mills (P) Ltd	P A Mills India Ltd
Perfect Spinners Ltd	GTN Textiles Ltd
Prabhat Silk & Cotton Mills	Garden Silk Mills Ltd
Rohit Mills Ltd	Arvind Mills Ltd
Swastik Textile Mills Ltd	Apte Amalgamations Ltd
Vareli Textiles Industries Ltd	Garden Silk Mills Ltd

Consumer Goods

Duracell India and Wilkinson Sword merged into Indian Shaving Products. In the capital goods sector, Chicago Pneumatic merged with Atlas Copco. Whirlpool Washing Machines Ltd was merged with Whirlpool of India Ltd. Electrolux was acquired by Whirlpool in 1996. Godrej Soaps was merged with Godrej Consumer Products Ltd in 1999. Goa Electrical & Fans Ltd merged with Crompton Greaves. Godrej Soaps acquired Tran Elektra Domestic Products and formed Godrej Hicare. In 1996, the sick unit, Lumino Lamps, merged into Compton Greaves. Samsung merged Samsung Electronics India with itself in 2003. Godrej Consumer Products Ltd acquired the trademark and copyright related to the brand Snuggy, the first brand of disposable baby diapers to be launched in India. Meanwhile, Dabur took care not to cannibalise Red Toothpaste. Its other oral care brand, Binaca (acquired in the mid-1990s), has been kept exclusively for the toothbrush market. Dabur's consumer care division was created by the merger of erstwhile personal care products and healthcare products. Dabur India acquired the distribution business of its franchisee, Redrock Ltd, for $5 million to add its manufacturing facilities, and was renamed Dabur International. Electrolux, takeover of Intron, Maharaja and Allwyn were basically meant for financial synergy. In 2004, Dabur India bought Egypt's hair oil brand Touch, reportedly for Rs 10 crore. Murugappa Electronics Ltd merged into E.I.D Parry Ltd. The Videocon Group merged Videocon Narmada Electronics with the flagship company, Videocon International Ltd. Tecumseh acquired SIEL Compressors and Kelvinator to get virtual monopoly.

Machinery

Esab India the Indian arm of $1.2 billion Swedish company, Esab, had been involved in a series of mergers, starting with the acquisition of the welding division of Philips in 1988. In 1991, it took over Indian Oxygen Ltd's (IOL) welding division. In 1992-1993, Esab acquired Rs 5.7 crore Maharashtra Welaids Ltd. Its main rival Advani–Oerlikon Ltd merged Advance Welding Alloys Ltd with itself. Crompton Greaves of the LM Thapar Group merged two of its subsidiaries–Hind Condenser and Indocom Industries–and two associate companies–Goa Telematics (GTL)–and Northern Digital Exchanges (NODE)–into itself. Hind Condenser was the only profit making company among the group. The merger fitted into one or the other of Compton's four focus areas–power systems, industrial systems, electrical consumer durables and telecom. Prashant Khosla Pneumatic Ltd merged with Kirolskar Oil Engines Ltd. Hind Auto Industries Ltd merged with Automobile Products of India Ltd. India Tool Manufacturers Ltd got merged with Zenith Ltd. Hyderabad Allwyn Ltd merged with Voltas Ltd. Utkal Machinery Ltd merged with Larsen & Toubro. International Tractor Co Ltd merged into Mahindra&Mahindra.

In 2007, the largest deal was the acquisition of Anchor Electricals by Japan based Matsushita for Rs 20 billion ($488 million).

Table 1.15 reviews the status of M&A activity in different sectors on the basis of domestic, inbound and outbound deals in recent years.

Table 1.15 *Status of Deals*

Sector	Domestic	Inbound	Outbound
Cement	Yes	Yes	Yes
Banking & Financial Services	Yes	Yes	Yes
Pharma	Yes	Yes	Yes
Food & Beverages	Yes	Yes	Yes
Media & Entertainment	Yes	Yes	No
Oil & Energy	Yes	No	Yes
Telecommunications	Yes	Yes	No
Chemical	Yes	Yes	Yes
IT&IT related	Yes	Yes	Yes
Steel	Yes	No	Yes
Automotive	Yes	Yes	Yes
Hotel	Yes	No	No

THE KEY DRIVERS FOR M&A

Consolidation is globally regarded as a key driver for M&A. Even today, there are over 2,000 software companies of all sizes and focuses, over 500 paper mills, over 5,000 pharmaceutical units and over 1,000 packaging companies in India. There is clear path for consolidation of some of these establishments. Renewed optimism in the economy and corporate profits have created confidence in companies to aggressively pursue M&A as key part of their growth strategy. In many sectors, small and niche players have key skills but are struggling due to lack of capital or skill sets. In other sectors, companies have created capacity in commodity upturn and are now facing the downhill path market since they are unable to manage their businesses profitably.

Product markets have become global in every sense of the word. Companies need to offer services across geographies to compete effectively. M&A help in leapfrogging the lead time required to achieve the global scale. More debt and capital is available for companies to put together mega sized deals. The spurt in commodity and asset prices has left more cash with corporates and investors, which is available to fund transactions. The entry of private equity has enabled companies to look at M&A more aggressively.

Factors Driving Indian Companies to go in for M&A

- The only way for companies with sick subsidiaries to seek a credible rehabilitation package is to amalgamate the sick subsidiary with the parent company.
- Companies are seeking to consolidate the core business activities of the group firms to attain balance sheet size and net worth to mount strategic takeovers of companies in similar business activities.
- In the third category of companies, promoters have proposed to merge investment subsidiaries with the parent to streamline their shareholding in other group companies.
- Many mergers and takeovers have happened for tax advantage (setting off losses against profits), tactical advantage (to avoid paying the sales tax at multiple stages in the production process) or outright distress.
- Another important factor driving M&A activity is the changing role of financial institutions. The proactive approach of financial institutions has forced many corporates to sell their loss making businesses.
- The presence of intermediaries, like investment bankers, has facilitated M&A activity by negotiating with buyers and sellers.

THE FUTURE AHEAD

In 2007, there was continued acceleration of outbound transactions driven by sectors like pharmaceuticals and automotives, and increasingly by emerging sectors like textiles and consumer markets. There was also an increased trend of inbound investments in infrastructure, real estate, retail and logistics.

In the future, contracting credit cycles are expected to propagate rationalisation of current expansionary business plans which involves divestiture of non-core businesses. Another trend could be the institutionalisation of businesses and managerial ambitions that will encourage control transactions with private equity backing.[13]

SUMMARY

Mergers and industrial/corporate restructuring have become topics of great importance in the global corporate arena. They represent a major force in modern financial and economic environment. The first part discusses the global M&A trend and the merger movement. The chapter also focuses on the emergence of M&A wave in India and highlights the trend of M&A activity. The chapter also discusses the sectoral M&A activity. The key factors driving Indian companies to go in for M&A are also highlighted. The rise of globalisation has exponentially increased the market for cross border M&A. The major factors influencing cross border M&A are globalisation of products and service goods, technological advancement, trends in the equity and bond markets, economic liberalisation and reforms in the developing nations. International M&A add a new perspective to the growth process. Product advantages and product differentiation could also emerge as reasons for international mergers and acquisitions. Cross border acquisitions can be considered more riskier than domestic acquisitions due to structural, technical, information and cultural barriers that exist in the target country. Indian companies are targeting different geographies for different sectors. For pharma and auto components, Europe is the major destination. Metal and mineral sectors are being targeted in the Asia Pacific region. IT&ITES and telecom space acquisitions are taking place in the US markets. The IT sector, banking and financial services and pharmaceutical companies have been most active in M&A deals.

[13]KPMG Report, Rohit Kapur, 'Country Perspective: Mergers and Acquisition Activity in India', January 2007

DISCUSSION QUESTIONS

1. Discuss the significance of the merger movement.
2. Review the major M&A activity that took place in different industrial sectors.
3. What are the major drivers for M&A activity in India?
4. What are the major factors influencing cross border M&A activity?
5. What are the major barriers for cross border M&A?
6. Discuss the status of cross border M&A activity in India.

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2 Perspectives on Mergers and Acquisitions

Chapter Objectives

The aim is to make the reader understand

- The economic perspective on M&A
- The finance perspective on M&A
- The strategic perspective on M&A
- The strategic facilitators for M&A growth in India

INTRODUCTION

There is a great deal of focus on the visible aspects of merger of companies. It is reflected in bold headlines in the media. Many of today's most successful companies, including Cisco Systems, use mergers very effectively to improve their skills. Corporations, like Swiss Bank and Union Bank of Switzerland, re-energise themselves by merging and follow with acquisitions. Deals between chemical and pharmaceutical companies have fundamentally altering the shape of those industries, while mergers, such as those between American Online and Time Warner, and between Citicorp and Travelers Group, have created whole new industries. Acquisition strategy played central role in effective restructuring of US businesses during the 1980s and the 1990s. During the merger mania of 1980s, the number of acquisitions completed in the US was about 55,000. The total value of these acquisitions exceeded $1.3 trillion. But, in 1999 alone, $3.4 trillion was spent worldwide on mergers and acquisitions, up from $2.5 trillion in 1998 and $464 billion in 1990.

Growth through acquisitions has played a critical part in the success of many companies in the globalised economy. The plain fact is that the process of acquiring is much faster than that of building. Speed is essential for marketing, positioning, and becoming a viable company in the new economy. Many big companies owe much of their success to skilful acquiring.

The reasons to acquire or merge a company range from industry consolidation, customer acquisition, forward or backward integration, synergy with existing businesses, extension of product range, and so on. Single mergers can be basically explained by any one of these reasons. The sources of value creation can vary widely from merger to merger. One merger may be based on proposed cost reductions, while another may be based on cross-selling or geographic growth.

M&A have been extremely important sources of top line growth for many big companies. For example, owing to M&A, Siemens was able to expand quickly into major electronics markets, like the US. Siemens have integrated these acquisitions into a solid strategic platform. In the late 1990s, Siemens spent around $8 billion on acquisitions over four and a half years. Cisco Systems has pursued a well-articulated strategy of expanding its products range through acquisition of small, niche companies. During the period 1994–2000, it acquired about 50 companies at the cost of $20 billion. General Electric made over 100 acquisitions each year during the period 1996–2000. AT&T has spent over $100 billion on acquisitions since 1998. Microsoft buys, on an average, ten technology companies a year, and acquired 51 companies during the 8-year period, 1995–2002.

Mittal Steel, in an acquisition drive, bought sick and government-owned steel companies across the world. In the last 12 years, Mittal Steel has bought over 19 companies, from Canada to China. Today, plants owned by Mittal Steel, ship over 40 million tonnes of steel every year, from 14 countries, including Romania, Bosnia, Herzegovina, South Africa, Poland, Indonesia, Kazakhistan, Ukraine and the US.

Multiple mergers have made GlaxoSmithKline a master at controlling change, from operations to country specific labelling. GlaxoSmithKline has grown through four major M&As in the last 15 years.

Merrill Lynch has made over 18 acquisitions during the period 1995-2000, including the purchase of Mercury Asset Management for $6.6 billion in 1997. Merrill Lynch followed a well-forged highly tuned strategy between acquisitions and green field investments.

Tyco a diversified manufacturing and services company, with offerings ranging from fire and safety systems to underwater telecom systems, has been very aggressive in making acquisitions. During the 1998-2000 period, the company spent about $25 billion on acquisitions, including the purchase of AMP for $12 billion. Worldcom, through a series of rapid acquisitions, has become one of the top two-telecom companies of the world.

The European serial acquirers include CRH, a building material group based in Ireland. The group relies on what it terms its 'bolt-on acquisition strategy', to help increase its presence in 19 countries. CRH typically buys small, often family–owned, building companies. During 2000, it acquired 60 businesses at the cost of $10.3 billion and, in 2001, it spent $1.15 billion on acquiring 22 businesses. WPP, a global advertising group has a remarkable M&A track record, having merged with leading advertising agencies, including Ogilvy & Mather, J. Walter Thompson and Young & Rubicam. In 2001, the company made 27 deals, making it UK's most acquisitive company of the year.

In India too, companies are using the strategy of multiple acquisitions to grow. The past couple of years have seen a spate of mergers and acquisitions by Indian IT companies. Many companies have used M&A to grow in size, by adding manpower, and to facilitate overall expansion. From 2001, in a span of 18 months, HCL Technologies struck ten deals to acquire companies or set up joint ventures. Since 2005, Wipro has acquired 8 companies.

Indian pharma companies have been aggressively making overseas acquisitions since the past few years. Dr Reddy's Lab, Ranbaxy, Matrix Lab and Torrent Pharma have made large acquisitions by taking over generic drug manufacturers in the foreign markets. Murugappa Group and United Breweries have diversified mainly through acquisitions.

ECONOMIC PERSPECTIVE ON M&A

The rationale for mergers, under the economic perspective, is that competitive advantage over rivals can be obtained through cost reduction or increased market power.

Economies of scale are cost savings that accrue directly from a large-sized operations as it is generally seen that unit costs are lower in a large plant than in a smaller one, lower in a large distribution centre than in a small one, lower for large volume of purchases of components than for small volume of purchases. Related businesses often present opportunities to consolidate certain value chain activities, or use common resources, and thereby eliminate costs. Such cost savings are termed as *economies of scope*. Economies of scope stem directly from cost savings strategic fits along the value chains of related businesses. Most commonly, economies of scope are the result of two or more businesses, sharing technology, performing R&D together and/or using common manufacturing or distribution facilities. The greater the economies associated with cost savings strategic fits, the greater the potential for a related diversification strategy to yield competitive advantage based on lower costs.[1]

As an organisation's experience in carrying out an activity increases, the cost of performing the activity often declines on a per unit basis. Cost reductions of this kind are called *economies of experience*.

Economies of scale and experience curve effects enable firms to successively lower their unit costs as both capacity and experience grow. Economies of scale and experience curve effects are particularly significant in the inbound logistics, operations, outbound logisitics, procurement and technology development activities of the value chain.

The major contributors to economies of scale are specialisation, fixed cost spreading, purchase discounts and vertical integration.

As the scale of activity increases, more employees are needed. The more the employees involved in performing an activity, the greater are the opportunities for individuals to specialise. Many fixed costs (for example, technology development and automated production equipment) do not increase proportionately as an activity expands in size. These costs can, therefore, be spread over a larger number of units, resulting in decline per unit cost. Large firms can operate activities on a big scale. Thus, they have greater opportunity to spread and amortise fixed costs.

Large purchasers frequently enjoy high bargaining power as suppliers frequently extend quantity discounts to them.

Vertical Integration: Vertical integration is an economic concept that refers to the degree of control a firm exerts over the supply of its inputs and the purchase of its outputs. For example, when an automobile manufacturer acquires a steel maker (a key supplier of crucial materials needed to produce cars), it is pursuing a form of vertical integration by attempting to control a supply source. Similarly, when the automobile manufacturer purchases a car rental firm, it is pursuing another form of vertical integration by extending its control over an important buyer of its products. Extending control over sources of supply (upstream operations) or buyers (downstream operations) is vertical integration. Vertical integration can be an important cost driver, depending on the nature of the firm's product, degree of technological change and the relative strength of buyers and suppliers in that industry.

FINANCE THEORY PERSPECTIVE ON MERGERS

Finance theory analyses merger decisions within the framework of the conflicts of interest among various financial claim holders of the firm. The central focus of this perspective revolves around the following elements.[2]

(a) Shareholder wealth maximisation as the primary objective of any firm
(b) The significance of the agency model in describing the conflict of interest between principals and agents
(c) The hindrances on managerial self-interest pursuit due to internal corporate governance constraints
(d) External constraints imposed by the market for corporate control.

Agency Theory[3]

Corporate managers are the agents of shareholders, a relationship often based on conflicting interests. Agency

[1]Arthur A Thompson, A J Strickland III, John E Gamble, *Crafting and Executing Strategy: The Quest for Competitive Advantage, Concept and Cases*, Tata McGraw Hill, 14th edition.

[2]Sudi Sudarsanam, *Creating Value from Mergers and Acquisitions: The Challenges*, Pearson, Edition 2003, pages 47-55.

[3]Jensen M C, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers, The Market for Corporate Control*, AEA papers and proceedings, 323-329.

theory, which deals with the analysis of conflicts has become a major part of economic literature. Payouts to shareholders reduce resources under the manager's control, thereby reducing the manager's power and making it more likely that he will incur the monitoring of that capital markets when the firm has to obtain new capital. Managers have incentives to cause their firms to grow beyond the optimal size. Growth increases the manager's power by increasing the resources under his control. It is also associated with increase in manager's compensation because changes in compensation are positively related to growth. An example is growth in sales-free cash flow which is the cash flow in excess of what is required to fund all projects that have positive net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organisation generates substantial free cash flow. The problem is how to motivate managers to give cash to shareholders rather than investing it at the rate below the cost of capital, or wasting it on organisation inefficiencies.

Role of Debt in Agency Cost Reduction The role of debt in motivating organisational efficiency can be explained in the context of control mechanism. Managers with substantial free cash flow can increase dividends, or repurchase stocks, and thereby pay out current cash that would otherwise be invested in low return projects. This leaves managers with control over use of future free cash flows. The fact that capital markets punish dividend cuts with large stock price reductions is consistent with the agency cost of free cash flow.

Debt creation without retention of the proceeds of the issue enables managers to effectively bond their promise to pay out future cash flows. By issuing debt in exchange for stock, managers are bonding their promise to pay out future cash flows in a way that cannot be accomplished by simple dividend increases. The firm can be taken into bankruptcy court if it does not maintain its promise to make interest and principal payments. Thus, debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of the managers.

A classical example is the case of oil industry in the eighties. Price increases generated large cash flows in the industry. For example, in 1984, the cash flows of ten largest oil companies were $448.5 billion, 28 per cent of the total cash flows of 200 firms in Dun's Business Month Survey. Consistent with the agency costs of free cash flow, the managements did not pay out the excess resources to the shareholders. Instead, the industry continued to spend heavily on E&D activity even though average returns were below the cost of capital. Oil industry managers also launched diversification programmes to invest funds outside the industry.

Market for Corporate Control[4] *Corporate control* is frequently referred to the phenomena that range from general forces that influence the use of corporate resources, such as legal and regulatory systems and competition in product and input markets, to the control of majority of seats on corporate's board of directors. Jensen and Ruback (1983) define corporate control as the rights to determine the management of corporate resources, that is, the rights to hire, fire and set the compensation of top level managers. When a bidding firm acquires a target firm, the control rights of the target firm are transferred to the board of directors of the acquiring firm. While corporate boards always retain the top level control rights, they normally delegate the rights to manage corporate resources to internal managers. In this way, the top management of the acquiring firm acquires the rights to manage the resources of the target firm.

The *market for corporate control*, often referred to as the *takeover market*, can be described as the market in which alternative managerial teams compete for rights to manage corporate resources. Thus, takeover market is an important component of the managerial labour market. The managerial competition model views competing management teams as primary activist entities with stockholders (including institutions) playing

[4]Michael C Jensen, Richard S Ruback, *The Market for Corporate Control, The Scientific Evidence*, Journal of Financial Economics, 11(1983), 5-50

a relatively passive and, more importantly, a judicial role. Stockholders are assumed to have no loyalty to the incumbent managers; they simply choose the highest value offer from those presented to them in a well functioning market for corporate control. In this perspective, competition among managerial teams for the right to manage resources compels managers to focus on shareholder wealth maximisation, and provides the mechanism through which economies of scale, or other synergies, are realised.

The evidence on takeover actions that affect the probability of takeovers suggest that takeovers serve to limit managerial departures from maximisation of shareholder wealth. Conflicts of interest between owners and managers can, however, be limited in the absence of takeovers through mergers and tender offers. Stockholders elect the board of directors, and the board of directors directly monitors managers. Stockholders can change managers by electing a different board of directors, and voting rights and proxy contests are, therefore, important aspects of the general control process.

Corporate Governance and M&A

Corporate governance refers to the set of contractual devices that regulate, monitor and control the behaviour and performance of executive managers, who are agents of capital providers, such as lenders and stockholders. If the benefits of mergers are related to size, managers may pursue M&A for their own self interest. Corporate governance has an important bearing, both on the choice of M&A as a means of achieving the firm's growth and shareholder value objectives, as well as on the outcome of the decisions. Thus, corporate governance perspective can explain the nature and type of acquisitions that occur, and also the success or failure of those acquisitions.

STRATEGIC PERSPECTIVE ON M&A

Competitive Strategies

Michael Porter has developed three generic competitive strategies. These strategies include (a) cost leadership, (b) product differentiation, (c) segmental focus with either cost leadership or product differentiation.

Cost leadership can be achieved by being the lowest cost producer and seller. It is possible for a company to achieve the lowest cost producer status through an efficient combination of value chain of the firm's activities, such as production, sales, marketing and distribution. In *product differentiation strategy*, the firm aims to endow the products with additional attributes so as to induce the customers to pay a premium price. In the *segmental focus strategy*, the focus is either on the basis of cost leadership or perceived customer benefits.

Resource Based View of Competitive Strategies Resources are tangible and intangible assets owned and controlled by the firm. Capabilities are essential organisational competencies required for effective use of resources. The sustained competitive advantage for a firm may arise due to heterogeneous distribution of strategic resources and capabilities across firms. These strategic capabilities can also be considered as core competencies. They represent collective learning in an organisation, in particular, how to coordinate diverse production skills and integrate multiple streams of technology[5]. Firms develop resources and capabilities over time, organically or through mergers, acquisitions or strategic alliances. In other words, mergers offer an alternate pathway to resource and capability acquisition. Merging firms may have complementary resources and capabilities. In the resource based view of mergers, the merging firms share their R&C to create value. This sharing may lead to cost reduction, sales revenue enhancement or growth opportunities. In a merger, two value chains need to be merged. There will be much wider overlap among the value chain elements in

[5]C K Prahalad and G Hamel, *The Core Competencies of the Corporation*, Harvard Business Review, May/June 1990,79-91

a horizontal merger than in a conglomerate merger. In a related merger driven by scope economies, non-production elements of the value chain may dominate the integration.[6]

Strategy of M&A

Mergers in western context have, over the course of the last century, transformed the corporate landscape. Merger activity, throughout the world, has captured the eye of public policy makers, corporate managers and financial investors. In corporate literature, motives for merger are manifold due to the fact that different acquiring firms may have different motives for different acquisitions.

Strategic fit in M&A context, can be addressed as the issue of combining company attributes under one roof because of their compatibility. The implication is that the products, services or qualities exclusive to one company fill the capability gap inherent in the other company, and vice versa. But, in many cases, the benefits of cost reduction do not continue beyond initial years. The economies of scale fail to deliver increased efficiency over the long term. Beyond the attention paid to cost reduction, the primary focus for strategic deals should be on melding complementary, non-financial assets with the vision for growth through integration over the long term.

Strategic synergy will lead to strategic advantage. True M&A driven strategic advantage is comprised of multiple synergies that focus on growth rather than cost savings, integrate easily and deliver benefits that materialise over the long term. Integration is critical to the success of any strategic merger or acquisition. The traditional definition of synergy in M&A circles is the potential cost savings that occurs when two companies combine. However, strategic synergies are the result of combined complementary attributes that focus on growth.

Strategic Drivers[7]

The basic opportunities for strategic synergy are:

1. Effecting Organisational Growth The strategic advantage of increased size through M&A can improve a company's financial performance through leveraging basic economies of scale. Along with other strategic synergies, the advantage of size can act as the foundation and catalyst for increased market share, production enhancements and new market penetration. When Time Inc and Warner Communications combined their two companies in 1989, they created the first of the giant media conglomerates. They focused on dominating–through size and leverage–all aspects of the market, from print to television, to movies and electronic media. In 1996, two Swiss competitors Sandoz Ltd., the 12th largest drug company, merged with Ciba, the 10th largest company, to dominate pharmaceutical and immunological markets. The combined company had initial sales of roughly $30 billion, and a market value of roughly $79 billion, making it the 12th largest corporation in the world. The merged company became a world leader in many therapeutic areas. The merger enhanced and linked the two companies' pharmaceutical and nutrition product lines creating the largest health food producer in Europe. The fuel for their growth was twofold: broader distribution channel and, a commanding position in each company's defined markets. Amazon.com acquired a host of internet ventures to expand and diversify its operations.

2. Increasing Revenue/Market Share and Market Power This motive assumes that the company will absorb a major competitor and increase its power. Increasing market share requires that the company seize already established customer royalty from a competitor and build on it to further increase its own share. One of the basic investigative areas of marketing *due diligence* is identifying the sources of future increases

[6]Sudi Sudarsanam, *Creating Value from Mergers and Acquisitions: The challenges*, Pearson Edition 2003, Pages 47-55
[7]Hitt, Michael A et al., *Strategic Management: Competitiveness and Globalization,* Thomson South-Western; 6th edition

in market share. The greatest deals are, indeed, acquisitions of customers. The market leader of a particular product will acquire smaller competitors to increase its base. The increase in size could then provide the necessary leverage with suppliers and distributors to make greater inroads within the market.

Market power exists when a firm is able to sell its goods or services above competitive levels, or when the costs of its primary or support activities are below those of its competitors. Market power is usually derived from the size of the firm, and its resources and capabilities, to compete in the marketplace. Firms use horizontal, vertical and related acquisitions to increase their market power. The cross–border transaction between Dailmer Benz and Chrysler Corporation was intended to create market power and generate synergies.

3. Access to New Distribution or Gaining Entry into New Markets Acquisition of targets gives a company access to a greater number of potential buyers which can also bring about enhanced production or distribution capabilities in new territories. Entering a new market for the first time involves multiple risks. Acquiring another company that already has a foothold in that segment helps in minimising the risk. The acquisition of Gerber Products by Sandoz in 1994 offered each company entry into new markets, as well as access to new products and distribution channels.

4. Obtaining New Products Companies that often focus on growth have to make a choice between *make or buy* decisions. Companies with available cash, depth of resources, and access to technology are in best position to acquire new products. The alternative to buying a new product or capability is a complex, costly and time-consuming period of product or service development. Technological gains have shortened the time required to design, manufacture, promote and deliver a product or service to the marketplace. Even the time period for imitations have come down drastically. This is one of the main reasons that many companies opt to buy rather than make, in order to avoid extended periods of R&D investment, with uncertain results. Developing a new product internally, and successfully introducing it into the marketplace, often requires significant investment. Studies have shown that almost 88% innovations fail to achieve adequate returns from the capital invested in them. Approximately 60% innovations are successfully imitated within four years, after the patents have been obtained.[8]

5. Overcoming Entry Barriers On account of differentiated products, new entrants typically spend considerable resources for promoting their goods and services. However, product loyalties may become a barrier difficult for new entrants to overcome. In the context of the scenario of barriers created by economies of scale and differentiated products, a new entrant may find acquisition of an established company more effective than attempting to enter the market as a competitor. The higher the barriers for market entry, the greater is the probability that a firm will acquire an existing firm to overcome them. For multinational companies, international markets have become attractive because of their future potential. It may be noted that the five emerging markets (China, India, Brazil, Mexico and Indonesia) are among the 12 largest economies in the world, with combined purchasing power already one-half of the group of seven industrial nations (United States, Japan, Britain, France, Germany)[9].

6. Keeping Pace with Change A number of variables can act as catalyst for change within a given market, industry or sector. Social, economic and demographic shifts result from factors beyond a company's control. Regulations typically change in response to socio-economic evolution, rather than vice versa. As changes occur, companies are often forced to modify their services and products in order to stay competitive. Change can be analysed from the perspective of reactive companies, that merge or acquire to keep pace, and proactive companies, that make visionary decisions that anticipate change, or even force it.

[8]E Mansfield, 1969, *Industrial Research and Technological Innovation*, New York, Norton
[9]J A Gingrich, 1999, *Five Rules for Winning Emerging Market Consumers*, Strategy & Business, 15, 19-33

7. Political and Regulatory Change World over, the past decade has seen increased competition in industries that were once heavily regulated, such as energy, telecommunications and banking. As regulations ease and competition increases, companies are aggressively pursuing entry into the once monopolised sectors. On account of removal of regulatory constraints in multiple global markets, telecommunication companies are using M&A strategies to develop economies of scale in the rapidly changing and cost-sensitive markets, and for entering new markets.

8. Innovations/Discoveries in Products and Technology A company's ability to 'make it faster' and 'price it cheaper' is increasingly becoming a function of its technological, rather than managerial, know-how. The inclusion of new technologies into the products and processes of companies and industries which are not technologically savvy is most critical. If a company's strategic objective is to attain competitive advantage, then it must harness technology in virtually every area, including engineering and production, operations, human resources, and specifically in the functions of marketing, product management and sales. In this context, strategic synergies would result in a scenario of merger, wherein the combination of products of one company with the services of another could lead to the creation of a more efficient delivery system, or adding of customer service capability to an already strong distribution network. Internal product development can be risky. Alternatively, as an acquisition's outcomes can be estimated more easily, and accurately as compared to the outcomes of an internal product development process, managers may view acquisitions as carrying lower risk.[10] Acquisition becomes a substitute for innovation.

The merger of AOL and Time Warner illustrates how one of the new companies, in what was then called the 'new economy' took over an older and larger business. This combination illustrates how innovation that creates rapid market growth can be exceedingly highly valued by the stock market. The booming US stock market of that decade had priced most of these new companies exceedingly high. American Online (AOL), one such company, provided service access through Internet to subscribers. It used its very high market value to merge with an older media company. Time Warner brought to the merger a powerhouse of media content producing companies, whereas American Online principally brought success in the new electronic business of that time.

The acquisition of Lotus by IBM in 1995, for $3.5 billion, was basically for Lotus's groupware products. The acquisition helped extend IBM's lead in the enterprise computing field over its rival Microsoft Corporation.

Lucent Technologies acquired 38 companies in the course of its strategic drive to be the technology leader in telecommunication networking. Gaining access to desirable technologies via acquisition enables a company to build its market position in attractive technologies quickly, and serves as a substitute for extensive inhouse R&D programmes.

9. Lessening Competition Buying one's competitor accomplishes dual goals of negating the competitor's market share while bolstering one's own. Microsoft, Gillette, IBM, Campbell Soup and Coca Cola are examples of companies that have increased market share domestically and abroad by acquiring their close competitors. The primary strategic driver for merger of Cadbury Schweppes and Dr Pepper/Seven Up was basically to lessen competition.

10. Responses to Economic Scenarios In the western context, it is often seen that when interest rates are low, the opportunity to access cheaper capital often sparks a flurry of acquisitions by companies who could not previously afford to borrow. There are many advantages of a loose monetary policy for an acquisitive company. It fosters refinancing of past acquisitions at lower rates while granting access to the

[10]M A Hitt, R E Hoskisson & R D Ireland, 1990, *Mergers and Acquisitions and Managerial Commitment to Innovation in M form firms*, Strategic Management Journal, 11 (Special Summer Issue): 29-47

capital markets using previously unaffordable methods. On the other hand, when equity markets are heated up, a company's overvalued stock price can be a catalyst for fuelling an acquisition programme with stock as currency.

11. Increased Speed to Market Acquisitions remain the quickest route for companies to access new markets and to new capabilities. Firms seek rapid market entry in different industries. British Telecommunications, PLC(BT) spent around $2.46 billion to acquire Esat Telecom Group, PLC, Ireland's second largest phone company. The acquisition gave BT immediate access to Ireland's rapidly growing telecommunications market, including in the area of high speed broadband delivery.

12. Diversification Firms typically find it easier to develop and introduce new products in markets served currently by them. In contrast, it is harder for companies to develop products that differ from their current lines. It is uncommon for a firm to develop new products internally as a means of diversifying its product lines. Instead, a firm usually opts for acquisitions as the means to engage in product diversification. Related and unrelated diversification strategies can be implemented through acquisitions. Acquisitions are the most frequently used means by firms to diversify their operations into international markets. Studies have shown that horizontal and related acquisitions tend to contribute more to strategic competitiveness than those through which a firm acquires a company operating in product markets, quite different from ones in which it currently competes.[11] A preferred strategy is to move into a diversification programme from the core of existing capabilities or organisational strength. In this context, the question is whether the specific capabilities, such as marketing, research and manufacturing, can be utilised in a different area. Managerial capabilities include competence in the generic management functions of planning, organising, directing and controlling, as well as in the specific management functions of research, production, personnel, marketing and finance. The development of such a range of capabilities requires substantial investment in training and experience of people.[12]

Growth and diversification can be achieved both internally and externally. The advantages of growth through external means, like mergers and acquisitions, have many valid reasons. The cost of building an organisation internally may exceed the cost of an acquisition. The early 1990s had seen substantial expansion in cement capacity, far in excess of demand. The average cost of setting up a Greenfield cement unit was Rs 3000-3500 per tonne. However, most of the acquired capacities have been taken over at cheaper rates due to their lower market value on account of recessionary trends. There may be fewer risks, lower costs or shorter time requirements involved in achieving the market share target by external growth.

Generally, four factors have contributed to increased diversification by companies. These include advances in managerial technology, increased technological change, larger fixed costs for staff services and developments in equity markets.

Important changes have taken place in management technology during the past decades. The long range planning to management has been related by financial objectives. The development of formal decision models, termed management science, systems analysis approach to the firm, increased role of management functions in the firm's operations and increased recognition of the value of investments in people are all major advances in the managerial technology which have led to increased diversification by business firms.

The increased rate of technological change has also contributed to greater business diversification. The increased pace of product development shortens the life cycle of products. The scope of economic profits from supplying advanced technological capabilities to firms who need them provides a motive for increased diversification.

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[11]J Anand & H Singh ,1997, Asset Redeployment, Acquisitions and Corporate Strategy in Declining Industries , Strategic Management Journal, 18 (Special Summer Issue): 99-118

[12]Fred Weston, Kwang S Chung, Susan E Hoag, "Mergers Restructuring and Corporate Control", PHI, 2006

The complexity of modern business operations have increased due to advances in management technology and increased technology change, along with changing dynamic economic and cultural environments. The need and cost for staff services have increased. It is often observed that scale economies have increasingly resulted from investments in managerial organisations rather than investments in physical plants.

The emergence of growth stocks in equity market have also contributed to increased diversification. Innovation creates rapid market growth that can be exceedingly valued highly by the stock market. AOL used its very high market value to merger with an older media company Time Warner.

13. Reshaping the Firm's Competitive Scope The intensity of competitive rivalry is an industry characteristic that affects a firm's profitability. To reduce the negative effect of intense rivalry on its financial performance, the firm may use acquisitions as a way to restrict its dependence on a single or a few products or markets. Reducing company's dependence on single products or markets alters the competitive scope of the company. In this context, it is worth mentioning that some automobile manufacturers are diversifying their operations to reduce their dependence on intensely competitive global auto markets. A famous and highly profitable manufacturer of electrical motors and electrical components, Emerson, is using acquisitions to develop a focus on the electronics and telecommunications sectors. The Japanese major, Hitachi, is also pursuing the same strategic approach.

Other Motives behind M&A

(1) **Cross selling:** A bank buying a stock brokering firm may sell its banking products to the stock broker's customers, while the broker may sign up the bank's customers for brokerage accounts. A manufacturer may acquire and sell complementary products.

(2) **Economies of scale:** Managerial economies may result from increased opportunity for managerial specialisation. Purchasing economies, due to increased order size and associated bulk buying discounts may also be achieved.

(3) **Taxes:** A profitable company may buy a loss maker to reduce its tax liability. Countries, like the US, have laws to restrict the acquisition of loss making companies by profitable companies, to limit the tax saving motive of the acquiring companies. A business could also be demerged to form two businesses for tax purposes or to correct market undervaluation by creating greater focus on each business. Hence, Ramco Systems was demerged by Ramco Industries.

(4) **Resource transfer:** Resources are unevenly distributed across firms. The interaction of the target and the acquiring firm's resources can create value through either overcoming information asymmetric, or by combining scarce resources.

A strategic model formulated by Heitman and Zahra[13] proposes that the antecedents of corporate restructuring, in the form of competitive and macro environmental factors, are key variables influencing the aggregate level of restructuring activity. The three main macro trends that have stimulated restructuring activity are: (1) Globalisation of industries and increasing world competition, (2) Deregulation of industrial sectors, and (3) Increasing threat of takeover bids leading to reconfiguration and portfolio contraction. Deregulation of markets and increasing competition have been considered major causes for high levels of restructuring activity in Europe and the US during the 1980s.

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[13]E Heitman and S A Zahra, *Examining the US experience to discover successful corporate restructuring, Industrial Management*, Jan/Feb, 7-10 (1993)

Problems in M&A Success

1. Integration Difficulties Integration issues include those of melding two disparate corporate cultures, linking different financial and control systems, building effective working relationships and resolving problems. Intel acquired Digital Equipment Corporation's semiconductors division. On the day Intel began integrating the acquired division into its operations, six thousand deliverables were to be completed by hundreds of employees working in dozens of countries.[14] Research conducted by the consulting firm, Allen Hamilton concludes that there is a positive relationship between the rapid integration of the acquiring and acquired firms and the overall acquisition success. In this context, it can be noted that Allied Signal kept the Honeywell name after acquiring it. Cisco Systems wears the mantle of M&A King. This is being attributed to the remarkable ability of the firm to quickly integrate its acquisitions into its existing operations.

2. Evaluation of Target Due diligence process evaluates a target firm for acquisition. The failure to complete an effective due diligence often results in the acquiring firm paying a premium for the target company. Due diligence is commonly performed by investment bankers, accountants, lawyers and management consultants. Effective due diligence helps a company to take the decision to whether acquire a target firm or not. For example, in 1999, Dailmer Chrysler was interested in taking over Nissan Motor Company for expansion into global auto markets, especially in South East Asia. The primary cause of concern was Nissan's $22 billion debt which compelled the company to call off the proposal.

3. Huge Amount of Debt In the Western developed countries, a large number of acquisitions completed in the 1980s and 1990s, were through financial innovations of junk bonds. Junk bonds are unsecured obligations, and interest rates for these high risk debt instruments were very high, often in the range of 18-20%. Academic studies during this period show that debt disciplined managers, causing them to act in shareholders' interest. Huge dependence on debt can lead to negative results, like rationing investments, that are essential to maintain strategic competitiveness over the long term.

4. Lack of Synergy Benefits A firm develops competitive advantage through acquisition strategy only when the transaction generates private energy, which is created when the combination and integration of the acquiring and acquired firm's assets yield capabilities and core competencies that could not be developed by combining and integrating either firm's assets with another company.[15]

5. Excessive Diversification Each firm may have a different capability that is required to successfully manage diversification. The need for related diversified firms to be able to process more and more diverse information creates a situation in which they become over diversified, with a smaller number of business units as compared to firms using an unrelated diversified strategy.[16] Even when a firm is not over diversified, a high level of diversification can have a negative effect on the firm's long-term performance. The scope created by additional amounts of diversification often causes managers to rely on financial, rather than strategic, controls to evaluate the business units' performance[17].

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[14]M Zolio 1999, M&A–**The Challenge of Learning to Integrate, Mastering Strategy** (Part 11), *Financial Times*, December 6, pp 14-15

[15]Hitt, Hosikisson, Ireland & Harrison, **Effects of acquisitions**: J B Barney 1988, Returns to Bidding Firms in Mergers and Acquisitions: Reconsidering the Relatedness Hypothesis: *Strategic Management Journal*, 9 (Special Summer Issue): 71-78

[16]C W L Hill & R E Hoskisson, 1987, **Strategy and Structure in the Multiproduct Firm**, *Academy of Management Review*, 12; 31-341

[17]R E Hosikisson & M A Hitt 1988, **Strategic Control Systems and Relative R&D Investment in Large Multiproducts Firms**. *Strategic Management Journal* 9; 605-621

Case Analysis I

Dailmer Benz and Chrysler Merger

At the time of its announcement, the merger between Dailmer Benz and Chrysler Corporation was the world's largest. This horizontal cross border transaction was intended to create market power and generate synergies. Chrysler lacked the infrastructure and management depth required to be a truly global automobile company. For Dailmer Benz, the increasingly intense competitive rivalry in its core luxury car segment made it necessary for the firm to diversify its product line and distribution channels. This merger was considered to be a complementary fit for two reasons. Dailmer was dominating Europe and South America while Chrysler dominated market position in United States. Secondly, the companies' product lines were complementary. The bulk of Chrysler's profitability was earned from sport utility vehicles and multipurpose vans, whereas luxury vehicles were the foundation of Dailmer's automotive based strategic competitiveness. This horizontal acquisition was based on the motive of creating cost and revenue based synergies. In 1999 alone, the integration of separate operations reduced the costs by $1.3 billion. The building of Mercedes M Class cars and the Jeep Grand Cherokee on the same production line in Graz, Austria, was one of the integration projects that was started immediately in the combined firm. In 1999, the new firm's operating profit for the year was approximately Euro 11 billion, up from Euro 8.6 billion in 1998.

Case Analysis II

Merger of AOL and Time Warner

Information technologies may strategically impact a business in different ways. The story of AOL illustrates how innovation creates rapid market growth that is valued highly by the stock market. In the 1990s, the new electronic commerce, or e–commerce, had created a whole new set of companies and media industry. The booming US stock market had priced most of these new companies exceedingly high. America Online was one such company providing service access through the internet to its subscribers. AOL used its very high market value to merge with Time Warner.

On December 10, 1999, the market capitalisation of America Online was $250 billion dollars, whereas the market capitalisation of Time Warner was about $85 billion. The difference was in the stock markets' multiplication of their relative price to earnings ratios. AOL stock was 3.8 times more valuable than Time Warner's stock, based on the earnings. This was the epicentre of the deal. AOL's vast P/E ratio gave it the leverage to take over Time Warner. Time Warner had a major debt load, which AOL did not have. AOL was operating in a rapidly growing new market—e-commerce—which Time Warner had tried to enter but failed. However, Time Warner had a much larger asset base. Time had 73 million consumer subscriptions compared to AOL's 24 million. Time Warner product brands included

(a) Time, People Sports Illustrated, Fortune and Money magazines
(b) The cable companies, HBO, Cinemax, CNN, TNT
(c) The movie and music production companies of Warner Bros.

In contrast, America Online had AOL, Netscape Navigator and stakes in several companies. Time Warner brought to the merger a powerhouse of media content producing companies, whereas American Online principally brought success in new electronic businesses of the time. AOL purchased Time Warner for $183 billion. AOL had just one-fifth of Time Warner's revenue and only 15% of its employees. After the swap exchange, based on shares, AOL owned 55% and Time Warner 45% of the new company.

In a strategic perspective of the merger, the cash flows of Time Warner's major publication and television empire would provide AOL, a steady and major source of income over long term. Also, the acquisition of Time Warner was expected to solve AOL's brand width problem. AOL had been providing Internet service connections through existing copper telephone lines. The market demand for Internet connections was through broadband. Time Warner owned a major cable company that could provide a much faster broadband connection to its cable customers. Through the merger, Time Warner gave AOL access to a market of 20 million cable customers. For Time Warner, it was important to move into the digital world of Internet and electronic commerce.

But the AOL Time Warner merger proved to be mostly a disaster, partly because AOL's rapid growth has evaporated, partly because there has been a huge clash of corporate cultures, and partly because most of the expected benefits are yet to materialise.

STRATEGIC FACILITATORS FOR M&A GROWTH IN INDIA

Macro Environment as a Facilitator of M&A Growth

India is witnessing a change in the flavour of M&A. It is increasingly moving away from inbound activity towards outbound activity.

India has seen 6% annual growth rate over the last two decades and continues to offer great investment opportunities, not only in the knowledge sectors but also in more traditional sectors, such as manufacturing, banking, pharmaceuticals, telecom and others.

Service has been the main sector driving growth for the economy, with 8% plus growth. The GDP is expected to grow at 6-8% in the foreseeable future. Services make up more than half of India's GDP. Initially there had been greater focus on investment in infrastructure and administrative reforms. The major drives for the industrialisation process were competition, tariff reductions, income velocity and financing. The new avenues of growth engine are real estate, organised retail, biotechnology, tourism, gems and jewellery and aviation. The main sectors driving growth include IT/ITES, financial services, healthcare, tourism and education. The GDP growth rate indicates that India has emerged as one of the fastest growing economies, with annual GDP growth of 6% to 8%. The foreign institutional investment reached a record US $8.5 billion for 2005-2006. The stock market performance indicates that it is one of the best performing markets, with the BSE appreciating by 45% in 2006 as compared to 2005.

Growing GDP and FDI, falling rates of interest and maturing capital markets create private equity investment opportunity in infrastructure, telecom, cement, toll roads, bridges, manufacturing, technology and pharmaceuticals.

With respect to the trends in net profit for Sensex companies, net profit rose to $16428.40 in 2006, as compared to $8135.8 US dollars in the year 2003. On comparative basis, the growth during this period was CAGR of 26%.

There have been increase in investment flows from abroad and growth in profits domestically. In 2003, the private equity flow was $774 million. In 2004, it rose to $1750, and further rose to $7500 in 2006.

According to AT Kearney's FDI Confidence Index, India is the second most attractive destination for manufacturing. According to UNCTAD's World Investment Report 2005, India is the second most attractive investment destination among transnational corporations.

Progressive Regulatory Policies

The relaxation in regulations proposed automatic approval for Indian companies for investing upto 200% of their net worth abroad. The salient features of the policy include:

- Ease in accessing funds through External Commercial Borrowing (ECB) and Foreign Currency Convertible Bonds (FCCB)
- Banking norms proposed to be liberalised further for foreign banks by 2009
- Insurance sector is proposed to witness an increase in FDI from 24% to 49%
- 100% FDI permitted in urban infrastructure projects, and in development of integrated townships, including housing, commercial buildings, hotels and resorts
- Engineering: 100% FDI permitted in heavy electrical industry.
- Power: 100% FDI permitted in power generation (except for atomic energy), transmission, distribution and trade
- Telecom: FDI of up to 74% permitted in telecom services companies, in basic, cellular unified access, national/international long distance, V-SAT, public mobile radio trunked services, global mobile personal communications services and other value-added telecom services.

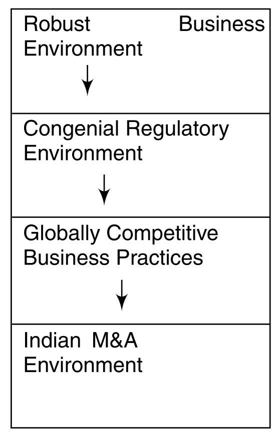

Figure 2.1

Indian firms have been adopting best business practices with sustainable competitive advantages. India is among the world's largest manufacturer of motorcycles, tractors, fertilizers, soaps and detergents. It is also the world's largest centre for cutting and polishing diamonds, and producer of engineering graduates. India is among the largest bulk drug manufacturers; top destination for R&D centres for MNC's outside US, and among the few countries that have developed their own super computers. India is also home to the producers of steel, CDs (Moser Bear) and car maker, at lowest cost in the world.

In 2001, there were 1634 inbound M&A activities in India, while the outbound activities were only 40. By 2006, the number of outbound M&A activities rose to 6361, while the inbound activities were 3898. The average ticket size 2006 was $74 million, an increase of 35% per annum since 2003. The largest outbound deal in 2006 was $677 million–Tata Tea acquiring 30% in Energy brands. The largest outbound deal was the acquisition of Corus by Tata Steel for an estimated $12 billion. Hence, the M&A trend clearly reveals the growing significance of Indian companies on a global shopping spree. In 2006, the Tata Group led the way in outbound M&A, both in numbers and value. Other key players are Dr Reddy's which was the second highest in terms of value of deals, and United Phosphorus, second highest in terms of number of deals. The average ticket size of deals in 2006 was $95 million, an increase of 133% per annum since 2003. The largest inbound deal in 2006 was Kohlberg Kravis Roberts's acquisition of software business of Flexitronics for $900 million.

These transactions have been effected by broad strategic drivers. Some of them are

- Pursuit for global expansion in terms of newer markets, geographies and sourcing human resource talent
- Enhancing existing product portfolio/service offerings
- Enhancing market share through customer acquisitions
- Recognition of the importance of strategic tie ups for accessing state-of-the-art technology and production processes
- Derisking the business model by acquiring plant capacities in various locations to beat the business cycle.

There are several ways to invest in India. Basically investment can be made through a financial investor (FII or FVCI). The other alternative is to be a strategic investor (FDI). Investment through a financial investor may be by (a) Investment in a US company, with a service fulfilment subsidiary in India, (b) Investment in a Caymans or Mauritius company, with a service fulfillment subsidiary in India, (c) Direct investment in an Indian company outside India, (d) Direct investment in an Indian company from outside India, through a venture capital fund registered with SEBI. The strategic investor may also adopt the route of a foreign company, with branch, liaison or project office in India. There is also the scope of operating as an Indian company, with joint ventures or a wholly-owned subsidiary in public or private partnership.

Table 2.1 *PE funds in India*

Type of Fund	Average Deal Size	Key Funds
Venture Capital Fund	Up to $20 million	Sequoia Westbridge, ICICI Ventures, JumpStartUP, UTI Ventures, IFC, Intel Capital, SIDBI
Mid Market Private Equity Fund	$10-$30 million	CVC, ChrysCapital, Actis, Baring, GW Capital, Oak, Kotak, ILFS, IDFC
Late Stage Equity Fund	$30-$100 million	Warburg, Temasek, General Atlantic Partners, 3i
Buyout Funds	> 100 million	New Bridge, Carlyle, Apax, Blackstone, ICICI Venture
Fund of Funds	> 100 million	Evolvence India
Real Estate Funds	> 100 million	IREO, Ascendas India Property Fund, OZ Capital, Trikona
Hybrid Hedge Fund	> 100 million	Oaktree Mgmt, New Vernon Pequot Capital

Source: Business India

SUMMARY

The rationale for mergers under economic perspective is that competitive advantage over rivals can be obtained through cost reduction or increased market power. The finance theory analyzes merger decisions within the framework of conflicts of interest among various financial claim holders of the firm. The central focus of this perspective revolves around the elements of shareholder wealth maximisation and the agency model. The role of debt in motivating organisational efficiency can be explained in the context of control mechanism. The market for corporate control, often referred to as the takeover market, can be described as the market in which alternative managerial teams compete for rights to manage corporate resources. The takeover market is an important component of the managerial labour market. Strategic synergy will lead to strategic advantage. True M&A driven strategic advantage is comprised of multiple synergies that focus on growth rather than cost savings, integrate easily and deliver benefits that materialize over long term. Integration is critical to the success of any strategic merger or acquisition. The Macro Environment and Progressive Regulatory Policy are facilitators for M&A growth in India.

DISCUSSION QUESTIONS

1. Explain the significance of economic, finance and strategic perspective on Mergers and Acquisitions.
2. Explain the agency theory and the role of debt in agency cost reduction.
3. What are the major strategic drivers for M&A?
4. What are the problems faced in M&A success?
5. What are the strategic facilitators for M&A growth in India?

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3 Theories of Merger

Chapter Objectives

The aim is to make the reader understand:

- The various hypothesis framework related to M&A
- The different theories of M&A

INTRODUCTION

The literature discussing the motivation for Mergers and Acquisitions (M&As) may be broadly classified into two groups. The neoclassical shareholder wealth maximising approach, which hypothesises that managers will pursue M&As when such investments appear to offer a positive net present value, based upon the discounted value of their estimated cash flows which may emanate from such factors as increased market power (e.g. price setting), synergies or the removal of incompetent management.

The new managerial theories[1] however argue that with widening share ownership and consequential divorce between ownership and control, managers may seek to maximise their self interest. This may be in the form of power, salary or reduction in risk of job loss subject to satisfactory profitability. Such aims may be achieved through size maximisation, and takeover is the quickest method of growth.

These two sets of theories are indirectly related, in that, if managers pursue their own (non-profit maximising) motives, other corporate managers, who are attempting to maximise shareholder returns, will seek to acquire the under-valued companies which are being inefficiently managed.[2] Various schools of thought on merger theories can be broadly classified as those based on capital market valuation of firms and actions of managers, primarily based on the empire building motives of managers. Some merger theories incorporate a blend of managerial and capital market elements. They state that in a scenario where managers deviate from shareholders' best interests, firms that behave inefficiently are likely targets for takeovers, because of capital gains that could be realised by a successful raider. (Manne1965, *Market* for *Corporate Control*).

Five wealth increasing motivations for mergers and acquisitions[3] can be explained in terms of (a) increase in efficiency by creating economies of scale, or by disciplining inefficient managers, (b) exploitation of asymmetric information between acquiring firm managers and acquiring, or target, firm shareholders, (c) solution to agency problems associated with the firm's free cash flow, (d) increase in market power, and (e) utilisation of tax credits.

[1]P D Hall and D Norburn, The Management Factor in Acquisition Performance, Leadership and Organisation Development Journal(3) 23-30, 1987

[2]H G Manne, Mergers and the Market for Corporate Control, Journal of Political Economy (73), 110-119 (1965)

[3]Jacob T Severiens, Creating Value through Mergers and Acquisitions: Some Motivations, Managerial Finance, Volume 17, Number 1, 1991.

The operating and financial economies of scale and scope are certainly major determinants of merger activity. The additional factors, like tax savings, increased leverage, bankruptcy avoidance and creative accounting can be grouped as financial incentives, or financial risk reduction opportunities.

A number of Western scholars have provided evidence consistent with the view that economic turbulence is an important driver of M&A activity. A 1998 book by a well-known M&A adviser, Bruce Wasserstein, cited five main forces driving the merger process: regulation and political reform, technological change, fluctuations in financial markets, the role of leadership and tension between scale and focus.

HYPOTHESIS CONCERNING MERGERS & ACQUISITIONS

The Perfectly Competitive Acquisitions Market Hypothesis (PCAM)

In a perfectly competitive market, competition will equate the expected rates of return on assets of similar risk. If the acquisitions market offers higher expected returns than equivalent activities of similar risk, more resources will be directed to this activity until expected rates of return are reduced to a competitive level. The reverse holds if the acquisition market has lower expected returns than equivalent activities of similar risk. The PCAM hypothesis implies that, for an acquiring firm, there are no monopolistic sources of gains, due solely to merging as a way of obtaining productive capacity. In a scenario of one-sided perfect competition where the acquiring firm might be in a perfectly competitive acquisitions market but the acquired firm might have some unique resources, only the acquiring firm's stockholders will earn normal levels of expected returns from the acquisition. If a firm to be acquired has some resources which are not used effectively, and which could provide economic gains to other firms by merger, then competition among these firms will result in abnormal returns (from the merger) to the stockholders of the acquired firm. (*Mandelker 1974*)

Some economists argue that firms merge to achieve synergy. In a perfect market, firms are able to achieve synergy equally by internal or external growth.

The Efficient Capital Market Hypothesis (ECMH)

The efficient capital market hypothesis states that stock prices adjust instantaneously to new information. Thus, stock prices provide unbiased signals for efficient resource allocation.

The Abnormal Gains Hypothesis (AGH)

This hypothesis states that information regarding forthcoming acquisitions is generally considered as good news for the stockholders of the acquiring firms.

The Chain Letter Hypothesis (CLH)

It states that investors rely on very few sources of information, the main ones being financial and accounting numbers. The chain letter hypothesis implies that shareholders are misled by manipulation of accounting numbers so that the announcement of a forthcoming merger is followed by rise in stock prices of the acquiring firm.

The Growth Maximisation Hypothesis (GMH)

This hypothesis states that managers maximise or at least pursue, as one of their goals, growth in physical size of their corporation rather than its profits or stockholders' welfare.

Market Power Hypothesis

The market power hypothesis implies that mergers increase product prices, thereby benefitting the merging firms and other competing firms in the industry. Higher prices allow competing firms to increase their own product prices or output, and therefore, equity values of competing firms also rise on offer announcement.

Collusion Hypothesis
Rivals of merging firms benefit from the merger since successful collusion limits output, and raises product prices and/or lowers factor prices. The central characteristic of the collusion theory is its implication for merger-induced changes in relative product (and factor prices). In other words, the basic proposition is that rivals can expect to benefit from the news of a horizontal merger, which significantly reduces the cost of enforcing a tacit collusive agreement within the industry of the merging firms.

Wealth Maximizing or Value Maximizing Hypothesis
Mergers should lead to positive expected and total realized gains on an average, since an increase in wealth should accrue from the mergers. Both firms involved in a merger are assumed to be value maximizers.

Management Utility Maximisation Hypothesis
The rational is that there need not be any overall economic gain from the merger, what the seller's shareholders gain as an enticement to enter the merger is offset by what the buyer's shareholders lose, and hence the total gain may be zero. If there are diseconomies of scale, total gain may be negative.

Improved Management Hypothesis
This hypothesis retains the assumption that wouldbe acquirers maximize value, but assumes that potential target firms are controlled by inefficient management. This hypothesis is related to the concept of market for corporate control. In other words, mergers are viewed as a response to the suboptimal management policies of target firms. The improved management hypothesis retains the assumption that would be acquirers maximize value, but assumes that potential target firms are controlled by inefficient management. The improved management hypothesis is related to Manne's (1965) concept of a market for corporate control. Under this hypothesis, corporate mergers shift control of an acquired firm's assets, from a relatively inefficient management, to the superior managers of the acquiring firm. One form of the improved management hypothesis assumes that investors receive adverse information about the incumbent management. This information leads investors to believe that management competence has deteriorated. They reduce their expectations regarding the level of future cash flows to be generated by the firm. Opportunity losses are expected to continue until the management is rehabilitated through the merger. Under the improved management hypothesis, a period of inefficient management is a prerequisite for the merger. The investors will realize the inefficient policies being pursued. Hence, the firm is now an acquisition candidate. Losses incurred during the period of inefficient management are analogous to a series of investment outlays that lead to the eventual merger. The improved management hypothesis predicts that this 'investment' is a negative present value project. In an efficient market, the net present value of a merger attempt is capitalized in stock prices when the investors realize that a future merger is possible. For acquired firms under the improved management hypothesis, this is also the time when investors learn that the management is inefficient. Expected losses due to inefficiency are capitalized at this time.

Asymmetric Information Hypothesis
Acquiring firm shareholders earn higher returns following cash offers.

Strategic Alignment Hypothesis
Acquiring firm shareholders earn higher returns following takeovers that expand the firm's operations geographically, or increase its market share.

Relatedness Hypothesis
Mergers or acquisitions between strategically related firms would generate abnormal returns.

Learning Hypothesis
Learning specifically means that the managers of the merging firms extract information from the stock market reaction to the M&A announcement and consider the information while making the closing decision. In short, learning implies information flows from the market to the company. The testable hypothesis are (1) companies are more likely to learn in pre-agreement deals than in agreement deals, (2) companies are more likely to learn in non high-tech deals than in high-tech deals, and (3) smaller bidders are more likely to learn than larger bidders.

Size Maximising
The size maximising hypothesis assumes that the net present value of a merger attempt is non-negative for potential acquired firms.

Investment
Under the **investment hypothesis**, both firms involved in a merger attempt are assumed to be value maximisers.

Other Hypothesis

The *organisational learning hypothesis* states that there is an *acquisitions learning curve*, and the *experienced acquirer* would be more successful than the less experienced one. Variations on the organisational learning hypothesis argue that the type of acquisition is important. There could be one for related acquisitions and another for unrelated, one for domestic and another cross border, one for public acquisitions and another for private acquisitions. Multiple acquisitions may also result in sequential improvement in the acquirer's performance, if they bestow upon the acquirer company a sequential increase in market power. For example, Kamien and Zang (1993) show that a sequence of endogenously formed mergers will eventually lead to monopolization of the industry. But Nilssen & *et al.* (1998) argue that, with the present day enforcement of competition policy throughout the world, this monopolisation hypothesis is a rarely observed phenomena.

The *Indigestion Hypothesis* argues that the acquirer is unable to successfully integrate subsequent acquisitions owing to the short time period between acquisitions. The *Hubris Hypothesis* suggests that the worsening performance of the acquire may be explained by lack of care with the next merger, due to overconfidence resulting from the success of the previous one. The *Diminishing Returns Hypothesis* applies the diminishing efficiency of investment schedule to the firm's acquisition programme. This hypothesis states that the best opportunities are taken first, and so the value derived from the subsequent mergers are bound to decline. The *Overvaluation Hypothesis* takes the view that mergers occur when the acquirer is in a good position, which is temporary. The *Accounting Manipulation Hypothesis* argues that the market may be fooled only initially by the accounting manipulations associated with mergers. The *Merger Programme Announcement Hypothesis* predicts a zero effect on share returns of later acquisitions.

Theory of Corporate Control Manne (1965) set the tone for the *theory of corporate control*. Mergers occur when incompetent managers reduce the value of the firm's shares to the point where it is profitable for outsiders to gain control. Mergers, then, can be viewed as effective discipline over management. Post merger, the new managers run the company more efficiently, thereby raising the welfare of the stockholders of the acquired firm. For example, suppose ABC Corp is being run badly by its managers and, for reason like managerial control of board of directors, stockholders are unable to remove the incumbent managers. As a consequence of managerial incompetence, investors bid down the price of the firm's stock. At the same time, of course, book value of assets is not adjusted and hence, dividends may be largely unaffected. Other firms would see the discrepancy between the market and the book value of ABC Corp and its its low price earnings ratio. They would then try to buy the undervalued shares. The reasoning is simple: if the new owners replace the incompetent managers, its long-term profits would rise and both the new and the old owners of ABC Corp would be better off. The only losers would be the incompetent managers who have to find employment elsewhere.[4]

Simply put, this theory states that, in a world where managers deviate from shareholders' best interests (i.e., the existence of widespread separation of ownership and control), the firms that behave inefficiently are likely targets for takeovers, owing to capital gains that would be realized by the successful raider.

Market Fiction or Inefficiency Theory It is often suggested that financial markets are close to being 'informationally efficient'. The current stock price reflects all publicly available information about the companies and their future. But other markets may not be so efficient and such inefficiencies may be exploited through successful merger and acquisition activity. For example, information about the various aspects of the target's operations is likely to vary from one potential acquirer to another. While there may be enough publicly available financial data on the target firm, information regarding the operations of the company, such as marketing strategies and production technologies, may not be uniformly among the potential acquirers.

Efficiency Theory The combination of firms will result in improved operations and better financial profile. This theory assumes that acquisitions provide either economies of scale or of scope. The merger will result in synergy whereby the two firms may together generate more cash flow than the sum of their individual cash flow.

Differential Efficiency Theories The following are the differential efficiency theories.

(a) Differential Efficiency Differential Theory is the most general theory of mergers. According to this theory, if the management of firm A is more efficient than the management of firm B, and if, after firm A acquires firm B, the efficiency of firm B is brought up to the level of the efficiency of firm A, efficiency is increased by the merger. The theory suggests that there are firms with below average efficiency, or they are not operating up to their potential. It is further suggested that firms operating in similar kinds of business activity are most likely to be the potential acquirers. An alternate explanation for differential efficiency may be called *Managerial Synergy Hypothesis*. If a firm has an efficient management team whose capacity is in excess of its current managerial input demand, the firm may be able to utilise its extra managerial resources by acquiring a firm that is inefficiently managed due to shortage of such resources.

(b) Inefficient Management Inefficient management simply means not performing upto one's potential. Another group may be able to manage the assets of this area of activity more effectively. In the differential efficiency (or managerial efficiency) theory, the acquiring firm's management seeks to complement the management of the acquired firm, and has experience in the particular line of business activity of the acquired firm. Another control group might be able to manage the assets of this area of activity more effectively. Or inefficient management may simply represent management that is inept in absolute sense.

The efficiency theories assume that owners (or shareholders) of acquired firms are unable to replace their managers and, thus, it is necessary to invoke costly mergers to replace inefficient managers. However, if the replacement of incompetent managers was the sole motive for mergers, it would be sufficient to operate the acquired firm as a subsidiary, rather than merge it into the acquirer. The theory also predicts that the managers of the acquired firm will be replaced after the merger.

[4]Jacobus T Severiens, Creating Value through Mergers and Acquisitions: Some Motivations, Managerial Finance, Volume 17, Number 1, 1991

(c) Operating Synergy Operating synergy, or operating economies, may be achieved in horizontal, vertical, and even in conglomerate mergers. This theory assumes that economies of scale do exist in the industry, and that prior to merger, the firms are operating at levels of activities that fall short of achieving the potentials for economies of scale. The operating synergy theory postulates economies of scale, or of scope, and mergers help to achieve levels of activities at which they are obtained. It includes the concept of complementarity of capabilities. For example, one firm might be strong in R&D but weak in marketing, while another may have a strong marketing department without R&D capability. Merging these two firms may result in operating synergy.

Economies of Scale This postulates that the larger post-merger firm will enjoy lower costs because it has attained a more efficient size. There are several potential sources for such efficiencies. The new firm may have a much higher debt capacity and, thus, may be able to borrow at a lower cost. Finance costs may also be reduced since the larger company would have better access to capital markets. A combined company may also be able to achieve greater efficiency in transportation, production and/or management. Also, the overlap in distribution system may be eliminated. Hence, the new company would be able to deliver products at lower costs.

Economies of scale arise because of *indivisibilities*, such as people, equipment and overheads, which provide increasing returns if spread over a large number of units of output. Thus, in manufacturing operations, heavy investments in plant and equipment typically produce such economies. Managerial economies in production, research, marketing or finance are sometimes referred to as economies in the specific management function. It has also been suggested that economies may be achieved in generic management activities, such as planning and control functions of the firm. Another area in which operating economies may be achieved is vertical integration. Combining firms at different stages of industry may achieve more efficient coordination at the different levels.

Economies of Scope Economies of scope exist when managers are able to produce multiple products jointly, at the cost lower than when production was spread across multiple firms. For example, managers who acquire skills in activity 'A' may find those skills very useful in lowering costs and increasing profits in activity B. This sort of merger activity may also be categorised as congeneric; the divisions of the post merger firms are engaged in related, but not identical activities. Managers are able to achieve better profits because of economies of scope.

Operating and financial economies of scale and scope are major determinants for the merger activity. There are additional factors which can be grouped as financial incentives or financial risk reduction opportunities. They include the possibility for tax savings, increased leverage, bankruptcy avoidance and creative accounting.

(d) Diversification Diversification, *per se*, may have value for many reasons, including demand for diversification by managers and other employees, preservation of organisational and reputation capital and financial and tax advantages.

The employees need to make firm specific investments. Most of their knowledge, acquired while working for the firm, may be valuable to the firm but not to others. Employees are more productive in their current jobs than in others because of their specialised knowledge.

Diversification argument also applies to an owner manager whose wealth is concentrated in his or her firm. The owner manager may not want to sell ownership shares in the firm for reasons of corporate control. An undiversified owner would require a higher risk premium in investments and would make smaller investments than otherwise optimal (Fama and Jensen 1985). Diversification of the firm may provide managers and other employees with job security and opportunities for promotion and, other things being equal, result in lower labour costs. Diversification ensures smooth and efficient transition of the firm's activities, and continuity of the teams and the organisation. Firms have reputational capital which customers, suppliers and employees utilise in establishing their relationships with the firm. Diversification may help preserve the firm's reputational capital which would cease to exist if the firm is liquidated.

Diversification may increase corporate debt capacity and decrease the present value of future tax liability. It may be achieved through internal growth as well as through mergers. However, the cost of building an organisation internally may exceed the cost of an acquisition. There may be fewer risks, lower costs or shorter time requirements involved in achieving an economically feasible market share by the external route. From a practical business standpoint, growth through mergers and diversification represents a sound alternative, to be taken into account in business planning.[5]

Combining two imperfectly correlated income streams can reduce total earnings variability and, hence, risk. Even if the amount of cash flows were to remain the same post merger, the lower discount rate would enhance the value of the firm. Diversification need not be undertaken only for earnings stability. A redeployment or expansion of assets may occur because of, or in anticipation of, changes in technology, market structure and globalisation of markets. This activity of diversification has especially been manifested by companies in declining industries and firms with high levels of excess cash flows. For example, US Steel acquired Marathon Oil in order to reduce its dependence on energy prices, and on the declining American steel industry.

The option pricing theory states that a stock's price is positively correlated with earnings variability. A merger that reduces the variability of earnings would reduce the value of equity. By the same token, the value of debt would be increased as the probability of default would be reduced. Certainly, there is redistribution of wealth in this case.

The factors that have contributed to increased diversification include advances in management technology and technological change. Development in equity markets also facilitated the trend of diversification. The increased interest in growth stimulated mergers intensified the management's search for product markets with growth opportunities.

(e) Financial Synergy The *Financial Synergy Theory* hypothesises complementarities between merging firms in the availability of investment opportunities and internal cash flows. A firm in the declining industry would produce large cash flows since there are few attractive investment opportunities. A growth industry would have more investment opportunities than the cash required to finance them. The merged firm would have a lower cost of capital, due to lower cost of internal funds, as well as possible risk reduction, savings in floatation costs and improvement in capital allocation. The debt capacity of the combined firm may be greater than the sum of the two firms' capacities before the merger, and this provides tax savings on investment income.[6] Lewellen (1971) postulates that merged firms can increase their financial leverage without increasing the pre-merger level of risk propensity because of an increase in debt capacity that results from mergers. An increase in financial leverage benefits shareholders of the merging firms through tax deductibility of interest payments on corporate debt. The conglomerate merger of the two firms, with imperfectly correlated earnings streams would increase the total capacity of the firms for additional debt. Since interest payments are tax deductible, additional debt reduces the tax of the merged entity, and so increases its value.

(f) Undervaluation Merger motives may also be attributed to undervaluation of target companies. One cause of undervaluation may be operation of the company below its potential. This may be linked to the inefficient

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[5]J Fred Weston, Kwang S Chung, Susan E Hoag, Mergers, Restructuring and Corporate Control, Prentice Hall, 2006 edition, Pages 75-79.

[6]J Fred Weston, Kwang S Chung, Susan E Hoag, Mergers, Restructuring and Corporate Control, Prentice Hall, 2006 edition Pages 75-79.

management theory. The second possibility is accessibility of inside information to the acquirers. Bidder firms may possess information which the general market may not have, and they may place a higher value on the shares than the current market rate. The *q* ratio is also related to the undervaluation theory. Firms can acquire assets for expansion more cheaply by buying the stock of existing firms than by buying or building assets, when the target's stock price is below the replacement cost of its assets.

Information and Signalling Theory This theory suggests that the tender offer disseminates the information that target shares are undervalued, and the offer prompts the market to revalue the shares. No particular action by the target firm, or any other, is necessary to cause revaluation. Another alternate explanation is that the offer inspires the target firm's management to implement a more efficient business strategy on its own. An important variant of the information hypothesis is the *Signalling Theory*. The signalling theory states that particular actions may convey other significant forms of information. The signalling concept was used by Ross (1977) in connection with capital structure decisions. Ross described how signalling and managerial compensation arrangements can be used to deal with information asymmetry. Signalling may be involved in mergers and tender offers in a number of ways. The fact that a firm has received a tender offer may signal to the market that hitherto unrecognised extra values are possessed by the firm, or that future cash flow streams are likely to rise. When a bidder firm uses shares for buying another firm, it may be a signal for the target and others that the shares of the bidder may be overvalued. When business firms repurchase their shares, it may be a signal for the market that management has information about its shares being undervalued, and that favourable new growth opportunities would be achieved.

Capital Structure Theory Perspective This theory suggests that, under reasonable conditions, changes in capital structure may affect the value of shares, if everything else remains unchanged by the merger. In the case of two firms, identical in every way except for their capital structure, the firm with greater amount of debt would have higher market value. Consequently, mergers, which increase the debt equity ratio of a firm, would give more value to the firm than if the acquisition had been financed exclusively through the sale of equity. Lewellen (1971) have argued that conglomerate mergers are profitable because the debt capacity of the merged firm exceeds the sum of debt capacities of the individual firms involved in the merger.

The capital structure hypothesis states that M&A can be an effective method to adjust the capital structure of a firm. Myers and Majluf (1984) propose the theory that slack rich firms pair with slack poor firms to create value. The sum of cash in hand and unused debt capacity is referred to as *financial slack*. In other words, value is created when firms with low financial leverage acquire firms with high financial leverage. Firms with unused debt capacity may be able to create value by using financial slack to acquire other firms. There is a specific financial motive for a merger based on the complementary fit between the slack rich bidders and the slack poor targets. In the Myers–Majluf theory, the value created through a merger of complements arises from the additional positive NPV investment taken by the merged firm that the slack poor firm might pass up. The theory of Myers-Majluf suggests that the value will be created in merger when firms rich in financial slack acquire slack poor firms. This theory also assumes asymmetry in information between managers and shareholders, and assumes that managers act in the interests of the existing stockholders.

A low debt to equity ratio or a low interest expense to earnings ratio indicates the ability to service more debt. Value is created because slack rich bidders pursue the profitable, but unfunded, investment opportunities of the previously slack poor targets. This hypothesis also states that the acquirer firms will have lower financial leverage as compared to the target firms.

Distress Sales or Bankruptcy Avoidance Theory The managers of financially distressed companies (whether they are inefficiently managed or not), may actively seek a merger partner, rather than slide into liquidation proceedings, and thereby avoid bankruptcy costs, protect the value of their equity stakes and, additionally, enable the acquiring company to utilise the tax loss carry forwards of the financially distressed target.

Some mergers are simply distress sales, where the acquired firm is threatened with imminent bankruptcy, or its financial difficulties can be resolved with infusion of outside capital. The increase and diversification of assets reduce the probability of bankruptcy. The shareholders of merging firms have increased liability. They will benefit only if the incremental tax subsidy is greater than the cost of increased liability.

P/E Aspect Another factor on the financial side of mergers is the creation of the Price Earnings (P/E) magic. If a firm with a high P/E ratio purchases a firm with low P/E ratio, earnings per share would increase post merger, even though there is no real increase. There appears to be some evidence that P/E magic was an important motive in the conglomerate merger boom in the United States during the 1960s.

Managerial Wealth Maximization Theory Managerial Wealth Maximization Theory implies that the acquired firm's managers are engaged in suboptimal behaviour. This theory seems more consistent with the fact of separation of ownership and control in corporations or the agency theory.

Agency Theory Corporate managers are the agents of shareholders, a relationship fraught with conflicting interests. Agency theory, the analysis of such conflicts, is a major part of economics literature. Economists have for long been concerned with the incentives problems that arise when decision-making is the province of managers who are not the firm's security holders. An attempt is made by the managers to maximise their own wealth, possibly at the expense of the shareholders. This explanation has its origin in the separation of ownership and control in modern corporations. This is known as *Agency Theory*.

Payouts to shareholders reduce the resources under the managers' control, thereby reducing their power, and making it more likely that they would incur the monitoring of capital markets for obtaining new capital. Growth increases managers' power by increasing the resources under their control. It is also associated with increase in managers' compensation because changes in compensation are positively related to the growth in sales.

Free cash flow is the cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organisation generates substantial free cash flow. The problem is to monitor managers to disgorge the cash rather than invest it at below the cost of capital, or waste it on organisation inefficiencies.[7]

Suppose the managers are not the perfect agents of other participants in the corporate venture, they pursue their own interests whenever possible, that is, they are not the residual claimants to the firm's income stream. Instead, there may be a substantial divergence between their interests and those of the other participants. It would be advantageous for the managers, investors and other participants to set up such devices as monitoring, bonding and ex-post readjustments, that give managers the incentive to act as better agents. One form of agency costs is the cost of monitoring managers. This is costly for shareholders and lack of collective actions ensures that shareholders undertake too little of it. Although a monitor shareholder would incur the full costs of monitoring, he would reap gains only in proportion to his holdings. Since shares are widely held, shareholder's gains are not substantial. A second source of agency costs is risk aversion on the part of managers. The investors, with diversified portfolios of stocks would be concerned only about any non-diversifiable risk with respect to a firm's ventures. Managers, though, have a substantial part of their personal wealth tied up in their firms. If the firms do poorly, or worse, go bankrupt, the managers would lose their jobs, along with any wealth tied up in their firms' stock. Managers, therefore, would be concerned

[7]M C Jensen, 'Agency costs of Free Cash Flow, Corporate Finance and Takeovers', The Market for Corporate Control, AEA Papers and Proceedings, Vol. 76. No. 2, Pages 323-329

about total risk, and their personal risk aversion would magnify this concern. The risk averse managers may choose projects that are safe but have a lower expected return than riskier ventures. Shareholders have the opposite preference. Riskier ventures enrich shareholders at the expense of creditors, and the shareholders would thus want managers to behave as risk preferrers[8].

Managers can change the risk of the firm, not only by altering its mix of projects, but also by altering its debt-equity ratio. The lower the ratio of debt to equity, the lower the chances of bankruptcy of the firm.

Role of Debt in Improving Organisational Efficiency Debt creation without retention of proceeds of the issue enables managers to pay out future cash flows. Thus, debt can be an effective substitute for dividends. By issuing debt in exchange for stock, managers are bonding their promise to pay out future cash flows in a way that cannot be accomplished by simple dividend increases. Debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers. The debt created in a hostile takeover (or takeover defence) of a firm suffering severe agency costs of free cash flow, is often not permanent. In these situations, leveraging the firm so highly that it cannot continue to exist in its old form generates benefits. It creates the crisis to motivate cuts in expansion programmes and sale of those divisions which are more valuable outside the firm. The proceeds are used to reduce the debt to a more normal or permanent level.

Takeovers can be considered as a solution to agency problems.

Fama and Jensen (1983) hypothesise that, when a firm is characterised by separation of ownership and control, decision systems of the firm separate decision management (initiation and implementation) from decision control (ratification and monitoring), in order to limit the power of individual decision agents, to expropriate shareholder interests. A number of compensation agreements and market for managers may mitigate agency problems. (Fama 1980). Compensation can be tied to performance through such devices as bonuses and executive stock options. The stock market gives rise to an external monitoring device because stock prices summarise the implications of decisions made by managers. Low stock prices exert pressure on managers to change their behaviour, and to stay in line with the interests of the shareholders. When these mechanisms are not sufficient to control agency problems, the market for takeovers provides an external control device of the last resort. (Manne 1965) A takeover through a tender offer or a proxy fight enables outside managers to gain control of the decision processes of the target, circumventing existing managers and the board of directors. Manne emphasised mergers as threats of takeover if the firm's management lagged in performance, either because of inefficiency or because of agency problems.

Managerialism Mergers are also considered as the manifestation of agency problems rather than their solution. The managerialism explanation for conglomerate mergers was set up by Mueller (1969). Mueller hypothesised that managers are motivated to increase the size of their firms. It is assumed that the compensation to managers is a function of the size of the firm and, therefore, managers adopt a lower investment hurdle rate. The managerialism theory suggests that merger activity is a manifestation of the agency problems of inefficient, external investments by managers.

Hubris Hypothesis Roll (1986) hypothesises that managers commit errors because of over optimism in evaluating merger opportunities. In other words, managers of bidding firms are infected by hubris, and hence overpay for targets, because they overestimate their own ability to run them. In a takeover, the bidding firm identifies a potential target firm and values its assets (stocks). When the valuation is below the market price of the stock, no offer is made. Only when the valuation exceeds the current market price, a bid is made and enters the takeover sample. If there are no synergy or other takeover gains, the mean of valuations would be

[8]Frank H Easterbrook, 'Two Agency Cost Explanations of Dividends', The American Economic Review, Vol. 74, No. 4, Pages 650-659.

the current market price. Offers are made only when the valuation is too high. The takeover premium is a random error, a mistake made by the bidder. The hubris hypothesis assumes strong form efficiency of markets. Stock prices reflect all (public and non-public) information; redeployment of productive resources cannot bring gains, and management cannot be improved through reshuffling or combinations across firms.

Free Cash Flow Hypothesis The *free cash flow hypothesis*, advanced by Jensen (1988), states that managers endowed with free cash flow will invest it in negative net present value (NPV) projects rather than pay it out to shareholders. Jensen defines free cash flow as the cash flow left after the firm has invested in all available positive NPV projects. Testing the hypothesis requires knowledge of the firm's investment opportunities. *Tobin q* is often used to measure the firm's investment opportunities. It is defined as the ratio of the market value of the firm's assets to their replacement cost, and is used to distinguish between firms that have positive investment opportunities under the current management, and those that do not. High *q* firms are likely to have positive NPV projects. Hence, these firms are expected to use their internally generated funds productively. For these firms, the acquisition of other companies is expected to be a positive NPV project. If the acquisition is unexpected, its announcement should cause an increase in the bidder's stock price. Further, the stock price reaction should not be related to the bidding firm's cash flow.[9]

Low *q* firms are not likely to have positive NPV projects. Hence, they should pay out cash flow to shareholders or invest in zero NPV projects, if such projects are available, rather than make acquisitions that decrease shareholder value. For these firms, the free cash flow hypothesis implies that the shareholder wealth effect of the tender offer announcement is inversely related to cash flow, since free cash flow considerations are more likely to influence the management's actions when it is large.

To the extent that *Tobin's q* measures investment opportunities, the free cash flow hypothesis suggests that firms with high cash flow and low *q* are more likely to engage in acquisitions that do not benefit shareholders.

The free cash flow theory predicts the mergers and takeovers that are more likely to destroy, rather than to create value; it shows how takeovers are both an evidence of conflicts of interest between shareholders and managers, and a solution to the problem. Acquisitions are one way managers spend cash instead of paying it out to shareholders. Therefore, the theory implies that managers of firms with unused borrowing power and large free cash flows are more likely to undertake low benefit, or even value destroying, mergers.

The theory predicts that value increasing takeovers occur in response to breakdown of internal control processes in firms with substantial free cash flows and wasteful organisational policies (including diversification programmes).

Based on western studies, the free cash flow theory predicts that many acquirers tend to be exceptionally good performers prior to acquisition. The exceptional performance generates good performance prior to acquisition. Studies have also shown that takeovers financed with cash and debt generate larger benefits than those accomplished through exchange of stock. (Jensen, 1986)

Radical changes in the world energy market, since 1973, generated large increases in free cash flows in the petroleum industry and simultaneously required major shrinking of the industry. In this environment, the takeover market played a critical role in reducing the huge agency costs of free cash flows. Price increases generated large cash flows in the industry. For example, in 1984, cash flows of the ten largest oil companies were $48.5 billion, 28 per cent of the total cash flows of the top 200 firms in Dun's Business Month Survey. Consistent with the agency costs of free cash flows, management did not pay out the excess resources to shareholders. Instead the industry continued to spend heavily on E&D activity even though average returns were below the cost of capital.

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[9]L Lang, Rene M, Ralph A, 'A Test of the Free Cash Flow Hypothesis', The Case of Bidder Returns, Journal of Financial Economics 29 (1991), 315-335.

Market Power The *market power theory* suggests that merger will increase the firm's market share. Increasing market share means increasing the size of the firm relative to other firms in the industry.

Tax Considerations The effect of tax law on returns to mergers is relatively straightforward. A highly profitable firm, faced with highly effective corporate tax rate, can generate substantial tax savings by acquiring a firm with large accumulated tax losses. Tax benefits can also accrue to the acquiring firm through credit carry-forwards, step-ups in asset bases, and increased interest deductions.

Mergers may be motivated by tax minimizing opportunities. A firm with accumulated tax losses and tax credits can shelter the positive earnings of the firm with which it is joined. Carry over of net operating losses is a motivation for mergers.

Redistribution Theory This theory advocates that the source of value increases in mergers is redistribution among the stakeholders of the firm. Possible shifts are from bondholders to stockholders and from labour to stockholders and/or consumers. An increase in leverage, following mergers, might also enhance shareholder wealth through an expropriation of wealth from bondholders. An immediate consequence of the higher debt capacity, following mergers, is the co-insurance effect, that is, existing bondholders are better-off because debt becomes relatively safer. Shareholders can appropriate a part or all of the benefits from bondholders by financing the merger with debt and increasing the financial leverage of the merged firm.

Merger Contingency Framework

This framework has been adapted from the diversification contingency framework. The theory suggests that whether a buyer firm gains or loses from a merger is contingent upon the firm's competitive strengths, the growth rate of its markets, and the degree to which these two factors achieve a logical or strategic fit with the competitive strengths and market growth rates of its targeted firm. According to this theory, the better the strategic fit between the acquiring and acquired firms (that is, more the unifying features of the respective environments of the two firms), the greater is the potential value created by the merger.[10]

Asymmetric Theory This theory explains how any incremental value associated with a particular merger is shared between the buying and the selling firms. Assuming that the buying firms, on an average, are managed by rational decision-makers who pursue mergers as a means to improve the wealth position of their firms' stockholders, the asymmetric theory predicts that a competitive hierarchy is developed by the price that each competing firm is willing to pay for the seller firm. That price is approximated, in each case, by the discounted value of the expected post-merger earnings, and is predicted to be a positive function of the strategic fit between the two firms. As a general rule, the 'best fit buying' firm will pay at least marginally above the highest price offered by the 'best fit' firm. The value of the best fit firm will, therefore, increase by approximately the difference between the incremental value associated with its fit with the seller and the incremental value associated with the fit of the second best fit acquiring firm.

A key assumption of both the merger contingency framework and asymmetric theory is that value added is a function of relatedness.

SUMMARY

Various schools of thought on merger theories can be broadly classified into those based on capital market valuation of firms and actions of managers, primarily based on the empire building motives of managers. The Theory of Corporate

[10]Michael Lubatkin, 'Merger Strategies and Stockholder Value', Strategic Management Journal, Vol. 8, 39-53, 1987.

Control states that mergers occur when incompetent managers reduce the value of the firm's shares to the point where it is profitable for outsiders to gain control. The Efficiency Theory assumes that acquisitions provide economies of scale or scope. The Differential Efficiency Theories are Differential Efficiency, Inefficient Management, Operating Synergy, Diversification, Financial Synergy and Undervaluation. Information and Signalling Theory suggests that tender offer disseminates information that target shares are undervalued, and the offer prompts the market to revalue the shares. Capital Structure Theory perspective suggests that, under reasonable conditions, changes in capital structure can affect the value of shares if everything else remains unchanged by the merger. The Agency Theory analyzes the cost of conflict of interest between stockholders and management. The Free Cash Flow hypothesis states that managers endowed with free cash flow will invest it in negative net present value (NPV) projects rather than pay it out to shareholders. According to the Merger Contingency Framework Theory, the better the strategic fit between the acquiring and acquired firm, the greater is the potential value created by the merger.

DISCUSSION QUESTIONS

1. Explain the Theory of Corporate Control.
2. Discuss the Different Efficiency Theory.
3. What is the significance of Information and Signalling Theory?
4. Explain the Agency Theory.
5. Explain the theory of Free Cash Flow Hypothesis.
6. Explain the Hubris Hypothesis.

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4 Mergers and Acquisitions: Types and Characteristics

Chapter Objectives

The aim is to make the reader understand:

- The different types of mergers and acquisitions
- The difference between a merger and an acquisition
- The sources of synergy
- The sources of value creation in different mergers

MERGERS AND ACQUISITIONS

Mergers & Acquisitions (M&A) are part of the corporate restructuring exercise. Corporate restructuring aims at re-allocation of corporate resources to optimise their value, either by adding the related, or divesting the unrelated, businesses.

MERGERS

A *merger* is a combination of two companies into one larger company. This action involves stock swap or cash payment to the target. In a merger, the acquiring company takes over the assets and liabilities of the merged company. All the combining companies are dissolved and only the new entity continues to operate. In general, when the combination involves firms that are of similar size, the term, *consolidation*, is applied. When the two firms differ significantly by size, the term *merger* is used. Merger commonly takes two forms. In the first form *amalgamation*, two entities combine together and form a new entity, extinguishing both the existing entities. In the second form, *absorption*, one entity gets absorbed into another. The latter does not lose its entity. Thus, in any type of merger, at least one entity loses its entity.

Hence, A + B = A, where company B is merged into company A (Absorption)

A + B = C, where C is an entirely new company (Amalgamation or Consolidation)

Usually, mergers occur in a consensual setting, where executives from the target company help those from the purchaser in a *due diligence* process to ensure that the deal is beneficial to both the parties. In a merger, the boards of directors of the two firms agree to combine and seek stockholder approval for the combination. In most cases, at least 50% of the shareholders of the target and the bidding firms have to agree to the merger. The target firm ceases to exist and becomes part of the acquiring firm; Digital Computers was absorbed by Compaq after it was acquired in 1997. The merger of TOMCO Ltd. with HLL is a classic example of absorption. In a consolidation, a new firm is created after the merger, and both the acquiring firm and the target firm stockholders receive stock in this firm; Citigroup, for instance, was created after the consolidation of Citicorp and Travelers' Insurance Group.

ACQUISITIONS

Acquisition is a more general term, enveloping in itself a range of acquisition transactions. It could be acquisition of control, leading to takeover of a company. It could be acquisition of tangible assets, intangible assets, rights and other kinds of obligations. They could also be independent transactions, and may not lead to any kind of takeovers or mergers.

An acquisition, also known as a *takeover*, is the buying of one company (the target) by another. An acquisition can be friendly or hostile. In a friendly takeover, the companies proceed through negotiations. In the latter case, the takeover target is unwilling to be bought, or the target's board has no prior knowledge of the offer. Acquisition usually refers to a purchase of a smaller firm by a larger one. Sometimes, a smaller firm may acquire management control of a larger, or a longer established company. This is known as *reverse takeover*.

There are several ways in which a firm can be acquired by another firm**.** In a tender offer, one firm offers to buy the outstanding stock of the other firm at a specific price, and communicates this offer in advertisements and mailings to stockholders. By doing so, it bypasses the incumbent management and board of directors of the target firm. Consequently, tender offers are used to carry out hostile takeovers. The acquired firm will continue to exist as long as there are minority stockholders who refuse the tender. From a practical standpoint, however, most tender offers eventually become mergers, if the acquiring firm is successful in gaining control of the target firm. In a purchase of assets, one firm acquires the assets of another, though a formal vote by the shareholders of the target firm being acquired is still needed.

A firm can also be acquired by its own management or by a group of investors, usually by a tender offer. After this transaction, the acquired firm ceases to exist as a publicly traded firm, and becomes a private business. These acquisitions are called *management buyouts*, if managers are involved, and *leveraged buyouts*, if funds are predominantly raised from debt. The aquisition of RJR Nabisco in the 1980s is an example of leveraged buyout.

Asset acquisition involves buying assets of another company. The assets may be tangible assets, like a manufacturing unit, or intangible assets, like brands. Acquisition of brands of Lakme by HLL is an example of asset acquisition. Corn Products India acquired Captain Cook. Smithkline Beecham acquired the Crocin brand.

Friendly and Hostile Takeovers

From another perspective, acquisitions can be friendly or hostile events. In a friendly acquisition, the managers of the target firm welcome the acquisition and, in some cases, seek it out. In a friendly takeover, the controlling group may sell its controlling shares to another group of its own accord. In a hostile acquisition, the target firm's management does not want to be acquired. In a hostile takeover, an outside group launches a hostile attack to take over the control of the target company without the concurrence of the existing controlling group. The buyer buys the shares and, therefore, the control of the target company. Ownership control of the company, in turn, results in effective control of its assets. However, since the company is acquired intact, as a going business, this form of transaction carries with it all of the liabilities accrued by that business in the past, and all of the risks it faces in its commercial environment. Abrupt jumps in share prices and sudden rise in trading volumes are warning signs of a hostile takeover.

Prior to acquisition, the acquiring firm offers higher price than the target firm's market price, thus inviting stockholders to tender their shares. In both friendly and hostile acquisitions, the difference between the acquisition price and the market price, prior to the acquisition, is called the *acquisition premium*. The acquisition price, in the context of mergers and consolidations, is the price per share paid by the acquiring firm for target firm's shares. This price is usually based on negotiations between the acquiring firm and the target firm's managers. In a tender offer, the acquisition price is the price at which the acquiring firm receives enough shares to gain control of the target firm. This price may be higher than the initial price offered by the acquirer, if there are other firms bidding for the same firm, or if an insufficient number of stockholders tender at the initial price. In 1991, AT&T initially offered to buy NCR for $80 per share, a premium of $25 over the stock price. AT&T ultimately paid $110 per share to complete the acquisition. In February 1998, Sterlite made a bid for 10% stake in Indal at Rs 90 per share. Indal's Canadian parent, Alcan, with 34.6% in Indal, made a counter offer at Rs 105 per share. Sterlite upped the offer to Rs 115, Alcan responded with Rs 120. In May 1998, Sterlite offered Rs 221 through a mix of cash and preference shares. Alcan responded by offering Rs 175 cash down. Finally, Alcan offered Rs 200 a share to all shareholders. Meanwhile, the Indal stock trebled in five months, from Rs 66 in February to Rs 170 in June 1998. Once the open offer ended, the stock again receded to the Rs 60 level.

IBM's acquisition of Daksh was a friendly takeover whereas Oracle's bid on PeopleSoft was a hostile takeover attempt.

India Cements Takeover of Raasi Cements

The takeover of Raasi Cements by India Cements was the first major hostile takeover in India. It was one of the fiercest takeover battles ever fought between two companies in the history of mergers and acquisitions in corporate India. Raasi Cement was the closest competitor of India Cements in South India. During the period 1997-98, ICL acquired several cement companies, like Visaka Cements, Cement Corporation of India's Yerraguntala plant, Sri Vishnu Cements, spread across South India. The takeover battle, that stretched over several months, witnessed an intense fight between the two southern competitors over control of Raasi Cement. The Raasi promoter fought an unsuccessful battle to thwart the predator. Earlier, in order to thwart the takeover bid by Kotak Mahindra, ICL, at the behest of Raasi promoters, had started accumulating Raasi shares from the market. The promoters of Raasi adopted various tactics to stop the deal, by challenging the takeover code and adopting the poison pill. ICL bought out Raasi for a sum of Rs 445 crores, but had to lose Sri Vishnu Cements, a subsidiary of Raasi Cements, on account of the poison pill transaction effected by the promoters of Raasi. India Cement paid around 70 per cent above the then prevailing market price of Raasi Shares. If ICL were to set up a Greenfield of this capacity, according to the then prevailing pricing estimates, the total cost would have been Rs 550-600 crores. In the Raasi acquisition case, the valuation was based on Raasi Cement's capacity of 1.6 mt, as well as its 40 per cent stake in SVCL, with a capacity of 1.0 mt pa. The acquisition gave ICL an additional market share of approximately 22-25% in Andhra Pradesh. The accessibility of cement deficit regions, Tamil Nadu and Kerala, helped ICL to further consolidate its position in the Southern market. ICL also got access to limestone reserves. The infrastructure of Raasi helped ICL Ltd. to reduce freight and other costs, and avoid duplication of a number of functions. During the period 1998-1999, as a result of the merger, the combined cement capacity of ICL increased around 8 million tp.

TYPES OF MERGERS

Horizontal Mergers

Horizontal mergers take place when two merging companies produce similar products in the same industry. In other words, a horizontal merger occurs when two competitors combine. For example, in 1994, two defence firms, Northrop and Grumman, combined in a $12.7 billion merger. If the horizontal merger results in the combined firm's increase in market power, it will have anticompetitive effects, and hence, the merger may be opposed on antitrust grounds. In other words, the acquisition of a firm competing in the same industry as the competitor is referred to as horizontal acquisition. It is stated that horizontal acquisitions of firms with similar characteristics result in higher performance than when firms with dissimilar characteristics combine their operations. These characteristics include strategy, managerial styles and resource allocation patterns.

The firm specific non-managerial human capital can only be supplied by long-term learning effort, or by merging with existing firms in the same industry. The industry specific managerial resources can be obtained by internal learning, or by merging with a firm in the same or related industries.

Horizontal mergers take place with a motive to attain market power. It is of concern to the government because it might lead to concentration or monopoly. Hence, comparison between their efficiencies versus their effects of increased concentration must be made. Horizontal mergers may be regulated by the government for their potential negative effect on competition. The number of firms in an industry may be decreased by horizontal mergers.

Vertical Mergers

A vertical merger refers to a firm acquiring a supplier or distributor of one or more of its goods or services. These are combinations of companies that have a buyer-seller relationship. Vertical mergers occur when two firms, each working at different stages in the production of the same product, combine. In 1993, Merck, the pharma company, acquired Medco Containment Services Inc, the largest marketer of discount prescription medicines, for $6 billion. This merger enabled Merck to become the largest integrated producer and distributor of pharmaceuticals. In India, the classical example of a mega merger was the RIL–RPL merger in 2002. Vertical mergers take place between firms in different stages of production operation. There are many reasons why firms want to be vertically integrated between different stages. There are technological economies, such as avoidance of reheating and transportation in the case of an integrated iron and steel industry. Transaction within firms may eliminate the cost of searching for competitive prices, contracting, payment collecting and advertising, and may also reduce the cost of communicating, and of coordinating production. Some economic activities really do create value that did not formerly exist. Planning for inventory and production may be improved due to more efficient information flow within a single firm. The efficiency and affirmative rationale of vertical integration rests primarily on the costliness of market exchange and contracting. Anticompetitive effects have also been cited as both the motivation for vertical mergers and their result. Most conceived anticompetitive effects assume monopoly power of the integrated firm at one stage of operation. A monopolistic input supplier may be able to practice price discrimination through vertical integration, when input is used by different industries having different elasticities of demand[1]. When the market share of an integrated firm at one stage is large, non-integrated firms at the other stage may be foreclosed from their customers or suppliers.

Note that horizontal mergers are not the only type of mergers that can yield more market power. Vertical mergers can enable a company to capture sources of supplies that are of paramount importance to its competitors. Therefore, industry regulators routinely limit and even disallow horizontal and vertical mergers, if there is even a hint of too much market power concentrating in the hands of only a few companies.

The objective of PepsiCo acquiring Pizza Hut, Taco Bell and KFC was to use the three restaurant chains as distribution channels to sell Pepsi's drinks. Later PepsiCo spun-off its three food units to form Tricon, a separate entity.

The merger between Reliance Industries Ltd. and Reliance Petroleum Ltd. was the largest merger in India that occurred in 2002. Reliance was perhaps the only company that started with crude oil and ended up with saris, shirts and dress materials. The merger was meant to create huge amounts of cash flows every year. One of the advantages of the merger was the huge depreciation cover from RPL. RIL's plants are relatively

[1]J Fred Weston, Kwang S Chung, Susan E Hoag, 'Mergers, Restructuring and Corporate Control', PHI, 2006.

older and have used up their depreciation cover to a large extent while RPL, whose refinery is relatively new, enjoys a huge depreciation cover on its assets. RPL's products, like petrol, diesel and kerosene, sell mostly on cash basis while RIL's products are sold on credit. Vertical integration helped RIL to insulate its petrochemicals business against price volatility in naphtha. The merger of Nocil with Polyolefins Industries was a vertical merger with backward integration for raw materials.

Congeneric Mergers

These types of mergers occur when two merging firms are in the same general industry, but have no mutual buyer/customer or supplier relationship, such as a bank and a leasing company. One example is Prudential's acquisition of Bache & Company.

Conglomerate Mergers

This merger occurs when the companies are in different industry sectors. Philip Morris, a tobacco company, acquired General Foods in 1985 for $5.6 billion. In other words, conglomerate mergers involve firms in unrelated business activities. There are three types of conglomerate mergers. *Product extension mergers* are mergers between firms in related business activities and may also be called *concentric mergers*. A geographic market extension merger involves two firms whose operations are conducted in non-overlapping geographic areas. *Pure conglomerate mergers* involve firms in unrelated business activities and hence do not involve carry over of industry specific managerial capabilities. Therefore, any benefits related to managerial capabilities have to be in the areas of generic management functions.

Financial Synergy and Conglomerate Mergers It can be hypothesised that a pure conglomerate merger occurs when a firm in an industry with low demand growth relative to the economy acquires a firm operating in an industry with high expected demand growth. The motive of the merger is financial synergy in the context of capturing investment opportunities available in the acquired firm's industry by lowering the cost of capital of the combined firm, and also utilising the acquiring firm's internal funds available at lower cost. The opportunity for utilising the cash flows of the acquiring firm would be enhanced if the cash flows of the acquired firm are low. The reason a firm needs to acquire another firm in order to internalise investment opportunities in the latter's industry is that it lacks the organisation capital or production knowledge specific to the acquired firm's industry.

The cost of capital may be lowered for a number of reasons. If the cash flow streams of the two firms are not perfectly positively related, bankruptcy probabilities may be lowered. This will decrease the 'lender risk and the debt capacity will be increased' (Lewellen, 1971). A potential important source of lower cost capital for post-merger investments in the acquired firm's industry stems from the distinction between internal and external funds. Internal funds do not involve transaction costs of the floatation process and may have differential tax advantages over external funds. The industry of the acquirer firm may be growing at a lower rate than the average industry growth in the economy. The acquirer firm may have internal cash flows in excess of current investment opportunities in its own industry. Thus, the acquiring firm may supply lower cost internal funds to the combined firm.

Economies of scale in floatation and transaction costs of securities are other potential sources of financial synergy. The possibility of reducing the cost of capital would be greater when the pre-merger cost of capital of the acquired firm is higher, and when the cost of capital of the acquiring firm is lower. In brief, a pure conglomerate merger occurs to internalise the investment opportunities in the acquired firm's industry, by initially lowering the cost of capital of the combined firm.

Reverse Mergers

In a reverse merger, a private company may go public by merging with an already public company that is often inactive. The combined company may then issue securities, and hence avoid incurring the costs and scrutiny normally associated with an initial public offering. An example of reverse merger was the $229 million Ariel Corporation and Mayan Network Corp. merger in March 2001.

In India, companies opt for reverse mergers to take advantage of the Tax Savings Act (under section 72A) so that a healthy and profitable company is allowed the benefit of carry forward losses when merging with a sick company. This process which ensures survival of a sick unit by merging with a healthy one (which loses its identity) is called *reverse merger*. Kirloskar Pneumatics merged with Kirloskar Tractors, a sick unit. Godrej Soaps merged with the loss making Gujarat Godrej Innovative Chemicals. By using the tax benefits provided by the reverse merger, it improved its post-merger profit performance.

Reverse merger can also occur on account of the regulatory requirements. An example is the reverse merger of ICICI into ICICI Bank. ICICI could become a universal bank only through a reverse merger with its banking subsidiary.

Holding Company An acquiring company becomes a holding company when it chooses to purchase only a portion of the target's stock. The holding company that owns sufficient stock has a controlling interest in the target. If an acquirer buys 100% of the target, the company is known as a wholly owned subsidiary. It is not necessary to own 100% stock of a company to exert control over it. In case of companies with widely distributed equity base, effective control can be established with as little as 10% to 20% of the outstanding common stock.

The main advantages of a holding company in comparison to outright acquisition are:

1. **Lower cost:** An acquirer can attain control of a target for a much lesser investment than would be necessary in a 100% stock acquisition.
2. **No control premium:** 51% shares are not purchased, the control premium, normally associated with 51% to 100% stock acquisitions, would not have to be paid.
3. **Control with fractional ownership:** Working control may be established with less than 51% of the target company's shares.

The main disadvantages are:

1. **Multiple taxation:** The holding company could add another layer to the corporate structure. Stockholder income is subject to double taxation.
2. **Antitrust problems:** A holding company combination may face some of the same antitrust concerns which are associated with an outright acquisition.
3. **Lack of 100% ownership:** Though a holding company formed without 100% share purchase may be a source of cost savings, it leaves the holding company with outside shareholders, who would have some controlling influence in the company, thus leading to differences of opinion.

Accretive Mergers

In these mergers the acquiring company's earnings per share increase. An alternative explanation is that a company with high price to earnings ratio (P/E) acquires one with a low P/E.

Dilutive mergers

Here the company with a low P/E will be acquiring one with high P/E.

Difference Between a Merger and an Acquisition

In the general sense, mergers and acquisitions (takeovers) are very similar corporate actions. They combine two previously separate firms into a single entity. A merger involves mutual decision of two companies to combine and become one entity. A typical merger involves two relatively equal companies, which combine to become one legal entity, with the goal of producing a company that is worth more than the sum of its parts. In a merger of two corporations, the shareholders usually have their shares in the old company exchanged for an equal number of shares in the merged entity. For example, in 1998, American Auto maker, Chrysler Corp merged with German Automaker, Daimler Benz, to form Daimler Chrysler. This had all the makings of a merger of equals as the Chairmen of both organizations became joint leaders in the new organization. The merger was considered to be beneficial to both companies as it gave Chrysler an opportunity to reach more European markets and Daimler Benz gained greater presence in North America. In 2006, the two steel giants, Arcelor and Mittal, merged to form Arcelor-Mittal. In 2002, RPL merged with RIL, the largest ever merger in Indian corporate industry. The merger was aimed to create India's only world scale fully integrated energy company, with operations ranging from oil and gas exploration, production, refining and marketing of petrochemicals, power and textiles. ICICI Ltd. and ICICI Bank merged to create India's first universal bank. ASEA merged with Hindustan Brown Boveri to form ABB Ltd. The four ICI companies—Crescent Dyes, Chemical & Fibers, Alkali & Chemicals and Indian Explosives—merged into one giant conglomerate, IEL, which was later named as ICI India Ltd.

An acquisition, or takeover, is characterized by the purchase of a smaller company by a much larger one. This combination of unequals can produce the same benefits as a merger, but it does not necessarily have to be a mutual decision. A large company can initiate a hostile takeover of a smaller firm, which essentially amounts to buying the company in the face of resistance from the smaller company's management. Unlike the merger, in an acquisition, the acquiring firm usually offers either a cash price per share to the target firm's shareholders or the acquiring firm's shares, according to a specified conversion ratio. Either way, the purchasing company essentially finances the purchase of the target company, buying it outright for its shareholders. An example of an acquisition would be Walt Disney Corporation bought Pixar Animation Studios in 2006. It was the manner in which friendly takeover as Pixar's shareholders approved of the decision to be acquired. Examples of successful takeovers include the takeover of BSES by Reliance, and the Tata takeover of Corus. In an all cash deal, Hindalco acquired Indal in 2000. In 2007, British telecom giant, Vodafone, bagged the 67% Hutch Telecom International (HTIL) stake in Hutch-Essar at an enterprise value of $19.3 billion (approx Rs 86,000 crore), which comes to $794 per share.

Merger is principally a legal process and a follow up to an acquisition of controlling interest.

Industry Lifecycle and Merger Types

The product life cycle consists of the development, growth, maturity and decline stage.

In the introduction stage, newly created firms may sell out to outside large firms in a mature or declining industry, enabling larger firms to enter new growth industries, thereby resulting in conglomerate or related mergers. Horizontal mergers between smaller firms may enable firms to pool management and capital resources. Mergers during the growth stage are similar to mergers during the introductory stage. The impetus for such mergers is reinforced by more visible indications of growth and profit.

During the maturity stage, excess capacity may develop. Prices and profits may decline. In this stage, large firms within the industry, or from other industries, are likely to be acquirers. Mergers are undertaken to achieve economies of scale in research, production and marketing, in order to match low cost and price performance of other firms.

In the decline stage, or in the late maturity stage, pressures are created for different types of mergers: mergers for vertical integration, horizontal mergers for survival and mergers for diversification, particularly the concentric form of conglomerate mergers. Conglomerate mergers of firms in growth industries are undertaken to utilize the financial slack of mature firms in declining industries.

SYNERGIES IN MERGERS

Synergy: Synergical effect occurs when two substances or factors combine to produce a greater effect, more than the sum of those together operating independently. The principle of synergy (2+2=5) aims to maximize the shareholder value of the merged entity. Synergy is the ability of a merged company to create more shareholder value than the standalone entity.

If synergy is perceived to exist in a takeover, the value of the combined firm should be greater than the sum of the values of the bidding and target firms, operating independently.

Hence, $V(AB) > V(A) + V(B)$

where, $V(AB)$ = Value of a firm created by combining A and B (Synergy)

$V(A)$ = Value of firm A, operating independently

$V(B)$ = Value of firm B, operating independently

The value created by the combination of firms may result from more efficient management, economies of scale, improved production techniques, combination of complementary resources, redeployment of assets to more profitable uses, exploitation of market power, or any number of value creating mechanisms that fall under the general rubric of corporate synergy.[2] Given that value is based on profits, and profits are the difference between revenue and cost, the magical arithmetic happens in at least two ways in a merger: shared cost (for example, by sharing overhead) and enhanced revenue (for example, by increasing sales without adding to costs).

Two types of synergy need to be distinguished–cost based and revenue based. Cost-based synergy focuses on reducing incurred costs by combining similar assets in the merged businesses. Cost synergy can typically achieve economies of scale, particularly for sales and marketing, administrative, operating, and/or research and development costs. When two companies in the same industry merge, the combined revenue tends to decline to the extent they overlap each other, and some customers may also be alienated. For the merger to benefit the shareholders, there should be ample opportunities for cost reduction, so that the initial lost value is recovered in due course through synergy.

Revenue based synergy focuses on enhancing capabilities and revenues and combining complementary competencies. Revenue based synergy can be exploited if merging businesses develop new competencies that allow them to command a price premium through higher innovation capabilities (product innovation, time to market, etc.), or boost sales volume through increased market coverage (geographic and product line extension). Revenue synergy is achieved through product cross-selling, higher prices due to less competition, or staking a larger market share.

M&A create three kinds of synergies by combining and customising resources differently. *First*, companies create *modular synergies* when they manage operations independently and pool only the results for greater profits. In a collaboration between an airline and a hotel chain, where the hotel's guests earn frequent flyer miles, clubbing of consumer's choice of hotel and airline benefits both the organizations. *Second*, firms

[2]Fred Weston, Kwang S Chung, Susan E Hoag, 'Mergers Restructuring and Corporate Control', PHI, 2006.

derive *sequential synergies* when one company completes its tasks and passes on the results to a partner to do its bit. In such cases, the resources of the two firms are sequentially interdependent. For instance, when a biotech firm specializing in discovery of new drugs, like Abgenix, works with a pharmaceutical giant more familiar with the FDA approval process, such as Astra Zeneca, both companies are seeking sequential synergies. *Third*, companies generate *reciprocal synergies* by working closely together and executing tasks through an iterative knowledge sharing process. Exxon and Mobil realised that they would have to become more efficient in almost every part of the value chain from research and oil exploration to marketing and distribution in order to remain competitive[3].

Sources of Operating Synergy

Operating synergies are synergies that allow firms to increase their operating income or increase their growth or both. Operating synergy results from economies of scale that may arise from the merger, allowing the combined firm to become more cost efficient and profitable. The sources of operating synergy may be attributed to greater pricing power, from reduced competition and higher market share, which may result in higher margins and operating income. The combination of different functional strengths would also result in operating synergy. For example, a firm with a good product line when acquired by a firm with strong marketing skills may result in operating synergy. Higher growth in new or existing markets, arising from the combination of two firms may also become a source of operating synergy. In this context, a case scenario can be visualised in which a consumer products firm acquires an emerging market firm, with an established distribution network and brand name recognition, and uses these strengths to increase sales of its products.

Sources of Financial Synergy

The resultant feature of corporate merger or acquisition on the cost of capital of the combined or acquiring firm is called *financial synergy*. It is the result of the lower cost of internal financing as compared to external financing. A combination of firms, with different cash flow positions and investment scenarios may produce the synergic effect and achieve lower cost of capital. It means when the rate of cash flow of the acquirer firm is greater than that of the acquired firm, there is a tendency to relocate the capital to the acquired firm, and thus, the investment opportunity of the latter increases. If the cash flows of the two entities are not perfectly correlated, the financial synergy can be expected, thus reducing risk. The perceived reduction of instability of cash flow would lead the suppliers to trust the firm, and hence the debt capacity of the combined firm would be greater than the individual firms. Debt capacity may increase because when two firms combine, their earnings and cash flows may become more stable and predictable. This, in turn, would allow them to borrow more than they could have as individual entities, which creates a tax benefit for the combined firm. This tax benefit can either be shown as higher cash flows, or taken as lower cost of capital for the combined firm. Tax benefits can arise either from the acquisition taking advantage of tax laws or from the use of net operating losses to shelter income. Thus, a profitable firm that acquires a money losing firm may be able to use net operating losses of the latter to reduce its tax burden. Alternatively, a firm that is able to increase its depreciation charges after an acquisition saves in taxes, and increases its value.

A combination of a firm with excess cash, or cash slack, (and limited project opportunities) and a firm with high-return projects (and limited cash) can yield a payoff in terms of higher value for the combined firm. The increase in value comes from projects that were taken with excess cash, which otherwise would

[3]Jeffrey H Dyer, Prashant Kale, and Harbir Singh, ‘When to Ally & When to Acquire’, Harvard Business Review, July–August 2004, Page 111-112.

not have been taken. This synergy is likely to most often show-up when large firms acquire smaller firms, or when publicly traded firms acquire private businesses.

Motivation for Horizontal Mergers

Pure horizontal mergers result when firms selling the same products merge. When firms selling products, though not identical in terms of end use, but with certain commonalities such as technology, markets, marketing channels and branding merge, it is a related merger. Horizontal mergers often characterise industries and markets whose products are in the mature or declining stages of product life cycle. The combination of low market growth and excess capacity places pressure on firms to achieve cost efficiencies through consolidating mergers.

Mature industries are characterised by low overall growth in demand for their products, excess capacity, a small number of large competitors and considerable price pressure, and pressure to reduce costs.[4] New business models, or developments in information technology, may create a scenario in which the current installed capacity is in excess of that needed to meet the expected demand. Firms equipped with new technologies will increase capacity and gain market share at the expense of the obsolescent firms. Wal Mart entered the new retail market through capacity enhancement and use of information technology, along with direct dealings with manufacturers'. In the era of dotcoms, only retailers who adopted the new technology survived. In this context, it is worthy to mention the example of Barnes and Nobles, who quickly adopted new technology to ward off stiff competition from Amazon.com. Internal restructuring activities, like closures of plants, may reduce overcapacity. Horizontal mergers can also be an alternate strategy for reduction of excess capacity.

Value Creation in Horizontal Mergers

(a) Revenue Enhancement The basic value creation in a horizontal merger would be increased market power and revenue growth. Revenue growth can be achieved through lowering prices for products that are highly price sensitive. As a result of horizontal merger, market share may increase and contribute to revenue enhancement, if the price elasticity of products are unchanged. Revenue enhancement may also be achieved through network externality, whereby a customer base is created, with customers sharing a common experience that may be facilitated, enriched or made more effective by interaction among themselves. This may provide an incentive to intensify interaction and to join the installed base, that, in turn, provides the incentive to buy the product.[5] Acquirer firms involved in horizontal mergers with target firms with network externality can realize revenue enhancement. The acquisition of Lotus by IBM resulted in generation of an even larger network externality by the combination of installed bases of the two firms. Takeovers can also facilitate revenue growth by acquiring firms whose products are complementary in nature. These takeovers can enable the firm to leverage its competencies to enhance, and make more visible, the latent complementarities. In UK, utility companies, like water companies, have acquired electricity distribution companies. They offer price discounts to customers switching from other water or electricity companies. GE Capital, by providing finance and credit to the customers of GE's Aerospace Division, selling aero engines, acts as the latter's complementor. GE's Avionics Division is a complementor to its Aero Engine Division.[6]

[4]Sudi Sudarasanam, 'Creating Value from Mergers and Acquisitions–Value Creating in Horizontal Mergers', Page 97.
[5]Sudi Sudarasanam, 'Creating Value from Mergers and Acquisitions–Value Creating in Horizontal Mergers', Page 101.
[6]Sudi Sudarasanam, 'Creating Value from Mergers and Acquisitions–Value Creating in Horizontal Mergers', Page 103.

The sources of value creation in horizontal mergers, by means of revenue growth, can be achieved by leveraging marketing resources and capabilities of the merging firms. The existing distribution capacities of the merging firms can be used to further enhance revenue.

(b) Cost Savings The combination of the activities of functional areas, like production, marketing, sales and distribution, and R&D, of the acquirer and the target would lead to cost savings. The same activities may be carried out at a lower cost than either firm's individual cost. This would lead to reduction in production and fixed costs. The profit margin may be improved and pricing pressure be eased by reducing supply to match the demand. Throughout the world, mergers and acquisitions in steel industry were motivated by wish to reduce excess capacity and enhance cost savings.

In horizontal mergers, cost savings may also result from economies of scale in production, marketing, sales and distribution, logistics, branding and R&D.

Economies of scope exist when the cost of joint production of two or more goods by a multiproduct firm is less than the combined costs of separate production of those goods by firms specialising in their production. Scope economies are realised when costs are spread over an increased range of output of different products. In horizontal mergers, cost savings result due to scope economies in branding, marketing, distribution, production and logistics. R&D activity often generates spillovers when ideas developed in one research project provide the stimulus for other projects.

Learning economies arise when managers and workers, over time become more experienced and effective in using the available resources of the firm and thus help lower the cost of production. It is the function of cumulative output over several periods. A merger involving complex technological processes may yield valuable learning opportunities. Horizontal mergers on account of learning economies result in cost savings.

The acquirer usually hopes to make money by combining the functions of the companies. If two banks merge and each has a branch at a certain intersection, one would be closed. Merger may result in the new company buying supplies, services and raw materials in larger quantities, and hence getting larger discounts.

(c) New Growth Opportunities New growth opportunities arise due to creation of new technologies, products and markets. In this context, horizontal mergers can facilitate creating of new capabilities, resources and products. The increasing cost of the cycle of development of a new chemical entity and drying pipeline of blockbuster drugs forces companies to consider such alternatives as M&A.

VERTICAL INTEGRATION

The degree to which a firm owns its upstream suppliers and downstream buyers is referred to as *vertical integration*. The vertical scope of the firm is an important consideration in corporate strategy, on account of its significant impact on a business unit's position in industry, with respect to cost, differentiation and other strategic issues. Vertical integration may be defined as the process in which several steps in the production and/or distribution of a product or service are controlled by a single company or entity, in order to increase its power in the market. In other words, vertical integration refers to the degree of integration between a firm's value chain and the value chain of its suppliers and distributors. Expansion of activities downstream is referred to as forward integration while expansion upstream is referred to as backward integration. *Backward vertical integration* refers to ownership and control of inputs into the production process, like a chocolate manufacturer owning the cocoa-growing plantation. Alternatively, *forward vertical integration* involves owning and controlling distribution and retail elements of the value chain. A vertical chain represents the various stages from raw materials inputs to the final products sold to the customer. Vertical integration combines firms along the value chain. For example, a steel manufacturer might acquire upstream operations (iron ore mines) and downstream operations (fabricators of steel products). Full vertical integration occurs when a firm incorporates the value chain of the supplier and/or the distribution channel into its own value chain.

The decision on vertical integration depends on factors of cost and control. The cost aspect depends on the cost of market transactions between firms versus the cost of administering the same activities internally within a single firm. The second issue is the impact of asset control, which can impact barriers to entry, and which can assure cooperation of key value-adding players.

Advantages of Vertical Integration

The main advantages of vertical integration include:

1. Economies of scale, economies of scope, cost reduction and improved competitiveness,
2. Reduced threat from powerful suppliers and/or customers,
3. Higher degree of control over the entire value chain, and improved supply chain coordination,
4. On account of geographical proximity, reduction in transportation cost,
5. Creation of entry barriers to potential competitors,
6. Accessibility to distribution channels.

Vertical integration offers scale advantages and allows companies to be monopolists, or pretend to be monopolists. As they own all stages of the value chain, there is no competition until the final stage, i.e., sales to the consumer.

Disadvantages of Vertical Integration

The disadvantages of vertical integration include:

1. Load and capacity balancing between old and new activities may be difficult to achieve,
2. Absence of market discipline makes internal production inefficient and costly,
3. Higher cost may result due to low efficiencies resulting from lack of supplier competition,
4. Small production volumes reduce the opportunities for scale and learning economies.

Classical examples of vertical integration can be found in the airlines industry and the petroleum industry. Airlines industry has achieved forward integration through the role of travel agents and backward integration through the role of suppliers in aircraft maintenance, and in flight catering. Oil refining industries have traditionally owned their oil distribution channels, such as gas stations. They later moved into exploration and development.

Carnegie Steel followed the expansive strategy of vertical integration. The company dominated the steel value chain by buying up a host of companies, including coal mines, coke ovens, steel mills, iron ore barges, and railways. During the early 20th century, companies were vertically integrated to the extent that they made their own tool parts and finished products, and were then involved in the sales and distribution of those products. For example, Ford required specialized tools and machinery. Naturally enough, given the specialist nature of the equipment, it was easier for the company to make the tools itself. But this vertical integration was more a product of circumstances than intentional corporate strategy.

Large vertically integrated companies, like Exxon, Shell and BP, explore and then drill for crude oil, refine that oil and own many pumps through which they retail their products. In India, Reliance Industries Ltd. is a vertically integrated company. Apple Computers is one of the few successful technology companies which design their own products, control marketing and selling through Apple stores. Samsung is another example of a vertically integrated company.

Vertical integration remained a key strategy during the 1970s, especially forward integration, with companies moving into distribution and sales of their products. But later, in the 1980s and 1990s, the trend turned decisively against vertical integration, as companies discovered the flexibility and efficiency of markets. During this period, the focus shifted to core activities and outsourcing, which emerged as an alternate path to vertical integration.

Value Creation in Vertical Mergers

A merger or an acquisition can be termed as vertical if there is a kind of buyer-seller relationship between the partnering firms, and they seek integration along the value chain. Vertical mergers increase the vertical integration of a firm by taking over a customer or a supplier. Vertical mergers and acquisitions mainly reduce market uncertainties which result in lower transaction costs. These transaction cost savings include search and information cost to gather price and product characteristics of suppliers, cost for contract conclusion, as well as cost for quality control and other costs like administration and taxation. Vertical mergers can reduce warehousing costs and increase capital turnover. Vertical mergers thus create synergy effects, based on the transaction cost synergy mechanism. Vertical mergers can also provide opportunities for indirect price discrimination. They can also lead to the creation of entry barriers by raising the capital requirement for new entrants.

Vertical mergers can create value if they improve economic efficiency by cutting out intermediaries and reducing overhead expenses and redundant assets. Improved coordination through inventory and purchasing business processes may further create business efficiencies. In a strategic perspective, it may guarantee a source of supply in a right market, pre-empting competitors and preventing being locked out.[7] The disadvantage is that the creation of internal market can lead to loss of economic discipline, and a distancing from information conveyed by external markets.

Vertical mergers may increase the ability of firms to provide a package of services and products rather than only products. This could lead to revenue enhancement. This could be the reason why automobile companies, like Ford Motors and General Motors, have acquired or built up consumer finance or dealership activities.

Vertical mergers have blurred the boundaries segregating banking, insurance and asset management industries. The modern concept of bancassurance is based on the backward integration of banks to source insurance industry products, and forward integration of insurance companies to acquire distribution channels. The financial supermarket giant, Citigroup, has been built on the basis of this model. In the 1990s, Travelers Group diversified its business, from insurance into securities, by buying Smith Barney (brokerage firm), Salomon Brothers (investment bank and securities trading firm) and Citibank (commercial bank) to form a full fledged financial institution called Citigroup.[8]

Vertical mergers are generally deemed to yield efficiencies in the company's way of doing business rather than lessen competition. In industries characterized by network effects, such as telecommunications, electronic telecommunications and media sector, a dominant standard has emerged. All sectors of the industry are impacted to a degree by the New Economy which encompasses not only the enterprises in telecommunications, electronic communications, media, software and Internet sectors, but also the traditional sectors, creating opportunities for integration of the Internet and new information and communications technologies in distribution processes.[9] Vertical mergers have also blurred the boundaries between telecommunications, cable transmission, media and the Internet. The array of new technologies, combining elements of broadband technology, wireless devices, personal video recorders, telephony and other interactive services have facilitated the scope for coming together of different media platforms within a single company. In this context, opportunity for growth exists due to the merger of a content company with a company that controls different distribution channels.

[7]Robert F Bruner, Joseph R Perella, 'Applied Mergers and Acquisitions', John Wiley & Sons, 2004

[8]A Gart, 'The Long Reach of Banking's Acquisition Wave', Mergers and Acquisitions, May/June 1998, 25-35.

[9]Gide Loyrette Nouel, 'Competition Assessment of Vertical Mergers and Vertical Agreements in the New Economy', ec.europa.eu/enterprise/library/libcCmpetition/doc/merger_agreement_summary.pdf.

Vertical integrations and alliances between businesses, active at different levels of the delivery chain, will undoubtedly contribute towards better compatibility among those products. As technological convergence accelerates between the computing, communications and broadcasting industries, the tendency for vertical and horizontal integration will further increase. Vertical integrations and alliances may benefit consumers, and new information and communication technologies would undoubtedly reduce certain costs, with the benefit of greater competition being passed on to them.

Value Creation in Conglomerate Mergers

In conglomerate mergers, the merging firms do not have any relation between their products and markets. Some conglomerate mergers and acquisitions benefit from better management. This corresponds to transfer of scarce resources, like management capabilities, from one firm to another. The main synergy effect in conglomerate mergers is based on specific risk reduction, which lowers the cost of capital. In unrelated acquisitions, value creation is also associated with co-insurance effect. If the merger reduces the probability that one of the firms would default on its debt, then the value of the debt would increase and the merger would be beneficial. But the opponents of conglomerate mergers and acquisitions argue that shareholders can achieve co-insurance effects better by diversifying their share portfolio, and that diversified companies create less value than a portfolio of focused companies.[10] Some researchers argue that even in conglomerate mergers and acquisitions, reduction of overhead costs is possible. This reduction can mainly be realised in specific functions like research and development, and sales, or in support functions that are not product related, such as the legal department or the IT department.

Conglomerate diversification might promote knowledge transfer across divisions. For example, General Electric practices Total Quality Management and extends its productivity enhancing techniques to new businesses that it acquires. When diversification takes place in a related field, it may be possible for the diversified firm to reduce costs through improved bargaining power with its suppliers. The cost of financing may be lowered due to the portfolio diversification effect. Lewellen (1971) suggested that combining two unrelated businesses whose cash flows are imperfectly correlated can reduce the risk of default of the entire enterprise. Diversification can also bring aggregation of resources that can be shaped into core competencies to facilitate competitive advantage. The diversified firm internalizes the capital market by acting as an allocator of resources among the businesses in its portfolio. This close proximity to the companies and access to better information about them permits internal capital market to operate more efficiently than the external markets.[11]

The conglomerate merger boom, exemplified by such firms as LTV, Litton, and Gulf and Western in the 1960s, and by the oil companies in the 1970s, was widely attributed to accounting cosmetics, fashions, and other less rational motives. The trend reversed itself in the 1980s, when managements typically explained this restructuring with ‘focusing’ and ‘synergies,’ that is, economies of scale and scope. It is suggested that, when the relative price risk is greater, it is optimal for the management to diversify at the margin, and emphasize economies of scale or scope when the risk is smaller. Conglomerate mergers should, therefore, be positively associated with relative price risk, given the variables affecting mergers as a whole. Empirical evidence is found to lend support to the theory. The inflation rate explains conglomerate mergers even better, which suggests that relative price risk may constitute another real resource cost of inflation.[12]

[10] C Prahalad and G Hamel, ‘The Core Competencies of the Corporation’, Harvard Business Review, May/June 1990, 79-91

[11] Robert F Bruner, Joseph R Perella, ‘Applied Mergers and Acquisitions’, John Wiley & Sons, 2004.

[12] Ahtiala Pekka, Conglomerate Mergers as Defense Against the Risk of Relative Price Variability’, Review of Economics and Statistics, Feb. 2000, Vol. 82, Issue 1, page 160.

Empirical Evidence on Value of Horizontal Mergers

Microeconomic theory suggests that combination of firms in the same or closely related industries (horizontal or vertical mergers) may have different effects than combination of firms in unrelated industries (conglomerate mergers). For example, relative to a conglomerate merger, a horizontal merger may achieve larger economies of scale in operations, and greater reduction in competitive activity. In this context, one might expect horizontal mergers to have more positive effects on shareholder returns than conglomerate mergers.[13]

It is often seen that horizontal mergers generate positive abnormal returns to stockholders of the bidder and target firms because they increase the probability of successful collusion among rival producers. Under the collusion hypothesis, rivals of the merging firms benefit from the merger since successful collusion limits output and raises product prices, and/or lowers factor prices. The study by Eckbo (1983) found little evidence indicating that horizontal mergers would have collusive, anticompetitive effects. The study by Edward et al. (2004) investigate the upstream and downstream product-market effects of a large sample of horizontal mergers and acquisitions from 1980 to 1997. The study finds evidence consistent with improved productive efficiency and buying power as sources of gains to horizontal mergers. Robert (1980) finds that there is some indication that horizontal acquisitions were associated with increased rates of return during the decade 1962-1971.

Empirical Evidence on Value of Vertical Mergers

A study by Joseph et al. (2006), based on vertical mergers between 1962 to 1996, found that vertical mergers generate positive wealth effects that are significantly larger than those for diversifying mergers. Vertical integration can change the pricing incentive of an upstream producer. In his study, Yongmin (2001) found that vertical integration can also change the pricing incentive of a downstream producer, and the incentive of a competitor in choosing input suppliers. The study also finds that competitive effects of a vertical merger depend on the cost of switching suppliers and the degree of downstream product differentiation. Robert (1980) found that vertical mergers in the seventies were associated with increased rates of return during the decade 1962-1971. Lubatkin (1987) found no significant differences in returns to bidding firm shareholders for strategically related and unrelated acquisitions. Singh and Montgomery (1987), despite controlling for the type and degree of strategic relatedness between bidding and target firms, found that these acquisitions did not generate abnormal returns for shareholders of bidding firms. Their study also states that shareholders of related target firms obtain higher abnormal profits than shareholders of unrelated firms. The study further concludes that strategically related acquisitions create more economic value than unrelated acquisitions. Rumelt (1974), in his landmark study of diversification strategies, showed that related diversification strategies, outperformed unrelated diversification strategies.

Empirical Evidence on Value of Conglomerate Diversification

Two sets of arguments are commonly used to explain why companies diversify. The first set argues that firms diversify to increase shareholder wealth. The second set of arguments explains diversification as an outgrowth of agency problems between managers and shareholders.[14]

Diversification strategy is an important component of strategic management of a firm, and the relationship between a firm's diversification strategy and its economic performance is of considerable interest to both academicians and managers. The industrial organization literature, including studies by Gort (1962),

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[13]Robert S Harris, 'The Impact of Corporate Mergers on Acquiring Firms', The Journal of Financial Research, Vol. II, No. 3, Fall 1980, page 283-295.

[14]Henri Servaes, 'The Value of Diversification During the Conglomerate Merger Wave', The Journal of Finance, Vol. LI, No: 4, September 1996, page 1201-1227.

Arnould (1969) and Markham (1973), concludes that no significant relationship exists between diversification and firm performance. In contrast, studies by Rumelt (1974,1982), Montgomery (1982) and Christensen and Montogomery (1981) in the strategic management literature, report a systematic relationship between a firm's diversification strategy and its economic performance. Gort (1962) was one of the first to examine the profitability of diversified firms. His analysis on 111 large US corporations showed that there was no significant cross-sectional correlation between profitability and diversification. Markham (1973) speculated that diversification during 1961-1970 was generally not a profitable activity. The work of Rumelt (1974) was pioneering among the strategic management studies that examined the profit impact of diversification. He analyzed the profit performance of 246 diversified, firms and concluded that firms that diversified, but restricted their range of activities to a 'central skill or competence', have shown better performance than other types of firms. Williamson (1970) suggests that firms diversify to overcome imperfections in external capital markets. Product extension mergers seemed to have especially strong (statistically speaking) positive correlation with rates of return during the peak merger years of 1965-1967 (Robert 1980). If the information asymmetry between the firms and the potential investors becomes too large, firms may decide to forego positive net present value (NPV) projects (Myers and Majluf, 1984). Through diversification, managers create internal capital markets, which are less prone to asymmetric information problems. Lewellen (1971) argues that conglomerates can sustain higher levels of debt because corporate diversification reduces earnings variability. If the tax shields of debt increase firm value, this argument predicts that conglomerate firms are more valuable than companies operating in a single industry. Shieifer and Vishny (1992) have also argued that conglomerates may have higher debt capacity because in some states of the world they can sell assets in industries that suffer least from liquidity problems. Teece (1980) argues that diversification leads to economies of scope.

Elgers and Clark (1980) examined the risk adjusted common stock returns associated with 377 mergers during the period 1957-75. They found that both buyer and seller stockholders appear to benefit more from conglomerate mergers than from non-conglomerate mergers, though these differences were not statistically significant.

Amihud and Lev (1981) argue that managers diversify to protect the value of their human capital, and Jensen (1986) suggests that companies diversify to increase the private benefits of managers. Amihud and Lev (1981) and Morck, Shieifer, and Vishny (1990) provide empirical support for these arguments. In a similar vein, Shieifer and Vishny (1989) suggest that managers diversify because they are better at managing assets in other industries, and diversifying into those industries will make their skills more indispensable to the firm.

Bhide (1990) argues that because of economic, technological, and regulatory changes during the 1970s and 1980s, information asymmetries have become less of an issue in corporate financing, and that the disadvantages of diversification have started to outweigh the benefits. For example, as pointed out by Stulz (1990), one of the drawbacks of reducing potential underinvestment is that it can lead to overinvestment. The cross-subsidization of divisions within a conglomerate gives divisional managers easy access to capital (Meyer, Milgrom, and Roberts (1992)), which may exacerbate the agency costs of free cash flow (Jensen (1986)). Proponents of conglomerate diversification implicitly assume that managers of conglomerates are better at monitoring the divisions than the external capital market, and that these agency costs are not large enough to offset this benefit.

A conglomerate merger generally leads, through the diversification effect, to reduced risk for the combined entity. In perfect capital markets, such risk reduction will not be beneficial to stockholders, since they can achieve, on their own, the preferred degree of risk in their 'homemade' portfolios[15]. The study by Amihud

[15]Amihud Yakov, Lev Baruch, 'Risk reduction as a managerial motive for conglomerate mergers', Bell Journal of Economics, Autumn 81, Vol 12, Issue 2, page 605-617.

& Lev (1981) examines the managerial motive for conglomerate mergers. They opine that managers, as opposed to investors, engage in conglomerate mergers to decrease their largely undiversifiable 'employment risk' (i.e., risk of losing job, professional reputation, etc.). Such risk-reduction activities are considered as managerial perquisites in the context of the agency cost model.

SUMMARY

A merger is a combination of two companies into one larger company. These actions involve stock swap or cash payment to the target. Merger, commonly takes two forms. One, in case of amalgamation, two entities combine together and form a new entity, extinguishing both the existing entities. Second, in case of absorption, one entity gets absorbed into another. The latter does not lose its entity. An acquisition, also known as a takeover, is the buying of one company (the target) by another. An acquisition can be friendly or hostile. In a friendly takeover, the companies proceed through negotiations. In the latter case, the takeover target is unwilling to be bought, or the target's board has no prior knowledge of the offer. Mergers are basically of three kinds: horizontal, vertical and conglomerate mergers. There is a relationship between mergers and industry life cycle. Operating synergy results from economies of scale that may arise from the merger, allowing the combined firm to become more cost-efficient and profitable. The resultant feature of corporate merger or acquisition on the cost of capital of the combined or acquiring firm is called as financial synergy. The value creation in horizontal mergers are through revenue enhancement, cost reduction and new growth opportunities. Vertical mergers can create value if it improves economic efficiency by cutting out intermediaries and reducing overhead expenses and redundant assets. The main synergy effect in conglomerate mergers is based on specific risk reduction which lowers the cost of capital. In unrelated acquisitions, value creation is also associated with co-insurance effect.

DISCUSSION QUESTIONS

1. What are the different types of mergers?
2. Distinguish between hostile and friendly acquisitions.
3. Explain the linkage between financial synergy and conglomerate merger.
4. What is meant by synergy?
5. What are the sources of operating and financial synergy?
6. Explain the concept of value creation in horizontal, vertical and conglomerate mergers.

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5 Mergers and Acquisitions: Due Diligence

Chapter Objectives

The aim is to make the reader understand:

- The process of due diligence
- Types of due diligence
- Challenges of due diligence
- Issues in due diligence process in India

INTRODUCTION

Due Diligence is the process through which a potential buyer evaluates a target company or its assets for acquisition. It involves examining financial records, management decisions, competitive challenges, assets, liabilities and any other consideration that make the acquisition a good or bad decision. In other words, due diligence, with reference to M&As, is the process of examining all aspects of a company, including manufacturing, financial, legal, tax, IT systems, labour issues, regulatory issues, as well as understanding issues related to IPR, environment and other factors. It is done to investigate and evaluate a potential company for acquisition purposes. It helps the acquiring company to determine if it is worth pursuing a target, and at what price.

The process of due diligence helps in valuing and negotiating deals in an effective manner. The due diligence process needs to cover the following aspects of the target company:

1. The organisational structure and management style
2. The operational aspects, which include production technology, processes and systems
3. The financial aspects, which include operating performance information and potential tax liabilities
4. The human resources environment
5. Various legal aspects
6. The information system.

Due diligence is a highly complex process when conducted correctly. The most effective due diligence process begins in the earliest stages of the acquisition. The due diligence process should help the firm select its target so that value creation occurs with a long-term perspective, through competitive advantage. If a wrong target firm is selected, the rest of the due diligence process may not have much value. Dynamic due diligence begins with an empowered due diligence team with the responsibility and authority to obtain and analyse information for effective integration. Effective due diligence goes beyond financial numbers and inventories to include cultural and human resource attitudes and other critical attributes.

A critical part of the due diligence process is analysing the firm's financial resources. This should include return on assets per employee, economic value added, percentage of revenues and profits from new businesses and quantification of lost business opportunities. Lost business revenues are due to lost business opportunities due to competition and new product failures.[1]

A dynamic due diligence process also carefully and completely analyses customer and marketing related issues. Customer relationship issues should be evaluated and a customer satisfaction index be developed. The market share analysis vis-a-vis the competitor could also be analysed.

The analysis of major processes, like manufacturing and provisions of services, is another area of importance in the due diligence process. This analysis may include measurements of cycle times and improvements over time, achievement of quality goals, assessment of effectiveness of management information systems and administrative expense per employee.

In hostile deals and in deals with companies listed on the stock market, due diligence is likely to be deficient. It may also be inadequate in assessing the intangible assets of the target firm. Intangibles depend on people, teams and organisational networks. Due diligence needs to include a human resource component.

An effective due diligence also undertakes the appraisal of human resources of the firm. This process may involve evaluation of management capabilities, investment in human resources and indices on leadership, motivation and employee empowerment.

The due diligence team members specialise in different types of analyses. The reports on specialised areas are then consolidated in order to have a final set of conclusions.

The due diligence process is further complicated by cross-border acquisitions. This is due to the differences in legal structures, tax policy, accounting practices and environmental laws that exist in different countries.

Inadequate evaluation of the target firm is considered to be one of the main reasons for failure of M&A. A classical example for the failure of due diligence was the purchase of Inforex by Data Point. Inforex had filed for bankruptcy in the year before the acquisition by Data point because it could not meet its semi-annual debt payment. In the year after the acquisition, Data point suffered 95% reduction in its net income from the previous year. Managers put the blame on recession. But the total revenue was higher in the previous year. Thus, it can be stated that due diligence was not able to visualise the scenario of not being able to control cost aspects.[2]

Due diligence will help firms to minimise the risks involved, especially for the acquirer. In another perspective, due diligence also involves mutual review by both the acquirer and target. The basic aim of due diligence is to assess the benefits and liabilities of a proposed acquisition by exploring the status of the business, particularly the future of business along the framework of risk.

It has to be noted that no due diligence is perfect. The due diligence of American Motors is also a case to be highlighted. American Motors had multiple, well-publicised problems in production, labour relations and organisation. Chrysler suffered reduction in overall productivity after the acquisition and experienced substantial production overcapacity. The turnaround attempt of American Motors proved futile for Chrysler. American Motors, market share constituted just one per cent of the US automobile market. The manufacturing plants were outdated and the firm had negative working capital. The Jeep brand's acquisition was only profitable for Chrysler.

In 1999, Daimler-Chrysler strongly considered acquiring Nissan Motors Company. The management was interested in acquiring Nissan to increase its firm size. The main area of concern was Nissan's $22 billion debt. Many experts suggested that Daimler Benz should conduct a thorough due diligence process. In the end, the deal did not materialise.

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[1]Michael A Hitt, Jeffrey A Harrison, R Duane Ireland, 'Mergers and Acquisitions–A Guide to Creating Value for Stakeholders', Oxford University Press.

[2]Michael A Hitt, Jeffrey A Harrison, R Duane Ireland, 'Mergers and Acquisitions'–A Guide to Creating Value for Stakeholders', Oxford University Press.

DUE DILIGENCE CHALLENGES[3]

Due diligence involves assessing important characteristics of the target, like its financial condition, management capabilities, physical assets and other intangible assets. It is important to detect potential liabilities. Undetected liabilities could later pose significant financial problems. The process should be able to obtain complete information about the financial, operating, human and legal implications of the merger or the acquisition. Ineffective due diligence would result in failure of M&A. Quaker Oats had acquired Snapple Beverage Co in 1994 for $1.7 billion. In 1997, the company had to sell Snapple for only $300 million, which was less than 18% of the original purchase price. AT&T bought NCR Corporation for $7.5 billion in 1991. Afterwards, NCR accumulated almost $4 billion in net losses before AT&T spun it off as a separate company. Novell lost almost $700 million on its acquisition and sale of Word Perfect. Some companies pay a higher premium due to lack of knowledge about the target firm.

A major potential due diligence problem occurs on account of top management hubris, known as *managerial hubris*. Overestimation and hype about the target firm may lead the acquirer firm to conduct a less effective due diligence process. Research studies have shown that managerial hubris is the major cause for the high premium paid for acquisitions.

Managerial hubris was one of the reasons for Sony's controversial $5 billion acquisition of Columbia studios. Sony had to pay $800 million to two producers in order to extricate them as they had signed a long-term contract with Warner Brothers. These producers were Peter Guber and Jon Peters. Other battles of CEO egos were evident in the attempted takeover of ITT by Hilton Hotels, and the battle between Viacom and QVC for Paramount. MCI was targeted by three companies, namely British Telecom, GTE and WorldCom. The premiums paid were staggering, as the bids more than doubled over the course of auction.

It is also important to consider factors that are related to organisational, cultural and human barriers in the process of due diligence. Details about the target firm's customers, along with the duration for which products are bought by them from the target firm has to be considered. The cost and revenues for continued operations, or provisions of services, should be forecasted. It is also important to analyse the culture of the organisation.

Union Pacific's acquisition of Southern Pacific is another case where due diligence process was ineffective. Union Pacific had implemented substantial cost cutting actions immediately after its acquisition of Southern Pacific. It laid off thousands of experienced workers and consolidated the rail yards of the two companies. But, shortly thereafter, there was crisis in the company and Union Pacific lost cargo. There was substantial chaos leading to significant delays in the delivery of customer goods. The due diligence process failed to consider the importance of the experienced employees of Southern Pacific.

The role of investment bankers is vital as they can add value by identifying appropriate acquisition targets. The top investment banking institutions providing support for mergers and acquisitions include Merrill Lynch, Morgan Stanley, Goldman Sachs, Salomon Smith Barney and Credit Suisse First Boston.

Due diligence process should help the acquiring firm avoid paying too high a premium or making an inappropriate acquisition.

CHECKLIST FOR DUE DILIGENCE[4]

To gain understanding of a company's past and current standing, the due diligence process should check out corporate details, trade names, service marks and trade registrations. The buyer must establish the jurisdic-

[3]Michael A Hitt, Jeffrey A Harrison, R Duane Ireland, 'Mergers and Acquisitions—A Guide to Creating Value for Stakeholders', Oxford University Press.

[4]Stanley Foster Reed, Alexander Reed Lajoux, The Art of M&A, McGraw-Hill, page 440-458.

tion of the company's incorporation, and document the company's organisation by finding and examining articles of incorporation. The due diligence process should also include intra-company transactions, especially subcontracts and transfer of assets, including cash and credit.

A substantial list of documents should be exchanged early in the negotiations process for review by each party. The list should include documents relating to the organisation's legal structure and incorporation, IRS records, insurance coverages, personnel policies and structure, finance and fund raising, contracts, licences, agreements and affiliations, capital and real estate, marketing materials, programme activities and any current or potential legal liabilities. The exchanged documents can then either be reviewed by each organisation's attorneys and consultants, or, more economically, by the negotiations committee itself.

Resources for Due Diligence

The acquirer typically draws from the sources of expertise available, both in-house and from retained consultants and advisors. The due diligence team includes financial/accounting and legal personnel. It may also bring in economic consultants, engineers, environmental experts and other professional talents.

Asset Appraisal

Appraisal of salable assets used in the business such as machinery, real property or inventories, is mandatory. Such appraisals could help the lenders base the amount of their loans on market value of assets as security. Appraisal of assets, such as unused real property, marketable securities, excess raw material, investment in non-integrated subsidiary operations and reserves is also done, though it is not mandatory.

Cultural Due Diligence

Cultural due diligence basically deals with corporate culture, and attempts to ascertain an organisation fit between the two merging companies. Cultural due diligence attempts to find how far two companies with different cultural components—like corporate policies, rules, compensation plans, leadership styles, communication and work environment—would be able to adapt to the differences. The wider the cultural gap, the greater is the problem of integration. The process of due diligence, in the cultural context, attempts to maximise the value of human resource capital, including retention of existing efficient employees and incentive plans. It is often stated that, intellectual assets are usually worth three to four times the tangible book value of a business on an average across all industries. Studies have found that culture is significantly correlated with achieving financial success. The future of the combined entity depends, to a great extent, on the right mix of tangible skills in the firm. When an acquisition is primarily about getting new skills, techniques and competencies, then staff retention in the target firm is of greater significance. The headcount and the manner in which labour is organised are fundamental drivers of total business operating cost and work efficiency. It would be beneficial to obtain the headcount allocations for each job category and organisation structure. It is vital to obtain staff remuneration data and understand the labour market position. It is also essential to check out redundancy liabilities, including staff transfer obligations, leave obligations, employment agreement entitlements, trade union agreements, health and safety, contractual commitments with HR related suppliers and the target's history on legal action.[5]

[5]Ravindhar Vadapalli, Cultural Due Diligence in Acquiring a Business, Adapted from the Book, 'Future of Work; Mastering Change', Excel Books.

CULTURE ISSUES

The organizational culture, sectoral differences and national cultural differences are determinants for variance in human resource system across organisations. If the compensation differential exists in the acquirer and target company, if may lead to different consequences. The acquisition might raise expectations for employees of the acquired firm if the compensation in the acquired firm is lower than that of the acquirer firm. If on the other hand the compensation level is higher in the acquired firm, then the employees of the acquirer firm may demand equal compensation.

A classical example is the HLL acquisition of TOMCO. The employees of TOMCO had better terms and service conditions prior to merger. The HLL employees argued that if the TOMCO employees are allowed to work on their original terms and conditions, it will lead to segregation of employees into two classes reflecting discriminatory policies.

Similarly problems cropped up during the merger of Glaxo and Wellcome Burroughs in 1996. For seven years the Indian subsidiaries of these two companies couldn't merge due to differences with pay structure. The employees of Wellcome refused the one-time compensation of Rs. 2 lakh in 1998. Hence, the companies are operating as independent subsidiaries since 1997.

Equity in human resource system can be bought out only by rectifying differences in compensation structure and performance appraisal system. Another area of concern is the grading or organisational structures. Issues related to management–union relations, number of trade unions and the dynamics among trade unions also occupy much significance in the due diligence process.

Source: www.imahd.ernet.in/sandeepk/merger.pdf

Accounting Due Diligence

The key issues in accounting due diligence include:

- Differences in Accounting Standards, US GAAP, IFRS, IAS, Indian GAAP, which impact historical and combined financials
- Differences in Accounting Policies, Revenue Recognition, contracts, inventory valuation, bad debt, provisioning, depreciation, etc., —Quantum and Amortisation
- Off balance sheet items and contingent liabilities—recording assets and liabilities post-transaction
- Goodwill Accounting Policy, Fair Value Accounting and Accounting System Integration, control facilitation through financial reporting system.

Intellectual Property (IP) Due Diligence in M&A[6]

Intellectual Property Rights' due diligence is the process of investigating a party's ownership, right to use and right to stop others from using the IP rights involved in the sale or the merger—the nature of transaction and rights being acquired will determine the extent and focus of the due diligence review.

Due diligence should reveal:

1. Who owns the rights?
2. Are the rights valid, transferable and enforceable?
3. Are there any agreements or restrictions that prevent the party from granting rights to others?
4. Is the property registered in the relevant office?
5. Are there any shortcomings or default on payment?
6. Is there any past or potential litigation?

[6]Seth Associates, 2006, IP Due Diligence in Mergers and Acquisitions.

Due diligence should also evaluate agreements material to the company's business that may be affected by change of control, agreements that may vest rights in intangibles and company policies and practices.

Formalities Before the due diligence commences, counsels of both parties must consider important legal issues related to conducting due diligence, such as confidentiality obligation of the target company, and execution of the due diligence should be arranged between the parties. Legal basis for due diligence often starts in the form of Letter of Intent or Memorandum of Understanding, and commonly regulates the due diligence process. Confidentiality agreement between the buyer and the target company is one of the necessities and both should ensure that it is carefully drafted and includes the scheduling, modus operandi and deadlines, with due emphasis on Attorney Client Privilege.

The scope of intellectual property due diligence would be determined by a number of factors, such as party's goals in the transaction—like capital contribution, asset transfer, security of loan or internal assessment of its own—and would be influenced by budgeting, available human resources, the size and complexity of target company and its intellectual property portfolio, among other issues.

The target company has to make a preliminary assessment of the current status of its intellectual property rights and evolve policies to manage prospective investment in intellectual property.

The most significant provisions of the agreement from the IP attorney's perspective include (a) definitions of assets and IP, (b) scope of transfer and (c) representations and warranties.

Crucial Factors for IP Due Diligence The important factors include extent of statutory protection, value of each IPR and the level of risk infringement of third party rights, and infringement by others. With respect to agreement involving the acquisition, it is critical that the seller provides appropriate warranties, such as warranty that it owns full title in the intellectual property, as well as representations regarding controversies, litigations, claims of infringement, title disputes and other such matters.

With respect to technology valuation, it is important to analyse the size and scale of the technology market. It is also important to analyse whether the technology is appropriate for available infrastructure, which includes power, telecommunications and transport.

Independent investigation methods

- Due diligence check at Indian registries of patents, trademark and copyrights designs
- US and foreign patents, trademark and copyrights and filings
- PTO, WIPO websites
- Assignment records and maintenance fee/annuity records for patents
- Commissioned copyright office searches with chain of title information and information on any security interest
- UCC filings; Internet/news database searches.

Challenges of Valuing IP Assets Valuing IP assets is often a difficult task because their true value may not be easily assessed. The full value of an IP asset is probably never recognised in income because much of the asset's value resides in the negative right to prevent others from doing something they would otherwise be permitted to do. The problem of valuing IP asset is further complicated because such value often changes over time. Consequently, a company should periodically reassess the value of its IP assets. The pending patent application is an asset representing a potentially enforceable right that may be conferred to the company in the future. If the company were to be acquired by another company, some value would certainly be attributed to its pending patent applications, as company 'assets', in determining a fair purchase for acquiring the company. A company may possess a vast amount of IP, only some of which is readily identifiable.

DECISION ABOUT ACQUISITION PRICE

Basically, the decision about the acquisition price is based upon the completion of the due diligence exercise. The valuer has to decide how the findings impact the valuation. The actual value of target firm would be known only through this process. It is a vital tool to understand whether the assets are legally held in the name of the company, whether the feedstock supply is guaranteed for long term, are there any major liabilities that could wipe out future profitability or any other contingent liabilities that do not appear in the accounts. If the target company has a presence in several countries, the exercise becomes even more difficult. One needs to rely on local lawyers and tax experts in each of the different geographies to get the flavour of local regulatory and tax issues, and then factor them into the valuation exercise, as well as in the contractual documentation to protect one's interests.

Exploring the Real Value through Due Dilligence

Master acquirers vision goes beyond the financial and legal aspects. They focus on creating real value for the target products by enhancing its capabilities. In this context the business development staff takes the early initiative. They try out the target's products and talk to the customers. On account of the time constraints to run elaborate tests, the team takes the help of some experienced in-house engineers. These engineers try to understand every aspect of the product including its performance. They also visit the candidate's key product developers to ascertain whether the target company has the intellectual capital. Sometimes the candidate doesn't have a fully developed working product, so the engineers check what they have. Whe Bay Networks was looking to buy Rapid City, for example, it needed to make sure that the latter's expertise in high-end gigabit switches was real. Hence, its engineers obtained Rapid City's prototypes and confirmed that they included sophisticated computer coding.

The business development team also try to understand whether the key people would fit into the environment. The business development engineers from both companies would interact to understand the future synergies and the synchronisation of cross-cultural pollination. Cisco seeks prudent, critical people who are not caught in the web of hierarchies. Acquirers also check whether employees at the targeted company have material incentives to stay. Most high-tech companies give their employees stock options.

A sophisticated in-depth due diligence would help to tackle serious problems. During AT&T's acquisition of NCR* in 1991, AT&T executives were struggling for a new growth strategy in the wake of long-distance de-regulation and they believed that telecommunications and desktop technologies were converging. NCR emerged as a star potential on account of its sale of personal computers. AT&T took over NCR in a hostile takeover. But the engineers from AT&T's Bell Labs assessed NCR's technology only after the acquisition. They discovered substantial differences between AT&T's switching abilities and basic PC technology differences that would reduce the synergies expected from the acquisition. NCR's PC group had no real competence in personal computing. Even the cultural similarities proved superficial. NCR's resistance to the purchase reflects that hostile takeovers are difficult to succeed in high-technology sector as key human resources are automatically alienated from the acquirer. NCR operated in a highly centralised fashion, while AT&T was decentralised. After suffering heavy losses, AT&T spun off NCR in 1996.

In contrast Advanced Micro Devices (AMD) had a systematic due diligence at NexGen before acquiring it in 1996. AMD's internal technical staff assessed NexGen's technological competence and design concept. They were impressed by the gifted engineering team and its promising new methodology for chip design, for making successive product generations. AMD also ascertained that the developed chip concept could be supported by its existing marketing capabilities. Finally, AMD found that the company shared an engineering team dominated environment with a relatively open culture that encouraged interaction. NexGen avidly shared AMD's vision of beating intel. Nex Gen was a young company which had cash flow related problems and its people welcomed the change process. The acquisition resulted in a smooth integration process and led to the successful redesign and launch of the K6 microprocessor. AMD became a strong competitor for intel.

Adapted from: Saikat Chaudhuri and Behnam Tabrizi, "Capturing the Real Value in High Tech Acquisitions", *Harvard Business Review*, September–October 1999, page 127–128.

*NCR corporation is a technology company specialising in products for retail, financial, travel, healthcare, food service, entertainment, gaming and public sector industries.

DUE DILIGENCE IN INDIA

Any M&A in India has to be carefully planned and executed, cutting through a wide spectrum of tax and regulatory issues, such as exchange control, income tax, capital market regulations, etc. From the tax perspective, it would be important to structure these transactions into the company in a tax efficient manner, taking into account the manner of funding, and choice of the holding company jurisdiction.

Outbound acquisitions are guided not only by the tax laws of foreign countries but also by political relationships, free trade agreements (FTAs) and double taxation avoidance agreements (DTAAs or tax treaties) between these countries. Deal structuring from tax perspective has become one of the most important factors for structuring transactions in recent times, such that the transaction is tax neutral, or has minimum tax outflow. Tax, legal and financial due diligence of the target company is of utmost importance. Very few geographies have similar legal systems.

According to RBI regulations, companies cannot bid for overseas acquisition under the automatic route, if the total funds required for the acquisition exceed 200 per cent of the Indian company's net worth. Several other aspects which need to be looked at to determine if the proposed acquisition falls within the 200 per cent limit.

Also, according to the Indian Companies Act, if the acquisition value exceeds 60 per cent of the Indian company's net worth or 100 per cent of its free reserves, then the Indian company is required to take prior approval from its shareholders for making the investment in the target company. It means disclosing vital details about the target company to the shareholders, including the price being paid. This results in certain sensitive and confidential information, which could be of critical importance to competing bidders, becoming available in public domain even prior to submitting a bid to the target company. Dr. J J Irani Committee, constituted for suggesting reforms in the Indian Companies Act, has submitted a report to the government in which it has specifically recommended that when Indian companies participate in international competitive bidding, they should not be required to disclose such sensitive information, as it puts them in a disadvantaged position vis-à-vis their competitors.

The business and legal environment in India differs from the environment overseas. Each country has its own set of issues, regulatory framework in terms of legal and judicial system, tax regime, social and cultural issues and business dynamics. There are very few geographies that have similar legal systems.

Legal due diligence covers contractual documentation, litigation, ownership of movable, fixed and intangible assets, like IPR, etc. It also looks at any contracts on which there could be onerous covenants, or which may become infructuous by reason of change in control of the target following the acquisition. All these aspects could significantly impact the valuation of the target company.

The due diligence (DD) report aims at factoring all critical issues which impact the decision on valuation of the target. The DD report becomes the basis for negotiating and providing, in the transaction documentation, comprehensive representations and warranties—where the target company or its promoters provide indemnity for their representations and warranties. Secondly, issues that cannot be immediately resolved before closing the deal are put under *Conditions Subsequent* (CS)—certain percentage of the purchase consideration is held back in an escrow account and released only when those conditions are met by the target company or its promoters.

The factors that are crucial in domestic M&As become critical in international acquisitions. For example, violation of environmental laws may not be taken very seriously in some states in India, while in the west, there are penalties, including closure of a production facility for even minor environmental infractions. This necessitates a comprehensive environmental due diligence exercise that has to be adhered to in an international acquisition, more so, if the company is in the business of manufacturing chemicals.

Tata Chemicals undertook a systematic due diligence process when it acquired one-third equity stake in IMACID, a state owned company in Morocco. Tata Chemicals had a clear-cut objective of securing a long-term assured supply of phosphoric acid for their Haldia facility. With this objective in mind, the company had prepared a checklist. Tata Chemicals did not know much about the complex legal system of Morocco which was based on the French legal system (Napoleonic Code) with a strong Islamic influence. A team of specialists with complementary skills was appointed for due diligence, which included legal advisors, to understand the complexities of the Moroccan legal system.

During the due diligence of Hutchison Essar Ltd, a team of 20 top executives of Vodafone carried out the process. Vodafone had appointed the accounting firm—Ernst and Young, and Delhi based legal firm, Trilegal, for assistance in the due diligence process.

Obstacles in the Due Diligence Process

Issues in the due diligence process in the Indian context include:[7]

1. Lack of Adequate Information Comprehensive information required for the due diligence process is not readily available with the Indian companies due to lack of detailed management information system. For example, detailed schedule of margins by product and by customer may not be easy to come by with these companies. The forecasting methodologies of such small and medium sized Indian companies are not very robust, often leading to simplistic projections. The forecasts tend to be aggressive, without a track record to boot.

2. Quality of Information The quality of financial statements, financial infrastructure and business processes are generally lower and less explicit than what western investors are accustomed to. This results in the need to explore more risk areas and take more time for the due diligence process.

3. Insufficient Disclosure Inadequate disclosures impede the ability to access critical information that might alter the investor's perception with regard to the value of the company, environment issues and aggressive tax positions, among others.

4. Lack of Corporate Governance Companies are slowly realising the importance of corporate governance and some of the leading organisations are benchmarking to global standards. Some others are moving towards improvement. Weak corporate governance is often supplemented with tardy legal system where dispute resolution takes longer.

[7]E&Y Report, 'Doing successful transactions in India', Virtus Global Partners, www.virtus global.com

5. Dilution of Conrol It is often observed that founding members of a start-up company would refuse to give up control and settle for a minority ownership stake (a common condition for many start-ups in exchange for Private Equity funding).

Challenges to Due Diligence in the Indian Market

The notion of preferred shares is not acceptable under Indian law. However, many law firms have agreed upon the OCCPS (Optionally Convertible Cumulative Preference Shares) as a structure that provides an investor with many of the benefits of preferred shares, while adhering to Indian law.

Exit Limitations In the Indian stock market, it is relatively easy for a company to go public but it is difficult to get analyst coverage and remain a valid public company with significant trading volume. One advantage is the ability to create an ADR (American Depository Receipt), an instrument that can be easily traded on the US stock exchange.

Currency Hedging An additional level of complexity when making direct investments in India, that is not encountered in US based deals, is the fluctuation of the Indian Rupee. Most VC investors are not used to, nor have extensive knowledge of and experience in, currency hedging and protection.

Accounting As in any non-GAAP based economy, it is hard to make an investment without deep understanding of the local accounting standards. However, one advantage of the Indian market is that many management team members have worked in the US, or for US companies, and hence, have a good understanding of GAAP accounting rules.

Table 5.1 *Comparison of Due Diligence in India and Western Countries*

	Western Countries	India	
		Large companies with prior M&A experience	Others
1. Transparency in Financial Information	High	Medium	Low in medium
2. Normal Duration of Due Diligence	1-8 Weeks	1-8 Weeks	3-12 Weeks
3. Assistance Required by Target Company to Prepare for Due Diligence	Minimal	Minimal	Generally Require Assistance
4. Basis of Financial Information	US GAAP and IFRS	Generally Indian GAAP (Some companies follow US GAAP or IFRS)	Indian GAAP
5. Audited Financial Information	By Reputable Standards	By Reputable Standards	May Not be Very Reliable
6. Extent of Related Party Transaction	Varies: Typically Fully Disclosed	Usually Extensive: Fully Disclosed	Usually Extensive: May Not be Fully Disclosed
7. Disclosure of Contingent Liabilities	Usually Transparent	Generally Adequate Disclosures	Inadequate Disclosures

(*Contd*)

(*Contd*)

8. Reliance on Computerized Systems	Typical	Typical	Evolving Dependence on Manual Process
9. Reliability on Representations and Warranties	Normally Reliable	Untested	Untested
10. Enforceability of Indemnification	Strongly Backed by Courts	Untested: May Need to Consider 'Holdbacks' or 'Escrows'	Untested: May Need to Consider 'Holdbacks' or 'Escrows'

Source: Virtus Global Partners

DUE DILIGENCE IN THE AGE OF TECHNOLOGY

In this modern era, M&A deals involve a lot of research about the target company and the country. Internet technologies have made the process easy. Thus, even before the legal due diligence, acquirer companies are familiar with the country's legal/tax environment, economic system and other issues. Nowadays, target companies prefer international competitive bidding. The bidding process is dictated either by the target company or its promoters. The company fixes a date and time for conducting the due diligence and keeps the data ready in a data room. Most importantly, one needs interpreters in the data room as the documents may not always be in English. With technology advancements and the increasing number of cross-border deals, targets have been making documents available to potential bidders through a 'virtual data room'. Using this password protected internet link, one can conduct an online due diligence sitting on one's desk.[8]

SUMMARY

Due diligence, with reference to M&As, is the process of examining all aspects of a company, including manufacturing, financial, legal, tax, IT systems, labour issues, regulatory issues, as well as understanding issues related to IPR, the environment and other factors. It is done to investigate and evaluate a potential acquisition. The basic aim of due diligence is to assess the benefits and liabilities of a proposed acquisition by exploring the status of the business, particularly the future of the business along the framework of risk. It is also important to consider factors related to organizational, cultural and human barriers in the process of due diligence. Cultural due diligence basically deals with corporate culture and attempts to ascertain an organization fit between two merging companies. Cultural due diligence attempts to find about how far two companies with different cultural components, like corporate policies, rules, compensation plans, leadership styles, communication and work environment, would be able to adapt to the differences. The key issues in accounting due diligence include differences in Accounting Standards, difference in Accounting Policies, Revenue Recognition, Contracts, Inventory Valuation, Bad Debt, provisioning, depreciation. Intellectual Property Rights due diligence is the process of investigating a party's ownership, right to use and right to stop others from using the IP rights involved in sale or merger.

[8]www.tata.com/company/Articles

DISCUSSION QUESTIONS

1. Discuss the significance of cultural due diligence.
2. What are the key issues in accounting due diligence?
3. Explain IP due diligence.
4. What are the challenges of the due diligence process in India?

ADDITIONAL REFERENCES

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6 Negotiation, Deal Structuring and Methods of Payment in Mergers and Acquisitions

Chapter Objectives

The aim is to make the reader understand:

- The negotiation variables and structuring of transactions
- The status of deal making in India
- The different modes of payment in M&A
- The implications of research studies involving methods of payment in M&A

INTRODUCTION

The commercial terms of a deal, specifically the price or sale value for a given transaction, are perhaps the most involved and important aspects of the deal. It is natural that the seller would want the highest possible price for the business, just as the buyer would want to pay the lowest possible price. From a conceptual viewpoint, a business which comprises sets of assets and associated intangibles can yield different economic returns to different people. This would again depend on how the business is managed. A successful dealmaker ensures that he does not stick to the initial position. Two parties may be heatedly defending their initial values (indicated earlier) for a business, yet their interest (risk adjusted price) could be more compatible than their positions. Typical negotiating variables are (initial) sale consideration, deferred/annual payments–depending on performance (such as royalty), management compensation, selling/purchase price of the products, committed dividends, sharing of transaction costs, etc. It is important to have a comprehensive financial model that captures all negotiating variables and gives net result of their various combinations.

STRUCTURING OF TRANSACTIONS[1]

The objective of structuring a transaction is to optimise or maximise achievement of concerned stakeholders. Some of the factors that determine the importance of structuring are:

(a) Satisfying interest of each party. The target wants maximum price for the deal and the acquirer focuses on risk minimisation.
(b) Government policy and regulations. Sectoral caps on foreign investment, takeover code.
(c) Transaction costs, such as income tax, sales tax, stamp duty, etc.

[1]Ragunath TV, Master Speak, Dynamics in M&A Putting Concepts to Practice, The Money Manager, Vol 3, Page 13-15.

(d) Capital Structure, financing needs, etc.
(e) Business consideration aspects.

The most important variables that have to be dealt with in M&A include:

- **Mode of transaction**: The examples could be sale of a business as a going concern, sale of shares of the company, etc. Depending on the mode, the sale consideration and attendant tax implications could vary.
- **Transaction Vehicle**: Transaction vehicles include a holding company, a special purpose vehicle, a subsidiary, etc.
- **Consideration**: This is typically influenced by the differing risk perceptions of the buyer and the seller. The buyer takes time to analyse the business performance and, in such cases, the payment takes the form of 'deferred payment structure'. The deferred payment structure is preferred because it helps in minimising risk as the buyer takes all risk of future business performance.
- **Management Issues**: The importance of human aspects is also significant in the deal making process.

Deal making is no longer confined to relationships. In this modern era, clients like to know what value addition a deal maker brings to the deal. A deal maker, who is able to offer top quality integrated global solutions, will be more successful and in better position to complete the deal. While individuals clearly play an important role, one should not underestimate the importance of teams and institutions in both winning and executing complex and cross border matches.

One of the most crucial aspects in any overseas acquisition is the structuring of the deal and the vehicle used for funding. This is generally dictated by *Double Taxation Avoidance Treaties* (DTAs) between various countries. For example, India has a very favourable tax treaty with Mauritius and hence, major inbound investments in India are routed through special purpose legal entities set-up in Mauritius.

REGULATORY APPROVAL

Every cross border M&A transaction requires regulatory approvals, not only in India but also in the country where the target company is located. In India, post 1991, monopoly legislation was scrapped when the entire Chapter 3 of the MRTP Act was abolished. In the US, or in EU (European Union), anti-trust laws are very stringent. One requires approval from the Federal Trade Commission or the Department of Justice for any acquisition in the US, and from the European Commission (EC) for any target in EU. In most jurisdictions where the target company has business presence, pre-merger notification is required. These anti-trust aspects were complied with when VSNL acquired assets of Tyco Global Network in the US. Employees' immigration and visa issues need special attention if the acquisition pertains to the IT sector in the US. In Europe, EC examines in great detail whether the acquisition would lead to distortion in market competition. Sometimes, proposals are cleared only if the acquiring company agrees to divest some of its businesses. UK has a very interesting law, 'TUPE' — Transfer of Undertaking and Protection of Employees Act—which dictates how employees are to be protected when the ownership of a company changes.

DEAL MAKING IN INDIA

In the regulated era each industrial house had its own house broker. Later Monopolies & Restrictive Trade Practices Act (MRTP) acted as a big hindrance for M&A transactions. The Reserve Bank of India also placed restrictions on lending for acquisitions and, hence, most of deals were executed and financed overseas. But, in 1973, the momentum picked up when foreign companies were asked to dilute their stakes in companies on enactment of FERA.

Till 1995, the M&A scene in India was dominated by the auditing/consulting firm-Arthur Andersen, Coopers & Lyrabrand and A F Ferguson.

In the early 1990s, the only known deal makers were Hemendra Kothari of DSP Financial or Nimesh Kampani of JM Financial. In the late 1990s, Kotak Securities came into the picture. The scenario has changed over the last few years. More than two dozen investment firms, domestic and overseas, are active in the M&A market in India. Some of the most active players include DSP Merrill Lynch, Kotak Mahindra Capital Company, J M Financial, HSBC Capital Market, Enam Financial Consultants, SBI Capital Markets and Infrastructure and Leasing Financial Services.

The enterprise value of the deals have increased manifold over the last two decades. Previously, the total enterprise value of the target company and the acquirer would often be less than Rs 1 billion, but, today, due to increase in enterprise value, a deal size of less than $50 million rarely gets noticed in the financial newspapers. The investment banks have full-fledged research teams and highly paid experts in company law, regulation and equity markets to guide them.

It is said that pure investment banks, like DSP Merrill Lynch and JM Morgan, would not touch deals that are less than Rs 100 crore. The only exceptions are the InfoTech deals or those that are necessary for maintaining relationships.

Global firms like Merrill and Morgan Stanley bought out their Indian partners in a bid to go solo, while Goldman Sachs' stake in the joint venture was bought by Kotak Mahindra, thus enabling Goldman Sachs to tread out its individual path.

Tatas' bid on Corus involved ABN, Credit Suisse and Deutsche Bank, besides NM Rothschild, as consultants. Hindalco's bid on Novelis was supported by UBS. Lazard was the consultant for the $1.2 billion Tata Chemical's takeover of the UK based Bruner Monde, one of the largest soda ash manufacturing companies with multi-country production facilities. UBS India advised on UB Group's takeover of Whyte and Mackay. Yes Bank was responsible for securing the mandate for Suzlon in its acquisition of Hansen, which was taken over for $565 million. A deal maker who has the backing of a global network and size can inspire clients into giving him the mandate. Firms having overseas branches can facilitate deal making more efficiently compared to firms with specific deal tie-ups as the former will be able to access more easily data and details about the client. DSP Merrill Lynch was the adviser for the sale of 49% stake in Orissa Power to AES Transpower for Rs 603 crore, and for Rs 780 crore demerger of Indian Rayon's cement business. ANZ advised Industrial Oxygen when it sold out to Air Products of US for Rs 430 crore. Bank of America advised Wipro when it spun off its Internet service provider into a subsidiary. Jardine Fleming advised Videocon Power when it sold its 36% stake to National Power of the UK for Rs 645 crore.

Many industrial groups have set up their in-house M&A divisions. Some of the most active groups involved in multi-billion dollar mega deals—the Tatas, the AV Birla Group and Mahindra & Mahindra—have their own divisions. These business groups have identified growth through acquisitions as an integral part of their strategy. An in-house M&A division is advantageous as the investment bankers on the sale side can contact them directly.

In 2008, as an investment/target destination, India was the only Asian market, apart from Japan, to have witnessed a fall in the M&A space. China, Hong Kong and the South-East Asian countries have all witnessed an increase in deals; both in value and volume.

Deals in the Indian market fell by 38% in value in the first half of 2008 as compared to 2007, whereas China witnessed an increase of about 70% in deal value. This could be attributed to widespread rupee fluctuation and slowdown in developed markets, which seem to have hit the outsourcing boom.

Real estate and infrastructure management sector saw private equity (PE) deals of more than $2 billion in the first half of 2008, nearly 3% higher than during the same period in 2007, even as the average deal size fell by over 9%, reflecting the sluggishness in valuations.

Table 6.1 *Deal Makers: Statistics*

Financial Advisors	2007 Proceeds (US$ million)	Rank	Number of Issues	2006 Proceeds Raised (US $ million)	Rank	Number of Issues
UBS	28297.9	1	11	2140.1	11	5
Goldman Sachs & Co	19138.5	2	9	675.8	19	5
Morgan Stanley	12921.0	3	6	15201.6	7	10
Citi	9578.3	4	12	3460.3	10	13
Standard Chartered PLC	7727.9	5	10	832.6	16	6
Evercore Partners	5766.7	6	1	NA	NA	NA
Merrill Lynch	4342.2	7	9	5726.8	9	12
Ernst &Young LLP	4129.0	8	45	1816.6	12	48
ABN AMRO Bank	3354.4	9	5	17461.9	3	7
Deutsche Bank AG	3065.3	10	6	16579.6	4	2
Credit Suisse	2549.5	11	13	16,394.6	6	1
Pricewaterhouse Coopers	1874.5	12	40	812.8	17	21
Genuity Capital Markets	1467	13	1	169.9	29	1
Macquarie Bank	1300	14	2	NA	NA	NA
ICICI Bank Ltd	1185.1	15	3		56	2
JP Morgan	1031.1	16	4	18836.1	1	6
Lazard	744.1	17	6	2131.6	27	5
Rothschild	729.7	18	7	17882.5	2	12
Lehman Brothers	645	19	4	NA	NA	NA
IMAP	606.4	20	3	10	52	2
HSBC Holdings PLC	568.0	21	11	16,435.5	5	3
Network Corporate Finance	552.8	22	1	NA	NA	NA
Nomura	460.3	23	3			

(*Contd*)

(*Contd*)

Global Trust Capital Finance	454.9	24	2	43.4	43	1
Greenhill & Co LLC	441.2	25	1	NA	NA	NA
Blackstone Group LP	441.2	25	1	NA	NA	NA
Deloitte & Touche	53.7	46	1	8657.2	8	5
Banc of America Securities LLC	165.4	36	1	1452.9	13	3
First Securities ASA	NA	NA	NA	1104.4	14	2
ENAM Financial Consultants	NA	NA	NA	1013.6	15	2
Rabobank				751.5	18	5
Enskilda	116.8	41	1	657.6	20	1
Sal Oppenheim				571.4	21	1
Bear Stearns & Co Inc	122.5	40	1	571.4	21	1
Dresdner Kleinwort	NA	NA	NA	566.9	23	1
Indusind Bank Ltd	NA	NA	NA	450	24	1
KPMG Corporate Finance	277.7	31	10	411.2	25	15

Source: Thomson Financial, Business Standard, February 2008, Page 47.

METHODS OF PAYMENT IN M&A

Cash Deal In a cash deal, the payment is by cash. Such transactions are usually termed as acquisitions rather than mergers because the target firm comes under control of the acquirer's shareholders as its own shareholders are removed. Using cash for acquisition tends to lessen chances of EPS dilution for the acquiring company. The disadvantage is that it places the constraints on the cash flows of the acquirer. In a cash deal, the roles of the two parties are clear-cut and the exchange of money for shares completes simple transfer of ownership.

Exchange of Shares The acquirer's stock may be offered as a consideration. Acquisitions financed through debt are known as *leveraged buyout*. In exchange of shares, the distinction between a buyer and a seller is at times blurred because in some cases, the shareholders of the acquired company end up owning most of the acquirer company. A share exchange, in contrast to a loan, stock or leveraged acquisition, can lead to decline in the EPS of the acquirer in the year of acquisition.

Hybrid An acquisition can involve a combination of cash and debt, or a combination of cash and stock of the purchasing entity.

In the US, in 1988, nearly 60% of the value of large deals—those over $100 million—was paid for entirely in cash. Less than 2% was paid for in stock. But ten years later, the profile was almost reversed. About 50% of the value of all large deals was paid for entirely in stock and only 17% was paid in cash. Many of the mega deals of the 1990s—Vodafone's acquisition of Mannesmann, WorldCom's acquisition of MCI, AOL Time Warner and Dailmer Benz merger with Chrysler—were financed with equity. The high valuation of the acquirer's stock and the huge cost of raising cash to finance the acquisitions made stock exchange offers quite attractive in these cases.

In UK, cash has been the most important acquisition currency, followed by share exchange, and then debt or hybrid currencies.

Factors Affecting Choice of Payment

Many factors may influence the choice of payment method. When companies consider making or accepting an offer for exchange of shares, the valuation of the company is one of the factors that managers need to consider. Stock offers could send the signal that the acquirer's shares are overvalued. In principle, therefore, a company that is confident about integrating an acquisition successfully and believes that its shares are undervalued has to proceed with cash offers. Acquirers generally offer shares in exchange if their shares are overvalued.

The factors that may influence choice of payment method include accounting, tax and financial strategy considerations.

When the bidder has an already high gearing ratio, issue of loan stock to pay for the acquisition is less attractive than a share exchange offer. Moreover, the operating cash flows of the combined entity and its cash flow or earnings cover for debt interest must be sufficient and sustainable.[2]

DISTINCTION BETWEEN STOCK AND CASH TRANSACTIONS

In cash transactions, the acquiring shareholders take on the entire risk of the expected synergy value embedded in the acquisition premium not materialising. In stock transactions, that risk is shared with selling shareholders. More precisely, in stock transactions, the synergy risk is shared in proportion to the percentage of the combined company the acquiring and selling shareholders own. The expected net gain from an acquisition to the acquirer is the *shareholder value added* (SVA), which is the difference between estimated value of synergies obtained through the acquisition and the acquisition premium.[3]

In general, two types of risk are faced during an acquisition—fall in share prices of the acquiring company from the times of announcement of the deal to its closing, and the possibility of synergies not being realised after the deal is closed. In a cash deal, the acquiring company assumes the risk completely. In stock deals, the risk is shared between two entities.

TYPES OF EXCHANGE OF SHARES

There are two ways to structure an offer for exchange of shares and the choice of one approach or the other has significant impact on the allocation of risk between the two sets of shareholders. Companies can either issue a fixed number of shares or they can issue a fixed value of shares.

Fixed Shares In this offer, the number of shares to be issued is fixed, but the value of the deal may fluctuate between the announcement of the offer and the closing date, depending on the acquirer's share price. Both the acquiring and selling shareholders are affected by the fluctuations. However, the fluctuations in the acquirer's share price will not affect the proportional ownership of the two sets of shareholders in the combined company. Therefore, the interests of the shareholders in the deal's shareholder value added do not change, even though the actual shareholder value may vary.

In a fixed share deal, shareholders in the acquired company are particularly vulnerable to fall in the price of the acquiring company's stock because they have to bear a portion of the price risk from the time the deal is announced.[4]

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[2]Sudi Sudarsanam, 'Paying for the Acquisition', Creating Value from Mergers and Acquisitions, Page 385.
[3]Alfred Rappaport and Mark L Sirower, Stock or Cash?, Harvard Business Review, November-December 1999, Page 147-158.
[4]Alfred Rappaport and Mark L Sirower, Stock or Cash? , Harvard Business Review, November-December 1999, Page 147-158.

Fixed Value In this offer, the acquirer issues a fixed value of shares. In this deal, the number of shares issued is not fixed until the closing date, and depends on the prevailing price.

Boot Strapping The phenomena whereby shareholder value increases by the application of the bidder's higher bid to the target's earnings is known as boot strapping. In other words, a high PE (Price Earnings ratio) firm buys a low PE firm resulting in a higher EPS for the merged firm.

Research Studies involving Methods of Payment

In studies covering more than 1200 major deals, researchers have consistently found that, at the time of announcement, shareholders of acquiring companies fare worse in stock transactions than in cash transactions. If the acquirer believes in undervaluing its shares, then it should not issue new shares to finance a transaction because that would affect the current shareholders. Research consistently shows that the market takes the issuance of stock by a company as a sign that the company's managers—who are in a better position to know about its long-term prospects-believe the stock is overvalued.

Myers and Majluf (1984) have found that differential stock returns of bidders in mergers and tender offers may be due to the method of acquisition financing. The Myers and Majluf model suggests that the managers will prefer cash offer if they believe that their firm is undervalued, while a common exchange offer will be preferred in the opposite case. Similar suggestions were made by Angelo, De Angelo et al. (1984). Accordingly, the market participants interpret a cash offer as good news and a common stock exchange offer as bad news about the bidding firm's true value. If such information effects are important, the bidding firm's stock price change at the proposal's announcement will reflect both the gain from the takeover (weighted by the probability that the takeover bid will go through) and the information effects.

Cash offers and exchange offers have different tax implications. Cash offers generate tax obligations for the target firm's stockholders but allow the acquiring firm to raise the depreciation basis of acquired assets to their market value. Common stock exchange offers are, in general, tax free acquisitions as any capital gains realised by the target firm's stockholders are deferred until the stock is sold, but the depreciation basis of acquired assets remain the same.[5]

The study by Travlos (1987) provides direct confirmation of a differential return relationship across different methods of payment for bidding firms announcing takeover bids. The results on pure stock exchange bidding firms show that their stockholders experience significant losses at the announcement of the takeover proposal. On the other hand, the results on the cash financing bidding firms show that their stockholders earn 'normal' rates of return at the announcement period. Their findings are consistent with the signalling hypothesis which implies that financing a takeover through exchange of common stock conveys negative information that the bidding firm is overvalued.

Willard (1983) argues that cash takeovers and security exchange mergers may well be motivated by different considerations. The study further finds that lower dividend payout ratios and lower market to book ratios increase the probability of being acquired in a cash takeover relative to being acquired via an exchange of securities, even though neither variable can be shown to be an important explanatory factor for the simple categorisation of firms into those that have been acquired and those that have not been acquired.

In the western context, a number of reasons have been suggested for increased use of cash as a means of financing mergers. In the 1960s, many mergers were consummated with convertible bonds. The interest payments on such convertibles were tax deductible. Since 1969, however, interest payments on convertible debt, expressly issued for acquisitions, have not been allowed as tax deductible expenses, thus reducing their

[5]Travlos N G , Corporate Takeover bids, Methods of payment and Bidding Firms Stock Returns, The Journal of Finance , Vol XLII, No. 4, September 1987, page 943-963.

desirability as means of financing takeovers. Other possible explanations for increased use of cash rest on market imperfections and/or agency considerations. Another factor that may contribute to increased use of cash is the increase in the number of hostile takeovers. It is said that in an efficient market, it can be argued that cash is a more effective bargaining tool in the face of resistance by incumbent management when there is public controversy about the business merits of the combination.[6]

Amihud tested the proposition that corporate control considerations motivate the means of investment financing-cash (and debt) or stock. The results suggest that corporate insiders who value control will prefer financing investments by cash or debt rather than by issuing new shares, which dilutes their holding and increases the risk of losing control. The empirical results also suggest that in corporate acquisitions, larger the managerial ownership fraction of the acquiring firm, more likely is the use of cash financing. The negative abnormal returns associated with stock financing are mainly in acquisitions made by firms with low managerial ownership. A cash acquisition creates an immediate liability for capital gains tax for the target company shareholders, while an exchange of shares (equity financing) defers any payments until new shares are sold. This difference leads to a prediction of general use of stock financing for corporate acquisitions, or at least in cases where the bid premia are large (i.e., the expected capital gains to target shareholders are substantial).

DeAngelo et al. (1980) have shown that the means of financing is not relevant if firms have different expected marginal effective tax rates due to differences in fixed charges.

Hansen (1987) argues that, if target shareholders are better informed than outsiders about the value of their firm prior to the acquisition (the true valuation being revealed after the acquisition), equity offers will be preferred to cash when target equity is believed to be undervalued. Fishman (1989) argues that, when the fixed costs of collecting information about the target are high, cash financing is more likely than stock financing as a means to signal high valuation in order to deter competing offers for the target firm.

SUMMARY

Typical negotiating variables are (initial) sale consideration, deferred/annual payments depending on performance (such as royalty), management compensation, selling/purchase price of products, committed dividends, sharing of transaction costs, etc. The most important variables one has to deal with in M&A include mode of transaction, transaction vehicle, consideration and management issues.

In a cash deal, the payment is by cash. Such transactions are usually termed acquisitions rather than mergers because the target comes under the control of the bidder's shareholders as the shareholders of the target company are removed. In exchange of shares, the acquirer's stock may be offered as a consideration. An acquisition can involve a combination of cash and debt or a combination of cash and stock of the purchasing entity. When companies consider making or accepting an offer for an exchange of shares, the valuation of the company is one of the factors that managers need to consider. Stock offers could send the signal that the acquirer's shares are overvalued. In cash transactions, acquiring shareholders take on the entire risk that the expected synergy value embedded in the acquisition premium will not materialize. In stock transactions, that risk is shared with selling shareholders. Researchers have consistently found that, at the time of announcement, shareholders of acquiring companies fare worse in stock transactions than they do in cash transactions.

[6]Willard T Carleton, David K Guilkey, Robert S Harris, John F Stewart, 'An Empirical Analysis of the Role of the Medium of Exchange in Mergers', The Journal of Finance, Vol XXXVIII, No. 3, June 1983.

DISCUSSION QUESTIONS

1. What are the important variables involved in M&A deal making?
2. What is the status of deal making in India?
3. What are the factors affecting the choice of payment in M&A?
4. Distinguish between stock and cash transactions?
5. What are the significant results of research studies involving methods of payment?

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7 Mergers and Acquisitions: Valuation

Chapter Objectives

The aim is to make the reader understand:

- The significance of valuation
- The different approaches to valuation

INTRODUCTION

In this modern world of knowledge economy, a significant part of a country's output is intangible, and that part is growing at exponential rates.[1] Today's economic world is based on the foundation of new technologies, globalisation and increased importance of intangible assets.

Alan Greenspan, Former Federal Reserve Chairman, said, "Virtually unimaginable a half century ago was the extent to which concepts and ideas would substitute for physical resources and human brawn in the production of goods and services".

We are living in the world of knowledge Economy. Organisations are creating value in totally new ways, using assets and their combinations. Every new member on the Forbes list of 400 wealthiest individuals in 1999 built his/her fortune on technology. The case of an upstart Internet company, America Online Inc, acquiring Time Warner Inc's media empire is a classical example. In early 2000, Microsoft achieved market value exceeding the combined value of eight US giants—Boeing, Caterpillar, Ford, General Motors, Kellogg, Eastman Kodak Company, JP Morgan &Company and Sears Roebuck—built mostly on intangibles.[2]

Value creation is future value captured in the form of increased market capitalisation. In other words, it deals with the manner in which successful businesses are creating value in the New Economy. *Value realisation* is the value captured in the form of past and current earnings or cash flows.

Four realities of the new economy are:[3]

1. *Emergence of new business models:* In the new economy, the intangible assets, such as relationships, knowledge, people, brands and systems, are centre stage. Companies like Microsoft Corporation and Amazon.com are combining both old and new economy assets.

[1]Richard E S Boulton, Barry D Libert and Steve M Samek, 'Cracking the Value Code ', Harper Business, Harper Collin Publishers, ISBN 0-06-662063-5, Page 25.
[2]Richard E S Boulton, Barry D Libert and Steve M Samek, 'Cracking the Value Code', Harper Business, Harper Collin Publishers, ISBN 0-06-662063-5, Page 26.
[3]Richard E S Boulton, Barry D Libert and Steve M Samek, 'Cracking the Value Code', Harper Business, Harper Collin Publishers, ISBN 0-06-662063-5, Page 29.

2. *New business models create risks*: Companies are increasingly employing unique business models which push the boundaries of traditional controls. New economy is producing a whole set of different risks–from new transactions and new markets to new technologies, new competitors and new relationships.
3. *New processes and tools are needed to succeed*: Businesses need new processes for setting strategy, operating, managing risk and using information in decision-making.
4. *Transparency of information is vital to value creation*: The model of the future is transparent and user driven, and allows stakeholders to readily access information as and when they require.

The greatest challenge that companies face today is identification of the combination of assets–tangible and intangible–that creates greatest amount of economic value. It is the complex interaction of a company's mix of assets, termed economic DNA, which creates or destroys value. AOL was an upstart Internet company in 1993 with just 124 employees. It had a net income of $4.3 million from annual revenues of $31.6 million. By 2000, AOL had grown into world's premier online server with market value of $169.6 billion. In 1999, out of the revenue of $5.7 billion, it made a profit of $1 billion. Time Warner Inc had a market cap of $93 billion on January 1, 2000. Revenues at the end of the third quarter of 1999 were $23.5 billion, with net income at $1.2 billion. Richard et al. points out that if an investment of $1000 was made in AOL at the opening of trading in January 1993, it would have grown to $332,057 by the end of 1999. Meanwhile, the same amount invested at the same time in Time Warner with almost 500 times the sales of AOL and 24 times its net income–would be worth $4,944 in 1999. AOL was destined to be the dominant partner in the huge new company. AOL's book value was a miniscule 3.3% of its market capitalisation. In other words, nearly 97% of AOL's value was not to be found on the balance sheet.

In early 2000, the Coca Cola Company's book value was at 7.9% of its total market value, while PepsiCo, Inc was at 15.5%. Intangible assets play an increasing role in creating value for companies. Between 1978 and 1998, the non-book value of all companies rose from 5% to 72% of their market value. Cisco's stock price grew 124,825% in the last decade.

UNDERSTANDING THE DRIVERS OF VALUE[4]

A value driver is a performance variable that has impact on the results of a business, such as production effectiveness or customer satisfaction. The metrics associated with value drivers are called *key performance indicators* (KPIs). Copeland[5] states that the principles that are central to defining value drivers are:

1. Value drivers should be directly linked to shareholder value creation, and they should go down the organisation. This perspective of value drivers ought to align the objectives of all levels of the organisation to a single objective.
2. Value drivers should be targeted and measured by both financial and operational KPIs. Companies frequently undertake value driver analysis by breaking down return on investment into its component financial measures. Focusing on operation details allows managers to analyse concrete improvement actions which, in turn, allow them to improve the financial indicators. In order to increase the earnings before income and tax (EBIT) margin, a retailer can break it down into its components–gross margin, warehouse costs, delivery costs and other selling and administrative costs. It can be further analysed in terms of trips per transaction, the cost per trip and the number of transactions.

[4]Tom Copeland, Tim Koller, Jack Murrin,Mckinsey Company 'Valuation: Measuring and Managing the Value of Companies', John Wiley & Sons Inc, 2000.

[5]Tom Copeland, Tim Koller, Jack Murrin, Mckinsey Company, 'Valuation: Measuring and Managing the Value of Companies,' John Wiley & Sons Inc, 2000.

3. Value drivers should cover long term growth as well as operating performance. Successful companies must find ways to grow. The value driver analysis should highlight drivers to grow at a return above the cost of capital, as well as drivers to improve today's return on invested capital.

Tom Copeland et al. (2000) identify three phases in the process of value driver creation:

1. **Identification**: The first task is creating value trees that systematically link operating elements of the business to value creation. The managers must be aware of the process and their involvement is necessary in identifying the value creators.
2. **Prioritisation**: This step involves understanding which drivers have the greatest impact on value creation. The first part of prioritisation is building a discounted cash flow model for testing the sensitivity of the business unit's value to changes in each of the value drivers, looking one by one at the effect that a small change in each driver could bring.
3. **Institutionalisation**: Value drivers are incorporated into targets and score cards of an on-going business performance management. Value drivers must be periodically reviewed as the highest priority levers may change, as market conditions or company skills evolve.

Every asset, financial as well as real, has value. The key to fundamental aspect of investing and managing assets lies in understanding of not only what value is but also the sources of value. Basically, valuation is important in portfolio management, acquisition analysis and corporate finance. Valuation is the central focus in fundamental analysis. The major theme in fundamental analysis is that the true value of a firm can be related to its financial characteristics, its growth prospects, risk profile and cash flows.

Valuation plays a vital role in corporate finance. The wealth maximisation principle of Corporate finance is embedded in the objective of maximisation of firm value. The value of a firm is directly related to the firm's financing, investment and dividend decisions.

Valuation also plays an important part in acquisition analysis. The biding firm has to decide on a fair value for the target firm before making the bid, and the target firm has to decide a reasonable value for the offer. The value of the target from the bidder's point of view is the sum of the pre-bid standalone value of the target and the incremental value that the bidder expects to add to the target's assets. The incremental value may arise from improved operations of the target or the synergy between the two companies. Valuation of the target requires valuation of the totality of the incremental cash flows and earnings.

BRAND VALUATION

Brand valuation mainly measures two criteria—the potential profitability of the brand and non-financial factors, like brand recall, as compared with competitors. In India, such exercises have mostly been undertaken by large conglomerates, such as Tata, since it is easier to quantify the royalty to be charged from group companies using the corporate brand name. In the FMCG sector, brands are intangible assets and central to value creation. Companies like Marico and Dabur use brand valuation. For multinational companies like Coca Cola and Pepsi, brand valuation is central to the strategy that determines the marketing spend for each brand, and is also a significant contributor to enterprise value. In brand valuation transactions, a company rarely pays book value to acquire another company. The difference between book value and actual acquisition price paid is due to intangible assets, of which brands are an important part. The process of estimating the financial value of a brand helps in determining the premium over book value that a buyer has to pay. For an acquirer, it is essential to determine the target's brand value in the long-term perspective. A classical example of how brands play an important role in M&A is the case of Volkswagen's 1998 acquisition of Rolls Royce. Volkswagen paid around £400 million for the deal. The deal did not include the brand value of Rolls Royce due to reasons that included legal matters. Subsequently, BMW acquired the rights of Rolls Royce and revitalised Rolls Royce's brand image.

Foreign companies are acquiring Indian brands and Indian companies are also scouting for International brands. Tata Motors bought Land Rover and Jaguar. Another notable deal involved the acquisition of Divatex of US by Himatsingka.

Acquiring a domestic brand also helps in increasing the growth potential for a foreign multinational company. The acquisition of Thumbs Up helped Coca Cola India to increase its market share in the Indian market.

Valuing a Brand

One of the most popular methods for valuing a brand is the *relief from royalty method*. Under this method, it is assumed that the business does not own its brand but licences it from another business at market rate. The royalty rate is usually expressed as percentage of sales. The valuation consists of first estimating the royalty rate and then projecting that fee over the useful life of the brand. Then the net present value of the sum of the fees over the brand's expected lifespan is calculated. The royalty rates are determined on the basis of the character of the markets served, such as consumer market versus industrial market. Higher royalty rates are charged for consumer markets as compared to industrial markets. The qualitative factors to be considered to determine royalty rates include market share, consumer recognition, longetivity and product differentiation.

The other methods to value a brand include premium profit method and residual value method. The *premium profit method* looks at valuing the brand by considering the premium profit generated by a business, if any, using the brand, and comparing it with a business which is not using a comparable brand. The residual value method relies on first estimating the value of intangible assets by subtracting the value of tangible assets from the value of the business. Subsequently, the intangibles' value, so arrived, is apportioned over specific intangible assets, including brand, based on their expected returns.

Valuation–Different Approaches[6]

Basically there are three approaches to valuation. The first, the *discounted cash flow valuation* relates the value of an asset to the present value of the expected cash flows on that asset. The second, *relative valuation approach*, estimates the value of an asset by analysing the pricing of comparable assets relative to a common variable, like earnings, cash flows, book value or sales. The third, *contingent claim valuation* uses option pricing models to measure the value of assets that share option characteristics.

In another perspective, firms evaluate targets based on, (a) assets, (b) earnings, and (c) cash flows. There are several techniques to value a business. These can be broadly classified into earnings based valuation, market based valuation and asset based valuation. *Earnings based valuation* (discounted cash flow valuation) takes into consideration the future earnings of the business and the appropriate value of the business depends on projected revenues and costs in future, expected capital outflows, number of years of projection, discounting rate and terminal value of the business. The value of a business is estimated in the capitalised earning method by capitalising the net profits of the business of the current year, or average of three years, or a projected year, at required rate of return.

While using *market based valuation* for unlisted companies, comparable listed companies have to be identified and their market multiples, such as market capitalisation to sales or market price to earnings, are used to arrive at a value.

The *asset based value* considers either the book value (asset's net liabilities) or the net adjusted value (revalued net assets). If the company has intangible assets like brands, copyrights, intellectual property, etc.

[6]For detailed study, see Aswath Damodaran, Investment Valuation, John Wiley & Sons, 2003, Page 9-15.

these are valued independently and added to the net asset value to arrive at the business value. Sometimes, if the business is not acquired on a going concern basis, the liquidation value, or the realisation from the sale of assets, is considered for the purpose of valuation. Premiums or discounts are typically attached to a business valuation, based on the situation. These could be market share premium, controlling stake premium, brand value premium, small player discount or unlisted company discount.

Time is very critical while divesting a business since valuation depends on timings. In the scenario of a stock market lull, there could be a situation where there are buyers but no sellers due to the low valuation. A reasonable purchase price consists of a premium of 10% above the market price. The premium of 50% and above requires the expectation of substantial synergy gains. Companies that use cash tend to be more careful when calculating bids and valuations.

In some cases, acquisitions are based on the cost of replacing the target company. For example, the value of a company can be taken as the sum of all its equipment and staffing costs. But this approach is difficult to use when intangible assets have to be valued.

In the case of relative valuation, an undervalued target firm is one that trades at a multiple (of earnings, book value or sales) well below that of the rest of the industry, after controlling for significant differences on fundamentals. In discounted cash flow valuation approaches, an under valued stock is one that trades at a price well below the estimated discounted cash flow value. The motive for diversification would be to acquire a firm that is unrelated to the business of the acquiring firms. The benefit from diversification would be derived if a cyclical firm acquires a non-cyclical firm. The aim for operating synergy through acquisition could be realised through cost savings as a result of economies of scale. For the purpose of financial synergy, a target firm ought to be chosen so that the acquisition could result in increased debt capacity.

Steps in Acquisition Analysis

The process of analysing acquisitions can be classified broadly into three major stages: corporate strategic planning, deal structuring and post merger integration and audit.

The corporate *strategic planning process* involves setting up corporate objectives for growth in terms of corporate strengths and weakness, and an assessment of the company's social, economic, political and technological environment.

Target valuation is an integral part of the deal structuring process. The target firm has to be valued in the context of investment, financing and dividend policies of the firm. The financial evaluation process should be able to answer questions such as, what is the maximum price that should be paid for the target company. The principle areas of risk and earnings, cash flow and balance sheet implications of the acquisition should also be understood by the financial evaluation process. The sources required to finance the acquisition should be suggested through the evaluation process.

Common Trends

Acquiring companies commonly value the purchase price for an acquisition at the market value of the shares exchanged. This practice is not economically sound, and could be misleading and costly to the acquiring company. A well-conceived analysis for an exchange of shares acquisition requires sound valuations of both the buying and the selling companies.

Most acquisition minded companies rely extensively on the discounted cash (DCF) technique to analyse acquisitions.

Concept of Free Cash Flow *Cash flow* of a company is defined as the sum of net income plus depreciation and other non-cash items that are subtracted while computing net income. However, cash flow is not available for distribution to investors when the firm plans to reinvest all, or a part of it, to replace equipment, and finance future growth. *Free cash flow* is the cash available for distribution to investors after all planned capital investments and taxes. The free cash flows generated by an enterprise can be decomposed into two components—the after-tax cash flow corresponding to equityholders, and the after-tax cash flow available to pay bondholders.[7]

Free cash flow reflects the cash flow generated by a company's operations that is available to all the company's capital providers, both debt and equity.

Discounted Cash Flow Valuation Model The *discounted cash flow criterion* can be utilised for valuation of internal organic growth opportunities—such as addition to existing capacity—and also for external inorganic growth opportunities like acquisitions. The discounted cash flow technique takes into account the time value of money. A rupee received today is worth more than a rupee received tomorrow because today's rupee can be invested to earn a return during the intervening time.

The basic difference between the dividend discount model and the cash flow equity discount model is that the dividend discount model is based upon the premise that the only cash flows received by shareholders are dividends. The cash flow to equity model takes into account the cash flow left after meeting all financial obligations, including debt payments, and after covering capital expenditure and working capital needs. Thus, the primary difference between the dividend discount model and the free cash flows to equity model lies in the definition of cash flows.

In the context of projecting the cash flow stream of a prospective acquisition, it is important to take into account the cash flow contribution the target firm is expected to make to the acquiring company. The acquirer may be able to achieve operating synergy not available to the standalone company. The acquisition may provide post-acquisition investment opportunities whose initial outlays and subsequent benefits also need to be incorporated in the cash flow schedule.

Hence, cash flow is defined as:

Cash flow = (operating profit) (1–income tax)+depreciation and other non-cash charges–(incremental working capital investments + capital expenditures)

The Forecast Period While developing the cash flow schedule, two additional issues need to be considered:[8]

1. The basis for setting the length of the forecast period. In another perspective, the period beyond which the cash flows associated with the acquisition are not specifically projected needs to be known.
2. The residual value of the acquisition at the end of the forecast period.

A common method is to forecast cash flows for that certain period for which estimation can be made. The estimation of the forecasted period varies with industry settings. Five to ten years is usually taken as the forecasted period in many situations. A better approach suggests that the forecast duration for cash flows should continue only as long as the expected rate of return on incremental investment required to support forecasted sales growth exceeds the cost of capital rate.

The value of the company is unaffected by growth when the company is investing in projects that are earning at the cost of capital or at the minimum acceptable risk adjusted rate of return required by the market.

Thus, for the purpose of simplification, we can assume a 100% payout of cash earnings after the end of the forecast period, or equivalently a zero growth rate, without affecting the valuation of the company. The residual value is then the present value of the resulting cash flow perpetuity beginning one year after the horizon date. Of course, if after the end of the forecast period the return on investment is expected to decline below the cost of capital rate, this factor can be incorporated in the calculations.

[7]Enrique R Arzac, 'Valuation for Mergers, Buyouts and Restructuring', John Wiley & Sons, 2005, Page 9.

[8]Alfred Rappaport, Discounted Cash Flow Valuation, Pricing, Valuation, Negotiating and Deal Structuring, Page 161-178.

COST OF CAPITAL

When the risk perspective for both the acquirer and target are the same, then appropriate rate for discounting the candidate's cash flow stream is the acquirer's cost of capital. The cost of capital, or the minimum acceptable rate of return on new investments, is based on the rate investors can expect to earn by investing in alternative, identically risky, securities.

The cost of equity of a corporation is one of the fundamental concepts of corporate finance, and an essential input to most practical valuation problems. The main problem in estimating the cost of equity is the proper risk premium (equity premium) that investors demand for holding equity.

Methods for Estimating Cost of Equity

The following are the methods used for estimating the cost of equity.

Capital Asset Pricing Model The capital asset pricing model provides the framework for estimating the cost of equity. It envisages the relationship between risk and the expected rate of return on a risky security. It provides the framework to price individual securities and determine the required rate of return for them.

The essence of capital asset pricing model is that investors always combine a risk free asset with a market portfolio of risky assets. They will invest in risky assets in proportion to their market value. Investors will be compensated only for that risk which they cannot diversify. This is market related (systematic) risk. *Beta* is the ratio of covariance between the asset returns and market returns, divided by the market variance.

Investors can expect returns from their investment according to the risk. This implies a linear relationship between the asset's expected return and its beta. The message of CAPM is that only the systematic component of risk will be rewarded with risk premium. This does not mean that total risk combination of systematic and unsystematic risk is unimportant to the value of the firm.

In the context of financial distress, an inverse relation exists between risk and expected cash flows. Firms with high risks can impose the cost on customers, suppliers and employees. A firm that is struggling to survive is unlikely to find suppliers willing to provide it with specially developed products or services, except at a higher than usual price. The uncertainty created by volatile earnings and cash flows may also hinder the management's ability to take a long view of the firm's prospects and make the most of its opportunities.

To summarize, total risk is likely to adversely affect a firm's value by leading to lower sales and higher costs. Consequently, any action taken by a firm that decreases its total risk will improve its sales and cost outlook, thereby increasing its expected cash flows. These considerations justify the range of corporate hedging activities that multinational firms engage in to reduce total risk.

Moreover, international diversification may actually allow firms to reduce the total risk they face. Much of the general market risk facing a company is related to the cyclical nature of the domestic economy of the home country.

The basis of the CAPM is that an individual investor can choose exposure to risk through a combination of lending, borrowing and a suitably composed (optimal) portfolio of risky securities. According to CAPM, the composition of this optimal risk portfolio depends on the investor's assessment of the future prospects of different securities, and not on the investors attitude towards risk. The latter is reflected solely in the choice of a combination of risk portfolio and risk free investment.

CAPM is considered the backbone of modern price theory for financial markets. It is also widely used in empirical analysis so that the abundance of financial statistical data can be utilized systematically and efficiently. Moreover, the model is extensively used in practical research and has, thus, become an important basis for decision making in different areas. Important examples of areas where CAPM and its beta coefficients are used routinely include calculations of the cost of capital associated with investments and takeover decisions, estimates of cost of capital as a basis for pricing in regulated public utilities, and judicial inquiries related to court decisions regarding compensation to expropriated firms whose shares are not listed on the stock market.

For investors, CAPM's message is that the expected rate of return will not compensate them on the risk they undertake unless they invest in a well-diversified portfolio, like that of a market index fund.

The CAPM approach to estimating the cost of equity requires a riskless (a zero beta) rate as input. In valuing a company, a division of a company or a long-term investment project, one has to discount free cash flows that extend over many periods into the future. If a short-term riskless rate is chosen, the equity premium consists of a term premium reflecting the longer maturity of equity cash flows and a pure risk premium reflecting their risky nature. Alternatively, if a long-term riskless rate is chosen, the equity premium measures only the pure risk premium associated with equity.[9]

Hence,

$$R_i = R_f + \beta\,(R_m - R_f)$$

where R_i is the rate of return on security i, R_f is the risk free rate of return, R_m is the market portfolio and is the beta coefficient of the stock.

The Fama/French Three Factor Model Fama and French,[10] in their classical research papers, found that two factors account for most of the variance in average stock returns: a) The size of the firm is measured by market capitalization and b) Book to market equity. Average returns are higher for small capitalisation firms even after accounting for their betas. Size can be interpreted as a proxy for liquidity. Average returns are higher for stocks with higher book to market ratios. Firms with poor prospects tend to have high book to market ratios and have higher cost of capital. This ratio could be interpreted as a proxy for relative distress. These findings led Fama and French to propose estimating the cost of equity with the three factor model: 1. The traditional CAPM factor (return on market portfolio minus the return on risk free rate), 2. The return on a portfolio of small capitalisation stocks minus the return on a portfolio of large capitalisation stock, and 3. The return on a portfolio of high book to market stocks minus the return on portfolio of low book to market stocks. Fama and French showed that these factors explain better the cross-section variation of stock returns than the simple CAPM.

The model postulates that the risk premium over risk free rate demanded by investors from firm j is given by

$$R_j - R_f = \beta_j(R_m - R_f) + S_j SMB + h_j HML$$

where R_j is the rate of return on security j, β_j is the CAPM beta coefficient for stock j, R_m-R_f is the risk premium, S_j is the factor sensitivity with respect to size, and h_j is the factor sensitivity with respect to book to market ratio. SMB is the difference between the returns on a portfolio of small stocks and a portfolio of big stocks. HML (high minus low) is the difference between the returns of a portfolio of high book to market stocks and a portfolio of low book to market stocks.

Arbitrage Pricing for Theory The foundation for the multifactor return model is the arbitrage pricing theory formulated by Ross (1976). Chen Roll and Ross (1984) found that four factors explain expected returns–level of industrial activity, rate of inflation, spread between short-term and long-term interest rates and spread between the yields of low and high risk corporate bonds. Their results also suggested that the market index did not add to the explanatory power of regression. Macroeconomic factors are fundamental

[9]Enrique R Arzac, 'Valuation for Mergers, Buyouts and Restructuring', John Wiley & Sons, 2005, page 36.

[10]Fama, E F and French, K R, 'Common Risk Factors in the Returns on Stocks and Bonds', Journal of Financial Economics , 33, 1993, 3-56 , Fama E F and French K R,'Industry Costs of Equity', Journal of Financial Economics, 43, 1995, 153-193, Fama EF and French K R, 'Multifactor Explanation of Asset Pricing Anomalies', Journal of Finance, 51, 1996, 55-84 .

explanations of expected return. In fact, the market portfolio is proxy for the complex of factors that affect expected returns.

Discounted Cash Flow Approach[11] To establish the maximum acceptable acquisition price under DCF approach, estimates are needed for, 1. incremental cash flows expected to be generated because of the acquisition, and 2. discount rate or cost of capital which is the minimum acceptable rate of return required by the market for new investments by the company.

The basis for this approach is that the value of any asset is the present value of expected future cash flows on it.

Hence,
$$\text{Value} = \sum_{t=n}^{t=1} \frac{\text{Cash Flow}_t}{(1+k)^t}$$

where n = life of the asset, Cash Flow_t is the cash flow to the firm in the period t, and k is the discount rate.

The discounted cash flow valuation has two approaches. The first approach values the equity stake in the business and the second approach values the entire firm, which includes equityholders and debt holders.

EQUITY VALUATION

The value of the equity is obtained by discounting expected cash flows of equity, which is the residual cash flows after meeting all expenses, tax obligations and interest and principal payments, at the cost of equity. Hence,

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

where cash flow to equity_t is the expected cash flow to equity in period t, k_e is the cost of equity.

The dividend discount model is a specialised case of equity valuation and the value of the stock is the present value of expected future dividends.

Equity investors receive a residual claim on its cash flows.

Cash flow to equity for an unlevered firm is calculated as:

Net Income + Depreciation and Amortisation = Cash flow from operations

Cash flow from operations – Capital Expenditures – Change in Working Capital = Free Cash flows to Equity (FCFE)

Net Income is derived as follows:

Revenues – Operating Expenses = Earnings before interest, taxes, depreciation and amortisation (EBITDA)

EBITDA – Depreciation and Amortisation = Earnings before interest and taxes (EBIT)

EBIT – Taxes = Net Income

The cash flow to equity is the residual cash flow after meeting all financial needs of the firm.

Cash flow for a levered firm is calculated as:

It has to be noticed that a levered firm additionally has to generate cash flows to cover interest expenses and principal repayments. A levered firm, however, also finances some of its capital expenditures and working capital needs with debt, thus reducing the equity investment needed.[12]

Revenues – Operating Expenses = EBITDA

EBITDA – Depreciation and Amortisation = EBIT

EBIT – Interest Expenses = Earnings before Tax

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[11]For detailed study on Valuation, see Investment Valuation by Aswath Damodaran, John Wiley & Sons.

[12]Aswath Damodaran, Cashflow to Equity Investment Valuation, John Wiley & Sons, Inc, 2003, Page 101.

Earnings before tax – Taxes = Net Income

Net Income + Depreciation & Amortisation = Cash flows from operation

Cash flow from operations – Preference dividends – change in working capital – principal repayments + proceeds from new debt issues = Free cash flow to equity (FCFE).

Stable Growth FCFE Model

The stable growth FCFE model is used to value a firm that is growing at a stable growth rate.

The value of equity under stable growth rate model is a function of expected FCFE in the next period, the stable growth rate and the required rate of return.

$$V_0 = \frac{FCFE_1}{r-g_n}$$

where V_0 is the present value of the stock, $FCFE_1$ is the expected FCFE next year, r is the cost of equity and g_n is the growth rate in FCFE for the firm forever.

The Two Stage FCFE Model

The two stage FCFE model is designed to value a firm that is expected to grow much faster than a stable firm in the initial period, and at a stable rate after that.

The model states that the value of any stock is the present value of the FCFE per year for the extraordinary growth period plus the present value of the terminal price at the end of the period.

Value = PV of FCFE + PV of Terminal price

$$\sum_{t=1}^{t=n} \frac{FCFE_t}{(1+r)^t} + P_n/(1+r)^n$$

where $FCFE_t$ = FCFE in year t, P_n = price at the end of the extraordinary growth period, r = required rate of return to equity investors in the high growth period.

The terminal price is generally calculated using the infinite growth rate model:

$$P_n = FCFE_{n+1}\ /(r_n-g_n)$$

The Three Stage FCFE Model

The three stage FCFE model is designed to value firms that are expected to go through three stages of growth an initial phase of high growth rate, a transition period where growth rate declines and a steady state period where growth is stable.

$$V = \sum_{t=1}^{t=n_1} \frac{FCFEt_t}{(1+r)^t} + \sum_{t=n_1+1}^{t=n_2} \frac{FCFEt_t}{(1+r)^t} + \frac{Pn_2}{(1+r)^n}$$

$$Pn_2 = FCFEn_2{+}1/(r-g_n)$$

where V is the value of the stock. $FCFE_t$ is the free cash flow in year t, r is the opportunity cost of capital, Pn_2 is the terminal price at the end of the transition period. $FCFEn_2+1$ is the free cash flow to equity after the end of the transition period. n_1 and n_2 are the end of the initial high growth period and end of the transition period, respectively.

FIRM VALUATION

The value of the firm is obtained by discounting expected cash flows to the firm, that is, the residual cash flows after meeting all operating expenses and taxes but prior to debt payments at the weighted average cost of capital, which is the cost of the different components of financing used by the firm weighted by the market value proportions.

$$\text{Value of Firm} = \sum_{t=1}^{t=n} \frac{\text{Cash Flow to Firm}_t}{(1 + \text{WACC})^t}$$

where Cash Flow to Firm_t = expected cash flow to firm in period t, WACC = Weighted Average Cost of Capital

The free cash flow to the firm is the sum of the cash flows to all the claimholders in the firm, including stockholders, bondholders and preferred stockholders.

Free Cash flow to the firm (FCFF) = Free Cash flow to equity + Interest Expenses (1-tax rate) + Principal Repayments – New Debt Issues + Preferred Dividends

The other way involves the usage of earnings before interest and taxes (EBIT) as the basis for the calculation

FCFF = EBIT (1–tax rate) + Depreciation – Capital Expenditure – Change in Working Capital[13]

Stable State FCFF Model

A firm with FCFF growing at a stable growth rate can be valued by the model

Value of firm = $\text{FCFF}_1/(\text{WACC}-g_n)$

where FCFF_1 is the expected FCFF next year, WACC is the weighted average cost of capital and g_n is the growth rate in the FCFF forever.

Two Stage FCFF Model

If the firm reaches steady state after n years and starts growing at a stable growth rate g_n after that, the value of the firm can be written as:

$$\text{Value of the firm} = \sum_{t=1}^{t=n} \frac{\text{FCFF}_t}{(1 + \text{WACC})^t} + \frac{\text{FCFFn+1}/(\text{WACC-}g_n)}{(1 + \text{WACC})^n}$$

where WACC_n = Weighted Average Cost of Capital in steady state.

Limitations of DCF Model of Valuation The discounted cash flow valuation is based upon expected future cash flows and discount rates. Discounted cash flow techniques fail in their role of valuing a firm when it is in a distressed state. The future cash flows of distressed firms are very difficult to measure as there is always the possibility of negative earnings and bankruptcy. There will be difficulties while estimating future cash flows of cyclical firms as their earnings and cash flows tend to rise during economic boom and fall during recession. Many cyclical firms during the recession period look like distressed firms with negative earnings. The discounted cash flow techniques will not be able to unearth the real value of a firm with unutilised assets. The usage of discounted cash flow techniques is limited to such firms that have good growth options but currently are not able to produce current cash flows. Firms which are in the process of restructuring often change their capital structure. Hence, it would be very difficult for such firms to estimate future cash flows.

[13]Aswath Damodaran, Cash flow to Equity Investment Valuation, John Wiley & Sons, Inc, 2003, Page 101.

RELATIVE VALUATION

In relative valuation, the value of an asset is derived from the pricing of 'comparable" assets standardised using a common variable, such as earnings, cash flows, book values or revenues. The most commonly used valuation multiples include price to earnings, price to book, price to sales, enterprise value to EBITDA and enterprise value to revenues. These multiples are calculated as ratio of value to some normalising metric, such as net income, EBITDA or revenues. Multiples are estimated from the prices of other companies with characteristics comparable to the company being valued. Usually these comparables are companies in the same industry.

Price Earning Ratios

The most commonly used multiple is the *price earnings (P/E) ratio* obtained by dividing the share price of a comparable company by its earnings per share. PE ratio reflects the earning potential of a firm. The price earning ratio is said to be the most widely used of all multiples. PE ratio is significant because it relates the current price to current earnings. It eliminates the need to make assumptions about risk, growth and payout ratios, all of which have to be estimated for discounted cash flow valuation.

Using this ratio, the acquiring company makes an offer that is a multiple of the earnings of the target company. Comparisons of the P/E for all stocks within the same industry group will give the acquiring company good guidance about the target's P/E multiple.

Portfolio managers sometimes compare PE ratios to expected growth rate to identify undervalued and overvalued stocks. In the simplest form, firms with P/E ratios less than their expected growth rate are viewed as undervalued. In its more general form, the ratio of P/E to growth is used as a measure of relative value, with lower values believed to indicate undervaluation relative to other firms.[14]

P/B Ratio

Price to book ratio can be used to gauge the value of companies for which book value provides a reasonable estimate of the replacement value of the assets in place. Price to book ratios can be computed by dividing the share price by book equity per share, or, for enterprise value to book ratios, by dividing the enterprise value by the book value of equity and net debt. The book value of equity is the difference between the book value of assets and the book value of liabilities.

Tobin Q

Firms having high Tobin q are said to be have high growth potential. It relates market value of the firm to the replacement value of assets in place. In practice, since the replacement cost of assets is difficult to measure, analyst often substitute it with the book value of assets.

Price to Sales ratio (P/S)

The price/sales ratio is used to value firms, with average price/sales ratios of firms with similar characteristics used for comparison. Unlike P/E and price to book ratio which can become negative and hence are not meaningful, the price to sales ratio can be derived for distressed firms also. Price to sales ratio does not depend upon accounting method, unlike earnings and book value, which are influenced by accounting decisions on depreciation, inventory and extraordinary charges.

[14]Aswath Damodaran, Investment Valuation Price/Earnings Multiples, John Wiley & Sons, 2003, Page 296.

ENTERPRISE VALUE

Enterprise value refers to the market capitalisation of a company plus debts. When an investor acquires a company, he not only takes over the assets of the company, but also assumes the liabilities to pay the existing debts and liabilities of the company. Thus, enterprise value is the sum of fair value of assets and liabilities of the acquired entity. The key performance metrics to evaluate enterprise value are:

(a) The **EV/EBITDA Ratio**: This ratio reflects the time period in which the unit has to yield operating profit (EBITDA) to return the basic investment made by the investor. This ratio is in the nature of PE ratio from the viewpoint of retail investor, and varies from industry to industry.

(b) **EV/Revenue Ratio**: This ratio indicates the number of years required to generate revenue, to return the investment price paid by the acquirer. In a way, it can be likened to pay back period.

(c) **Enterprise Value to Sales Ratio** (EV/Sales): With this ratio, the acquiring firm makes an offer as a multiple of the revenues while being aware of the price to sales ratio of other companies in the industry.

EBITDA[15] multiples are obtained by dividing the enterprise value (value of equity and net debt) of comparable companies by their EBITDA. When applied to target company's EBITDA, this multiple yields an estimate of its enterprise value. Revenue multiples are calculated by dividing enterprise value by revenues.

Valuation multiples, based on measures of gross cash flow or operating income, such as EBITDA and EBIT, are often preferred by practitioners to price earnings multiples. This is particularly so when valuing divisions of companies, or businesses that have experienced recapitalisations or asset write-ups. The best way to identify proper multiples is to choose comparable companies with similar: (a) rates of expected growth which, in practice, limit the comparables to those followed by analysts, (b) leverage, and (c) size.[16]

Economic Profit Model[17]

The value of a company equals the amount of capital invested plus a premium equal to the present value of the value created each year. Alfred Marshall, the noted economist, stated that the value created by a company during any time period (its economic profit) must take into account not only the expenses recorded in its accounting records but also the opportunity cost of capital employed in the business. Firms create value by investing in projects with returns in excess of their cost of capital. The value created by a firm is essentially the difference between the present value of its future cash flows and the capital invested. It is obtained by subtracting the cost of capital utilisation from the operating income after taxes.

The advantage of the economic profit model over the DCF model is that economic profit is a useful measure for understanding a company's performance in any single year, which is not true for free cash flow. For example, we would not track a company's progress by comparing actual and projected free cash flow because free cash flow in any year is determined by discretionary investments in fixed assets and working capital. The management could easily improve free cash flow in a given year at the expense of long-term value creation by simply delaying investments.

Hence, Economic Profit = Invested Capital *(ROIC-WACC) where ROIC is Return On Invested Capital. In other words, economic profit equals the spread between the return on invested capital and cost of capital times the amount of invested capital.

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[15]Earning before Interest, Tax Depreciation and Amortization.

[16]Enrique R Arzac, 'Valuation for Mergers, Buyouts, and Restructuring,' Metric & Multiples, John Wiley & Sons, 2005, page 70.

[17]Tom Copeland, Tim Koller, Jack Murrin, Valuation, Framework for valuation, page 143-144, John Wiley & Sons, 3rd edition, 2000. Enrique R Arzac, Valuation for Mergers, Buyouts, and Restructuring, Metric & Multiples , John Wiley & Sons, 2005, page 77-78.

Economic Profit can also be stated as
Economic Profit = NOPAT – (Invested Capital *WACC)
where NOPAT is after-tax operating profit. The economic profit approach states that the value of a company equals the amount of capital invested plus a premium or discount equal to the present value of its projected economic profit. A company is worth more or less than its invested capital only to the extent it earns more or less than its WACC.

The economic profit model is also known as *Economic Value Added (EVA)*. According to the EVA approach, a firm creates value for its shareholders in a given period if net operating profits after tax (NOPAT) exceed the after-tax cost of invested capital (C).
Hence, EVA = NOPAT-wC
where EVA is the economic value added during the period and w is the WACC.

Adjusted Present Value Model

The adjusted present value (APV) model is similar to the enterprise DCF model. APV model separates the value of operations into two components: the value of operations as if the company were entirely equity financed, and the value of tax benefit arising from debt financing.

Adjusted Present Value = Present Value of investment outlay + Present Value of operating cash flows + Present value of interest tax shield + Present Value of interest subsidies.

VALUATION OF INDIAN COMPANIES – SOME SCENARIOS

IBM's Acquisition of Daksh e Services.

IBM bought out 100% stake in Daksh e Services. Daksh was one of the leading independent third party BPO services providers in India. In 2004, Daksh had revenues of about $ 50 million and net profits of $ 10 million. The value of the deal was estimated to be between $ 130 to 170 million. This worked out to a sales multiple of 3 and earnings multiple of 15.[18] Small companies commanded a revenue multiple of 1 to 1.5 during this period. Several factors made the deal worth the premium paid. The deal enabled IBM to focus more on the Indian market. It proved beneficial for Daksh as it became stronger to face stiff competition from domestic and international players. The deal gave good returns to the financial investors and provided scope for availing of the existing opportunity.

Citigroup's Acquisition of eServe International

Citigroup bought out 55.6% public shareholdings in its publicly listed subsidiary, eServe International, for Rs 550 crores. Citigroup offered the existing shareholders of eServe Rs 800 per share. The price was at 26% premium over the 52 week average share price. This worked out as enterprise valuation of Rs 1000 crore for eServe. The premium was based on the synergy benefits to be realised. Citigroup was the largest shareholder with stake of 44.4%. eServe provided backoffice services to Citigroup companies. The acquisition was facilitated by Citigroup's belief that it is crucial to have full stakeholding in eServe for operational flexibility and control.

The Taro Acquisition

In the case of Taro's acquisition in May 2007, India's Sun Pharmaceutical Industries agreed to buy Israeli Taro Pharma for $454 million. But the minority shareholders opposed the deal, objecting to the low valuation

[18]Harish HV and C G SriVidya, Rationale and Valuation techniques for Mergers and Acquisitions, The Chartered Accountant, May 2004, page 1228-1232.

at which Taro was sold out. This forced Sun to initiate a tendering process to win their approval. Even as Sun Pharma struggles to win shareholder confidence to buy Israel's Taro Pharma, institutional shareholders like Templeton Asset Management and Brandes Investment Partners LP have added to the confusion surrounding the acquisition.

Other Examples

The factor that attracted Ranbaxy Ltd to acquire Chennai based Orchid Chemicals and Pharmaceuticals was perhaps the sharp drop in valuation of its shares in the stock market. In March, Orchid's stock dropped to about one-third of its January 2008 peak of Rs 315. In 2007, domestic deals accounted for just \$2.85 billion of India's overall \$71.11 billion M&A activity.

The Anil Ambani promoted Reliance Entertainment is on the prowl to acquire media companies in the context of low valuations. The combined market capitalisation of about three dozen media companies (many of them broadcasters) has dropped from Rs 54,742 crore to Rs 36,821 crore in 2008.

Future Capital picked up 51% stake in Mumbai-based Centrum Capital subsidiaries, Centrum Direct and Centrum Wealth Managers.

In the banking sector, consolidation is gaining momentum. In 2009, according to a roadmap laid down by the Reserve Bank of India, foreign banks will have greater operating freedom. In order to compete in the new regime, mid-sized, and even large local banks will have to substantially scale up their presence or risk becoming acquisition targets for foreign banks.

Valuation of Indian Telecom Industry

In the telecom industry, most of the deals struck in the past couple of years have been at EV/EDITDA ratio of 6-10 times. EV/Revenue ratio for telecom industry is, on an average, five or less.

The mobile phone, which is much younger than personal computers, has achieved much more in the last five years than personal computers in the past twenty-five years. Companies, like Reliance Communications (Rcom) and Bharti AirTel Ltd, are enjoying higher valuation as compared to many other industries. Rcom and Bharti Airtel accounted for 42% of the total market share of the industry. The Indian telecom sector is one amongst the few, which have attributes to take leeway from hovering macro concerns and provide higher growth. With the mobile subscriber base of more than 100 million, India is the fifth largest country in mobile usage, after China, the US, Japan and Russia.

Amongst the Asian peers, Indian companies enjoy higher valuations. The estimated EV/EBDITA of Reliance and Bharti are about 8.3 and 9.2, respectively, which is higher than the Asian average of 5.1. The average PEx FY07 of major Asian telecom companies is at 12.3 as compared to P/E multiple of about 22x for Reliance and Bharti. The valuation of state owned BSNL Ltd is estimated to be \$30 billion, one of the highest in India. As on July 2006, China Mobile has emerged as the world's most highly valued Telco Company, with enterprise value of \$131.46 billion.

The first M&A deal in India was the sale of Mumbai licence by Max Group to Hutchison Whampoa Group of Hong Kong. The deal fetched half a billion dollars for the Max Group. Some other high profile deals were Vodaphone's acquisition of 10% equity stake in Bharti in 2006 for \$1 billion, Max's acquisition of Aircel at enterprise value of \$1 billion, and Birla Group's acquisition of Tata's stake in Idea Cellular for Rs. 44.06 billion.

Brand Value[19] In most cases, when the acquisition is for majority control, the foreign investor is likely to introduce its own brand in India instead of using the local brand. Hence, generally no value is placed on

[19]Sanjoy Banka, 'Mergers and Acquisitions in Indian Telecom Industry', Banking and Finance, The Chartered Accountant, December 2006, page 927-941.

brand related expenditure amortised or any goodwill. However, where the investor takes minority stake, and the brand stabilised by the controlling local partners has become popular, brand value plays an important role in valuation.

There may be wrong estimation for the value of synergy. For example, internet companies were valued very high in the 2000, such as Satyam's acquisition of India World for $100 million. Some methods, like net asset value or past earnings based method, may prove inadequate in case of growing businesses or those with intangible assets.

GENERAL GUIDELINES

Professional valuation in the Indian context is set to emerge as a trend because of the fact that many Indian companies have to adopt a global outlook for accessing capital or making acquisitions abroad. The international accounting standards are more value oriented. The assets have to be based on true and fair value rather than on historical costs. The International Financial Reporting Standards (IFRS) is expected to be implemented by 2011. Valuation work revolves around transactions. With IFRS implementation for Indian companies accessing capital abroad, valuation is required post the transaction as well. There is also need to regularise valuation professionals in India. About 100 companies have already adopted IFRS. Currently, the discount rate for valuation of Indian companies is much greater than IFRS compliant companies.

Indian firms are more focussed on tangibles and real estate valuations. Intangible valuation work is a gray area in India. Different intangibles are valued using different approaches. A brand is typically valued using the royalty savings method.

Reserve Bank of India Guidelines on Valuation

- Allotment of shares on preferential basis shall be as per the requirements of the Companies Act, 1956, which will require special resolution in case of a public limited company.
- In case of listed companies, valuation shall be as per the Reserve Bank of India/SEBI guidelines as follows:
- The issue price shall be either at:
  - (i) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date, or
  - (ii) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the two weeks preceding the relevant date.
- In case of unlisted companies, valuation shall be done in accordance with the guidelines issued by the erstwhile Controller of Capital Issues.

SYNERGY AND VALUE CREATION

In the context of value creation, synergy has an effect on one of the four inputs into the valuation process cash flows from existing assets, higher expected growth rates, longer growth period, or lower cost of capital. The value of synergy is the present value of the cash flows created by it, the longer it takes for it to show up, the lesser is its value.

The value of synergy can be obtained by an extension of the discounted cash flow technique. In the first step, the firms involved in the merger are valued independently, by discounting expected cash flows to each firm at the weighted average cost of capital for that firm. Then the value of the combined firm is estimated with no synergy, by adding the values obtained for each firm in the second step. The effect of synergy is built into the expected growth rates and cash flows, followed by the valuation of the combined firm with synergy. The difference between the value of the combined firm with synergy and the combined firm without synergy gives the value of the synergy.[20]

PROBLEMS

On Valuation

Free Cash flow to equity Model

1. Stable Growth FCFE Model

Background information:

- Earning per share = Rs 4
- Capital expenditure = Rs 3
- Depreciation per share = Rs 2.50
- Δ working capital = Rs 0.5
- Expected growth = 9%.
- Beta co-efficient = 0.90
- Risk free rate of return = 8%
- Market risk premium = 6%

Solution:

$$\begin{aligned}
\text{Cost of Equity} &= R_f + \beta\,(R_m - R_f)\\
&= 8\% + 0.9(6\%)\\
&= 13.4\%\\
\text{FCFE} &= \text{EPS} - (\text{Cap. Ex.} - \text{Dep.}) - \Delta\text{WC} + \text{New Debt Issue}\\
&= 4 - (3 - 2.5) - 0.5\\
&= \text{Rs } 3\\
\text{Value per share} &= \text{FCFE}_o\,(1 + g)/(r - g)\\
&= 3 \times 1.09/(0.134 - 0.09)\\
&= \text{Rs } 74.32
\end{aligned}$$

Stock now trading at Rs 76.55.

2. The Two Stage Model

Background information:

- The company is growing at a pace of 25% in the first 5 years, and 10% per year thereafter.
- EPS is Rs 3, Cap.Ex. per share is Rs 2.50, Depreciation per share is Rs 2 and ΔWC is Rs 0.50 per share.
- It is assumed that Cap.Ex., Depreciation grow at the same rate as earnings
- Beta during high growth period is 1.5
- Risk free rate is 7.5%, Market risk premium is 5.5%
- Beta (stable growth period) is 0.90

Solution

a. Calculation of PV FCFE during extraordinary growth period:

[20]For detailed study, See Aswath Damodaran, Corporate Finance, Theory and Practice, John Wiley & Sons (Asia) Pvt. Ltd, Second Edition 2001.

Particulars	**1**	**2**	**3**	**4**	**5**
EARNINGS	3.75	4.69	5.86	7.32	9.16
(CAP.EX – DEPN)	(0.625)	(0.781)	(0.976)	(1.220)	(1.526)
Δ IN WC	(0.625)	(0.781)	(0.976)	(1.220)	(1.526)
FCFE	2.5	3.128	3.908	4.88	6.108
PV OF FCFE @ 15.75%	2.16	2.33	2.52	2.72	2.94

Cost of Equity = 7.5 + (1.5 × 5.5)
= 15.75%

PV of FCFE during the high growth phase = 2.16 +2.33 + 2.52 + 2.72 + 2.94
= Rs 12.67

b. Calculation of terminal price at the end of extraordinary growth period :

Expected EPS = 9.16 × 110% = 10.076
(Cap.Ex – Deprn) = 1.526 × 110% = (1.6786)
Δ in WC = 1.526 × 110% = (1.6786)
FCFE = Rs 6.7188
Terminal price = FCFE stable growth period/(r – g)
$r = k_e = 7.5 + 0.9 \times 5.5 = 12.45$
Terminal Price = 6.7188/ (0.1245 – 0.10)
= 252.196
PV of Terminal Price = $252.196/(1.1575)^5$
= Rs 121.396
PV today = PV of FCFE during the high growth period + PV of terminal price
= 12.67 + 121.396
= Rs 134.066

Its market value is Rs 130

3. Three Stage Model

Background information:

Current Information:

Earnings per Share = Rs.0.50
Capital Expenditure per share = Rs. 0.75
Depreciation per share = Rs. 0.25
Working Capital per share = Rs. 0.70

Inputs for high growth period:

Length of the period = 5 years
Expected growth = 55% a year
Working Capital, Capital expenditure and Depreciation grow @ 20%
Beta coefficient for the high growth period = 1.5

Inputs for transition period:

Length of the period = 5 years
Growth rate will decline from 55% to 10% in a linear manner
Working Capital, Capital expenditure and Depreciation grow @ 15%
Beta coefficient for the transition period will decline from 1.5 to 1 in a linear fashion

Inputs for stable growth period:

Growth rate remains at 10%
Working Capital, Capital expenditure and Depreciation grow @ 10%
Beta coefficient for the stable growth period is 1

Stock is currently trading at Rs. 85

Solution:
Calculation of present value of FCFE in high growth period:

High growth Period	**1**	**2**	**3**	**4**	**5**
Earnings	0.775	1.20125	1.861938	2.886003	4.473305
Less, (Capital Exp – Depreciation)	0.6	0.72	0.864	1.0368	1.24416
Less Change in Working Cap	0.14	0.168	0.2016	0.24192	0.290304
FCFE	0.035	0.31325	0.796338	1.607283	2.938841
PV Factor @ 17%	0.854701	0.730514	0.624371	0.53365	0.456111
PV of FCFE	0.029915	0.228833	0.49721	0.857727	1.340438

Present value of FCFE in high growth period = Rs. 2.954122 (1)
Calculation of present value of FCFE in transition period:

Transition Period	**6**	**7**	**8**	**9**	**10**
Growth Rate	46%	37%	28%	19%	10%
Beta	1.4	1.3	1.2	1.1	1
Cost of Equity	16.40%	15.80%	15.20%	14.60%	14%
Earnings per Share	6.531025	8.947504	11.45281	13.62884	14.99172
Less, (Capital exp – Depreciation)	1.430784	1.645402	1.892212	2.176044	2.50245
Less Change in Working Cap	0.33385	0.383927	0.441516	0.507744	0.583905
FCFE	4.766391	6.918176	9.119078	10.94505	11.90537
PV Factor	0.3918	0.3384	0.2936	0.2563	0.2247
PV of FCFE	1.867472	2.341111	2.677361	2.805217	2.675136

Present value of FCFE in transition period = Rs. 12.3663 (2)
Calculation of present value of FCFE in stable growth period

Stable Growth Period	11
Earnings per Share	16.49089
Less, (Capital Exp – Depreciation)	2.752695
Less Change in Working Cap	0.642296
FCFE	13.0959
Terminal Price	327.3976
PV factor	0.2247

PV of Terminal price = Rs. 73.56624 (3)
Value of the stock = (1) + (2) + (3) = Rs. 88.88666

On Free Cash Flow to Firm (FCFF)

4. Valuing one of the subsidiaries of Shiva Ltd

Background Information:

- In 2002, the subsidiary had revenues of Rs.16 crore on which it earned Rs.7 crore before interest and taxes
- It had capital expenditure of Rs. 530 lakh and depreciation of Rs. 410 lakh in 2002
- Working capital, as a percentage of revenues, averaged at 5% between 2001 and 2002 (working capital increases by Rs. 150 lakh in 2002)
- The beta of comparable firms in the industry is 1.05, and the average debt ratio of these firms is 24.79%. (The cost of debt for the largest of these firms is approximately 8%)
- Tax rate is assumed to be 30%
- FCFF is expected to grow 5% a year in the long term.

Solution:

Valuing the subsidiary:

The estimated FCFF of the subsidiary is as follows (values in lakh):

	FCFF in 2002	Long term
EBIT(1–t)	490	514.5
– (Capital Expenditure–Depreciation)	120	126.0
– (Change in Working Capital)	150	157.5
= FCFF	220	231

The cost of capital is computed, based upon comparable firms in the industry:

- Beta (based upon comparable firm) = 1.05
- Long-term bond rate = 7.50%
- Cost of equity = 7.5 + (1.05*5.5) = 13.275
- Pre-tax cost of debt (8.5%) = 8.5(1–0.3) = 5.6%
- Debt ratio = 24.79%
- Cost of capital (based on comparable firms) = (13.275*0.7521) + (5.6%*24.79) = 11.37%

The value of the subsidiary, using cost of capital and expected growth rate of 5%, is estimated as:

Value of the subsidiary = 231/(0.1137 – 0.05) = 3626.37

5. Valuing an Overleveraged firm using the FCFF Approach

Background information:

Base year information:

- Earnings before interest and taxes in 2002 = Rs 630 lakh
- Capital expenditure in 2002 = Rs. 360 lakh
- Depreciation in 2002 = Rs 246 lakh
- Revenues in 2002 = Rs. 7130 lakh
- Working capital as a % of revenue = 25%
- Tax rate = 30 %
- Long-term bond rate = 7.50%

Inputs for the high growth rate phase:

- Length of the high-growth rate phase = 5 years
- Expected Growth Rate in EBIT = 9%
- Beta = 1.30
- Cost of Debt = 10% (pre-tax)
- Debt Ratio = 50%
- Revenues, Capital Expenditures and Depreciation will all grow at 9%

Inputs for stable growth phase:

- Expected Growth Rate in FCFF = 5%
- Beta = 1.05
- Cost of Debt = 9.50%
- Debt ratio = 30%
- Capital Expenditures are offset by depreciation.

Solution:

Estimating the value:

The forecasted free cash flows to the firm over the next five years are provided below (values in lakh):

	1	**2**	**3**	**4**	**5**	**Terminal Year**
EBIT	686.7	748.50	815.87	889.29	969.33	1056.56
–t(EBIT)	206.01	224.55	244.76	266.78	290.80	316.97
–(Cap.Ex. – Dep.)	124.26	135.44	147.63	160.92	175.40	00.00
–Δ Working Capital	160.43	174.86	190.60	207.75	226.45	246.83
= FCFF	196	213.65	232.88	253.84	276.68	492.76

Cost of equity during high-growth phase = 7.5% + (1.30 × 5.5%)
= 14.65%

Cost of capital during the high-growth phase = (14.65% × 0.5) + 10.00% (1–0.30)(0.5)
= 12.23%

The FCFF in the terminal year is estimated to be Rs. 492.76 lakh

FCFF in terminal year = $EBIT_6$ (1 – t) – ($Revenue_6$ – $Revenue_5$) × working capital as % of revenue
= 1056.56 (1–0.30) – 246.83
= Rs.492.76 lakh

Cost of equity during stable growth phase = 7.50% + (1.05 × 5.5%)
= 13.28%

Cost of capital in stable growth phase = (13.28% × 0.70) + 9.50% (1–0.30) (0.30)
= 11.29%

Terminal value of the firm = Rs 492.76/(0.1129 – 0.05)
= Rs 7834.02 lakhs

The value of the firm is the present value of the expected FCFF and the present value of the terminal value:

PV of FCFF = Rs 824.34
PV of Terminal Value = Rs 4402.72
Value of Firm = Rs 5227.06

Three-Stage FCFF Model

Background information:

Current inputs:

- EBIT in 2000 = Rs. 239.4 lakh
- Capital expenditure in 2000 = Rs 250.5 lakh
- Depreciation and amortisation in 2000 = Rs 225.4 lakh
- Working capital in 2000 = Rs 80
- Revenues in 2000 = Rs 799.8 lakh
- Long-term bond rate = 7.50%
- Corporate tax rate = 30%

Inputs for the high-growth period:

- Length of the high-growth period = 5 years
- Expected growth rate in revenues/EBIT = 30.00%
- Beta = 1.60
- Cost of Equity = 7.5% + (1.60 × 5.5%) = 16.30%
- Debt Ratio = 60 % (The firm will continue to use debt heavily during this period, at a pre-tax cost of debt of 10%)
- Capital expenditures and depreciation are expected to grow at the same rate as revenue and EBIT
- Working capital remains at 10% of revenue.

$$\text{Weighted Average Cost of Capital} = (16.30\% \times 0.40) + (10\% \times 0.70 \times 0.60) = 10.72\%$$

Inputs for transition period:

- Length of the transition period = 5 years
- Growth rate in EBIT will decline from 30% in year 5 to 5% in year 10 in linear increments
- Capital expenditure will grow at 8% a year, and depreciation will grow at 10% a year
- Beta will drop to 1.25 for the entire transition period
- Cost of Equity = 7.5% + (1.25 × 5.5%) = 14.38%
- The debt ratio will drop to 50%, and the pre-tax cost of debt will be 10%
- Working capital will remain at 10% of revenue

$$\text{Weighted Average Cost of Capital} = (14.38\% \times 0.50) + (10\% \times 0.7 \times 0.50) = 10.69\%$$

Inputs for the stable growth period:

- Expected growth rate in Revenues and EBIT = 5%
- Capital expenditures and depreciation will grow at the same rate as EBIT
- Beta = 1.00
- Cost of equity = 7.50% + (1.00 × 5.5%) = 13%
- Debt ratio = 40%
- Pre-tax cost of debt = 9.5%

Solution:

Estimating the value:

These inputs are used to estimate FCFF, cost of capital, and present values during the high growth and transition periods:

Calculations for FCFF

Period	EBIT(1–t)	Cap.Ex	Depreciation	Δ WC*	FCFF
1	167.58	325.65	293.02	23.93	111.02
2	217.85	423.35	380.92	31.19	144.23
3	283.21	550.35	495.20	40.56	187.50
4	368.17	715.45	643.76	52.71	243.77
5	478.63	930.08	836.89	68.53	316.91
6	598.28	1004.50	920.58	74.24	440.12
7	717.94	1084.86	1012.64	74.24	571.48
8	825.63	1171.64	1113.90	66.82	701.07
9	908.19	1265.38	1225.29	51.22	816.88
10	953.60	1366.61	1347.82	28.18	906.63

Calculation for present value

Period	Debt Ratio	Beta	WACC	Present Value
1	60%	1.60	10.72%	100.25
2	60%	1.60	10.72%	117.69
3	60%	1.60	10.72%	138.19
4	60%	1.60	10.72%	162.11
5	60%	1.60	10.72%	190.46
6	50%	1.25	10.69%	238.96
7	50%	1.25	10.69%	280.32
8	50%	1.25	10.69%	310.69
9	50%	1.25	10.69%	327.04
10	50%	1.25	10.69%	327.91

Calculation for ΔWC

Working capital*	Revenue	WC – 10%	Δ WC
1	1039.74	103.97	23.93
2	1351.66	135.17	31.19
3	1757.16	175.72	40.56
4	2284.31	228.43	52.71
5	2969.60	296.96	68.53
6	3712.00	371.20	74.24
7	4454.40	445.44	74.24
8	5122.56	512.26	66.82
9	5634.82	563.48	51.22
10	5916.55	591.66	28.18

The terminal value at the end of year 10 can be calculated based upon the FCFFin year 11, the stable growth rate of 5%, and the cost of capital in the stable growth phase:

$$FCFF = FCFF_{10} \times 1.05 = \text{Rs } 374.20 \times 1.05 = \text{Rs } 392.91$$

$$\text{Cost of capital in the stable growth period} = (13\% \times 0.6) + 9.5\%(1 - 0.3)(0.4) = 10.46\%$$

$$\text{Terminal Price} = \text{Rs } 392.91 / (0.1046 - 0.05) = \text{Rs } 7196.15$$

The components of value share as follows:

PV of FCFF in High Growth Phase	Rs. 708.70
PV of FCFF in the Transition Phase	Rs. 1484.92
PV of Terminal Value at the End of Transition	Rs. 2608.60
Value of Firm	
Value of Outstanding Debt	Rs. 4802.22

MISCELLANEOUS PROBLEMS

Problem 1

Capital structure of the company has 100000 fully paid up equity shares of Rs 100 each. The company's earning per share for the past 5 years are given below:

Years	EPS (Rs.)
1	10.00
2	10.50
3	11.00
4	11.60
5	12.30

Price earning ratio of the company is 10 multiple. Calculate the value of the firm.

Solution:

Calculation of growth rate:

g = [(12.30/10)^1/5] – 1
= 1.0423 – 1
= 0.0423

Calculation of EPS of next year (EPS 6):
= EPS 5 (1.0423)
= 12.30 (1.0423)
= 12.82

Market price of the share:

P 7 = EPS 6 * P/E Ratio
= 12.82 * 10
= Rs 128.2

Value of the firm:
Market Price * Number of shares
Rs. 128.2 * 1,00,000 Equity shares
Rs. 12,82,000

Problem 2

The company has 4,00,000 equity shares of Rs 100, each fully paid up. The company's expected earning after tax is Rs. 3,40,00,000, and its current P/E ratio is 10 multiple. Calculate the value of the firm.

Solution:

Calculation of earning per share:

EPS = (Earnings available to equity shareholders/Number of equity shares)
= Rs. 34,00,000/4,00,000 equity shares
= Rs. 8.5

Market price of the share:

P 0 = EPS 1 * P/E Ratio
= Rs. 8.5 * 10
= Rs. 85

Value of the firm:

Market Price * Number of equity shares

Rs. 85 * 400,000

Rs. 34,00,000

Problem 3

Following are the particulars of two companies, A Ltd and T Ltd:

Particulars	**A Ltd**	**T Ltd**
Earnings after tax	200000	60000
Number of equity share outstanding	8000	4000
EPS	25	15
P/E Ratio	8	5
Market Price	150	75

Calculate 1. Exchange ratio based on EPS and market price,
2. Value of the firm.

Solution:

Based on earning per Share:

Exchange ratio based on EPS:

T Ltd/A Ltd

Rs. 15/Rs. 25

0.6 : 1

Total number of shares = 8000 + (4000 * 0.6)
= 8,000 + 2,400
= 10,400 shares.

Combined EPS = Combined earnings/Total number of shares
2,60,000/10,400 shares.
Rs. 25

Market price of the combined firm = EPS * P/E Ratio
Rs. 25 * 8
Rs. 200

Post-merger value of the firm = Market price * Number of equity shares
Rs. 200 * 10,400 shares
Rs. 20,80,000.

Based on Market Price:

Exchange Ratio based on market price:

T Ltd/A Ltd

Rs. 75/Rs. 150

0.5: 1

Total number of shares = 8,000 + (4,000 * 0.5)
8000 + 2000
10,000 shares

Combined EPS = Rs. 2,60,000/10,000 shares
Rs. 26

Market Price of the Share = Rs. 26 * 8
Rs. 208

Post merger value of the firm = Rs. 208 * 10,000 shares
Rs. 20,80,000.

SUMMARY

Value creation is the future value captured in the form of increased market capitalisation. Value realisation is the value captured in the form of past and current earnings or cash flows. Basically, there are three approaches to valuation. The first, discounted cash flow valuation, relates the value of an asset to the present value of the expected cash flows on that asset. The second, relative valuation approach, estimates the value of an asset by analysing the pricing of comparable assets relative to a common variable, like earnings, cash flows, book value or sales. The third, contingent claim valuation, uses option pricing models to measure the value of assets that share option characteristics. In another perspective, firms evaluate targets based on (a) assets, (b) earnings, and (c) cash flows. The discounted cash flow technique takes into account the time value of money. In relative valuation, the value of an asset is derived from the pricing of 'comparable' assets standardised using a common variable, such as earnings, cash flows, book values or revenue. Enterprise value refers to the market capitalisation of a company plus debt. According to the economic profit model, the value of a company equals the amount of capital invested plus a premium equal to the present value of the value created each year.

DISCUSSION QUESTIONS

1. Explain the term 'valuation'.
2. What are the different approaches to valuation?
3. Explain discounted cash flow valuation.
4. Explain relative valuation.
5. What is meant by enterprise value?

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8 Accounting for Mergers

Chapter Objectives

The aim is to make the reader understand:

- The accounting aspects of Mergers
- The methods of accounting for Mergers

INTRODUCTION

Accounting for Amalgamation

Accounting Standard 14 deals with Accounting for Amalgamation. It gives a picture of the accounting to be made in the Transferee Company. This standard is not applicable in the case where one company acquires or purchases share of another company, the acquired company is not dissolved, and its separate entity continues to exist.

It is applicable, when the acquired company is dissolved and has ceased to exist as a separate entity and the purchasing company continues with the business of the acquired company. The acquiring company has to pay consideration in form of cash, or by issue of shares, or other securities, in the acquired company, or partly in the form of cash, and partly in other form.

Some of the important terms that we come across in this standard are defined below:

Amalgamation: It means, An amalgamation pursuant to the provisions of the *Company Act 1956*, or any other statute which may be applicable to the company.

Transferor Company: It means target company.

Transferee Company: It means acquirer company.

Amalgamation may be

1. Merger.
2. Purchase.

The following conditions have to be satisfied to call a particular amalgamation a merger:

- After amalgamation, all assets and liabilities of the transferor company become the assets and liabilities of the transferee company.
- Shareholders of transferor company become the shareholders of transferee company, who are holding not less than 90% of the face value of equity share of transferor company.
- Equity shareholders of the Transferor company are discharged by the equity shares of transferee company and cash for fractional shares as consideration is payable to transferor company.
- Transferor company continues its business, even after amalgamation.

- To ensure uniformity of accounting policies, no adjustment is intended to be made to the book value of assets and liabilities of the transferor company.

Every condition stated above has to be satisfied to call it an *amalgamation by the nature of merger* if any one of the conditions is not satisfied, then it would be *amalgamation by the nature of purchase*.

Methods of Accounting for Amalgamation

Accounting for amalgamation can be handled in the following two ways:
- Pooling of interest method
- Purchase method

1. The Pooling of Interest Method In this method, balance sheets of both companies, i.e. transferor and transferee would be combined at book value, without revaluing assets or creation of goodwill and liabilities. Balances of profit and loss account of both companies would be added, or else, would be transferred to general reserve account. Any difference between consideration paid and amount recorded, would be adjusted in reserves.

Example 1:

	Firm A	**Firm B**	**Post-Merger Firm A (Rs. In lakhs)**
Fixed Assets	100	50	150
Current Assets	30	15	45
Total Assets	130	65	195
Share Capital	60	30	90
Debentures	40	20	60
Current Liability	30	15	45
Total Liability	130	65	195

2. The Purchase Method Under this method, we come across the term *net asset value*, which means total assets minus liabilities. For this purpose, assets and liabilities have to be valued. They may be valued at their book value, or each asset and liability may be valued on the basis of fair value.

If the consideration paid is equal to the net asset value, then the effect would be the same as in case of pooling of interest method. If price paid is more than its net asset value, then assets have been recorded at an increased price while preparing the consolidated balance sheet. If any excess is found even after adjusting individual assets, it is recorded as 'goodwill'. If price paid is less than net asset value, then asset value should be written down in the consolidated balance sheet, or adjusted as capital reserve.

Example 2:

Fixed assets of firm B are valued at Rs. 30 lakh, and current assets are also valued at Rs. 30 lakh. Consideration paid is Rs. 50 lakh worth equity shares.

	Firm A	Firm B	Post-Merger Firm A (Rs. In lakhs)
Current Assets	50	25	80
Fixed Assets	50	25	80
Goodwill		0	10
Total Assets	100	50	170
Share Capital	60	20	110
Debentures	40	30	60
Total Liability	100	50	170

Consideration

Consideration is the price paid for amalgamation of another company. Price may be paid in the form of issue of securities and payment may be made in the form of cash or other assets, by the transferee company to the shareholders of the transferor company.

Methods for calculating consideration are listed below:

- Lump sum method
- Net asset method
- Net payment method
- Intrinsic method

1. Lump Sum Method When the transferee company agrees to pay a certain sum to the transferor company as consideration, then it is called *lump sum payment method*. Here consideration is stated in lump sum.

For example, company A acquires company B for Rs. 10,00,000. In this case, Rs. 10,00,000 is the consideration.

2. Net Assets Method Under this method, difference between the agreed value of assets, excluding fictitious assets, and the agreed value of liabilities that are taken by the transferee company is taken as consideration. Points to be considered while calculating consideration are as follows:

- The term *assets* will always include cash in hand and bank balance, unless otherwise specified, but it does not include fictitious assets, such as preliminary expenses, discount on issue of debentures, underwriters' commission, and debit balance of profit and loss account.
- If the asset is not taken by the transferee, then it should not be included for calculation of consideration.
- The term liability means all liabilities to third party. It even includes funds or reserves that denote liability for third party.
- The term *liability* does not include past accumulated profits and reserves.

Example 3:

Firm A purchasers business of Firm B and agrees to take over all assets and liabilities at agreed value. Goodwill is valued at Rs. 1,00,000, fixed assets at Rs. 6,00,000, current assets at Rs. 4,00,000, bills payable at Rs. 2,00,000 and sundry creditors at Rs. 1,50,000. The firm issues 60,000 equity shares of Rs. 10 each and balance in form of cash as consideration.

Goodwill	1,00,000
Fixed Assets	6,00,000
Current Assets	4,00,000
Value of Total Assets	11,00,000
Bills Payable	–2,00,000
Sundry Creditors	–1,50,000
Total Consideration	7,50,000
Issue of Shares (60,000 shares of Rs. 10 each)	–6,00,000
Balance in Cash	1,50,000

3. Net Payment Method In this method, consideration is calculated as the sum of all payments made in the form of shares, securities and cash to the transferor company.

4. Intrinsic Method In this method, consideration depends on the agreed value of shares of the transferor company. Here, exchange ratio depends on the value of shares of both transferor and the transferee companies.

ACCOUNTING ENTRIES

Journal Entries in the Books of Transferor Company

Transfer of all assets, which are taken over by transferee company, to realisation account

Realisation Account	Dr
To Various Assets Account	

(Assets must be transferred individually to realisation account at their book value)

Transfer of all liabilities, which are taken over by transferee company, to realisation account

Various Liabilities Account	Dr
To Realisation Account	

(Liabilities must be transferred individually at their book value)

Credit realisation account with consideration and transferee company account with consideration

Purchase consideration received

Bank account	Dr
Shares in Transferee Company	Dr
To Transferee Company Account	

Assets which are not taken over by the transferee company and are disposed of

If any profit on disposing the asset,

Bank Account	Dr
To Realisation Account	
To Asset Account	

If any loss while disposing of asset,

Bank Account	Dr
Realisation Account	Dr
To Asset Account	

Liquidation expenses met by transferor company

Bank Account	Dr
To Realisation Account	

Liabilities which are not taken over by the transferee company, and has been met by transferor company.

If any profit in paying the liability,

Liability Account	Dr
To Realisation Account	
To Bank Account	

If any loss in paying liability,

Liability Account	Dr
Realisation Account	Dr
To Bank Account	

If preference shareholders are paid more than preference share capital,

Preference Share Capital Account	Dr
Realisation Account	Dr
To Preference Shareholders Account	

If preference shareholders are paid less than preference share capital,

Preference Share Capital Account	Dr
To Realisation Account	
To Preference Shareholders Account	

Transferring equity share capital and accumulated profit to equity shareholders account

Equity Share Capital Account	Dr
Capital Reserve Account	Dr
Capital Redemption Fund Account	Dr
Share Premium Account	Dr
General Reserve Account	Dr
Profit & Loss Account	Dr
Any other Reserve Account	Dr
To Equity Shareholders Account	

(Any other reserve means, all those reserves which belongs to equity shareholders)

Transferring accumulated loss and expenses not written off to equity shareholders' account

Equity Shareholders Account	Dr
To Profit & Loss Account (Debit Balance)	
To Discount/Expenses on issue of Shares or Debenture	
To Preliminary Expenses	
To Underwriters Commission	

Paying the Shareholders of the company,

Equity Shareholders Account	Dr
To Bank or Shares in Transferee Company Account	

Journal Entries in the Books of Transferee Company

In case of Amalgamation by Nature of Merger

Entry for amalgamation of business,

Business Purchase Account Dr
To Liquidators of Transferor Company Account

For recording of various assets and liabilities taken over,

Various Assets Account Dr
To Various Liabilities Account
To Different Reserves Account
To Business Purchase Account

(Amount of assets and liabilities and reserves are recorded at the book value appearing in the books of transferor company at the time of amalgamation. Difference in amount of consideration paid and transferee company's share capital will be adjusted to general reserve account and other reserves account.)

Payment made to liquidators of transferor company,

Liquidators' Account Dr
To Equity Share Capital Account
To Preference Share Capital Account
To Share Premium Account

Payment of liquidation expenses by transferee company,

General Reserve Account Dr
To Bank Account

If any formation expenses incurred by transferee company,

Preliminary Expenses Account Dr
To Bank Account

In case of Amalgamation by Nature of Purchase

Entry for amalgamation of business,

Business Purchase Account Dr
To Liquidators' Account

For recording of various assets and liabilities taken over,

Various Assets Account Dr
To Various Liabilities Account
To Business Purchase Account

(Only assets and liabilities which are taken over by the transferee company have to be considered. These assets and liabilities have to be recorded at an agreed value.)

If the amount of debit exceeds the credit, then the balance has to be treated as capital reserve. The entry would be:

Various Assets Account Dr
To Various Liabilities Account
To Business Purchase Account
To Capital Reserve Account

If the amount of credit exceeds the other, then the balance has to be treated as 'goodwill'. The entry would be,

Various Assets Account	Dr
Goodwill Account	Dr
To Various Liabilities Account	
To Business Purchase Account	

Payment made to liquidators of transferor company,

Liquidators Account	Dr
To Equity Share Capital Account	
To Preference Share Capital Account	
To Share Premium Account	

Payment of liquidation expenses by transferee company,

Capital Reserve Account/Goodwill Account	Dr
To Bank Account	

To record statutory reserve of the transferor company in the books of transferee company

Amalgamation Adjustment Account	Dr
To Statutory Reserve Account	

If any formation expenses incurred by transferee company

Preliminary Expenses Account	Dr
To Bank Account	

In some cases transferee company owes to transferor company, or transferor company owes to transferee company. For example, if both have creditor and debtor relationship, then no changes would be made in the books of transferor company, whereas, in the books of transferee company an additional entry needs to be passed.

Sundry Creditors Account	Dr
To Sundry Debtors Account	

Similar entry would be in case of holding any bill. The entry would be

Bills Payable Account	Dr
To Bills Receivable Account	

If investment is held in the form of Debentures, then the entry would be,

Debentures Account	Dr
To Investment in Debentures Account	

(These entries are passed in order to cancel the effect of being liable to either of the companies.)

Unrealised Profit on Stock: If unsold goods remain in the stock purchased by transferee company or by transferor company, then, after amalgamation, profit would be included in that stock, while sale of those goods, would be deducted, and would be adjusted in goodwill or capital reserve in case of amalgamation in the nature of purchase, or in general reserve/profit & loss account in case of amalgamation in the nature of merger.

In the books of transferee company, additional entry has to be passed,

In case of amalgamation by nature of merger,	
General Reserve/Profit & Loss Account	Dr
To Stock Account	
In case of amalgamation by nature of purchase	
Capital Reserve Account/Goodwill Account	Dr
To Stock Account	

Treatment of Reserves on Amalgamation

If amalgamation is by nature of merger, then identity of reserves would be maintained as they appear in transferor company's books. For example, general reserve in transferor company would appear as general reserve itself in transferee company, revaluation reserve would be maintained as revaluation reserve. No changes would be made in the books of transferee company. Thus, funds available for distribution of dividend before amalgamation would also be available after amalgamation.

If amalgamation is by nature of purchase, then identity of reserves would not be preserved in transferee company. Statutory reserves would be maintained as they are in Transferor Company for specified period; these reserves are created under Income Tax Act 1961 and the Act requires it to be maintained for specified period to get the benefit. In the balance sheet, a separate amalgamation adjustment account would be entered in the assets side to balance the effect of statutory reserve. If the reserve is no longer required to be maintained, then this effect would be reversed and cancelled.

Other reserves would not be preserved. If the difference between net assets value and consideration is negative, it would be shown as goodwill. If it is positive, it would be credited to capital reserve account.

Problem 1

On 31st March 2010, T Ltd merged with A Ltd. A Ltd agreed to take over all assets and liabilities of T Ltd at book value. The consideration was fixed at Rs. 4,00,000 to be discharged by the transferee company in the form of its fully paid up equity shares of Rs. 10 each for every two shares held in T Ltd.

Balance sheets of both the companies are as follows:

Liabilities	A Ltd (Rs.)	T Ltd (Rs.)	Assets	A Ltd (Rs.)	T Ltd (Rs.)
Share capital (equity share of Rs. 10 each fully paid)	9,00,000	2,00,000	Goodwill	2,00,000	60,000
			Plant and machinery	4,12,000	1,00,000
General reserve	1,80,000	50,000	Furniture	80,000	30,000
Profit and loss a/c	20,502	12,900	Stock in trade	2,65,500	60,000
Workmen compensation fund	12,000	9,000	Sundry debtors	2,21,200	46,700
			Income tax refund claims	—	6,000
Sundry creditors	58,567	30,456	Cash in hand	869	356
Staff provident fund	10,200	4,000	Cash at bank	14,000	8,300
Provision for taxation	12,300	5,000			
	11,93,569	3,11,356		11,93,569	3,11,356

Amalgamation expenses amounting to Rs. 1,000 were paid by A Ltd. You are required to show the balance sheet after amalgamation.

Solution:

Working note 1

Calculation of amount to be adjusted in General Reserve Account of A Ltd

Consideration paid	4,00,000
Less: Equity Share Capital of T Ltd	–2,00,000
	2,00,000
Less: T Ltd's General Reserve	–50,000
T Ltd's Profit and Loss Account	–12,900
Amount debited to A Ltd General Reserve A/C	1,37,100

Working note 2

General Reserve of A Ltd	1,80,000
Less: Amount debited from T Ltd's General Reserve A/C	–1,37,100
Amalgamation expenses	–1,000
Balance for amalgamation	41,900

Working note 3

Cash at Bank

14,000 + 8,300 – 1,000 = Rs. 21,300

(Rs. 1,000 is amalgamation expense)

Balance sheet of A Ltd after amalgamation

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
<u>Share Capital</u> (Equity Shares of Rs. 10 each		<u>Fixed assets</u>	
fully paid)	13,00,000	Goodwill	2,60,000
<u>Reserves and Surplus</u>		Plant and Machinery	5,12,000
General Reserve	41,900	Furniture	1,10,000
Profit and Loss A/C	20,502	<u>Current Assets and Loans and</u>	
Workmen Compensation Fund	21,000	<u>Advances</u>	
<u>Current Liabilities and Provisions</u>		Stock in Trade	3,25,500
Sundry Creditors	89,023	Sundry Debtors	2,67,900
Staff Provident Fund	14,200	Income Tax Refund Claims	6,000
Provision for Taxation	17,300	Cash in Hand	1,225
		Cash at Bank	21,300
	15,03,925		15,03,925

Problem 2

Following is the Balance Sheet of T Ltd as on 31 March 2010:

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Equity Share Capital	10,00,000	Goodwill	1,90,000
General Reserve	1,10,000	Land and Buildings	2,00,000
Workmen's Accident Compensation Reserve	50,000	Plant and Machinery	4,40,000
Profit and Loss Account		Patents and Trademark	30,000
Sundry Creditors	70,000	Stock	2,10,000
	1,60,000	Sundry Debtors 180000	
		Less Provision for 12000	
		Bad Debts	1,68,000
		Cash at Bank	1,32,000
		Preliminary Expenses	20,000
	13,90,000		13,90,000

The company is acquired by A Ltd., which pays Rs. 14,00,000 as purchase consideration, of which Rs. 12,00,000 is through issue of fully paid up shares and balance is by cash.

The balance sheet of A Ltd as on 31 March 2010 is as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Equity Share Capital	20,00,000	Goodwill	2,20,000
(2,20,000 Equity Shares of Rs. 10		Land and building	6,00,000
each)	2,00,000	Plant and Machinery	8,00,000
General Reserve	1,00,000	Stock	5,00,000
Profit & Loss Account	3,50,000	Sundry Debtors	3,00,000
!2% Debentures	2,10,000	Cash at Bank	4,40,000
Sundry Creditors			
	28,60,000		28,60,000

Liquidation expenses amount to Rs. 10,000.
Prepare the balance sheet of the company after amalgamation in the nature of purchase.
Working note

Land & Buildings	2,00,000	
Plant & Machinery	4,40,000	
Patents and Trademark	30,000	
Stock	2,10,000	
Sundry Debtors	1,80,000	
Bank	1,32,000	
	→	11,92,000
Sundry Creditors	–1,60,000	
Provision for Bad Debts	–12,000	
Business Purchase Account	–14,00,000	
	→	–15,72,000
Goodwill (balancing figure)		–3,80,000

Calculation of cash balance

4,40,000 – 2,00,000 + 1,32,000 = 3,72,000

Balance Sheet of A Ltd after Amalgamation

Liabilities	Amount (Rs.)	Assets		Amount (Rs.)
Share Capital	32,00,000	Fixed Assets		
Equity Share Capital		Goodwill		6,00,000
(3,20,000 Equity Shares of Rs. 10		Land and Building		8,00,000
each)		Plant and Machinery		12,40,000
<u>Reserves and Surplus</u>		Patents and Trademark		30,000
General Reserve	2,00,000	<u>Investments</u>		
Profit & Loss Account	1,00,000	<u>Current Assets and Loans and</u>		
<u>Secured Loans</u>		<u>Advances</u>		
12% Debentures	3,50,000	Stock		7,10,000
<u>Current Liabilities and Provisions</u>		Sundry Debtors	480000	
Sundry Creditors		Less Provision for	12000	
	3,70,000	Bad Debts		4,68,000
		Cash at Bank		3,72,000
	42,20,000			42,20,000

Illustration 1: The balance sheets of Sun Ltd and Shine Ltd as on 31st March 2009 were as follows:

(Rs. in '000)

Liabilities	Sun Ltd	Shine Ltd	Assets	Sun ltd	Shine Ltd
54,000 10% Preference Shares of Rs. 100 each	5,400	—	Goodwill		162
			Land and Buildings	7,992	
16,20,000 Equity Shares of Rs. 10 each	16,200		Plant and Machinery	17,690	
			Furniture	292	540
4,32,000 Equity Shares of Rs. 10 each		4,320	Patents	648	
			Motor Vehicles		761
Capital Reserve	5,184	–	Stock	4,374	2,808
General Reserve	3,780	1,080	Debtors	864	1,393
Profit and Loss Account	648	162	Cash at Bank	108	168
Creditors	756	270			
	31,968	5,832		31,968	5,832

Sun Ltd and Shine Ltd merged and formed a new company, called Sunshine Ltd, with an authorised capital of Rs. 4.32 crore divided into 54,000 preference shares of Rs. 100 each and 37,80,000 equity shares of Rs. 10 each. The two companies merged on the following conditions:

(i) Sunshine Ltd alloted to Sun Ltd 54,000, 13% fully paid preference shares and 21.6 lakh fully paid equity shares to satisfy the claims of Sun Ltd's preference and equity shareholders, respectively.

(ii) Sunshine Ltd alloted to Shine Ltd 4,75,200 fully paid equity to be distributed among Shine Ltd's shareholders in full satisfaction of their claims.

(iii) Mr. Green, who mooted the scheme, was alloted 5,400 fully paid equity shares in consideration of his services. The company debited the amount to Preliminary Expenses Account.

(iv) Expenses on liquidation of Sun Ltd and Shine Ltd totalled Rs. 3,240 and were borne by Sunshine Ltd.

Sunshine Ltd made a public issue of 2.16 lakh equity shares of Rs. 10, each at a premium of Rs. 2 per share. The issue was underwritten at a commission of 2½% on the issue price of the shares. The issue was fully subscribed for by the public. Sunshine Ltd paid Rs. 91,800 in cash as preliminary expenses.

Show important ledger accounts to close the books of Sun Ltd, pass journal entries in the books of Sunshine Ltd, and also prepare balance sheet of Sunshine Ltd.

Solution:

Sun Ltd's Ledger

	Rs. ('000)		Rs. ('000)
To Land and Buildings	7,992	By Creditors	756
To Plant and Machinery	17,690	By Sunshine Ltd.	
To Furniture	292	--Consideration	27,000
To Patents	648	By Equity Shareholders Account	
To Stock	4,374	--Transfer of Loss	4,212
To Debtors	864		
To Bank	108		
	31,968		31,968

Sunshine Ltd's Ledger

	Rs. ('000)		Rs. ('000)
To Realisation A/c	27,000	By 13% preference shares in Sunshine Ltd	5,400
		By Equity shares in Sunshine Ltd	21,600
	27,000		27,000

13% Preference Shares in Sunshine Ltd

	Rs. ('000)		**Rs. ('000)**
To Sunshine Ltd	5,400	By Preference Shareholders A/c –distribution	5,400
	5,400		5,400

Preference Shareholders Account

	Rs. ('000)		**Rs. ('000)**
To 13% Preference shares in Sunshine Ltd –settlement	5,400	By 12% Preference Shares Capital Account	5,400
	5,400		5,400

Equity Shares in Sunshine Ltd

	Rs. ('000)		**Rs. ('000)**
To Sunshine Ltd	21,600	By Equity Shareholders Account	21,600
	21,600		21,600

Equity Sharesholders Account

	Rs. ('000)		**Rs. ('000)**
To Realisation Account –Loss	4,212	By Equity Share Capital A/c	16,200
		By Capital Reserve	5,184
To Equity Shares in Sunshine Ltd		By General Reserve	3,780
–settlement	21,600	By Profit and Loss A/c	648
	25,812		25,812

Journal Entries in the Books of Sunshine Ltd

		Rs. ('000)	**Rs. ('000)**
Business Purchase A/c Dr		31,752	
To Liquidator of Sun Ltd			27,000
To Liquidator of Shine Ltd			4,752
(Consideration Payable for Business of Sun Ltd and Shine Ltd)			

(*Contd*)

(*Contd*)

Goodwill	Dr	162	
Land & Buildings	Dr	7,992	
Plant & Machinery	Dr	17,690	
Furniture	Dr	832	
Patents	Dr	648	
Motor Vehicles	Dr	761	
Stock	Dr	7,182	
Debtors	Dr	2,257	
Bank	Dr	276	
To Creditors			1,026
To Capital Reserve			5,022
To Business Purchase A/c			31,752
{Incorporation of assets, liabilities and reserves of Sun Ltd and Shine Ltd; Rs. 5,832, the excess of total share capitals of the two companies being adjusted against the balances of General Reserve and Profit and Loss Account, and then against the balances of Capital Reserve (as explained in working note)}			
Liquidator of Sun Ltd	Dr	27,000	
Liquidator of Shine Ltd	Dr	4,752	
To 13% Preference Share Capital Account			5,400
To Equity Share Capital Account			26,352
(Allotment of 54,000 preference shares of Rs. 100 each and 21,16,000 equity shares of Rs. 10 each to Sun Ltd, and 4,75,200 equity shares of Rs. 10 each to Shine Ltd in discharge of consideration of their business)			
Bank	Dr	2,592	
To Equity Share Applications and Allotment Account			2,592
(Receipt of application money at Rs. 12 per share in respect of 2,16,000 equity shares of Rs. 10 each issued at a premium of Rs. 2 per share)			
Equity Share Applications and Allotment Account	Dr	3,024	
To Equity Share Capital Account			2,592
To Share Premium Account			432
(Allotment of 2,16,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share)			
Underwriting Commission Account	Dr	64.8	
To Underwriters			64.8
(Underwriting commission at 2½% on the issue price of the shares underwritten payable to underwriters)			
Underwriters	Dr	64.8	
To Bank			64.8
(Payment of underwriting commission to underwriters)			
Preliminary Expenses Account	Dr	54	
To Equity Share Capital Account			54
(Allotment of 5,400 fully paid equity shares of Rs. 10 each to Mr.Green in consideration of his services.)			

(*Contd*)

(*Contd*)

Preliminary Expenses Account	Dr		91.8	
To Bank				91.8
(Preliminary expenses paid in cash)				
Expenses on Liquidation of Sun Ltd and Shine Ltd A/c	Dr		3.24	
To Bank				3.24
(Payment of expenses incurred on liquidation of Sun Ltd. and Shine Ltd.)				
Profit and Loss A/c	Dr		3.24	
To expenses on Liquidation of Sun Ltd and Shine Ltd A/c				3.24
(Transfer of expenses on liquidation of Sun Ltd and Shine Ltd account to Profit and Loss account)				

Balance Sheet of Sunshine Ltd as on 31st March 2009

Liabilities	**Rs. (‘000)**	**Assets**	**Rs. (‘000)**
Share Capital		Fixed Assets	
Authorised:		Goodwill	162
54,000 Preference Shares of Rs. 100 each	5,400	Land and Buildings	7,992
37,80,000 Equity Shares of Rs. 10 each	37,800	Plant and Machinery	17,690
Issued and Subscribed:		Furniture	832
54,000, 13% Preference Shares of Rs. 100 each, fully paid	5,400	Patents	648
		Motor Vehicles	761
28,56,600 Equity Shares of Rs. 10 each, fully paid	28,566	Current Assets, Loan and Advances	
		(A) Current Assets	
(Of the above shares, all preference shares and 26,40,600 equity shares have been allotted as fully paid pursuant to contracts without payment being received in cash)		Stock	7,182
		Debtors	2,257
		Cash at Bank	2,708.16
		(B) Loans and Advances	
Reserves and Surplus:		Miscellaneous Expenditure	
Capital Reserve	5,022	Preliminary Expenses	146*
Share Premium	432	Underwriting Commission	64.8
Current Liabilities and Provisions	1,026	Profit and Loss Account	3.24
Current Liabilities	Nil		
Creditors			
(B) Provisions			
	40,446		40,446

Working notes

	Rs. (‘000)	**Rs. (‘000)**
(i) Consideration for Sun Ltd’s business		27,000
Consideration for Shine Ltd’s business		4,752
Total consideration		31,752
Less: Share capital of Sun Ltd	21,600	
Share capital of Shine Ltd	4,320	25,920
Amount to be adjusted in Reserves		5,832

Rs. ('000)

	Combined	Adjusted	Balance
	Rs.	Rs.	Rs.
General Reserve	4,860	4,860	Nil
Profit and Loss Account	810	810	Nil
Capital Reserve	5,184	162	5,022
	10,854	5,832	5,022

(ii) Debit Balance of Profit and Loss Account as:

Ascertained in working note above	162
Add: Expenses on liquidation of Sun Ltd and Shine Ltd	3.2
Debit balance as appearing in Balance Sheet	165.2

(iii) Cash Book (Bank columns only)

	Rs. ('000)		Rs. ('000)
To Business Purchase Account	276	By Underwriters	64.8
To Equity Share Application and Allotment Account	2,592	By Preliminary Expenses A/c	91.8
		By Expenses on Liquidation of Sun Ltd & Shine Ltd Account	3.24
		By balance c/d	2,708
	2867.4		2867.4
To Balance b/d	2,708		

(iv)

	Rs. ('000)
Amount paid to Sunshine Ltd in the form of shares	54
Preliminary expenses paid in cash	91.8
Total preliminary expenses	145.8*

(*rounded off)

Illustration 2: X Ltd and Y Ltd agreed to amalgamate their business by transfering their undertaking to a new company, XY Ltd, formed for that purpose. On the date of amalgamation, balance sheets of the two companies were as under:-

Liabilities	X Ltd (Rs.)	Y Ltd (Rs.)	Assets	X Ltd (Rs.)	Y Ltd (Rs.)
Equity Share Capital (Rs. 10 each)	5,00,000	3,00,000	Assets	4,80,000	2,50,000
			Freehold Property	2,00,000	1,00,000
Reserve Fund		50,000	Investments	50,000	20,000
Profit & Loss A/c	30,000	20,000	Debtors	2,50,000	1,50,000
5% Debentures	2,00,000	1,00,000	Preliminary Expenses	20,000	80,000
Mortgage Loan	50,000				
Sundry Creditors	2,20,000	1,30,000			
	10,00,000	6,00,000		10,00,000	6,00,000

Purchase consideration consisted of:

(a) Discharge of debentures of both companies by issue of equalent amount of 6% debentures in XY Ltd
(b) Assumption of liabilities of both companies
(c) The issue of equity shares of Rs. 10 each in XY Ltd at a premium of Rs. 2 per share.

For the purpose of amalgamation, the assets were revalued as under:

	X Ltd	Y Ltd
Goodwill	1,00,000	75,000
Freehold Property	2,60,000	1,40,000
Investments	51,000	20,000
Assets	4,10,000	2,80,000
Debtors	2,25,000	1,35,000

Pass journal entries in the books of XY Ltd and prepare the balance sheet after the amalgamation.

Solution:

Purchase Consideration

	X Ltd (Rs.)	Y Ltd (Rs.)
Assets Taken over :		
Goodwill	1,00,000	75,000
Freehold Property	2,60,000	1,40,000
Investments	51,000	20,000
Assets	4,10,000	2,80,000
Debtors	2,25,000	1,35,000
	10,46,000	6,50,000
Less : Liabilities Taken over		
Creditors	2,20,000	1,30,000
	8,26,000	5,20,000
Mortgage Loan	50,000	—
	7,76,000	5,20,000

Purchase consideration payable to X Ltd.	7,76,000
Less: 6% Debenture in XY Ltd	2,00,000
Balance to be paid in equity shares	576,000

Rs. 5,76,000 is paid by the issue of equity shares of Rs. 10 @ a premium of Rs. 2 per share (10 + 2 = 12)

Number of shares to be issued: 5,76,000/12 = 48,000 shares

Purchase consideration payable to Y Ltd	5,20,000
Less: 6% Debentures issued	1,00,000
Balance to be paid in equity shares	4,20,000

Rs. 4,20,000 to be paid by issue of equity shares of Rs. 12 each, including the premium of Rs. 2 per share.

Number of shares to be issued = Rs. 4,20,000/12 = 35,000 shares

Journal Entries in the Books of XY Ltd

		Rs.	Rs.
Business Purchase A/c	Dr	12,96,000	
To Vendors of X Ltd			7,76,000
To Vendors of Y Ltd			5,20,000
(Business taken over and purchase consideration payable)			
Goodwill A/c	Dr	1,75,000	
Freehold Property A/c	Dr	4,00,000	
Investments A/c	Dr	71,000	
Assets A/c	Dr	6,90,000	
Debtors A/c	Dr	3,60,000	
To Mortgage Loan A/c			50,000
To Sundry Creditors A/c			3,50,000
To Business Purchase A/c			12,96,000
(Business Purchase Account Transfer)			
Vendors of X Ltd A/c	Dr	7,76,000	
To 6% Debentures A/c			2,00,000
To Share Premium A/c			96,000
To Share Capital A/c			48,00,000
(Purchase Consideration Paid)			
Vendors of Y Ltd A/c	Dr	5,20,000	
To 6% Debentures A/c			1,00,000
To Share Premium A/c			70,000
To Share Capital A/c			3,50,000
(Purchase Consideration paid)			

Balance Sheet of XY Ltd

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital (83,000 Equity Shares of Rs. 10 each)	8,30,000	Goodwill	1,75,000
		Freehold property	4,00,000
Share Premium	1,66,000	Investments	71,000
6% Debentures	3,00,000	Assets	6,90,000
Mortgage Loan	50,000	Sundry Debtors	3,60,000
Sundry Creditors	3,50,000		
Total	16,96,000	Total	16,96,000

SUMMARY

Accounting Standard 14 deals with Accounting for Amalgamation. It gives a picture of accounting to be made in the transferee company. This standard is not applicable in the case when one company acquires or purchases the shares of another company. The acquired company is not dissolved and its separate entity continues to exist. Accounting for mergers can be handled by pooling of interest method and purchase method. The methods for calculating consideration are lump sum method, net asset method, net payment method and intrinsic method.

DISCUSSION QUESTIONS

1. Discuss the two methods of accounting for amalgamation.
2. What are the different methods for calculating consideration?

ADDITIONAL REFERENCES

1. Financial Management (Theory and Practices), 9th edition, Eugen. F. Brigham, Louis. C. Gapenski, Michael. C. hrhardt. Har Court college publishers (Har Court Asia)
2. Financial Management, 9th edition, I M Pandey, Vikas Publishing House.
3. Advanced Accounts, 14th revised edition, M C Shukla, T S Grewal, S C Gupta, S Chand & Company, New Delhi.

9 Corporate Restructuring

Chapter Objectives

The aim is to make the reader understand:

- The significance of corporate restructuring
- The different types of restructuring activities under M&A

INTRODUCTION

Restructuring is the corporate management strategy of reorganising a company for value creation, and making it more efficient. Many companies undertake restructuring activities to focus on core businesses, while divesting non-core business activities. *Restructuring* is a strategy through which a firm changes its set of businesses or financial structure.[1] From the 1970s, through the 1990s, divesting businesses from company portfolios and downsizing accounted for a large percentage of firms' restructuring strategies.[2] The increased importance of corporate restructuring can be attributed to the fact that global business strategies are increasingly moving towards consolidation and redefining of core competencies to survive, sustain and achieve scale in a stiff marketplace.

Restructuring includes such activities as change in corporate management, sale of underutilized assets, like patents and brands, outsourcing of operations, relocation of manufacturing facilities to lower cost locations and reorganization of functions, like sales, marketing and distribution. Restructuring can also include refinancing of corporate debt to reduce interest payments, and reduction of staff.

Mergers and acquisitions are a part of corporate restructuring activities. Corporate restructuring aims at re-allocation of corporate resources to optimise their value, either by adding the related, or divesting the unrelated, businesses. It also includes swapping of existing equity with any other form of financial instruments or obligations. The restructuring of the asset side of the business is known as *business restructuring*. The restructuring of the liability side of the business is known as *financial restructuring*. Financial restructuring is basically aimed at optimizing the capital structure of the company.

Generally, firms adopt three types of restructuring strategies: downsizing, downscoping and leveraged buyout.

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[1]J E Bethel & J Liebeskind, 1993, 'The Effects of Ownership Structure on Corporate Restructuring', Strategic Management Journal 14(Special Summer Issue):15-31.

[2]A Campbell D Sadtler, 1998, 'Corporate Breakups, Strategy & Business ,12:64-73; E Bowman & H Singh, 1990, Overview of corporate restructuring :Trends and consequences in L Rock & R H Rocks (Eds) Corporate Restructuring (New York: McGraw Hill).

Downsizing is reduction in the number of a firm's employees and, sometimes, in the number of its operating units. Downsizing may or may not change the composition of businesses in the company's portfolio. The objective of downsizing is to improve profitability through cost reductions and efficient operations.

Downscoping refers to divestiture, spin-off or some other means of eliminating businesses that are unrelated to a firm's core businesses. It is found that, in general, US firms use downscoping as a restructuring strategy more frequently than the European companies.

Leveraged buyout is used as a restructuring strategy whereby a company buys all assets of a firm assets in order to—take it private. Once the transaction is complete, the company's stock is no longer traded publicly. Usually, significant amounts of debt are incurred to finance an LBO.

In another perspective, corporate restructuring encompasses multiple forms of changes in organisations, namely portfolio restructuring, financial restructuring and organizational restructuring.

Portfolio restructuring takes place through the sale of, or spin-off as well as mergers and acquisitions of lines of business. *Financial restructuring* encompasses LBOs, stock repurchases, ESOPs, and equity carve-outs or recapitalizations. *Organisational restructuring* is intended to increase efficiency through changes in organizational structure, internal reorganisations or downsizing. The rationale behind a spin-off, tracking stock or carve-out is that "the parts are greater than the whole."

These corporate restructuring techniques, which involve the separation of a business unit or subsidiary from the parent, can help a company raise additional equity funds. A break-up can also boost a company's valuation by providing powerful incentives to the people who work in the separating unit, and help the parent's management to focus on core operations. As financial statements are issued separately, shareholders get better information about the business unit. This would be of particular use when a company's traditional line of business differs from the separated business unit. Separating the subsidiary from the parent can reduce internal competition for corporate funds.

With respect to disadvantages, demerged companies are likely to be smaller than the parent company possibly making it harder to tap credit markets. Smaller size could also lead to the company losing its place in the stock market indexes.

Research studies[3] have shown that U.S. firms rely, to a considerable extent, on intensification, rationalisation, collaboration and incremental internationalization. In contrast, major Japanese enterprises' restructuring has concentrated on investment and technical change and incremental internationalisation. The emphasis of U.S. corporations has been on overcoming locational disadvantages and restoring the conditions for competitive operations in the home market.

European companies are also restructuring by 'off-shoring' and 'outsourcing' production. In European multinational companies, such relocation is increasingly taking place across borders, with a tendency for the companies in some sectors to shift production/service provision especially into the new EU States where manufacturing costs are substantially lower.

Employment trends have changed radically over the last decade in most of Europe. This has led to changes in employment patterns—increase in services and fall in manufacturing industry.

Restructuring has contributed to shareholder value creation. In the past decade, hundreds of corporations have used tracking stocks, equity carve-outs, and spin-offs for this purpose. AT&T's 1996 ownership restructuring provides a striking example. Before the company announced its intention to spin off Lucent Technologies and NCR, its market value was just $75 billion. Little more than a year later, in January 1998, the separately trading AT&T, Lucent and NCR had a combined market capitalisation of $159 billion.[4]

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[3]Enderwick Peter, 'Multinational Corporate Restructuring and International Competitiveness', California Management Review, 1989

[4]Patricia L Anslinger, Steven J Klepper and Somu Subramaniam, 'Breaking up is good to do. Restructuring through Spin-offs, Equity Carve-outs and Tracking Stocks can Create Shareholder Value', The Mckinsey Quarterly, 1999 Number 1, pp. 16-27.

EXAMPLES OF CORPORATE RESTRUCTURING

Restructuring by Unilever

Unilever is one of the largest consumer goods companies in the world. In September 1999, the company had announced its plan to restructure its brand portfolio by the end of 2004. The plan involved cutting down its unwieldy portfolio of 1600 brands and focusing on its top 400 brands. Unilever brands were facing sluggish growth. During the late 1990s, the market capitalization of Unilever lagged far behind its competitors, like Nestle and Procter & Gamble. During the 1960s and 1970s, Unilever rapidly expanded its operations through vertical and horizontal integration, emerging as a diversified conglomerate by the early 1980s. Diversification into different businesses was prompted by the existing line of business. The company's focus on oilseed business led it into the animal feed business. In February 2000, the company announced a Euro 5 billion growth strategy to improve its performance. The initiative was named the "Path to Growth Strategy". This exercise was aimed at comprehensive restructuring of operations and businesses. The plan involved modifying the existing organisational structure, focusing on leading brands and its innovations, simplifying the business processes and divesting the underperforming businesses and brands. The plan envisaged annual cost savings of Euro 1.5 billion by 2004. The plan also envisaged laying-off over 25,000 employees worldwide, about 10% of its employee base by 2004. By July 2002, Unilever's 400 leading brands accounted for 88% of the sales, up from 75% in 1999. By that time over 30,000 employees had been laid off.

Restructuring by Proctor & Gamble

In 1999, Proctor & Gamble announced its restructuring plan regarding its business structure and marketing plans. P&G's new plan involved new market development organisations, which would focus on developing market strategies to build P&G's entire business, based on local consumer and customer knowledge. The company was transforming from a structure of four business units, based on geographic regions, to seven global business units, based on product lines. Organization 2005–a six year long restructuring exercise–included standardisation of work processes to expedite growth, revamping of organisation culture, reduction in hierarchies to enable faster decision-making processes and entrenchment of employees to cut costs. With the implementation of its plan, P&G aimed to increase its global demand. The cost of the programme was estimated to be $1.9 billion, and it was expected to generate annual savings (after tax deductions) of approximately $900 million per annum by 2004. One of the major objectives of Organization 2005 was to significantly improve all inefficient work processes of P&G, including product development, supply chain management and marketing functions. P&G undertook several IT initiatives–like collaborative technologies, B2C ecommerce, web enabled supply chain and a dataware house project–for supplying timely data to company's operations located globally. Organisation 2005 is said to have failed to give desired results.

CORPORATE RESTRUCTURING: SELECT INDIAN EXAMPLES

Consolidation of Indo Gulf Fertilizers and Birla Global Finance with Rayon

The merger of Indo Gulf Fertilizers and Birla Global Finance with Rayon was one of the major consolidations of its kind in India. This restructuring exercise was valued at over Rs 5000 crores. It created a company that captured opportunities in the evolving Indian economy through leadership in focussed value businesses, viz., Carbon Black, VFY, and Textiles and Fertilisers, and driving high growth businesses, viz., Garments, IT/ITES, Financial Services, and Telecom.

Under two separate restructuring schemes, India Rayon issued one equity share of its company for every three equity shares held by the shareholders of Indo Gulf and Birla Global Finance. The swap ratio was expected to translate into a reasonable premium to both Indo Gulf and Birla Global Finance shareholders, based on the current Indian Rayon share price at that time. The share exchange ratios were based on valuations done by two firms, viz., Bansi S. Mehta & Co, and Deloitte Haskins & Sells. Though the fertilizers business has seen steady profits, regulatory uncertainties, constraints and growth avenues made accelerated value creation difficult. The merger was aimed to provide shareholders of Indo Gulf wider opportunity to participate in enhanced value creation. The consolidation of financial services business of the Group under Indian Rayon was aimed at extending the participation of Birla Global Shareholders in financial services beyond Mutual Funds into life insurance.

The Merger of Indo Gulf and Hindalco

The landmark corporate restructuring of Hindalco and Indo Gulf in 2002 was meant to create a non-ferrous metal powerhouse. This restructuring was valued at Rs 7000 crore (US$1.4 billion). Indo Gulf merged its copper business with Hindalco while its fertilizer business was demerged into a separate company, Indo Gulf Fertilizers.

One equity share of Hindalco was exchanged for 12 shares of Indo Gulf, and one equity share of the fertilizer company for five equity shares of Indo Gulf was issued to the Indo Gulf shareholders. The GDR holders of IGCL received one GDR of Hindalco for every 12 GDRs held by them in IGCL. The recommended swap ratio was meant to translate into a reasonable premium to IGCL shareholders, based on the Hindalco share price, and estimated price for Indo Gulf Fertilizers, based on fertilizer industry multiples and the company's financial performance and balance sheet strength.

A stronger balance sheet created by such a merger results in a variety of value enhancing opportunities.

Post restructuring, Hindalco emerged as one of the largest private sector companies in India. The merger was meant to enhance value for shareholders of Hindalco, which included all shareholders of Indo-Gulf, through the creation of a larger non-ferrous metal company, with strong profitability of the copper business and full consolidation benefits of INDAL's earnings. The fertilizer division, Indo Gulf Fertilizers, was expected to have a strong debt-free balance sheet, with significant leverage capability for future initiatives in the sector.

Restructuring of Sterlite Industries Ltd.

Sterlite Industries is a leading producer of copper in India. It is a part of Vedanta Resources, a London listed metals and mining major, with aluminum, copper and zinc operations in India and Australia.

In September 2008, Vedanta Resources plc announced its intention of restructuring to simplify its corporate structure into three commodity focused groups: copper and zinc-lead, aluminium and energy and iron ore. Under the scheme, which became effective in April 2009, Sterlite demerged its aluminium and energy businesses to Madras Aluminium Company (Malco) (to be simultaneously renamed Sterlite Aluminium), and Vedanta will transfer its 79.4% equity interest in Konkola Copper Mines plc (KCM) to Sterlite. The scheme eliminated cross holdings between businesses arising out of Malco's holdings in Sterlite. The corporate restructuring was expected to be completed by March 2009. Malco will issue 7 shares of Rs 2 each to the shareholders of Sterlite for every 4 shares of Rs 2 each held by them. Sterlite will issue 1 share of Rs 2 each to Malco shareholders for every 51 shares of Rs 2 each held by them.

Restructuring by BPCL Ltd

In the post 2002 decontrol era, BPCL decided to restructure into a marketing oriented company. After the lubricant sector was decontrolled in 1993, BPCL was divided into six Strategic Business Units, namely retail outlets, commercial users, lubricants, LPG, aviation and refinery. This action enabled managers to focus on specific customers. Twenty two divisional offices were replaced by sixty one branches in smaller territories, based on smaller geographical areas. All administrative offices were moved to supply locations, with 125 terminals for main fuels and thirty five LPG bottling plants.

Restructuring by Bharti Enterprises

Bharti Enterprises is one of India's leading business groups, with interests in telecom, agri-business, financial services and retail. Bharti Airtel Limited, a group company, is one of India 's leading private sector providers of telecommunication services, with over 71.7 million customers, as at the end of June 2008, spanning mobile services, telemedia services and enterprise services. Bharti Airtel has been ranked amongst the best performing companies in the world in the Business Week IT 100 List, 2007.

On 5th August 2008, Bharti Enterprises announced strategic restructuring of the group at corporate level, in order to strength organisation structure and governance model. As part of the new strategic apex level re-structuring, an office of the Chairman & Group CEO has been created, with primary focus on seeking growth opportunities, guiding businesses, securing financial health of the group, and growing and developing talent. Group functional directors have been further empowered to enable them to co-shape all businesses of Bharti. The Group functions will leverage best practices and synergies across group businesses, to create an environment of partnership and collaboration.

Restructuring by J K Tyres

J K Tyre is the foremost manufacturer of four wheeler tyres, and is the largest bus and truck tyre manufacturer. J K Industries' main business interest is in tyres, sold under the well-known brand 'J K Tyres'. It is the only Indian manufacturer producing the entire range of truck/bus, LCV, MUV, Jeep, Car and Tractor radials. The company later made foray into Agri business by setting up a facility for manufacture of sugar, and established research farms and facilities for production of hybrid and high yielding seeds. In 1997, J K Industries had acquired majority stake in Vikrant Tyres and turned it around in a very short period. The merger was aimed to achieve the benefits of scale, synergy, logistics and marketing.

Non-tyre business, viz. sugar and agri seeds, have been demerged into two separate entities, namely J K Sugar Limited (JKSL) and J K Agri-genetics Limited (JKAGL), respectively.

Restructuring by Birla Group

In October 1995, Kumar Mangalam Birla took charge of the AV Birla Group, after the death of his father, Aditya Birla. After he took over, the group turnover has grown fourfold. Kumar Birla has revamped the business portfolio, and started looking seriously at sunrise businesses, like telecom, branded apparel, software, ITES (IT enabled services) and insurance, through joint ventures and acquisitions. The group has also consolidated its competitive position in traditional businesses, such as cement, aluminium, copper, VSF (Viscose Stable Fibre) and carbon black.

DIVESTITURES: EMPIRICAL EVIDENCE

Divestitures have traditionally been seen as opposite of mergers and acquisitions. The 1980s were known as the decade of mergers and acquisitions, whereas the 1990s would be known as the decade of divestitures. In the eighties, many corporate acquisitions were driven by the objective of shareholder wealth maximisation through diversification in often unrelated industries and markets. The decade of 1980s is known for the nature and amount of restructuring among large corporations. During this decade, around 1200 divestitures, valued at $59.9 billion, took place. The leveraged buyout during this period amounted to 2540, worth $297 billion dollars. A staggering 55,000 mergers and acquisitions, worth under $2 trillion dollars, took place during the period, 1981-1989.[5] The impacts of these restructuring activities were felt in every sector of the US and European economies.[6] According to Mergerstat Review, the total number of divestitures increased from 1940 in 1990, to 1702 in 1996.

By 1990s, the focus was back on core businesses. In the 1990s, more and more businesses were selling, spinning-off or disposing of subsidiaries and divisions. With increased competition, companies had to focus on activities that had a comparative advantage. Divestitures are means through which companies can undo earlier diversification efforts. Divestitures involve selling of assets, product lines, division or subsidiary for cash or stock, or both. Divestitures can be used to focus on core areas while disposing of underperforming assets or declining businesses. There are a number of transactions in divestitures, like, spin-offs, split-offs, split-ups and equity carve-outs.

The sell-off of a unit raises money for the parent company which may be used for growth activities. Equity carve-out is another method of selling a division in which the parent company creates a new publicly traded company out of one of its divisions, and sells that stock to the public in an IPO (Initial Public Offering). If a company does not need cash, it can spin-off a business unit to its shareholders. The division can be turned into an independent company with publicly traded shares. Management Buyout (MBOs), Employee Buyout (EBOs) and whole firm buyouts are the three types of LBOs.

Researchers have offered several alternatives as triggers for downscoping.[7] Some studies, like Hoskisson & Hitt (1990), Shleifer & Vishny (1991), suggested that tax and antitrust policy triggered the realignment of assets among diversified firms in the early 1980s. Increase in global competition has also led to refocusing. These changes in the business environment suggest that firms engage in downscoping to shed unwanted or undervalued assets. The rationale for downscoping also involves firm governance, strategy and performance. Poor strategy formulation may lead to downsizing. Hoskisson et al. finds evidence that suggests that the majority of firms that refocused exhibited higher level of diversification than their industry counterparts. Poor performance represents the most studied antecedent for downscoping.[8] Poor firm performance or business unit performance signals the need for change. Financial restructuring is another antecedent for downscoping. Financial restructuring and asset restructuring (downscoping) may occur simultaneously. Seth and Easterwood (1993) provide evidence that many firms engaging in LBOs (financial restructuring) end up divesting units that no longer fit firm strategy. In this context, financial restructuring may lead to downscoping, as managers attempt to increase firm efficiency and pay down debt.

Ravenscraft and Scherer (1987) report that 33% of the acquisitions in the 1960s and the 1970s were later divested, while Porter (1987) finds that more than 50% of the acquisitions made by 33 firms in unrelated industries were subsequently divested. Kaplan and Weisbach (1992), who studied a sample of large acquisitions completed between 1971 and 1982, find that by the end of 1989, these acquirers divested almost 44% of the target companies. Kaplan and Weisbach (1992) argue that many acquisitions are not failures from an ex-post perspective, and suggest that an acquirer may sell a business it has improved, or a business that it once had synergies with, but does not have any longer.

Zsuzanna et al. suggest that the motivation for merging stems from the inability of a marginally profitable project to obtain financing as a standalone entity, due to agency problems between managers and potential claimholders. Divestiture occurs after good performance that allows the once marginally profitable project to be financed as a stand alone. Shleifer and Vishny (1989) argue that diversification and divestiture can be

[5]Jensen M C (1993), 'The Modern Industrial Revolution, Exit and Failure of Internal Control System', Journal of Finance 48: 831-880.

[6]Bowman E H and Singh H, (1993), 'Corporate Restructuring, Reconfiguring the Firm,' Strategic Management Journal 14 (Special Issue): 5-14 ; Markides C C, (1992 b), The economic characteristics of diversifying firms, British Journal of Management 3, 91-100.

[7]Richard A Johnson, 'Antecedents and Outcomes of Corporate Refocusing', Journal of Management, 1996, Vol 22, No 3, 439-483.

[8]Ravenscraft D J and Scherer F M, (19871), 'Mergers, Sell-offs and Economic Efficiency', Washington DC Brookings Institution.

viewed as managerial strategies to achieve entrenchment. Managers choose manager-specific acquisitions so as to make themselves indispensible to their firm at the shareholders' expense. When an asset or a subsidiary ceases to provide further entrenchment benefits for the manager, divestiture follows.

Matsusaka and Nanda (1995) provide an explanation that relies on it being easier to able to move resources within a firm than across firms. Merging two divisions into one firm allows resources to be transferred across divisions as profit opportunities arise. On the other hand, if the firm wants to commit resources credibly to a division, to deter entry into that division's industry, it may divest itself of the other division.

DIVESTMENTS: SELECT EXAMPLES

Alcan of Canada, the second largest producer of Aluminum in the world, divested 40 businesses, with more than 100 plants worldwide and combined sales of US $2.5 billion. Since 1991, Alcan has cut its annual cost by US $600 million, and has reduced its debt by selling non-core assets worth one billion dollars. Several multinational firms operating in India, like Glaxo, and Hindustan Ciba Geigy, have made large divestitures.

Union Bank of Switzerland sold its Swiss Car leasing and consumer credit business to GE Capital Services Ltd.

Table 9.1 *Nokia Disinvestments*

Date	Divestiture Target	Nokia Business Division
April 14, 2009	Nokia's Security Appliances	Services
June 16, 2008	Fit Automotive Business	Devices
June 2, 2008	Adaptation Software R & D Entity	Nokia Corporation
May 16, 2008	Identity System	Services and Software
November 5, 2007	3G Chipset Development	Nokia Corporation
March 18, 2005	Nextrom Holding	Nokia Corporation
September 5, 2005	Professional Mobile Radio Business	Networks
August 30, 2001	Parts of Mobile Core Related R & D	Nokia Networks
March 13, 2001	Narrow Brand Access Products	Nokia Networks
June 13, 2000	Cabling and Electromechanical Units	Nokia Networks
January 17, 2000	Nokia Display Products Branded	Nokia Display Products
January 10, 2000	Monitor Manufacturing Unit in Hungary	Nokia Display Products
November 1, 1999	SHD/DWDM Business	Nokia Networks
October 1, 1999	Salcomp Oy	Nokia Communication Products
September 9, 1998	Mobile Radios and Printed Circuit Boards	Nokia Networks
August 7, 1998	LK-Products Oy	Nokia Mobile Phone
March 3, 1998	Autoliv Nokia AB	Nokia Industrial Electronics
December 23, 1997	Loudspeaker Operationa	Nokia Industrial Electronics
February 7, 1997	Tuner Operations	Nokia Multimedia Network Terminals
July 17, 1996	Television Production	Nokia General Communications Products
March 18, 1996	Cable Business/NKF Holding NV	Nokia Communications Products

Source: www.nokia.com

DEMERGERS IN INDIA[9]

Companies in India are also adopting the technique of splicing their operations with the objective of getting more focused. Great Eastern Shipping took out the oil field services operations out of its flagship company, thus making it a pure shipping company. In 2005, five big companies restructured their business through this option. Reliance Group demerged into Reliance Industries and Anil Dhirubhai Ambani Enterprises. Mukesh Ambani got to manage the old economy businesses–Reliance Industries, IPCL and Reliance Industrial Infrastructure of the erstwhile Reliance Group. Anil Ambani got Reliance Capital, Reliance Power and Reliance Telecom. The Reliance Industries retained petrochemicals, refineries, industrial infrastructure and biotechnology divisions.Vardhman spinning offloaded its textiles business to group company, Mahavir Spinning. Eveready Industries demerged its tea activities from its battery business. Morargee Realties hived-off its textiles arm and JK Corp decided to park its investment arm in a non-banking financial company.

Table 9.2 *Demergers*

Group/Company	Core Business	Demerged Entity
Reliance Group	Reliance Industries	Anil Dhirubhai Ambani Enterprises
GE Shipping	Shipping	Offshore Oilfield Services
Morarjee Realties	Real Estate	Textiles
JK Corp	Cement	Investment
Vardhaman Spinning	Investment	Textiles
Eveready Industries	Battery	Tea

Source: Business Today, Oct. 9, 2005.

Involuntary Divestment

Sandoz sold part of its maize herbicide business to BASF German Chemicals for $778 million. The disposal removed one of the obstacles to the merger of Sandoz with Ciba. The maize herbicide business was one of the three areas to which the US Federal Trade Commission (FTC) has raised objections, as part of its investigation into the mergers.

CORPORATE SPIN-OFFS

Corporate spin-offs have become a popular way for companies to release shareholder value. A spin-off involves the pro-rata distribution of a controlled corporation's stock to the distributing corporation's shareholders without their surrendering any distributing corporation stock.

A corporate spin-off can be defined as the distribution of all, or substantially all, of the ownership interest of one firm (the parent) in another firm (the subsidiary) to the parent's shareholders, so that following the spin-off, there are two separate publicly held companies.[10]

A spin-off occurs when a subsidiary becomes an independent entity. The parent firm distributes shares of the subsidiary to its shareholders through stock dividend. Each shareholder receives shares in the new

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[9]Mahesh Nayak, 'The Demerger Option', Business Today, Oct. 9 2005, page 81.

[10]Ronald Kudla, Thomas H Mclnish,' Corporate Spin-offs Strategy for the 1980s'. Westport CT: Quorum Books 1984, page 3.

company proportionate to his or her ownership in the parent. The parent company/group does not receive any proceeds from the demerger, as the demerged company's shares are directly distributed to the parent company shareholders.

The subsidiary becomes a separate legal entity with a distinct management and board. The spin-off company's management does not have to compete for the parent's attention and capital. In a spin-off, since the transaction is dividend distribution, no cash is generated.

A corporate spin-off divides a company into two or more independent firms, and offers a firm an opportunity to improve managerial incentives with fresh compensation packages.

Corporate spin-offs are complex transactions that entail simultaneous restructuring of assets and top management. Spin-offs provide an opportunity to examine the manner in which economies of a firm are related to the way its top management team is structured. The persons, assets and intangibles transferred from the parent company constitute the key-element of the spin-off's core-business. They are often the consequences of restructuring or refocusing activity of the parent company.

Nature and Characteristics of Corporate Spin-offs

Corporate spin-offs are basically of two types, 1. Restructuring spin-off and 2. Entrepreneurial spin-off.

Restructuring type spin-offs are initiated by the parent company for strategic or operational motives related to the parent company. Spin-offs resulting from restructuring activities of large companies are undertaken in order to (a) dispose of businesses that no longer fit the company's core strategy, (b) externalise functions in order to reduce costs, and (c) avoid direct lay-offs and costly social plans. Restructuring spin-offs are particularly evident in countries like France, Germany and Sweden.

Entrepreneurial spin-offs are driven by one or more individuals (spin-off entrepreneurs) who want to exploit an unused potential based on their experience acquired within the parent company. These spin-offs are formed when the spin-off entrepreneurs form a new company, based on the critical knowhow acquired during their previous professional experience, in order to exploit an unused potential. Entrepreneurial corporate spin-offs appear to be more common in Spain and Denmark, where, relatively, SME base is more significant compared to lesser restructuring by large companies. There are two types of entrepreneurial spin-offs (a) those where spin-offs seek to continue to collaborate with their former parents, and (b) those which compete with their former parent company.

Each European country displays a different corporate spin-off environment and profile.

In the United Kingdom, well-developed capital markets and numerous support schemes for small, innovative businesses are stimulating corporate spin-off activity. In Sweden, corporate spin-offs are often the result of strategic programmes of large companies; whilst, in Italy, regional differences appear to shape the spin-off phenomena, due to diversity of regional industrial structures. In France, about three-quarters of corporate spin-offs result from restructuring of large companies. This is supported by the legal and fiscal framework, which favours spin-offs resulting from restructuring over entrepreneurial spin-offs. In Denmark, corporate spin-offs seem to have mainly entrepreneurial character.

Drivers for Spin-Offs

Spin-offs are usually about separating a healthy operation. In most cases, spin-offs unlock hidden shareholder value. For the parent company, it sharpens management focus. The management of the spin-off company does not have to compete for its parent's attention and capital. Once set free, the managers can explore new opportunities. The factors central to corporate spin-offs focus on the need to downsize and raise turnover per employee. Activities that are not within the company's core-competencies, and that do not meet its minimum performance requirements, are either closed or spun-off. The costs involved are crucial in terms of the decision to spin-off or close down an activity. Moreover, sectors with high spin-off activity undergo a high level of cost-cutting activity. Many corporate spin-offs are highly leveraged, because they have to finance the separation from the parent company, transition to a stand alone company and investment into new products and markets.

Mckinsey research[11] has shown that the parent company spin-off takes place when the parent company is no longer in the best position to create greatest value from its business through skills, systems or synergies. One reason for the 1996 spin-off of EDS from GM was the desire to free EDS from the constraints that prevented it from pursuing certain deals. Spin-off also takes place when the strategic interests of the parent and subsidiary conflict. When US West issued tracking stock for its Media Group in 1995, it expected the telecom services and cable businesses to converge. But when the expected synergy did not materialise, the parent and the subsidiary found themselves in opposite camps over regulatory issues. The Media Group was spun-off as MediaOne in June 1998.

Spin-offs can increase the strategic flexibility of businesses by allowing a subsidiary to form relationships with companies that do not want competitive information to flow to its parent. After being spun off from AT&T, Lucent was better able to do business with international telecommunications companies that perceived its parent as a rival. The present form of Lehman Brothers was formed from the spun-off of American Express in 1984.

Empirical Evidence on Corporate Spin-Offs

Empirical evidence suggests that market reaction on spin-off announcements is significantly positive. [(Schipper and Smith (1983), Hite and Owers (1983), Miles and Rosenfield (1983)]. Uyong (2007) analyzing a sample of 124 non-taxable spin-offs, during 1990-1997 found that changes in incentive compensation are significant motives for spin-offs. The study also found that spin-offs that are not accompanied by enhanced pay performance relationship do not improve operating performance, even with increased business focus. Daley et al. (1997) and Desai and Jain (1999) suggest that the value creation for FI spin-offs come from operating performance improvements. Cusatis, Miles, and Woolridge (1993) find an unusually high level of takeover activity for both parent and spin-off firms, following a spin-off. Gertner et al. (2000) find evidence of more efficient internal capital markets following spin-off transactions. Eric et al. (2007) establish that firm-specific human capital, governance expertise, and top management experience affect the composition of spin-off firms' top management, and the structure of spin-off top management is related to the value created by the spin-off.

The study by Sudha et al.[12] (1999) analyse information related motivations for why firms divest divisions through spin-offs. The information hypothesis argues that the separation of a firm's divisions into independently traded units, through a spin-off, improves market valuation by mitigating information asymmetry about the firm. Using the different measures of information asymmetry, the study finds that firms that engage in spin-offs have higher levels of information asymmetry prior to the spin-offs as compared to their industry and size-matched firms. Firms that have higher growth opportunities, and firms that are in need of external capital, show a higher propensity to engage in spin-offs even though spin-offs themselves generate no new capital for the firms.

The Pepsi Spin-Off

During the mid 1990s, Pepsi Co was not doing well. Its flagship, Pepsi Product, was losing ground to Coke in the United States and abroad. Diet Pepsi had slipped to fourth position among soft drinks (behind Coca

[11]Patricia L Anslinger, Steven J Klepper and Somu Subramaniam, 'Breaking Up is good to do. Restructuring through Spin-offs, Equity Carve-outs and Tracking Stocks can create shareholder value, The Mckinsey Quarterly, 1999, Number 1, pp 16-27.

[12]Sudha Krishnaswami, Venkat Subramaniam, 'Information Asymmetry , Valuation and the Corporate Spin-off Decision', Journal of Financial Economics, July 1999, Vol. 53, No. 1

Cola's citrus soda). Pepsi's Pizza Hut and KFC chains have increasingly come under intense pressure from competitors like McDonald's and Burger King.

Pepsi acquired Pizza Hut and Taco Bell in the 1970s with the aim to become world's largest fast food vendor. By mid 1980s, it acquired Kentucky Fried Chicken. Pepsi aimed to bring its vaunted expertise in marketing and new product development to Kentucky Fried Chicken. There was also scope for creating one-stop shopping for fast food. It was also expected to enhance Pepsi's share of fountain beverage sales, as Kentucky Fried Chicken franchisees switched from Coke to Pepsi.

The acquisitions failed on many accounts. Kentucky Fried Chicken trailed the market when its competitors, including Boston Market and grocery stores, successfully introduced healthier roasted chicken. Pizza Hut had to face severe competition from Domino's and Little Caesar. Taco Bell's new-product launches have also met with mixed success, and its attempt to attract price-conscious customers with 59-cent tacos failed when McDonald's and Burger King engaged in a bitter price war of their own. Overall, the profitability of Pepsi's restaurant division trailed that of its soft drink and snack food divisions. At the time of the Tricon spin-off, Pepsi's share of the fountain beverage market – just one-third that of Coke-was at its lowest since the Kentucky Fried Chicken acquisition.

In the year 1997, Pepsico spun-off KFC, Pizza Hut and Taco Bell into a separate corporation Tricon Global Restaurants Inc. The company spun-off 100% of its restaurant unit to stockholders who received shares in the new company. The spin-off was aimed at better focus on its Pepsi beverage operations and Frito Lay snack business.

The company also spun-off its main $7 billion bottling operation into an independent public company, something Coke did years ago to create Coca-Cola Enterprises. The spin-off left Pepsi's concentrate and bottling setup looking a lot more like Coke's. In the last decade, PepsiCo has undergone transformation through acquiring of Tropicana, and Quaker Foods, and spring-off of its restaurant and bottling divisions.

Other examples of spin-offs include AT&T spinning off Lucent Technologies, Whitman Corporation spinning off its Midas Muffler chain, Hilton spinning off its gambling and casino properties into Park Place Entertainment, and Campbell Soups spinning off Vlasic International, famous for making pickles. In 1993, the biosciences division (pharmaceuticals, bio-chemicals) of Imperial Chemical Industries were spun-off into Zeneca, leaving the chemical business with ICI. Several other conglomerates like ITT and Hannson, have also restructured through spin-offs. Companies like Novartis and Monsanto have created independent companies through spin-offs. Novartis spun-off its Speciality Chemicals, valued at $4.1 billion. Novartis, formed by the merger of Ciba and Sandoz, spun-off Ciba Specialty Chemicals, valued at $4.1 billion. Monsanto spun-off its chemical businesses to focus on its faster growing agriculture, food and health care units.

Philips spun-off BC components International BV as an independent company in the year 2001.

Indian Examples for Spin-Offs

Spin-offs have become fairly common in the Indian scenario. Basically, Indian promoters are generally reluctant to shed ownership control, or part with cash.

In 2008, online auction site, eBay Inc., spun-off its online classifieds business, Kijiji India, a part of Kijiji International Ltd, as a separate venture, in partnership with Mumbai-based venture capitalist (VC), Matrix Partners India. This is the first VC-backed spin-off for the San Jose, California-headquartered company in any of its markets. Kijiji will now be jointly owned by eBay and Matrix, which has invested an undisclosed amount in the company. Kijiji, launched by eBay in India in late 2005, allows users to put up advertisements for local services in 12 cities. eBay wants to grow its local businesses in the Asia Pacific region, either through direct presence, acquisitions or partnerships.

For better planning and inventory management, timely delivery and cost synergies, General Motors (GM) India, wholly-owned subsidiary of the world's largest automobile maker, the US-based General Motors Corporation, has formed a new sales and distribution entity, General Motors (India) Marketing Pvt Ltd.

As part of this restructuring exercise, GM India is transferring its sales, marketing and distribution activities to the new company, while all manufacturing activities will remain with General Motors (India) Pvt Ltd.

Ranbaxy spun-off its fine chemical businesses into a 100 per cent subsidiary. Clariant (India) has been split into chemical and dyestuffs division.

For the completion of acquisition of NatSteel by Tata, Nat Steel spun-off its steel business into a wholly-owned subsidiary—NatSteel Asia Pte Ltd.

In the year 2000, Morepen Laboratories initiated operational restructuring to spin-off its three business divisions into separate profit centres, with niche focus areas. The company's business, post-restructuring, was divided into three business areas of generic bulk drug, finished dosage (Pharma) and over the counter (OTC) divisions. The generic business constituted close to 50% of the company's turnover, and finished dosage and OTC contributed 40% and 10% respectively, during the period of spin-off.

Bayer India, Indian arm of the German pharmaceuticals and chemicals major, Bayer AG, hived off its non-crop science business into a separate company.

Tata Teleservices Maharashtra Ltd spun-off its telecom tower infrastructure division to a separate unit. Reliance Capital Ltd recently announced its decision to spin-off its home loans business into a new company.

In 2005, Hyderabad's Dr. Reddy's Laboratories spun out four drugs in various levels of testing to a company, predominantly owned by private equity firms, ICICI Venture and Citigroup Venture Capital. Sunpharma is splitting its R&D as a separate venture.

In one of the country's largest M&A transactions, Grasim Industries took a giant step towards becoming a global-scale cement player by buying out the cement division of rival Larsen & Toubro (L&T), valued at Rs. 2,200 crore. The complex deal was structured in different phases, and envisaged the spin-off of L&T's cement division into a company named Ultra Tech, followed later by the acquisition of control by Grasim.

Mumbai-based network engineering services company, GTL, demerged its telecom and network-related infrastructure business to GTL Infrastructure. Shyam Tele demerged its infrastructure business. GTN Textiles demerged its Aluva unit along with its investment in Patspin India to a new company, GTN Industries Ltd.

Wipro Ltd is a good example for spin-off. The information technology division was spun-off from the traditional business.

In the year 2008, Pantaloon Retail India Ltd declared a decision of their board that they were going to spin-off the sports business of its joint venture, Planet Retail Holdings, into a separate entity.

SPLIT-UP

In a split-up, the existing corporation transfers all its assets to two or more new controlled subsidiaries, in exchange for subsidiary stock. The parent distributes all stock of each subsidiary to existing shareholders in exchange for all outstanding parent stock, and liquidates. In other words, a single company splits into two or more separately run companies.

One of the classical examples for split-up is the split-up of AT&T into four separate units—AT&T Wireless, AT&T Broadband, AT&T Consumer and AT&T Business. It could be termed as one of the biggest shake-ups in the US telecommunications industry since 1984. AT&T had long fought against breaking up its operations, first in 1968, when the US Federal Communications Commission stripped it of its telephone equipment monopoly, and then again in the 1970s, when an antitrust suit led the 1984 court supervised break-up that created the seven, so called, "Baby Bells".

Another notable example of a split-up was the 1995 break-up of ITT into three businesses—diversified industrial, insurance, and hotels and gaming. ITT was founded in 1920 as the telecommunications company, International Telephone and Telegraph. The company gradually expanded its business into insurance, hotel and manufacturing sectors. In 1995, ITT divided itself into three companies, ITT Industries, a manufacturing company, ITT Hartford, an insurer, and the current ITT Corporation. In 1997, ITT Corporation again decided to split itself into three separate companies and bought back $2.1 billion of its stock. This restructuring was triggered due to the unsolicited $6.5 billion takeover bid from the Hilton Hotel Corporation. The split-up, aimed to create independent companies, consisted of ITT's hotel and casino operations, to be called ITT Destinations Inc., the ITT Corporation, whose sole asset would be ITT World Directories Inc., its telephone directory publishing business, and ITT Educational Services Inc., a leading technical-school business in which ITT has an 83.3% stake. But the split-up was held-up due to legal hassles.

In 1952 Japan split its Telecom utility into two—Nippon Telegraph and Telephone (NTT) serving the domestic market and KDD the international market. Hilton Hotel Corporation had split Hotel and gambling operations into separate companies.

Split-ups in Indian Companies

In 1980, the members of the Birla Group agreed to manage their own companies. Aditya Birla took control of Grasim Industries, Indian Rayon & Industries and Hindalco. B K Birla took control of Century Textiles, Kesoram Industries and Mangalam Cement. S K Birla took control of Birla VXL and Mysore Cements. G P Birla controlled Hindustan Motors. In 1989, Modi Group split up vertically into two companies—Modi Spinning & Weaving Mills Ltd and Modi Industries. Modi Industries had nine divisions, out of which six went to the KN group and three to the KK Group.

Prior to the split-up of Reliance Industries, Ambani brothers were engaged in a fratricidal power struggle. Reliance Industries was split into five listed companies in the year 2005-06—the Mukesh Ambani led Reliance Industries and Anil's Reliance Communications, Reliance Natural Resources, Reliance Energy and Reliance Capital. It was interesting to note that the market capitalisation of the five listed companies resulting out of the empire's demerger was about Rs 268,455 crore during the immediate period surrounding the split-up. Before the split, Reliance Industries, the only listed company of the group, was valued at Rs 129,339 crore. Sterlite Group also split into Sterlite Optical and Sterlite Industries.

SPLIT-OFF

A split-off is a type of corporate reorganization whereby the stock of a subsidiary is exchanged for shares in the parent company. Split-offs are basically of two types. In the first type, a corporation transfers part of its assets to a new corporation in exchange for stock of the new corporation. The original corporation then distributes the same stock to its shareholders, who, in turn, surrender part of their stock in the original corporation. In the second type, a parent company transfers stock of a controlled corporation to its stockholders in redemption of a similar portion of their stock. 'Control' refers to the ownership of 80% or more of the corporation whose shares are being distributed.

A split-off differs from a spin-off in that the shareholders in a split-off must relinquish their shares of stock in the parent corporation in order to receive shares of the subsidiary corporation, whereas the shareholders in a spin-off need not do so.

In 1994, five big companies took the split-off route. They included Cooper Industries, Eli Lily, Price/Costco, Viacom and GM. Cooper Industries created a subsidiary of its oil field services, Cooper Cameron, which it had acquired earlier. It invited shareholders to exchange their shares of Cooper Industries in exchange for shares of Cooper Cameron. This allowed shareholders, who preferred a certain part of the parent company, to shift their shares.

Viacom announced a split-off of its interest in Blockbuster in 2004, whereby Viacom offered its shareholders stock in Blockbuster in exchange for an appropriate amount of Viacom stock. In 2008, Liberty Media Corporation announced its intention to convert the tracking stock for Liberty Entertainment into shares in a subsidiary that would hold the unit's assets. The plan aimed to put 50% of DirecTV, 100% of Starz, Fun and Liberty Sports, 50% of GSN, and 37% of Wild Blue into the new subsidiary. Liberty Entertainment would be responsible for about $2 billion in debt, incurred when the company acquired DirecTV from News Corp.

In 2008, Krafts Foods split-off its *Post* cereal business. The split-off transaction was in connection with the merger of Cable Holdco Inc., a wholly-owned subsidiary of Kraft that will own certain assets and liabilities of the *Post* cereals business, and a subsidiary of Ralcorp Holdings. Kraft entered into a definitive agreement on November 15, 2007, to distribute and merge its *Post* cereals business into Ralcorp. In this split-off transaction, Kraft shareholders will have the option to exchange some or all of their shares of Kraft common stock and receive shares of Cable Holdco common stock. The value of Kraft shares and Cable Holdco common stock will be calculated using the simple arithmetic average of the daily volume-weighted average prices of Kraft common stock and Ralcorp common stock on the New York Stock Exchange on the last three trading days of the offer.

MetLife Inc, the largest U.S. life insurer, has initiated an action plan to divest its 52% stake in Reinsurance Group of America Inc. Under the multi-step transaction, MetLife said Reinsurance Group would recapitalise its common stock into two classes. Substantially, all of MetLife's interest in the company would be exchanged for Reinsurance Group Class B common stock. Immediately after this recapitalisation, MetLife plans a tax-free split. Its stockholders could exchange their MetLife shares for Reinsurance Group Class B common stock.

EQUITY CARVE-OUT

Equity carve-outs are an Initial Public Offering (IPO) of a stake in a subsidiary. Although a carve-out technically is an IPO, economically, it is an asset sale to public shareholders as opposed to a single buyer, where the parent firm typically remains the controlling shareholder after the offering[13]. In other words, a parent firm makes a subsidiary public through an initial public offering (IPO) of shares, amounting to a partial sell-off. A new publicly-listed company is created, but the parent keeps a controlling stake in the newly traded subsidiary.

Equity carve-outs (also known as partial public offering) are transactions in which a firm sells its minority interest in the common stock of a previously wholly-owned subsidiary.

Carve-outs have assumed a prominent place in US equity activity. In the past ten years, the US stock market has seen an average of almost 50 carve-outs a year, or about 10% of all IPOs. A noted example of a substantial carve-out is DuPont's IPO of Conoco in October 1998. DuPont raised $4.2 billion for 30% stake in its subsidiary.

The equity carve-out differs from a spin-off in two respects. In a spin-off, a distribution is made pro rata to the shareholders of the parent firm as dividend—a form of non-cash payment to the shareholders. In an equity carve-out, the stock of the subsidiary is sold in public markets for cash which is received by the parent. A second distinction is that in a spin-off, the parent firm no longer has control over subsidiary assets.

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[13]Allen, J. W., and J. J. McConnell (1998): 'Equity Carve-Outs and Managerial Discretion,' Journal of Finance, 53, 163–186.

In a carve-out, the parent generally sells only minority interest in the subsidiary and maintains control over subsidiary's assets and operations.[14]

More and more companies are using equity carve-outs to boost shareholder value. A carve-out is a strategic option a parent firm may take when one of its subsidiaries is growing faster and carrying higher valuations than other businesses owned by the parent. A carve-out generates cash because shares in the subsidiary are sold to the public, but the issue also unlocks the value of the subsidiary unit and enhances the parent's shareholder value. The new legal entity of a carve-out has a separate board, but in most carve-outs, the parent retains some control. In these cases, some of the parent firm's board of directors may be shared. Since the parent has a controlling stake, i.e., both firms have common shareholders, the connection between the two will likely be strong. Equity carve-out may not be successful in context of situations in which the carved out subsidiary is too loaded with debt, or faced problems when it was part of the parent, and is lacking an established track record for growing revenues and profits.

An Indian Example

From 1984 onwards, Nicholas Piramal acquired Gujarat Glass, Nicholas Lab, Roche, Sumitra Pharmaceuticals and Boehringer Manheim. In 1998, Nicholas Piramal created two units through equity carve-outs. These new companies were Gujarat Glass and the bulk drug unit.

Empirical Evidence on Equity Carve-Out

In providing financing for the parent firm, equity carve-outs are also comparable to seasoned equity offerings of parent firms.[15] However, while seasoned equity offerings are associated with negative announcement returns (Eckbo and Masulis (1995), equity carve-out announcements consistently yield positive announcement returns. Schipper and Smith (1986) studied the performance of a usable sample of 81 carve-outs announced between 1965-1983. The results suggested that, on an average, equity carve-out are associated with positive abnormal returns of almost 2% over a five day announcement. These have since been confirmed by numerous studies for the US (for example, Allen and McConnell (1998), Vijh (2002)), and for Germany (Kaserer and Ahlers (2000), Elsas and Loffler (2001)). Pagano, Panetta, and Zingales (1998) analysed the motives for going public for a sample of 69 Italian firms, 40 of which are stand alone IPOs and 29 are carve-outs.

Their main finding is that carve-outs are best explained by attempts to take advantage of high industry valuations at the time of the offering transaction. Powers (2003) uses a sample of 181 US carve-outs and focuses on a hypothesis of increased efficiency following the carve-out versus a similar hypothesis of market-timed transactions. The result suggests that that there is no support for the increased efficiency hypothesis. However, he finds evidence of market timing considerations. Another study of a sample of 188 US carve-outs by Allen and McConnell (1998) finds that financially constrained parent firms use carve-outs as a financing measure. Vijh (2002) uses a sample of 336 US carve-outs in the period 1980-1997 and finds no support for the asymmetric information hypothesis, but finds support for various aspects of the divestiture gains hypothesis. Baker and Wurgler (2002)), Pagano, Panetta and Zingales (1998), Hand and Skantz (1999) and Powers (2003) argue that equity carve-out transactions are also mainly driven by market timing considerations. Before the carve-out, and in most cases, after the transaction also, the parent firm has residual control rights over the subsidiary unit (Alchian (1969), Williamson (1975), Stein (1997)). These

[14]J Fred Weston, Kwang S Chung, Susan E Hoag, 'Mergers, Restructuring and Corporate Control', Prentice Hall 1990, page 234.
[15]Hannes F Wagner, 'The Equity Carve-Out Decision', Working Paper http://papers.ssrn.com/sol3/papers.cfm?abstract id=524723.

control rights enable headquarters to reallocate cash flows among conglomerate divisions using the internal capital market. Hannes (2004) examines a parent firm's decision to create a new publicly traded company from a subsidiary unit, using a hand-collected sample of 82 equity carve-outs and carve-out announcements in Germany between 1984 and 2002. The results show that parent firm managers make use of relative cost advantages of external financing and finance past investments through carve-outs. This paper shows that the reduction in ownership of the parent is positively related to the value of the firm.

TRACKING STOCKS

Tracking stocks, also known as letter or targeted stocks, are a class of parent company stock that track the earnings of a division or subsidiary. Typically distributed as a dividend to shareholders in the parent company, these shares can also take the form of an initial public offering (IPO). In the case of tracking stocks, control remains in the hands of the parent company's board; in carve-outs and spin-offs, by contrast, management reports to new and separate boards. Similarly, the assets of companies with tracking stocks are not physically separated from those of their corporate parents, though they do have to report their earnings separately. In carve-outs and spin-offs, conversely, the subsidiary's assets are transferred to the new company's balance sheet.

When US West issued tracking stock for its Media Group in 1995, it expected the telecom services and cable businesses to converge. But when the expected synergy did not materialize, the parent and the subsidiary found themselves in opposite camps over regulatory issues. The Media Group was spun-off as MediaOne in June 1998.

SELL-OFF

Asset sell-off involves the sale of tangible or intangible assets of a company to generate cash. Normally, sell-offs are done because the subsidiary does not fit into the parent company's core strategy. Sell-offs often aim to sharpen the corporate focus by spinning off (or divesting) units which are a poor fit with the remainder of the parent company's operations. The market may be undervaluing the combined businesses due to lack of synergy between the parent and subsidiary. Along with getting rid of unwanted subsidiary, sell-offs also raise cash. The cash proceeds from a sell-off can be put to more profitable use in other businesses within the group or be used to pay off debt.

Philips sold-off its car and audio navigation equipment division to the German engineering giant, Mannesmann, in a $760 million deal. In 2008, Citigroup announced plans to sell roughly $400 billion in non-core assets. In July 2008, Citi decided to sell seven of its CitiCapital equipment finance business lines to General Electric's, GE Capital, for an undisclosed price.

THE INDIAN SCENARIO

From the late nineties onwards, asset sell-off gained prominence in the Indian context. Asset buy-out does not come under the takeover code. The transactions are faster. For instance, Exide completed its deal with Standard Batteries in just six weeks, whereas the merger of TOMCO with HLL was completed in 18 months. Exide increased its market share in automotive batteries, from about 75% to 85%, immediately after the acquisition.

Table 9.3 *Major Asset Sell-offs*

Seller	Asset	Buyer	Price in Rs million
Standard Batteries	Factories, Brand, Multiproduct Organic Synthesis Plant	Exide Industries	1250
ITC Agrotech	Edible Oil Plant	ITC	1160
TISCO	67.5 MW Captive Power Plant	Tata Power	3000
Duphar Interfran	Crocin Unit	Smithkline Beecham	430
Ceat Ltd	Nylon	SRF	3000
DCW Products	Captain Cook	Corn Products	800
Gufic	Mox, Exel, Zole, Roxythro	Ranbaxy	800
Rickett & Coleman	Lacto Calamine	Piramal	900
SOL Pharma	Riflux Becelac	Dr. Reddy's Laboratories	220
Lakme	Lakme Brands	Hindustan Lever	1100
Knoll Pharma	Johnson & Johnson	Coldarin	210
Knoll Pharma	Burnol	Rickett & Coleman	120

Source: Investment Banking Series—M&A New Perspectives ICFAI 2001 Series

Companies like Dr Reddy's, Smithkline Beecham, and ITC AgroTech have been involved in buying of assets over a period of time. Best Foods Inc (Corn Products) India acquired the Captain Cook trademark from DCW Home Products. In the period 1997-1998, Dr Reddy's acquired the brands Clamp, Riflux and Becelac. Knoll AG sold coldarin and Burnol in the year 1997. ITC AgroTech spent Rs 25 crore to acquire five edible oil brands, including market leader Sundrop, from its parent company. Rickett and Coleman acquired the Burnol brand from Knoll Pharmaceuticals for a reported sum of Rs 12 crore in end 1997. Knoll also transferred several of its OTC brand—Dispirin , Dettol and Saridon—to Reckitt Piramal, its marketing alliance with Nicholas Piramal.

In 2001, BG Group PLC bought all the assets of Enron Oil & Gas India Ltd (EOGIL) for $388 million. The EOGIL assets include 30% of Tapti gas field and Panna-Mukta oil and gas field and a 62.64% interest in the CB-OS/1 exploration license, all off western India. In 2007, Argentum Motors has acquired Daewoo India assets at Rs 765 crore. The plant will now be used to manufacture engines and transmissions for the international market. In 2008, Tata Motors bought the brands Jaguar and Land for over US$ 2.3 billion. Ford will contribute upto approximately $600 million to the Jaguar Land Rover pension plans.

Empirical Evidence on Sell-offs

The impact of sell-off announcements on divestor shareholders wealth is generally positive and significant. John and Ofek (1995), using 321 sell-off announcement during the period 1986-89, found that the percentage CAR for divestor was 1.5%, and for buyer 0.4%, during 1986-1989 in the time window of three days. Using a sample size of 179 sell-offs during the period 1980-91, Slovin et al (1995) documents a CAR of 1.7% for the divestor.

LEVERAGED BUYOUT

In general, a Leveraged Buyout (LBO) is defined as the acquisition financed largely by borrowing, of all the stock, or assets of a hitherto public company by a small group of investors. This buying group may be sponsored by buy-out specialists (for example, Kohlberg, Kraves, Robert & Co) or investment bankers that arrange such deals. Once the buy-out group owns the stock, they de-list the firm and make it a private, rather than a publicly traded, company, which is the origin of the term, *going-private transactions*. In an LBO, debt financing typically represents 50% or more of the purchase price. The debt is secured by the assets of the acquired firms and is usually amortized over a period of less than ten years. The debt is scheduled to be paid off, as funds are generated by operations, or from the sale of assets of the acquired firm. Following completion of the buyout, the acquired firm is usually run as a privately held corporation rather than a public corporation. The combination of high debt, with its threat of bankruptcy, and managerial stock ownership create powerful incentives for managers to improve the company's performance.

Large companies that have been involved in LBOs are Beatrice Foods, City Investing, Conoco Chemical, Dr Pepper, Levi Strauss and RJR Nabisco. Beatrice Foods buyout is an example of a hostile LBO led by former managers (of Esmark, Inc) who had been displaced during Beatrice's spate of takeover activity during the early 1980s.[16]

Lloyds TSB took over HBOS in a $21.5-billion buyout, and emerged as one of the strongest banks in the UK.

A variant of the going private transactions is the unit management buyout. In a *Unit Management Buyout*, a division or subsidiary of a public corporation is acquired from the parent company by a purchasing group led by (or including) an executive of the parent company, or members of the unit's management.

Basically, there are four stages in a LBO operation.[17] The first stage of the operation consists of raising the cash required for the buyout and devising a management incentive system. The equity base of the new firm (which may involve 10% of total equity) is accounted by the contribution of the company's top managers and/or buyout specialists. Outside investors provide the reminder of the equity. About 50 to 60% of the required cash is raised by borrowing against company's assets in secured bank acquisition loans. The bank loan may be syndicated with several commercial banks.

In the second stage of the operation, the organizing sponsor buys all the outstanding shares of the company and takes it private, or purchases all the assets of the company.

In the third stage, the management tries to increase profits and cash flow by cutting operating costs and changing marketing strategies. Reorganisation of production facilities and improvement of inventory control is aimed at this stage. In the fourth stage, the investor may take the company public again if the company emerges financially stronger. This reverse LBO is affected through public equity offering, referred to as *secondary initial public offering (SIPO)*. This reconversion to public ownership is to create liquidity for existing stockholders. The success of an LBO is determined by how a company can withstand economic fluctuations and competition.

The History of LBO

On account of the Great Depression of 1930s that followed World War II, very few companies used debt as a major source of funding growth. The scenario changed by 1960s, when the concept of conglomerates came into picture. The 1980s saw the peak activity of the LBO boom. The PE firm Kohlberg Kravis Robert

[16]J Fred Weston et al, 'Mergers, Restructuring and Corporate Control', Chapter 16, Going Private and Leveraged Buy-outs, Page 394.

[17]J Fred Weston et al, 'Mergers, Restructuring and Corporate Control', Chapter 16, Going Private and Leveraged Buy-outs, Page 400-401.

& Co paid $31.4 billion for RJR Nabisco via an LBO in 1998. In 1990, RJR Nabisco collapsed after the company gave its pre-buyout shareholders a capital gain of over $13 billion. The other major LBOs of the era comprised Allied and Federated Campetau's retail business comprising Allied and Federated stores that fell in 1989 with $10 billion debt. Others that went into bankruptcy proceedings included Seven Eleven stores, Resorts International and Revco. In the 1980s and 1990s, there was a wave of junk bonds which were non-investment grade, high yield junk bonds. In an LBO, the buyer issued junk bonds to pay for the acquisitions. In 1998, a massive $150 billion was raised through junk bonds. The average size of LBOs in the boom of the late 1980s and early 1990s was $400 million, while it has been $1.3 billion in recent years.

Indian Leveraged Buyout[18]

The leveraged buyout phenomena is being witnessed from the year 2007 onwards, when about a dozen corporations had taken debt of nearly $15 billion (Rs 61,500 crores) to buy foreign companies which were about 3-5 times their size. The observed trend is that the companies are taking on debt about 4-5 times their net worth, and they are also paying interest rates as steep as 8-9.5% on their LBO loans.Tata Steel took loans of about $7 billion (Rs 28,7000 crore), more than twice its net worth. For the Corus deal, Tata created a special purpose vehicle to take debt against the assets of the acquiree. In 2007, India's largest aluminum producer, Hindalco Industries, with revenues of $4.57 billion (Rs 18,737 crore) and a manufacturing capacity of 461,000 tonnes, acquired the $9.8 billion (Rs 40,180 crore) Novelis of Canada for $6 billion (Rs 24,600 crore). The debt component of the deal amounted to $3.1 billion, which was about five times the company's net profit of $650 million (Rs 2665 crore) and 70% of its revenues in the year 2006-07. Chennai based Oilfield equipment producer, Aban Offshore, acquired 33.76% stake in Norwegian oil rig producer Sinvest for $446 million (Rs 1829 crore) via its subsidiary, Aban Singapore. The transactions left Aban and its subsidiaries with a debt of $2.1 billion (Rs 8610 crores). United Spirits acquired Glasgow based whiskey maker, Whyte & Mackay, for $1.18 billion (Rs 4838 crore), of which $675 million (Rs 2768 crore) was raised through loans. In 2006, Dr Reddy's bought German generic drug maker, Betapharma, for $570 million (Rs 2337 crore) of which $475 million (Rs 1948 crore) was raised through loans. Hyderabad based Rain Calcining funded its Rs 2440 crore acquisition of the US based CII Carbon with a debt equity ratio of 4:1.

The Corus acquisition made Tata Steel world's fifth largest steel producer. CII Carbon acquisition made Rain Calcining world's largest producer of calcined petroleum coke, a raw material used in aluminium and titanium dioxide production. Hindalco became a world leader in aluminium rolling after the acquisition of Novelis. The UB Group was catapulted into the position of world's second largest liquor maker, behind UK's Diageo, after the acquisition of Whyte & Mackay.

There are many reasons for Indian companies adopting the debt laden LBO route. The Reserve Bank of India prohibits domestic companies from leveraging more than three times their net worth for acquisitions. The option of merging with the acquiring company throws up the challenges of enormous legal and statutory complications compared to LBO deals. The current size and market capitalisation of domestic companies is so small in relation to the target that a share swap may reduce the Indian promoters' equity substantially. Indian companies are more and more confident of taking more risks in the global environment.

Reserve Bank of India does not allow a leverage higher than three times the net worth for foreign acquisitions. Hence, companies had to take debt on their own balance sheets. Hindalco's entire $3.1 billion (Rs 12710 crore) Novelis debt had recourse to Hindalco. Suzlon's entire $1.1 billion debt had recourse to Suzlon. Aban Singapore's leveraged deal of Sinvest had a $200 million one year loan with recourse to that Indian parent's balance sheet.

[18]Rajeev Dubey, Cover Story, 'The incredible weight of the LBO,' Business World, 30 July 2007, page 25-42.

In accordance with Basel II agreement, capital allocation would be on the basis of the risk of assets. The world's largest banks have been diversifying their debt portfolios and offering capital to be converted into credit derivatives and debt securities. There has been increased demand for instruments like credit default swaps (CDSs), and collateralized debt obligations (CDOs), where a multitude of buyers of such securities share the risk of failure. This action contributed towards the significance of attracting capital towards high risk assets, including LBOs. It is estimated that 80% of bank debt in the US, and over 50% in Europe had been sold to the CDS/CDO market. Private equity firms provide maximum funds to LBOs. But most Indian LBOs have been funded by banks rather than PE firms barring Aban's acquisition of Sinvest.

DIFFERENTIATING BETWEEN A LBO AND AN ACQUISITION

LBOS are structured transactions where a company (sponsor) that is proposing the investment creates or uses another company, or vehicle, to borrow to substantially fund the project. In an acquisition, usually the company that is being acquired is used to raise the funds to ensure no financial liability flows back to the sponsor. In other words, the sponsor gives managerial and operational support to the project but shuns financial responsibility for it. Even LBO transactions require minimum sponsor participation, which, by itself could be a stretch for the sponsor. Sponsors need to prudentially assess risk in keeping with returns, and also objectively evaluate the feasibility of the business and its ability to manage the new project.[19]

First Leveraged Buyout in India

India's first global LBO was Tata Tea's buyout of UK's Tetley in March 2000. For funding the acquisition of Tetley, Tata Tea floated a special purpose vehicle, Tata Tea GB in UK, by capitalising it with £71 million, which included £60 million from Tata Tea, £10 million from Tata Tea Inc and £1 million from Tata Sons. The company was then financed by £210 million which comprised of £140 million of seven year senior debt, £40 million of nine year mezzanine debt and £30 million of other debt.[20] The deal was first refinanced in March 2003, when Tetley's performance was short of target, though there were signs of improvement. The payout period was extended from the original period of 2007-2009 to 2012. In 2001-02, the net margin of the consolidated Tata Tea was 3.43%. Tata Tea paid off the previous loan and took on an £174 million loan. The performance of Tetley improved by 2005. The loan was then refinanced for the second time with £142.5 million, thereby reducing the payout period by two years. Finally, when Tata Tea acquired 30% equity in US based Energy Brands (Glaceau), the existing debt was clubbed with the extra requirement to raise £284.3 million in 2006. Tata Tea made windfall profit of £523 million by buying and then quickly selling its stake in Energy Brands. The cash was used to pay off £600 million debt Tata Tea took on to buy-out Tetley.

Thus, Tata Tea's Tetley buyout in 2000 went through three rounds of re-financing. In the first instance, the management failed to achieve revenue and profitability targets in two years. The second scenario was to get better terms at lower rates. The third instance was to club existing debt with more debt for the Glaceau acquisition.

Empirical Evidence on LBO

Lehn and Poulsen (1988) found that the average net of market stock price reaction to the announcement for 92 leveraged buyouts was slightly over 20%, measured over a period of 20 days before the announce-

[19]R Ravi Mohan, LBOs have skirted the Indian financial system, Business World, Page 32, July 2007.

[20]Typically, senior debt is secured through collateral on which the lenders have the first lien. It is prioritized for repayment in the event of liquidation. Mezzanine debt is subordinate financing, an unsecured high yield, subordinated debt, or preferred stocks, where lenders get priority repayment over the company's shareholders in the event of liquidation.

ment to 20 days after the announcement. For divisional management buyouts, Hite and Vetsuypens (1988) find small but statistically significant wealth gains to parent company shareholders. The sources of gains in stock price performance have been attributed to taxes, management incentives, wealth transfer effects, asymmetric information and underpricing and efficiency considerations. Jensen (1986) states that increased debt reduces managerial discretion in the allocation of free cash flows, and the agency cost of free cash flows are reduced in LBOs. Many studies report empirical evidence consistent with the management incentive rationale. Ownership shares of management are increased substantially after MBOs. For a sample of 76 MBOs in 1980-1986, Kaplan (1988) reports pre-buyout and post-buyout equity ownership of management. Muscaraella and Vetsuypens find that firms under private ownership realized substantial improvement in operating performance. Kaplan (1988) also provides evidence of improved operating performance following an LBO. The study finds that the level of operating income in LBO firms increased more than in other firms in the same industry during the first two years after the LBO. Smith (1989) finds that both the profit, or before tax operating margin, and the ratio of sales to operating assets, or employees, increase significantly relative to other firms in the same industry. Lehn and Poulsen (1988), based on 149 LBOs in the 1984-1987 period, show highly significant direct relationships between the undistributed cash flow in equity value ratio and the premium paid even after controlling for the effects of tax savings (by using the tax to equity variable). More MBOs occur in periods of economic expansion. Management efforts to restructure business operations following the buyout have greater value when business conditions are favourable. The ability to service debt is enhanced in periods of economic expansion.

EMPLOYEE STOCK OPTION PLANS (ESOPs)

Development of organisational capability based on skill and motivated human resource is a vital source of competitive advantage in business in the context of rapid advances in technology, financial markets and marketing strategies. Traditionally, stock option plans have been used as a way to reward top management and 'key' employees, and link their interests with those of the company and the other shareholders. Profit sharing and employee ownership plans have become worldwide phenomena. From a modest beginning in the US, Employee Stock Ownership Plans (ESOPs), through the holding of stocks in unequal numbers, often without the right to vote them or trade them, have spread throughout the world.

The popularity of broad based stock option plans has increased since the late 1980s. In markets like the US, ESOPs are seen as an important human resource tool. The rationale behind ESOPs is that they help companies to retain staff, attract talent, motivate employees and enable them to share the long-term growth of the company. ESOPs are a proven vector of managerial control and entrenchment of managers, with economic performance, which is difficult to determine.

Broad based ESOPs are now the norm in high technology companies and are becoming popular in other industries as well, as part of an overall equity compensation strategy. Basically, options work in industries where intellectual capital is precious and attrition level is high. Dynamic ownership culture symbolises the promotion of engaged employee ownership, which could enhance the performance of a company. There are two aspects of ownership culture—financial and psychological—that engage employees, leading to better business results. Shared investment, like ESOP, is the financial aspect. The psychological aspect goes beyond the financial by giving the employees access to business information and influence over decision-making. In the US, the largest continuing ESOP was sponsored by GE and has over $19 billion in assets, and about 140,000 active participants. Wal-Mart's ESOPs has the largest number of active has participants at 464,725, representing 54% of the company's almost 900,000 employees. Employee stock option plans, purchase plans and other stock related plans have become popular only in the last six to eight years in India, though companies like Infosys and NIIT allotted ESOPs to their employees a number of years back. Though originally conceived as long-term incentive plans, ESOPs were used as short-term incentives due to the boom in share prices in the technology-media-telecom sector. But the meltdown in these 10 sectors led the industry back to the original objectives of employee stock options/related benefit plans.

Now, other than knowledge industries, like software and financial services, companies in other sectors, from services to engineering to consumer goods and pharmaceuticals, are adopting ESOPs.

ESOPs were created on the premise that an ownership stake in the company for employees would act as an incentive to increase productivity and performance. An ESOP can become economically viable only if it improves productivity and firm's performance through greater involvement, morale and satisfaction. Employee-related productivity results in improved firm performance, which in turn results in enhanced value for both outside shareholders and employee shareholders. In fact, the extent to which ESOPs affect worker productivity depends on the organisational structure of the firm. In large corporations, the decisions of top management rather than those of lower level employees are reflected in the market sentiments. Hence, stock ownership is likely to be a better motivator for key executives than for operating level employees. Moreover, though collective actions may increase productivity and performance, an individual makes only a marginal contribution. Individual employees have limited incentive to participate more effectively because of the small perceived effect on productivity and performance.

Despite the advantages the ESOPs possess, they have also led to many problems. ESOPs dilute the interest of outside shareholders. In fact, shareholders of companies, like Peoplesoft, Intel, HP and IBM, have recently rejected proposals to grant options to employees. It is noteworthy that in December 2003, Microsoft decided to do away with ESOPs, and to reward employees instead with shares in the company.

ESOPs operate effectively only in profitable firms and not in less profitable ones, showing their limited role in stabilisation and expanding workplace incentives. Moreover, the long-term incentive effects are also reduced because the plans reward employees for previous performance, and not for future performance.

The establishment of ESOPs can be explained theoretically in terms of four reasons:

- as a motivating tool to improve worker involvement and productivity,
- to avoid taxes,
- as a wage concession,
- as a defence mechanism.

The managerial entrenchment hypothesis states that managers erect barriers to hostile takeovers to insulate them for corporate control. The stockholder interest hypothesis states that defensive strategies enable target firms to extract higher premiums, thereby benefiting shareholders.

Firms adopting ESOPs as a wage concession experience drastic reduction in labour expenses, which boost performance. ESOPs, established to motivate workers, ideally should have positive effects on both productivity and performance.

The term ESOP covers different types of employee benefit plans that invest in the stock of the employer sponsor. An employee stock ownership plan is a type of tax-qualified employee benefit plan in which most or all of the assets are invested in the stock of the employer. A stock option plan grants employees the right to buy company stock at a specified price during a specified period once the options are vested. There are also profit sharing plans, stock bonus plans, that are not ESOPs, Employee Stock Option Schemes (ESOS), Employee Stock Purchase Plan (ESPP), Employee Sweat Equity Plans, and Share Appreciation Rights (SARS)/Phantom Shares. Stock options, which were once the exclusive privilege of top executives, have been working their way down the power hierarchy. Increasingly, companies are moving towards broad based plans wherein at least half the employees receive and hold options.

In the US, capital gains from exercise of ESOPs are taxed at a lower rate as compared to salaries and bonuses. ESOPs can be used as a tool to reduce financial reporting costs. Firms with income below their target levels may shift the mix of compensation towards stock options and salaries, as ESOPs do not appear as a cost in a firm's income statement. Thus, income level is not affected and shareholder dissatisfaction and violation of debt covenants may be avoided.

The ESOP trend in India indicates that maximum number of companies offering ESOPs are either MNCs or Indian companies in the technology sector. The PwC ESOP Survey 2001 shows that employee stock option schemes have completed a full cycle of evolution in India, as in the United States. An area of immediate concern for ESOP companies in the software sector is to cope with their 'underwater options', where the market price dipped below the option exercise price.

An Employee Stock option is a kind of qualified employee benefit plan as it qualifies for tax benefits if certain rules are abided. A company sets up a trust fund for employees. The company then contributes cash to the trust so that is can buy company shares, or just contributes shares. Alternatively, the trust can borrow money to buy shares, with the company repaying the loan by making contributions to the trust. Closely held companies must have their share price set by an annual outside appraisal. Employees own the shares through the trust, but closely held companies can control the voting of the trust on almost all issues, if they so choose. In the US, the ESOP is the most taxed-advantaged mechanism for companies to share ownership with employees. In India; however, it is treated as a perquisite, and is subject to tax at two points. One, when the company issues the stock option, then the differential between the market price and the price at which the stock is offered to the employee under the ESOP would be taxed as a perquisite. Also, when the employee sells his stock. Thus, he has to pay capital gains tax on the differential between the cost of acquisition and the sale price. The draft guidelines on ESOPS and ESOS issued by Securities and Exchange Board of India clearly give the rules and definitions applicable to the same.

A stock option gives an employee the right to purchase a set amount of shares, at a fixed price, for some years into the future. It could be a stock purchase or restricted stock. Different types of plans involve actual purchase and holding of stock, or phantom stock, or it could be a cashless exercise.

A phantom stock is a bonus that rewards employees, based on the increase in value of the company's stock, the dividend performance of the stock, or both. Stock Appreciation Rights are similar, and, in effect, consist of phantom stock without phantom dividends. Some MNCs offer global stock options for stock listed outside India. The vesting period, that is, the period for which the option has to be held, differs from 2 to 5 years, depending upon the industry, company, management policy, etc. A company could have more than one stock option plans.

Eli Lily, Ranbaxy are examples of pharma major which extended its overseas ESOP to its Indian employees. Infosys, the leading Indian software major, has been credited with creating a large number of Indian millionaires. The employees who received the stock of the company have benefited manifold by the spectacular rise in the share price. Pharmaceuticals, infotechs, banks and financial services were major sectors which introduced employee ownership programmes.

Costs of ESOPs

The real costs of ESOPs are not fully factored in by domestic companies under the Indian GAAP. Reported profitability is higher when costs of employee stock options are expensed using Indian GAAP, compared with IFRS and the US Generally Accepted Accounting Practices (US GAAP). Under the Indian GAAP, an entity has the option to account for employee stock compensation, based on either the 'fair value' method or the 'intrinsic value' method. Under the 'intrinsic value' method, stock compensation is measured as the difference between the market price of the shares and the amount recoverable from the employee (exercise price). This method appears to be widely used here. As long as the market price of the share and the exercise price of the option are same on the grant date, no stock compensation expense need be recognised in the income statement.

Both IFRS and US GAAP prescribe the 'fair value' method of expense recognition for share-based awards granted to employees. An entity that grants stock options to its employees is required to measure their fair value using an option pricing model, and recognise the cost over the vesting period of the option. Even if the market price of the stock is equal to the exercise price of the option, the option will have a positive fair value because it can be exercised in the future, when the market price may exceed the exercise price. The 'fair value' method may, therefore, result in recognition of significant stock compensation expense.

Empirical Evidence on ESOPs

Most of the empirical research on the effect of ESOPs on performance and productivity has been done by Western researchers. Research on employee ownership has been described as 'transformation from advanced storytelling to sophisticated statistical analysis. There have been about 70 empirical studies on effects of employee ownership in the US in the past 25 years.

There is an element of uncertainty with respect to the contribution of ESOPs to shareholder wealth. Information, management and remuneration costs may nullify the productivity gains, and managers may use ESOPs to repel a hostile takeover bid to entrench themselves.

Yermack (1995) did a comprehensive study on the determinants of ESOPs for American firms, based on agency theory and financial contracting theory, using a sample of ESOPs granted to CEOs of 792 US-listed corporations from 1984 to 1991. He found only weak support for relationship between ESOPs and agency cost reductions. Matsunaga studied the relationship between ESOPs and accounting income management data, based on 123 US firms over the period 1979-1989. He found that lower the value of reported income relative to a target level, greater the value of the ESOPs issued. Gordon and Pound, Chang and Mayer examined the immediate stock market reaction to public announcement of ESOP adoption, and reported significant positive reaction to ESOPs adopted solely for the purpose of employee benefit or wage concession. Conte and Tannenbaum (1987) compared the profitability of 30 small private ESOP and non-ESOP firms of comparable size in the same industry. Borstadt's (1995) study of 85 publicly traded firms, that established ESOPs, provided no evidence of productivity gains or performance improvement. Henri and Trebucq (2002) examined how employee ownership can affect corporate performance and risk in France. The study by Blasi et al. (2000) shows that employee ownership is associated with greater employment stability, which does not come at the expense of lower efficiency.

The studies on employee attitudes and behaviour reflect the following aspects: Most studies find higher organizational commitment and identification under employee ownership, while studies are mixed between favourable and neutral findings on job satisfaction, motivation and other behavioural measures. There is clearly no automatic improvement of attitudes and behaviour associated with simply being an employee owner.

JOINT VENTURES

Joint Venture is a type of business combination. The companies enter into an agreement to provide resources towards achievement of a particular objective. A number of international joint ventures have taken place in the automobile industry. United States entered into agreements with Japanese manufacturers to take advantage of certain comparative advantages those firms enjoy, like quality control. The American-Japanese joint ventures in the automobile industry were basically aimed to produce cars that offered some beneficial features of Japanese cars–quality, durability and fuel economy–without investing significant resources to develop the technology and manufacturing know-how. The Japanese manufacturers' brand names, distribution networks and other marketing advantages were enjoyed by American manufacturers as good financing subsidiaries. In addition, the agreements allowed Japanese manufacturers to avoid trade restrictions. One classical example of such an arrangement was the joint venture between Chrysler and Mitsubishi Motors.

In 2001, Coke and Procter and Gamble established a separate company as a joint venture. The joint venture was meant to exploit the strengths of Coke which had an extremely broad global distribution system that Procter & Gamble lacked. P&G's strength lay in its ability to develop new consumer products, such as nutritional beverages. The combination gave a boost to certain successful Procter and Gamble products, such as the Pringles line of potato chips.

Joint ventures and alliances are often precursor to merger and acquisition transactions. A joint venture generally refers to joint equity ownership in a venture where two partners bring complementary resources. While alliances generally do not denote equity ownership in the venture, that simply provide technology know-how, research support, distribution support, licensing of brand, or any other rights, etc.

A joint venture may be organized as a partnership, a corporation, or any other form of business organisation the participating firms might choose to select. While mergers result in reduction in the number of firms, joint ventures increase the number of firms. Joint ventures may be used to acquire complementary technological or management resources at lower cost, or to benefit from economies of scale, critical mass and the learning curve effect. Firms may also use joint venturing as an element of long-term strategic planning. Tax advantage can also be a significant factor in many joint ventures. If a corporation contributes a patent or a licensable technology to the joint venture, the tax consequences may be less than on royalties earned through a licensing agreement.

The basic rationale for joint ventures can be stated as follows:

1. To diversify risk
2. To obtain distribution channels or raw materials supply
3. To overcome insufficient financial or technical ability to enter a particular line of business
4. To achieve economies of scale
5. To share technology and/or generic management skills in organizations.

The reasons for international joint ventures can be attributed to rapid technological change, short product life cycle, high costs of R&D and brand development.

Globalisation of product markets have resulted due to integration of consumer tastes, preferences and life-styles. Many of the modern products are based on complex technologies. The alliances, aimed at technology sharing and development, are the need of the hour. Companies form joint ventures in order to pool their expertise and achieve technological synergy. IBM made an alliance with Toshiba of Japan and Siemens of Germany to develop a 256 megabit chip. In the context of multimedia products, the boundaries between technologies is fast fading.

Classic Joint Ventures

In 1986, Boeing, the world's largest airplane builder, entered into an agreement to form a joint venture with three Japanese companies–Kawaski Heavy Industries Ltd, Mitsubishi Heavy Industries Ltd and Fuji Heavy Industries Ltd. Concerns were expressed that Japanese would become leaders in commercial aviation as in autos and electronics, by copying and improving American methods. The GM Toyota joint venture provided for production of a subcompact car in the GM plant. Through the joint venture, General Motors hoped to obtain hands on experience in the advanced management technology of building small cars. Toyota aimed to test its production methods in a new setting with different labour and supplier relationships.

Table 9.4 *Examples of Joint Ventures*

Partners	Product	Strategic Objective
AT&T/Olivetti	Computers	Foreign Market
Boeing/Mitsubishi/Fuji/Kawasaki	Small Aircraft	Cut Costs, Share Technology
Corning/Ciba Geigy	Lab Instruments	New Markets
Ford/Mesurex	Factory Automation	Cut Costs
GM/Toyota	Autos	Cut Costs
GTE/Fujitsu	Communication Equipment	Cut Costs, Better marketing
Kodak/Cetus	Biotech Diagnostics	New Market, Better distribution
3M/Harris	Copiers	Better Marketing
US Steel /Pohang Iron &Steel	Steel	Raise Capital, Expand market
Westinghouse/General Electric	Power Semiconductors	Cut Costs, Better Marketing

Source: Business Week, "Corporate Odd Couples", July 21, 1986, p 101.

Empirical Evidence on Joint Ventures

Fusefeld (1958) found anticompetitive effects as a result of joint ventures in the iron and steel industry, due to the horizontal relationship and limited number of joint venture parent firms. Boyle (1968) focused on the size of parent firms and found that joint venture participation increased with firm size, in spite of smaller firms' presumably greater need for external resources. McConnell and Nantell (1985), based on a sample of 210 firms engaged in 136 joint ventures, used residual analysis to study the performance of joint ventures. The study found that the two day announcement period's abnormal return was 0.73% which was significant at the 1% level.

Joint Ventures in India

Joint venture companies are the most preferred form for corporate entities for doing business in India. There are no separate laws for joint ventures in India. The companies incorporated in India, even with up to 100% foreign equity, are treated the same as domestic companies.

A typical Joint Venture is where:

1. Two parties, (individuals or companies), incorporate a company in India. Business of one party is transferred to the company, and as consideration for such transfer; shares are issued by the company and subscribed by that party. The other party subscribes for the shares in cash.
2. The above two parties subscribe to the shares of the joint venture company in agreed proportion, in cash, and start a new business.
3. Promoter shareholder of an existing Indian company and a third party, who/which may be individual/ company, one of them non-resident or both residents, collaborate to jointly carry on the business of that company, and its shares are taken by the said third party through payment in cash.

All joint ventures in India require governmental approval, if a foreign partner, or an NRI, or a PIO partner is involved. The approval can be obtained either from RBI or FIPB. In case, a joint venture is covered under automatic route, then the approval of Reserve Bank of India is required. In other special cases, not covered under the automatic route, a special approval of FIPB is required.

Foreign companies are also free to open branch offices in India. However, a branch of a foreign company attracts a higher rate of tax than a subsidiary or a joint venture company. The liability of the parent company is also greater in case of a branch office.

The Government has outlined 37 high priority areas covering most of the industrial sectors. Investment proposals involving up to 74% foreign equity in these areas receive automatic approval within two weeks. An application to the Reserve Bank of India is required. Besides the 37 high priority areas, automatic approval is available for 74% foreign equity holdings setting up international trading companies engaged primarily in export activities. Approval of foreign equity is not limited to 74%, and to high priority industries. Greater than 74% equity and areas outside the high priority list are open to investment, but government approval is required. Full foreign ownership (100% equity) is readily allowed in power generation, coal washeries, electronics, Export Oriented Units (EOU) or a unit in one of the Export Processing Zones (EPZs). For major investment proposals or for those that do not fit within the existing policy parameters, a high-powered Foreign Investment Promotion Board (FIPB) has been constituted. The FIPB is located in the office of the Prime Minister and can provide single-window clearance to proposals in their totality, without being restricted by any predetermined parameters. Foreign investment is also welcomed in many infrastructure areas, such as power, steel, coal washeries, luxury railways and telecommunications. The entire hydrocarbon sector, including exploration, producing, refining and marketing of petroleum products, has now been opened to foreign participation. The Government recently allowed foreign investment, upto 51% in mining for commercial purposes and upto 49% in telecommunications sector.

To facilitate and encourage International Joint Ventures, the Government of India has taken steps to collect and disseminate data by establishing economic divisions in the Ministries of Commerce, External Affairs and Industry, and the Indian Embassies. Indian Investment Centre (IIC) is also expected to play an important role by gathering data regarding opportunities for overseas projects, and has set up offices for the purpose.

The Federation of Indian Chamber of Commerce and Industry (FICCI), one of the largest private sector associations of business and industry, has been active in promoting the idea of joint ventures with other developing countries. The FICCI works out details for overseas ventures by sending its delegates to different countries, and by setting up of Joint Business Councils with other countries.

The Need for Joint Ventures

Joint ventures are formed basically as for strategy entry as they provide a lower risk option of entering a new country. The joint ventures provide opportunity for both the partners to leverage their core strengths and increase their profits. Companies like Fiat, Pepsi, Ford, Xerox and Suzuki have used joint ventures to enter Indian markets and establish themselves leaders in their own sectors. The Modi Xerox venture gave Xerox an early lead in the photocopier market and a strong brand recognition. Xerox learnt about distribution channels and copier usage models from the joint venture. The joint venture also proved to be successful for the Modi Group. The TVS Suzuki joint venture helped TVS to learn about the intricacies of bike manufacturing. The need for technology can also facilitate the formation of a joint venture. In the event of the partners having mutual rights over exclusive technology, a joint venture can be used to exploit the opportunities. Joint ventures emerge as options situations where one partner has profitable market opportunity but does not have necessary technology. The joint venture with a local partner is one of the best ways to minimise the risks of cross-border expansions. The foreign partner can leverage the local partner's knowledge about the local market conditions, contacts with local government and the pre-existing distribution networks, etc.

In developing countries like India, government rules and regulations prevent foreign players from establishing wholly-owned subsidiaries. For example, Indian government laws prevent foreign retailers and insurance companies from entering India directly. The current regulations force these companies to form

JVs with local partners. Lack of accessibility to adequate capital in emerging economies is one reason for local companies to enter into joint ventures. A JV or a strategic investment will infuse capital into local operations and make it more profitable. In an emerging economy, the local partner provides distribution network, human capital and government links as its investment in the JV, while the foreign partner provides the capital and technology.

Notable Joint Ventures in India

Maruti Suzuki Joint Venture

Till the early 1980s, the Indian passenger car industry offered limited choices to customers, with only two popular models in the form of Hindustan Motors' (HM) Ambassador and Premier Automobiles' (PAL) Padmini. The government not only controlled the price mechanism in the industry, but also strictly regulated the entry of foreign players.

However, the scenario changed in 1981, when Government of India, itself, entered the car business by establishing MUL, by acquiring the assets of Maruti Ltd. In October 1982, the Government of India signed a licensing and joint venture agreement with Suzuki Motor Corporation, wherein Suzuki acquired the 26% share of the equity.

Maruti Udyog Limited is India's largest automobile company. Its main factory is situated in Gurgaon district, Haryana. The company, a joint venture of Government of India with Suzuki of Japan, has been a success story like no other in the annals of Indian automobile industry. The first cars rolled out for sale on 14th December 1983, (the Company went into production in a record 13 months), marking the beginning of a revolution in the Indian automobile industry.

The Indian car market had been stagnating at 30,000 to 40,000 cars a year, for the decade ending 1983. In 1993, the volume was 1,96,820 cars. Maruti's figures are a different story altogether. Maruti reached total production of one million motorcars by March 1994, becoming the first Indian company to cross this milestone, and crossed the two million mark in 1997. Maruti has made profits every year since its inception, and has been paying dividends for ten years. Through the years, Maruti has provided world-class Japanese technology, suitably adapted to Indian conditions and car users. Maruti's market share figures reflect the response of customers. In 1997-98, its market share of vehicles was over 70%. In addition to leading in the economy car segment, Maruti is also the leader in luxury car segment, with market share of 38%.

The success of the joint venture led Suzuki to increase its equity from 26% to 40% in 1987, and further to 50% in 1992. As a result, Maruti changed from being a government company to a non-government company. With the introduction of economic liberalisation in July 1991, the government realised the high growth potential of the passenger car market. It took note of the contribution of this segment in promoting employment, technological upgradation of industry and contribution to government revenues. Policy changes were made accordingly. Maruti's excellent performance in the post-liberalisation milieu is in keeping with the earlier trend set by it. As a result, the transfer of technology from Suzuki has been a smooth process. By February 1990, local content of above 90% was reached for Maruti 800. Maruti 800 earned the tag of being the 'people's car...'

In the joint venture contract, Suzuki agreed to transfer technology, engineering design and development, all access to improvements and modifications in Suzuki technology during the life of the agreement, and provide support to the venture in building up its engineering and design capabilities. As MUL ceased to be a government unit, SMC began managing the company, with MD R.C. Bhargava taking directions from Japan. R.C. Bhargava reportedly shared a good rapport with the secretary and other high officials in the Ministry of Industry. The relations between SMC and GoI (Government of India) remained cordial. The first signs of dispute surfaced in late 1993, when SMC proposed a Rs 2,200 crore expansion and modernisation plan. The plan envisaged increasing the production by 1,00,000 vehicles to effectively meet the growing competition in the sector. The Heavy Industry secretary, Ashok Chandra, and the Finance secretary, Montek Singh Ahluwalia, suggested, in an informal discussion that SMC opt for public issue to raise finance for the expansion plan. Though, initially, SMC was reluctant for a public issue, Bhargava managed to persuade it in 1995.

In 1996, Suzuki wanted to increase its equity share. The Government of India rejected its offer and proposed to fund expansion through increase in debt. This resulted in distrust between both partners. On August 27, 1997, the Indian government appointed Mr Bhaskardu as the MUL's venture's managing director, giving Suzuki only thirty minutes prior notice before the board meeting. Suzuki was strongly against the appointment. The disagreement prompted both the partners to consult the original joint venture contract. The contract did not clarify the selection procedures. Since the government remained inflexible, Suzuki attempted to demonstrate its leverage by freezing all work on technology that were intended to meet India's emission goals. Suzuki discontinued the production of diesel models and development of new car models. These tactics lengthened the negotiations and further hampered relations between the partners. Suzuki was eventually forced to seek settlement through an Indian court, which ruled that the International Court of Arbitration would determine the MUL Chairman selection problem.

In late 1999, following the recommendations of Disinvestment Commission, the GoI announced its decision to divest its stake in MUL. The GoI's decision was a part of its industrial policy to privatize PSUs through gradual disinvestment or strategic sale. The first phase of MUL's disinvestment started with a Rs 400 crore rights issue in December 2001, with renunciation option for the government. In January 2002, the GoI announced its willingness to renounce its portion of the rights in favour of SMC during the rights issue.

The fiftieth lakh Maruti car rolled out in April 2005. Fiscal 2007 saw Maruti's post-net sales at Rs 1,78,603 million and PAT at Rs. 17,308 million. The company has a portfolio of more than 10 brands–including Maruti 800, Omni, Zen, Alto, WagonR, Gypsy, Esteem, Baleno, Versa and Grand Vitara XL7.

By 2004, Suzuki controlled 54% stake in Maruti. The Government of India holds a residual 18.6%. So there is no co-promoter with a strong interest in the business, and once the government sells its holding, SMC need not brook interference from any quarter. With its fully depreciated plant and strong and cost-competitive vendor base, Maruti has been a sourcing hub for Suzuki. It is already the single source supplier for SMC's global exports of Alto, the key markets being in Europe. In 2004, Suzuki announced its major Suzuki Motor Corp's intention of putting up a brand new plant to make cars, but in a new joint venture–Suzuki Maruti–thereby sidelining the existing Maruti Udyog Ltd. It is planning to invest $90-138 million in the venture. SMC also said it would invest in a new plant for making 250,000 diesel engines a year, in another JV, Suzuki Engineering.

The Joint venture between Maruti and Suzuki had been successful for sixteen years. However, the Indian government and Suzuki were involved in a bitter dispute over the appointment of the next managing director. Factors contributing to the problem included an ambiguous contract, incongruent goals, scare tactics, dissatisfaction over sharing agreement and other external factors.

MNYL is a joint venture between Max India and the US-based New York Life. In 2009, the domestic partner increased its equity stake from 54% to 74% in the joint venture. A recent research report by an Indian broking house has pegged the value of MNYL at over Rs 10,000 crore, based on 2009-10 premium estimates. MNYL accounts for about 80% of Max India's consolidated revenues. Under the fresh joint venture agreement, Max has repaid the Rs 174-crore deposit paid by New York Life, and increased its economic interest to 74%. The US partner will now have to buy the additional 24% shareholding at 90% of the fair market value. NYL will get a 10% discount for being a promoter-shareholder when the transaction takes place. This option will be valid till 2016.

ICICI Prudential Life Insurance Company is a joint venture between ICICI Bank, one of India's foremost financial services companies, and Prudential plc, a leading international financial services group, headquartered in the United Kingdom. Total capital infusion stands at Rs. 42.72 billion, with ICICI Bank holding a stake of 74% and Prudential plc holding 26%. The operations began in December 2000, on receiving approval from the Insurance Regulatory Development Authority (IRDA). Today, the nation-wide team comprises over 2000 branches (inclusive of 1,095 micro-offices), over 261,000 advisors, and 24 bancassurance partners. ICICI Prudential is the first life insurer in India to receive the National Insurer Financial Strength rating of AAA (Ind) from Fitch Ratings.

Another notable joint venture would be the one between Tata Motors and Fiat. Tata Motors would buy diesel engines for its cars from Fiat, while Fiat would distribute Tata cars in Europe.

The joint venture between Mahindra and Renault was meant as a market entry strategy for Renault. The joint venture will manufacture Renault's Logan cars in India. Renault will gain market knowledge, while Mahindra will learn how to make good cars, and leverage its dealership network for additional profits.

Tata AIG joint venture was created to take advantage of the new government regulations on private insurance companies. Private insurance companies need foreign collaboration for technical know-how. The current regulations prevent foreign insurance companies from setting up green field ventures in India. The other notable joint ventures in this field are ICICI Lombard and Bajaj Allianz.

The plan of Bharti-Wal-Mart joint venture was primarily aimed at entry for Walmart into India. The government regulations prevent large foreign retail firms from operating in India.

In the year 2006, Motorola announced two new joint ventures in India to develop telecom and IT applications and solutions. The venture partners include Tech Mahindra and Wipro Technologies. The joint venture with Mahindra will involve development of a variety of mobile IT solutions, including end-user applications, content services and frameworks for delivery and management. The venture with the IT services arm of Wipro Ltd. will be known as WMNetServ, and will provide outsourced telecom services to public and private network operators.

NTPC, with a rich experience of engineering, constructing and operating over 26,000 MW of thermal generating capacity, is the largest and one of the most efficient power companies in India, with operations that match global standards. In 1996, Utility Power Tech Ltd was established in collaboration with Reliance Energy to undertake project construction, erection and supervision in the power sector. In 1998, PTC (India Ltd) was incorporated. This joint venture has been promoted with Power Grid Corporation of India Ltd and Power Finance Corporation. In 1999, NTPC-ABB Alstom Power Services Pvt Ltd was incorporated to undertake renovation and modernization of power stations in India and other SAARC countries. SPCL, the Joint Venture company of NTPC and SAIL, with 50:50 equity participation, was merged with BESCL (Bhilai Electric Supply Co. Pvt Ltd, another JV company of NTPC and SAIL, with 50:50 equity participation) with effect from 2nd August 2006, as per the scheme of Amalgamation approved by the Delhi High Court.

AB Volvo, Swedish truck maker, has invested about $312 million, in a joint venture, VE Commercial Vehicles Ltd, with the Indian vehicle manufacturer, Eicher Motors. This venture involves entire truck and bus operations of both Volvo and Eicher.

Vornado Realty Trust in the year 2008 entered into a 50/50 joint venture with Reliance Industries Limited under which each partner will commit up to $250 million to the venture to acquire, develop and operate retail shopping centres across key cities in India. The shopping centres will contain 500,000 to 1,000,000 or more square feet and typically be anchored by a hypermarket to be owned and operated by Reliance. Reliance currently operates over 700 retail stores in multiple formats in India.

In 2008, the Boeing Company and Tata Industries Limited of India agreed on a plan to form a joint venture company that would initially involve more than US$500 million of defence-related aerospace component work to be done in India, for export to Boeing and its international customers. Under the memorandum of agreement signed by Boeing and Tata, it is contemplated that the joint venture company will be established later, and shortly thereafter, will begin building Boeing aerospace components. It is the intent of Boeing and Tata to not only utilize the existing Tata manufacturing capability, but also to develop new supply sources throughout the Indian manufacturing and engineering communities, for both commercial and defence applications.

The joint venture by the German auto major, Daimler, with India's Hero Group plans to set up a truck manufacturing facility in Chennai. The joint venture, Daimler Hero Commercial Vehicles Limited, signed a memorandum of understanding with the Tamil Nadu government in Chennai. Starting in 2010, the plant is expected to roll out 70,000 trucks in the initial phase.

Reasons for Failure of Joint Venture

Independent studies, like Mckinsey & Co have found that 70% joint ventures fell short of expectations, or were disbanded. Some of the reasons for the failure were: (a) the hoped for technology was never developed, (b) hindrances in sharing knowledge with the counterparts in the joint venture, and (c) management difficulties were compounded due to inability of the parent company to share control compromise on difficult issues.

Problems facing Indian Joint Ventures

There were many reasons for the break-up of Indian joint ventures. In many cases, partners were unable to infuse fresh capital. Irreconcilable and intractable conflicts croped up over technology transfer and its utilisation between partners. Many joint ventures are sewn-up without doing due diligence of cultural aspects. Multinational companies are increasingly being cobbled on account of Press Note 1. In the event of an MNC wanting to break free and float its own company, it is prohibited under Press Note 1, which states that any foreign company with existing joint ventures in India can start its own company in the same line of business only after getting a 'No-objection Certificate' from the existing Indian partners. Press Note. 1 is loaded in favour of domestic partners and heavily stacked against foreign partners. The trouble between Britannia and the French group, Danone, has brought into limelight the debate on Press Note 1. The change in partner's strategy also becomes a cause for the break-up of a joint venture. In the case of Ford Mahindra joint venture, Ford wanted to expand the operations but Mahindra wanted to focus more on the SUV segment, and did not want to invest in the expansion. When macro environmental factors become congenial for the local partner, the joint venture may fail. For example, the TVS-Suzuki JV fell apart when TVS learnt about motorbikes designing. TVS designed 'Victor' on its own, which was a success. This gave TVS the confidence to operate alone.

For a joint venture to be successful, both partners should have a good understanding of each other's cultures, establish good work collaboration and work towards a common objective.

Where mergers were not convenient, companies tried to form strategic alliances. Pharmaceutical companies, such as Ranbaxy and Lupin Laboratories, entered into strategic alliances with some MNCs. Another strategy was to form joint ventures with foreign majors, notably in automobile and consumer durables sectors. Unfortunately, most of these joint ventures did not last long. Some of the prominent joint ventures between Indian and foreign partners, particularly in the high-tech and high capital intensity automobile sectors, failed to mature, and the foreign partners assumed full control. These include the DCM-Daewoo, Tata-Mercedes, Mahindra-Ford, C. K. Birla group-General Motors, and PAL-Peugeot joint ventures. The main reason for these failures was the inability of the Indian companies to bring in additional funds needed for expansion, and poor corporate governance.

MASTER LIMITED PARTNERSHIP

Master Limited Partnership[21] (MLP) is a limited partnership that is publicly traded on the securities exchange. It combines the tax benefits of a limited partnership with the liquidity of publicly traded securities. Master Limited Partnerships apply to enterprises that engage in certain businesses pertaining to the use of natural resources like petroleum, natural gas extraction and transportation. Real estate enterprises also qualify as MLPs. Private Equity Management companies, like Blackstone Group and Fortress Investment Group, are structured as MLPs. In practice, MLPs pay their investors through quarterly required distributions (QRD), whose amount stated in the contract between the limited partners (the investors) and the general partner (the manager). Failure to pay the QRD may constitute as a default. Since MLPs are partnerships, they avoid corporate income tax on both the state and the federal basis. Additionally, the limited partner (investor) may also record a pro-rated share of the MLP's depreciation on his or her own tax forms to reduce liability. This is the primary benefit of MLPs and gives MLPs relatively cheap funding costs. However, this makes MLPs unattractive to tax-deferred funds, who must lose this tax saving advantage. To encourage tax-deferred investors, many MLPs set up corporation holding companies of LP claims which can issue common equity.

MLPs pay no income tax, and instead pay-out their income to the shareholders as dividends. MLPs trade on the stock exchange, like shares of any other stock. One of the most popular MLP groups is Pipelines.

Tax savings stimulated some companies to create royalty trusts in the early 1980s. Later, a number of firms established Master Limited Partnerships (MLPs). In royalty trusts and MLPs, pre-tax net operating profits go directly to shareholders (called unit holders in MLPs), where investors pay tax on the profits received. Managers operate a set of existing assets but rarely retain funds to invest in growth.

There are two types of partners in this type of partnership: The limited partner is the person or group that provides the capital to the MLP and receives periodic income distributions from the MLP's cash flow, whereas the general partner is the party responsible for managing the MLP's affairs, and receives compensation that is linked to the performance of the venture.

One of the most crucial criterion for a partnership to be legally classified as MLP is that the partnership must derive most (90%) of its cash flows from real estate, natural resources and commodities.

The advantage of MLP is that it combines the tax benefits of a limited partnership (the partnership does not pay taxes from the profit—the money is only taxed when unit holders receive distribution) with the liquidity of a publicly traded company.

Master Limited Partnerships, sometimes referred to as *United States Income Partnerships*, are investment vehicles that are similar to income royalty trusts, except that they are structured as limited partnerships. MLPs differ from high income stocks in several ways. Since they pass through income without being taxed at the corporate level, they avoid double taxation. In addition, MLPs can pass through tax deductions.

Kinder Morgan Energy partners is the MPL of the main corporation, KMI, which is traded in the New York stock exchange. The pipelines themselves are owned by the MLP Kinder Morgan Energy Partners, L.P. Finally, part of KMP's limited partner interests are held by the corporation, Kinder Morgan Management LLC, which allows tax-deferred investors to participate in KMP's operations.

[21]http://en.wikipedia.org/wiki/Master_limited_partnership2008

Terra Nitrogen Company, L.P.(TNH), pays a yield of over 14.1%. This Sioux City, Iowa-based company produces and distributes nitrogen fertilizer products, anhydrous ammonia and urea ammonium nitrate solutions.

Ferrellgas Partners LP (FGP) is a propane distribution company which has a yield of 10.9%. This Overland Park Kansas Company distributes gas in all 50 states.

Atlas Pipeline Partners LP (APL), is another natural gas distributor with about 7,900 miles of intrastate gas gathering pipelines.

Houston, Texas based Rio Vista Energy Partners LP (RVEP), which trades on NASDAQ, produces and transports oil and natural gas.

Suburban Propane Partners LP (SPH) distributes propane, diesel fuel, gasoline, fuel oil, kerosene, refined fuels, and natural gas. Energy Transfer Partner Ltd is in the business of transporting and storing natural gas through its pipeline system.

SUMMARY

Restructuring is a strategy through which a firm changes its set of business or financial structure. Mergers and acquisitions are part of corporate restructuring activities. Corporate restructuring aims at re-allocation of corporate resources to optimize their value, either by adding the related or divesting the unrelated businesses. Generally firms adopt three types of restructuring strategies: downsizing, downscoping and leveraged buyout. Divestitures have been traditionally seen as the opposite of mergers and acquisitions. A spin-off involves the pro rata distribution of a controlled corporation's stock to the distributing corporation's shareholders, without their surrendering any distributing corporation stock. In a split-up the existing corporation transfers all assets to two or more new controlled subsidiaries in exchange for subsidiary stock. The parent distributes all stock of each subsidiary to existing shareholders in exchange for all outstanding parent stock, and liquidates. A split-off is a type of corporate reorganization whereby the stock of a subsidiary is exchanged for shares in the parent company. Equity carve-outs are Initial Public Offering (IPO) of stake in a subsidiary. Although a carve-out technically is an IPO, economically it is an asset sale to public shareholders, as opposed to a single buyer, where the parent firm typically remains a controlling shareholder after the offering. In an LBO, debt financing typically represents 50% or more of the purchase price. Traditionally, stock option plans have been used as a way to reward top management and 'key' employees, and link their interests with those of the company and other shareholders. Profit sharing and employee ownership plans have become worldwide phenomena. Joint venture may be organized as partnership, a corporation or any other form of business, the participating firms might choose to select. Master Limited Partnership (MLP) is a limited partnership that is publicly traded on a securities exchange. It combines the tax benefits of a limited partnership with the liquidity of publicly traded securities.

DISCUSSION QUESTIONS

1. Explain different types of corporate restructuring.
2. What do you understand by the term 'Divestitures' ?
3. Explain the nature and characteristics of corporate spin-offs.
4. Distinguish between spin-off, split-up and split-off.
5. Explain Equity carve-out.
6. Explain the significance of an LBO.
7. What are the different stages of an LBO.
8. What is meant by ESOP?
9. What is an MLP?

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10 Corporate Control Mechanism and Takeover Defences

Chapter Objectives

The aim is to make the reader understand:

- The internal and external control devices
- The importance of differential shares, dual class recapitalisation, proxy contests, buyback of shares
- The various types of takeover defences

INTRODUCTION

In the market for corporate control, managers or teams of managers compete for the rights to manage corporate resources.[1] This market operates both within the firm and outside the firm. Transfer of control between management teams are accomplished either through internal control devices implemented by the board of directors, or through external control mechanisms, including proxy contests and hostile takeovers. The *internal control mechanism* includes competition among managers within the firm, the control function of the board of directors and the monitoring role of the large shareholders. Western Research Studies have shown that poor performance of the firm increases the likelihood of top management replacement. When the company performance is significantly lower than the industry performance, the probability that the board will remove the top management increases. The *external control mechanism* includes tender offers, differential voting rights and proxy fights.

DIFFERENTIAL VOTING SHARES

Differential voting rights allow investors to earn better returns in lieu of surrendering their voting rights. Indian companies have been permitted to issue shares with differential voting rights (DVRs) since 2001, when the Companies (Issue of Share Capital with Differential Voting Rights) Rules were made. Under the Companies Rules, holders of 'differential' shares will enjoy all other rights except the right to vote. Differential voting rights give the holders of a certain class of shares, higher voting power.

It allows a company to dilute its equity without the matching dilution in the promoters' stake. A company may issue it either due to corporate governance issues (the management may not want any interference in its style of functioning) or to prevent a hostile takeover. Large companies generally issue differential voting rights to prevent hostile takeovers. Promoters of a company may issue shares with DVRs to themselves, whereby they can hold a small number of shares, but still exercise a large number of votes.

[1]Jensen M C and R S Ruback, 'The Market for Corporate Control: The Scientific Evidence', Journal of Financial Economics, 1983, pp 5-50.

These are ideally good instruments for passive investors, typically small investors, who seek higher dividend, and are not necessarily interested in taking a voting position. Preferential voting shares are likely to be popular with retail investors and high net worth individuals as they command a discount. Internationally (US, UK), the discount ranges from 10-20%. Many institutional investors would be in favour for differential voting rights because their charters prevent them from buying such shares.

As per the *Companies Act*, a firm that has been profitable for three years, and which has no default record in filing annual accounts and returns, can issue shares with DVRs. However, the law says that the issue should not exceed 25 % of the share capital.

Foreign companies, like Google, Ford Motors and Berkshire Hathaway, have raised funds through DVR issues.

Nearly seven years after the government permitted the issue of equity shares with differential voting rights, Tata Motors became the first Indian company to make a rights issue carrying differential voting rights (DVR), with its offer opening on September 29, 2008. Tata Motors had issued 64.2 million differential voting shares at Rs 305, including a premium of Rs 295, along with an equal number of normal voting shares at Rs 340. The promoters of Tata Motors picked up the entire voting share lot, taking their stake in the company to 42.3%. Tata Motors' rights offer, now open, combines the offer of two different classes of shares. Shares with full voting rights are being offered at Rs 340 in the ratio of 1:6. But shares with one-tenth of the voting rights of the ordinary shares are being offered at a discount of Rs 35 per share. These shares will also be entitled to a 5% higher rate of dividend over the normal shares. Capital raised through the rights issue is proposed to be utilised to pay off the bridge finance loans for the Jaguar-Land Rover acquisition.

In 2008, the board of directors of Pantaloon Retail (India) approved a bonus issue of shares with differential voting rights (DVR) to existing shareholders of the company which was subject to necessary shareholder and regulator approvals. These bonus issue shares were offered to all shareholders of the company, in the ratio of one bonus share with differential voting rights for every ten equity shares held by shareholders on the record date. The new shares called Class B shares entitle the shareholders to an additional 5% dividend over the regular dividend payable to Class A shareholders in any financial year. Also, ten such Class B shares will carry one vote.

Promoters of Gujarat NRE Coke, India's largest merchant coke producer, will float a rights issue with DVR to ward off any takeover threats from companies seeking to secure coking coal assets. The strong demand for coke had resulted in steel companies scouting for takeover candidates in this space. The company thus hopes that differential voting rights would prove to be long-term guard against a takeover bid. The DVR offer from Gujarat NRE Coke is expected to help promoters increase their voting rights to 51% though their actual equity will remain at 41%.

If Tata Motors is the first to issue shares with DVR option, Pantaloon, India's leading retailer, is the first to issue bonus shares with DVR option.

DUAL CLASS RECAPITALISATION

It can be used to consolidate control of the corporation by insiders, protecting them from displacement by a hostile takeover. Dual class recapitalisation is the issue of a second class of common stock, generally with reduced voting power, in exchange for already outstanding shares of common stock. This type of recapitalisation typically results in entrenchment of management, and it enjoys increased control over corporate affairs.

The creation of second class of common stock with disparate voting power has been receiving increasing attention in the financial markets, especially in the wake of the 1984 New York Stock Exchange moratorium on delisting firms with dual-class common stock. The creation of limited-voting stock represents a deviation from the normal one share/one vote rule because it separates the ownership of equity from the ownership of voting rights. One class of common stock, often held by company founders and management, has superior voting privilege and lower claim to dividends. It enables corporate insiders to increase their voting control of the firm without increasing their equity stakes. The other class of common stock has limited voting privilege but preferential claim to the firm's dividends.[2]

Proxy Contests

Proxy contests are attempts for the control of a firm, in which a dissident group seeks from the firm's other shareholders, the right to vote their shares in favour of the dissident group's slate of directors. They are also known as *proxy fights*. Even though technically most contest are unsuccessful to the extent that the dissident group fails to win majority on the board of directors, proxy contest can have significant effects on target firm shareholder wealth regardless of the results.

Proxy contests have increased significantly since the early 1990s in the US. The promulgation of amendments to proxy rules by the Securities and Exchange Commission (SEC) in October 1992, has significantly encouraged shareholder communication, and allowed for more extensive use of the proxy machinery by shareholders, particularly institutional investors, to make their views known. The year 1995 is known as the year of the proxy contests. The factors that make a company vulnerable to a proxy contest include one or more of the following: (i) the company has a history of poor performance, whether compared to others in its industry or broader market indices; (ii) large shareholdings by institutional investors, particularly when combined with small share ownership by management and/or the board; (iii) the company is undervalued, *i.e.*, its asset value is greater than the market value of its stock, thus indicating that the market may believe the company's business strategy and/or management are not effective; or (iv) recent decisions by the company have resulted in a decline in the company's stock price, perhaps coupled with dissidents existing either within management, or as large stockholders who may be allies in a proxy contest.

The companies which had proxy contests are both large and small, including Avon Products, Del Webb Corporation, General Motors, Honeywell, Irving Bank, K-Mart, Lockheed, NCR Corporation, Pic 'N Save, Texaco, UAL Corporation and USX.

A proxy fight at Honeywell forced its management to restructure the company (Fromson, 1990). The HP Compaq merger also witnessed proxy contests. Dissidents have also used their influence to restrict the use of poison pills (and other management entrenching devices), and increase the use of confidential voting.

Raiders, who are able to raise enough capital to finance a cash tender offer, often initiate a proxy fight to help weaken management's defences against their offer. This tactic was used by Georgia-Pacific Corporation to gain control of Great Northern Nekoosa Corporation, and by AT&T to take over NCR Corporation.

De Angelo (1989) analysed proxy contests for seats on the boards of directors of 60 New York and American Stock Exchange listed corporations, and found that the contests were often followed by senior management resignations, and by the sale of assets or liquidation of the firm, even when the dissidents were unsuccessful in gaining a majority of board seats. Research by Hancock and Mougoue (1991), who analysed 55 proxy contests involving US corporations during the period 1970-1986, concluded that low earnings and dividend payout are likely to cause a proxy fight.

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[2]Charmen Loh, R S Rathinasamy, 'Insider Trading and Dual-Class Recapitalization,' Journal of Financial and Strategic Decisions, Vol. 8 No: 3, Fall 1995.

SHARE BUYBACK

Buyback is the reverse of issue of shares by a company, where it offers to take back its shares owned by the investors at a specified price. This offer can be binding or optional to the investors. In a share repurchase programme, the acquired (bought back) shares are liquidated, thereby reducing the company's equity base. The buying back of outstanding shares (repurchase) by a company happens in order to reduce the number of shares in the market. Companies will buyback shares either to increase the value of shares still available (reducing supply), or to eliminate any threats by shareholders who may be looking for a controlling stake.

It is often said that buyback of shares occurs because of the management's perception that the stock of the company is undervalued. Multinational companies utilise the buyback option to repurchase the entire floating stock from the market for the purpose of delisting. Critics often state that the option to convert their Indian ventures into wholly-owned subsidiaries and delist their shares from the stock markets, provided MNCs with complete control over their Indian ventures, allowed them to repatriate profits and make more independent investment decisions. Minority shareholders claimed that they had no option and were forced to sell their shares once MNCs bought back shares from the majority shareholders. Investors felt that the regulations framed by SEBI did not have provisions for preventing good stocks from delisting. Moreover, the buyback price, which was determined using the parameters specified in the SEBI Takeover Code, did not consider the future potential of the stock. The recessionary trends in 2008 in the Indian stocks markets had prompted about a dozen Indian companies to consider share buybacks, to take advantage of lower valuations and support falling prices. Share buybacks help companies to boost the intrinsic value of stock, but does not contribute to profit. Intrinsic value, loosely defined as excess of assets over liabilities, represents the price which shareholders will get if the business is sold at its book value.

Buyback of Shares in India

Share repurchase, a common practice in the bear market, is being widely used across the world, with firms like Microsoft, Abott, Nike and Hewlett Packard using the option. According to Thomson Reuters, India's buyback volumes soared to a record $1.4 billion in 2008, an increase of 268% over 2007, making it the second most active market after China in Asia. Topping the list is Reliance Energy's buyback in March 2008, valued at $886 million. Several companies, like EID Parry, Monnet Ispat & Energy Hindustan Unilever, Sasken Communication, DLF, Rain Commodities, Madras Cement and Patni Computers have undertaken share repurchase programmes. EID Parry, Monnet Ispat & Energy, and Godawari Power & Ispat's share buybacks were to be executed through open market purchases. With promoters opting not to sell their shares, their percentage of shareholding would go up on the contracted equity base. In 2008, ONGC announced plans to buyback shares held by IOC. ONGC would pay IOC about Rs 10,800 crore for buying back its 13.7 crore equity shares. IOC needs the money for funding major investments, including Rs 26,000 crore in Paradip Refinery cum Petrochemical Complex.

In October 2000, Royal Philips Electronics of Netherlands (Philips), the Dutch parent of Philips India Limited, announced its first offer to buyback shares of its Indian subsidiary. The open offer was initially made for 23% of the outstanding shares held by institutional investors, private bodies and general public. The offer was made at Rs 105, a premium of 46% over the then prevailing stock market price. With this, Philips became one of the first multinational (MNCs) companies in India to offer buyback option to its shareholders. In the financial year 2001-2002, twenty MNCs made buyback offers. Some of the well-known MNCs which offered to buy back their shares were Cadbury India Limited (Cadbury), Britannia Industries Limited (Britannia), Carrier Aircon (Carrier) and Otis Elevators (Otis). To buyback shares, Cadbury paid Rs 9 billion, Philips Rs 2 billion, and Carrier, Otis and Reckitt Benkiser, paid over Rs 1 billion each. In 2007, Abbott India Limited, a leading MNC pharma company approved the buyback offer to buy back the shares of Abbott India at Rs. 650 per share. In 2007, ICI India approved a proposal for buy back of shares of ICI India at a price of Rs. 575 per share from its existing shareholders through open market purchases. Godrej Soaps, Jindal Strips, Kirloskar Pneumatic Company, Ipca Laboratories, Great Eastern Shipping and Eicher Motors also announced buyback programme.

Buyback Regulations

The buyback of shares is governed by the Securities and Exchange Board of India's Buyback of Securities Regulation 1998 and Securities and Exchange Board of India's (SEBI) Substantial Acquisition of Shares and Takeover Regulations 1997. According to the guidelines issued under SEBI's Buyback of Securities Regulation 1998, a company could buy back its shares from the existing shareholders on proportionate basis. The ordinance allowed companies to buy back shares to the extent of 25% of their paid-up capital and free reserves in a financial year. The buyback can be done either through open market purchases or tender offer. The difference between the two routes is that in open market purchases, the promoters are barred from participating in the company's buyback programme, while in a tender offer, they are not. In a tender offer, every shareholder has the right to participate in the programme on a proportionate basis.

The objective of the buyback ordinance was to revive the capital market and protect the companies from hostile takeovers. The buyback could be financed only from the company's free reserves, securities premium account, or proceeds of any earlier issue, specifically made for buying back shares. The ordinance also prevented a company that had defaulted in the repayment of deposits, redemption of debentures or preference shares and repayment to financial institutions from buying back its shares. Moreover, a company was not allowed to buyback its shares from any person through a negotiated deal, whether through a stock exchange, spot transactions, or any private arrangement. It also allowed the promoters of the company to make an open offer (similar to acquisition of shares) to purchase the shares of its subsidiary.

Restrictions on Buyback by Indian Companies

Some features of government regulations for buyback of shares are: 1. A special resolution has to be passed in general meeting of the shareholders. 2. Buyback should not exceed 25% of the total paid-up capital and free reserves. 3. A declaration of solvency has to be filed with SEBI and Registrar of Companies. 4. The shares bought back should be extinguished and physically destroyed. 5. The company should not make any further issue of securities within 2 years, except bonus, conversion of warrants, etc.

These restrictions were imposed to restrict companies from using stock markets as short-term money providers apart from protecting the interests of small investors.

Reasons for Buyback

1. **Increase in promoter share for control purposes:** Some companies opt for buyback of shares to reduce the dilution in the promoters' holding, arising from the exercise of ESOPs issued to employees. Such exercising leads to increase in outstanding shares, and drop in prices. There is also scope for takeover bids due to dilution in promoter's share.
2. **High cash reserves:** Companies may go in for buyback if they have huge cash reserves with not many new profitable projects, with positive NPV. Some of the significant examples include Bajaj Auto's massive buyback in 2000 and the Reliance buyback scheme.
3. **Tax gains:** It is seen that dividends are taxed at a higher rate than capital gains. Companies prefer buyback to reward their investors instead of distributing cash dividends. At present, short-term capital gains are taxed at 10% and long-term capital gains are not taxed.

4. **Company's perception about the market performance:** It is often stated that during the October 1987 stock price crash in US, companies like Citigroup, and IBM had come out with buyback offers worth billions of dollars at prices higher than the market price. This was basically meant to convey the information to the investors that the share prices were undervalued.
5. **Exit option:** Buyback of shares becomes an option for a company if it wants to exit a particular country.
6. **Manipulate Performance:** Companies can use buyback methods to project profitability. When a company uses its cash to buyback stock, it reduces outstanding shares, and also assets on its balance sheet (cash is an asset). Thus, return on assets (ROA) increases with the reduction in assets, and return on equity (ROE) also increases as there is less outstanding equity. If the company's earnings are identical before and after the buyback earnings per share (EPS), the P/E ratio would look better even though earnings did not improve.

Valuation of Buyback

There are two ways by which companies determine the buyback price.

1. They use the average closing price (which is a weighted average for volume) for a period immediately before the buyback announcement. Based on the trend and value, a buyback price is decided.
2. In this method, shareholders are invited to sell some, or all of their shares within a set price range. The low point of the range is at a discount to the market price, while the top of price range is set at a premium to the market price. Investors are given more say in the buyback price than in the previous arrangement. Generally, the price is fixed at a mark-up, over and above the average price for the last 12-18 months. This method is rarely used.

Methods of Buyback

Basically, three methods are used for share buyback.

1. **Open offer Purchase:** In an open offer, a company can buy its shares back directly from the stock market through brokers. Open market purchases are used when the number of shares to be bought back is relatively small. The company has to fix a maximum price for an open market offer, stipulate the number of shares it intends to purchase and announce the closing date of the offer.
2. **Tender offer:** A tender offer is made when the number of shares to be bought back is large. The offer has a fixed price. In other words, the company fixes a particular price for the maximum number of shares it is willing to purchase. It also fixes an outer time limit for accepting the offer. The offer price is usually fixed at a premium, in order to encourage shareholders to surrender their shares. The company accepts the shares on proportionate basis if the offer is over-subscribed. But if offer is under-subscribed, the company may either accept whatever is tendered or extend the time limit. The fundamental difference between an open offer and a tender offer depends on the price at which the shares are repurchased. In a tender offer, a company has to pay the price it fixed for the repurchase, whereas in an open offer, the company only fixes a maximum price. The repurchase is made at the prevailing market price.
3. **Book building process:** The book building process is a mechanism of price discovery which helps determine the market price of securities. If the book building option is used, a draft prospectus has to be filed with SEBI. The prospectus should contain all details of the offer, except the price at which the securities will be offered (a price band is specified). The copy of the draft prospectus is also circulated among institutional buyers by a leading merchant banker acting as the book runner. Institutional investors specify the price as well as the volume of shares they intend to buy. The book runner, on receiving the above information, determines the price at which the offer is to be made public.

Companies can use targeted buyback methods to repurchase shares from a select group of shareholders. A notable example was the buyback of shares by the Great Eastern Shipping Company (GESCO) to protect itself from a hostile takeover bid led by the A H Dalmia Group. In October 2000, the A H Dalmia Group of Delhi made a hostile bid for a 45% stake in the Great Eastern Shipping Company (GESCO) at Rs. 27 a share. The price offered was less than half the book value of the company. The offer and the counter offers made by the A H Dalmia Group and the promoters of GESCO pushed up the bidding cost. The A H Dalmia Group ultimately sold its 10.5% stake (around 3 million shares) at Rs 54 per share, for a consideration of Rs. 163 million, before the year end. The A H Dalmia Group had acquired the 10.5% stake in Gesco at an average cost of Rs. 24 per share, for a consideration of Rs. 72 million. Hence, the A H Dalmia Group was able to make a profit of Rs. 91 million through greenmail transaction in less than 6 months.

TENDER OFFERS

Tender offer is a term that typically refers to a public, open offer (usually announced through a newspaper advertisement) by a company to all stockholders of a publicly traded corporation for sale at a specified price for a specified time, subject to the tendering of a minimum and maximum number of shares. To induce the shareholders of the target company to sell, the acquirer's offer price usually includes a premium over the current market price of the target company's shares. Cash or other securities may be offered to the target company's shareholders as consideration, although a tender offer in which securities are offered as consideration is generally referred to as an *exchange offer*. A tender offer may arise from friendly negotiations between the company and a corporate suitor, or may be unsolicited, and possibly unfriendly, resulting in counter-measures being taken by the target firm. A tender offer to purchase may be for cash or a type of corporate security of the acquiring company — like stock, warrants or debentures. Such an offer is sometimes subject to either a minimum or maximum that the offer will accept and is communicated to the stockholders through newspaper advertisements, or by general mailing to the complete list of stockholders.

Sun Pharma bought part of the 36 per cent stake in the Israeli company Taro at more than the initial offer price of $7.75 a share. Sun Pharma, in a bid to push up its stake, had earlier proposed to buy the residual stake at $10.25 per share to complete the merger, but negotiations did not happen. Under the earlier merger agreement, Sun offered $230 million at $7.75 per share in cash (a 27 per cent premium over the $6.10 per share value on May 18, 2007). Sun also agreed to refinance $224 million of Taro’s net debt. Sun has been able to mop up 36 per cent after the initial offer for $105 million, which included an upfront payment of $60 million to bail out Taro from immediate bankruptcy. After the infusion of funds, Taro’s fortune turned for the better and the Israeli company’s founders backtracked from the merger agreement. In January 2009, Sun Pharmaceuticals raised its offer by as much as 23 per cent to buy the residual stake of Taro Pharmaceutical Industries in a bid to gain a controlling stake in the Israeli drug maker.[3]

TAKEOVER DEFENCES

Takeover defences are means to make a target firm less attractive to raiders, or more difficult to take over. These include asset and ownership restructuring, anti-takeover charter amendments and adoption of poison pill rights plans. Defensive actions are taken in response to explicit threats ranging from early intelligence that a ‘raider’ or any acquirer has been accumulating the firm’s stock, to an open tender offer.[4] Adjustments in asset and ownership structures can be made even after a hostile takeover bid is announced.

[3]Business Standard, Jan 6, 2009.

[4]Weston et, Takeover Defences, PHI, Page 481.

Defensive strategies can be divided into pre-bid and post-bid strategies. The pre-bid defences by the target firm fall into two broad categories. *Internal defences* are those decisions/actions that alter the internal structure or nature of operations of the firm. *External defences* are actions taken to influence outsiders' perception of the firm and provide warning signals about potential predators. The internal defences include improving operational efficiency and undertaking restructuring activities like divestments, divestitures and equity carve-outs. The other methods involved in internal defences include change in ownership structure, share buyback, adoption of poison pill, and change in management structure, like staggered board and adoption of golden parachutes. The external defences include steps to improve investor relations and transparency about the company's performance, prospects and policies. Strategic defensive techniques, like joint ventures, are also external defence mechanisms. Emphasis on corporate social responsibility are external defence mechanism measures as they enhance the image of the company in the eyes of investors and public.

In the most effective methods, built-in defensive measures exist that make a company difficult to take over. These methods are collectively referred to as *shark repellents*. The classic 'poison pill strategy' (the shareholders' rights plan) is the most popular and effective defence to combat hostile takeovers.

Financial Defensive Measures

Many factors make a firm vulnerable to takeovers—a low stock price in relation to the replacement costs of assets or their potential earning power, undervaluation of the firm, or highly liquid balance sheet with large amounts of excess cash and unused debt capacity. Firms with good cash flows relative to current stock prices are also attractive targets.

Financial defensive measures include the target company taking on large debts in an effort to make the debt load too high to be attractive. The acquirer would eventually have to pay the debts, thus concentrating management's percentage holdings while using up debt capacity. Loan coevenants may be structured to force acceleration of repayment in the event of takeover. The debt may be increased, with borrowed funds used to repurchase equity. Dividends on remaining shares may be increased. Some of the excess liquidity may be used to acquire other firms, possibly in a regulated industry. The company may also buy a number of smaller companies, using stock swap, thus diluting the value of the target's stock.

Leveraged recapitalisation is a technique of financial restructuring developed by Goldman Sachs for Multimedia in 1985. In a typical recapitalisation, outside shareholders receive a large, one time cash dividend and insiders (managers) and employee benefit plans receive new shares, in place of cash dividend. The cash dividend is financed mostly by newly borrowed funds. This action would increases the firm's financial leverage, thus making it unattractive for takeover attempts. Leveraged recapitalisation is also known as *Leveraged Cash Out* (LCO). There are differences between leveraged cash-out and leveraged buyout. In leveraged recapitalisation, the firms remain publicly traded, and outside ownership is still in the majority. LCOs also have greater accessibility to capital markets, liquidity of managerial shareholdings and use of stock prices in devising management compensation packages.

Golden Parachutes

Golden parachute is explained as a takeover prevention, or takeover impact reduction strategy that gives the top management of the target company large termination packages, if their positions are eliminated as a result of a hostile takeover. It occurs after golden handcuffs, golden handshake and golden hello. Golden Parachutes envisage a provision in the employment contracts of top management providing for compensation for loss of jobs following a change of control. This anti-takeover strategy is usually adopted as a precautionary measure by the companies against mergers and takeovers. These tools usually come in a variety of forms, which include:

- Continuation of salary
- Bonus and/or certain benefits and perquisites
- Retirement benefits
- Accelerated vesting of stock incentives

Protection is provided to the employees in case any two events take place: (1) Controlling stake of the company changes hands, (2) Individual employees are terminated from their jobs due to change in control of management.

Golden parachutes are meant to maintain the competitiveness of the organisation's executive compensation. The company may be able to attract and retain a qualified management team who will act in the best financial interests of the shareholders. Moreover, consolidations may lead to redundancies in many executive positions. A good attractive compensation package must be offered to the executives to remove these redundancies.

VLSI Technology takes care of its employees in case of a takeover bid. The board of directors adopted an employee retention plan using golden parachutes for its top 27 executives, to protect the employees against a possible takeover by Royal Philips Electronics. Royal Philips could use the takeover bid to attract the senior management of VLSI Technology. This would lead to a 'shift' in loyalty among VLSI executives, which would be detrimental to the interests of the company. Hence, golden parachutes, which involved large sums of money, were offered to the employees, to retain them. The terms of the 'Parachute' included:

- Lump sum payment that was twice the executive's annual base salary
- Continued medical benefits.

One of the highlighted cases of golden parachute payment is the $23.5 million payment to six officers of Beatrice Companies in connection with its leveraged buyout in 1985. The advocates of golden parachutes emphasise the concept of implicit contracts for managerial compensation. In general, a manager's real contribution to the firm cannot be evaluated exactly in the current period, but can be estimated better as the time passes and more information is available on the firm's long-term profitability. In this situation, an optimal contract between managers and shareholders will include deferred compensation.[5] Another rationale for golden parachute is that the conflict of interest between managers and shareholders will be reduced.

White Knight

The option that the *white knight* bidder (a third party friendly to the incumbent management) be brought in to rescue the seller from an undesired takeover was generally considered when all defensive tactics proved ineffective.

A White Knight is a company that makes a friendly takeover offer to the target company which is facing a hostile takeover from another party. In other words, white knight is a company (the good guy) that gallops in to make a friendly takeover offer to a target company that is facing a hostile takeover from another party (a black knight). White Knight may be a corporation, a private company or a person that intends to help another firm. There are many types of knights. A *grey knight* is an acquiring company that enters a bid for a hostile takeover in addition to the target firm and the first bidder, and is perceived as more favourable than the black knight (unfriendly bidder), but less favourable than the white knight (friendly bidder). The knight might defeat the undesirable entity by offering a higher and more enticing bid, or strike a favourable deal with the management of the object of acquisition. For example, if Company T (target) is being acquired by Company H (hostile firm), but Company A (acquirer) can acquire ownership of Company T, then Company A would be acting as the white knight.

[5] Knoeber C R, 'Golden Parachutes, Shark Repellants and Hostile Tender offers', American Economic Review, 76, March 1986, pp 155-167.

The role of the white knight can be distinguished in two ways. The first type refers to the friendly acquirer of a target firm in a hostile takeover attempt by another firm. The intention of the acquisition is to circumvent the takeover of the object of interest by a third, unfriendly entity, which is perceived to be less favourable. Thus, white knight offers the target firm a way out with a friendly takeover. The second type refers to the acquirer of a struggling firm that may not necessarily be under threat by a hostile firm. The financial standing of the struggling firm could prevent any other entity from being interested in the acquisition. The firm may already have huge debts to pay to its creditors, or may already be bankrupt. In such a case, the knight, under huge risk, acquires the firm that is in crisis. After the acquisition, the knight rebuilds the firm, or integrates it into itself.

Examples of White Knights

1953: United Paramount Theaters buys bankrupt ABC.
1986: George Soros's Harken Energy buys Spectrum 7.
1998: Compaq merges with DEC.
2001: Dynegy attempted to merge with Enron to cover Enron's massive debts. The merger bid failed when it became clear that Enron had committed a fraud, resulting in the Enron Scandal.
2003: Often Analyst considered SAP to be the company that could most likely defeat Oracle's hostile attempt for PeopleSoft.
2006: Severstal tried to play its role as a white knight to Arcelor during its merger takeover by Mittal Steel.
2007: Nissin launched a friendly 37 billion yen ($314 million) bid for Myojo Foods after the US hedge fund, Steel Partners, offered 29 billion yen to buy the firm.
1995: When Reliance wanted to takeover Raasi Cements, Raasi called on Indian Cements as a white knight and offered it a stake. But, later, the white knight became the predator when India Cements took over Raasi Cements through an open public offer.

White Squire

A *white squire* is similar to a white knight, except that it exercises only a significant minority stake, as opposed to a majority stake. A white squire does not have the intent to take over a company, but rather serves as a figurehead to the defence against a hostile takeover. The white squire may often also get special voting rights for their equity stake. An example of a white squire might be Warren Buffett.

PacMan Defence

The Pac Man defence is a defensive option to stave off a hostile takeover. Under this option, a company that is under a hostile takeover, acquires its would-be buyer.

It is a transaction in which the target company turns the tables and makes a counter-offer to buy the shares of an unwelcome suitor. The name is derived from the electronic video game. The most quoted example in US corporate history is the attempted hostile takeover of Martin Marietta by Bendix Corporation in 1982. In response, Martin Marietta started buying Bendix stock with the aim of assuming control over the company. Bendix persuaded Allied Corporation to act as a white knight, and the company was sold to Allied in the same year. The incident was labelled as 'Pac Man Defence' in retrospect. The term was coined by the buyout guru, Bruce Wasserstein.

Macaroni Defence

It is a defensive tactic used by a corporation to defeat the takeover attempt by a raider or an unfriendly bidder. The target corporation issues a large number of bonds that must be redeemed at a mandatory high redemption value if the company is taken over. The redemption value of these bonds therefore increases when the company is threatened-like a macaroni when it is cooked-making the takeover prohibitively expensive to complete.

Crown Jewel Defence

A Crown Jewel is a particularly profitable, or otherwise particularly valuable, corporate unit or asset of a firm. The Crown Jewel Defence is an anti-takeover strategy in which the target firm sells off attractive assets to a friendly third party, or spins off the valuable assets in a separate entity. As a consequence, the target company becomes less attractive to the bidder. Sometimes, a specific aspect of a company is particularly valuable. For example, a telecommunications company might have a highly-regarded research and development (R&D) division. This division is the company's 'crown jewel'. The company may respond to a hostile bid by selling off the R&D division to another company, or spinning it off into a separate corporation. Other effects include dilution of holdings of the acquirer, making the takeover uneconomical to the third party, and adverse influence of current share prices.

In 2005, Japan's Livedoor warned the Nippon Broadcasting System Inc against adoption of a 'crown jewel' takeover defence. Livedoor called upon the target company to retain the key assets of the radio broadcast station while it (Livedoor or Nippon Broadcasting System) battled Fuji Television for takeover bid; the assets included major stakes in Fuji TV, Japan's top television network, and music label Pony Canyon.

Coercive Offers and Defence

The pressure or Coercion to tender arises when a takeover bid is front-end loaded, that is, when the offer price is greater than the price of any unpurchased shares. When a bid is front-end loaded, individual shareholders have the incentive to tender to receive the higher front-end price. In this two-tier offer, the bidder offers a first-tier price for a specified maximum number of shares it would accept, and, at the same time announces its intention to acquire, in a follow-up merger, the remaining shares at a second-tier price. In almost all cases, cash is offered for the first-tier transaction, but the second-tier price is typically paid by securities whose market value is often lower than the first-tier value. Front-end loading can occur not only in the two-tier offer, but also in partial and any or all offers.

Anti-takeover Amendments

Anti-takeover amendments are popularly known as *shark repellants*. These charter anti-takeover amendments must be voted and approved by shareholders. Evidence suggests that institutional shareholders, such as banks and insurance companies, are more likely to vote with the management on anti-takeover amendments.[6] There are four major types of anti-takeover amendments.

1. **Supermajority amendments:** These amendments require shareholder approval by at least two-thirds vote, and sometimes by as much as 90% of the voting power of all outstanding capital stock, for all transactions involving the change of control. Most often, the super majority provisions have a board out clause which provides the board power to determine if and when the supermajority provisions will be in effect.

[6]Brickley, J A, R C Lease and C W Smith Jr, 'Ownership Structure and Voting on Anti-takeover Amendments', Journal of Financial Economics, 20, 1988, pp 267-292.

2. **Fair price amendments:** These are supermajority provisions with a board out clause and an additional clause waiving off the supermajority requirement if a fair price is paid for all purchased shares. The fair price is commonly defined as the highest price paid by the bidder during a specified period, and is sometimes required to exceed an amount determined relative to the earnings or book value of the target.
3. **Classified board:** Staggered or classified board of directors is used to delay effective transfer of control in a takeover. This is considered an effective method through which a company might protect itself against an unwelcome takeover attempt. It is generally used in combination with 'Shareholder's Rights' plan. The method drags out the takeover process by preventing the entire board from being replaced at the same time. The directors are grouped into classes, each group stands for election at each annual general meeting. Under this procedure, from the board of directors, only a certain number of the directors, say, a third, are elected each year. With a staggered board, an outside group can only obtain control of a minority of the board of directors in any given year, since the holdover directors, elected in the earlier years, would continue to serve. Effectiveness of cumulative voting rights will be reduced under a classified board scheme, because greater shareholder vote is required to elect a single director.
4. **Authorisation of preferred stock:** The board of directors is authorized to create a new class of securities with special voting rights. This security, the preferred stock, may be issued to friendly parties in a control contest. Creation of a poison pill could be included in this category.

Poison Pill Defence

In the 1980s and the 1990s, poison pill was a very popular defensive technique in the US. It is a strategic move by a takeover target company to make its stock less attractive to the acquirer. It was created in the 1980s by the M&A lawyer, Martin Lipton, in the form of a warrant dividend plan, or the shareholder rights plan, to be used by El Paso Corporation as a successful defence against the hostile bid made by former railroad company, Burlington Northern. In 1983, the term 'poison pill' was coined, during the hostile takeover of fine china maker, Lenox, by Brown-Forman Distillers, producers of Jack Daniel's Whiskey, by Lenox's lead investment banker, Martin Siegel. Poison Pill is also known as Shareholder Rights Plan, or shark repellent.

The US Supreme Court passed a landmark ruling in the case of Edgar vs MITE Corporations, that invalidated the basis of anti-takeover laws in 37 states. This was followed by a lax policy in implementing anti-takeover laws, which prompted many companies to adopt their own versions of the poison pill, and also gave way to controversies pertaining to their legality. In 2007, 42 companies adopted poison pills in USA. In fact, in the United States, companies did even need shareholder approval before adopting a poison pill structure. Usually the poison pill lasts for about ten years unless the board decides to cancel it before its expiry. Experts estimate that for an unwanted bidder, on an average, the cost of swallowing a poison pill would be four to five times more than the normal cost. A target company can legally keep its poison pill in place and accept an offer from another bidder, as long as the final acquisition price is higher than the original hostile bid.

According to the research firm, Thomson Financial, there are currently over 1,500 poison pills in place at public companies in USA, with nearly 35% set to expire over the next two years. Non-US companies are also turning to poison pills more frequently, particularly in Canada and Japan, where hostile bids are on the rise. According to Thomson Financial, overseas firms now account for nearly 70% of first-time pill adopters.

Under this method, the target company gives existing shareholders the right to buy stock at a price lower than the prevailing market price if a hostile acquirer purchases more than a predetermined amount of target company's stock. The target company issues a large number of new shares, often preferred shares, to the existing shareholders. These new shares usually have severe redemption provisions, such as allowing them to be converted into a large number of common shares if a takeover occurs. The new rights issue triggers if anyone acquires more than a predetermined amount (20% to 30%) of the target's stock, thereby allowing shareholders (other than the bidder) to convert the right in order to buy additional equity securities in the company, or of the acquirer at a substantial discount. This immediately dilutes the percentage of the target owned by the acquirer, and it becomes more expensive to acquire 50% of the target's stock. This strategy has, therefore, aptly been termed as the *shareholder rights plan* as it provides shareholders (other than the bidder) with rights or warrants to buy more stock in the event of a control acquisition. The risk of dilution, combined with the authority of the target's board of directors to redeem the rights prior to a triggering event, compels the potential acquirer to negotiate with the target's board of directors, rather than proceed unilaterally.

The major benefits of a poison pill are: 1. The option allows the target firm to successfully ward off an unwelcome bid, 2. In case the target company is considering going ahead with the deal, it makes the raider negotiate, and buys time for the target company to get a proper evaluation of the offer, and thereby maximizes the takeover premium, in the best interest of the shareholders of the target company, 3. It equips the target company with a much-needed opportunity to investigate other alternatives, such as locating a white knight or exploring better takeover options, in the time period between the offer made by the hostile acquirer and acceptance. The cumulative effect of the strategy is to make it prohibitively expensive for an acquirer to buy control of the company. As a defensive tactic, poison pills are extremely effective. Not only do they fend off unwanted takeover bids, but boards often argue that the strategy gives the company an opportunity to find a more suitable acquiring party, a so-called 'white knight'.

The classic version of the poison pill is primarily of two types:

1. **Flip-in:** This common poison pill is a provision that allows current shareholders to buy more stocks at a steep discount in case of a takeover attempt. The provision is often triggered when any one shareholder reaches a certain percentage of total shares (usually 20 – 40%). By purchasing these shares cheaply, the investors get instant profits and, more importantly, dilute the shares held by the competitors. As a result, the competitor's takeover attempt is made more difficult and expensive. The shareholders are also less powerful in terms of voting, because now each share is a smaller percentage of the total.

   Internet major Yahoo! adopted this form of poison pill in the year 2000, allowing the board to issue up to 10 million shares on new stock in the event of an acquisition offer. Yahoo! adopted the poison pill plan to entitle its shareholders to buy one unit of a share of Yahoo! preferred stock for $250, should any single group or company accumulate 15% or more of Yahoo! preferred stock. The company entitled every director to cash in all of their outstanding stock options, which amounted to about 16 million potential new shares, and each share may have nearly unlimited voting power. This defence made it practically impossible for Microsoft to proceed with a hostile bid after Yahoo! expressed its unwillingness towards Microsoft's offer for Yahoo!, and ultimately resulted in its withdrawal. Yahoo!, the internet company, thus rejected a $44.6 billion bid from Microsoft. It is stated that Microsoft, the biggest software maker, would be able to get rid of the clause by replacing Yahoo's 10 directors, who are all up for re-election at the next annual meeting in 2009. Microsoft is pursuing Yahoo! to compete with Google Inc., the leader in Internet search. Google has grown faster than both Yahoo! and Microsoft in every quarter since the beginning of 2005. Boards also favour poison pills for the leverage they bring to the bargaining table. In 2003, enterprise software giant, Oracle, attempted to acquire its rival, PeopleSoft, through a $5.1 billion hostile takeover bid. But PeopleSoft's poison pill was set to trigger if Oracle bought more than 20% of the company's shares. After a year-long battle, PeopleSoft finally voided its poison pill and was acquired by Oracle for $10.3 billion, which was nearly double of Oracle's initial offer.

2. **Flip-Over:** A 'flip-over' allow stockholders to buy the acquirer's shares at a discounted price after the merger. The holders of common stock of a company receive one right for each share held, bearing a set expiration date and no voting power. In the event of an unwelcome bid, the rights begin trading separately from the shares. If the bid is successful, all shareholders, except the acquirer, may exercise the right to purchase shares of the merged entity at a discount. For instance, the shareholders have the right to purchase stock of the acquirer on a two-for-one basis in any subsequent merger. The significant dilution in the shareholdings of the acquirer makes the takeover expensive, and sometimes frustrates it. If the takeover bid is abandoned, the company might redeem the rights. Firms like TRW, Colgate Palmolive, J C Penney and Time Inc have adopted this plan.

Other Types of Poison Pills

1. Preferred Stock Plans It is also known as the original plan poison pill. It is an early poison pill anti-take-over defence in which the firm issues a dividend of convertible preferred stock to its common stockholders. If the acquiring firm passes a trigger point of share ownership, preferred stockholders (other than the large block holder) can put the preferred stock to the target firm (force the firm to redeem it) at the highest price paid by the acquiring firm for the target's common or preferred stock during the past year. If the acquirer merges with the target, the preferred stock can be converted into the acquirer's voting stock, with a market value of no less than the redemption value at trigger point.

2. Back End Rights Plans Under these plans, shareholders receive a rights dividend. If an acquirer obtains shares of the target in excess of a limit, holders, excluding the acquirer, can exchange a right and a share of the stock for senior securities or cash, equal in value to a back-end price set by the board of directors of the issuing (target) firm. The back-end price is higher than the stock's market price and, thus, back-end plans set a minimum takeover price for the firm. Back-end plans deter acquisition of controlling interest.

3. Voting Plans A voting plan is implemented by declaring a dividend of preferred stock with voting rights. In some cases, if a party acquires substantial block of a firm's voting stock, preferred holders, other than the large block holder, become entitled to super voting privileges. It is thus difficult for the block holder to obtain voting control. Long-term (three or more years) holders of preferred stock are entitled to more votes per share than the short-term holders.

4. Pension Parachute Pension parachute is a form of poison pill under which a pension agreement exists that specifies that, in the event of a hostile takeover attempt, any excess assets in the company pension plan can be used for the benefit of pension plan participants, such as increase pension payments. This prevents the raiding firm, or an individual, from using the pension assets to finance the takeover, and, therefore, acts as an additional deterrent to help the firm ward off the acquisition. In corporate governance, the pension parachute protects the surplus cash in the pension fund of the target from unfriendly acquirers; the fund remain the property of the plan's participants in the target company. Kelley Drye & Warren LLP claimed to be the pioneers of "pension parachute". Their first pension parachute was implemented for Union Carbide, and its design was upheld in Union Carbide's litigation with GAF.

Examples for Poison Pill Adoption

Japan's Nippon Steel, the world's third largest steel maker after Mittal Steel and Arcelor, has adopted poison pills to thwart hostile takeovers in the future. Net Networks Inc. has adopted a poison pill against 'coercive takeover tactics,' in a clear bid to block a group of investors, led by the activist hedge fund, Jana Partners, from gaining seats on the company's board. The plan would allow the company to issue additional shares at a discount if any person or group acquires 15% or more of the company's stock, thus diluting the bidder's holdings.

Alpharma Inc, a global specialty pharmaceutical company, announced that its Board of Directors has adopted a limited duration shareholder rights plan (the 'Rights Plan'). The Rights Plan has been adopted in response to King Pharmaceutical Inc.'s unsolicited offer to acquire all outstanding shares of Alpharma for \$33.00 per share, which the Board has determined to be inadequate, and not in the best interests of Alpharma shareholders. In 1998, The Walt Disney Company adopted a stockholder rights plan to prevent the company from being acquired in a hostile takeover. The poison pill was intended to make the hostile takeover expensive and was to take effect if anyone acquired more than 25% of Disney's shares or began a tender offer. It allowed other shareholders to acquire additional issues at half price.

Hokuetsu Paper Mills became the first major Japanese company to use a poison pill defence after it rejected an unsolicited \$1.2 billion offer from Oji Paper, Japan's largest paper manufacturer. There are cases in the US itself where poison pills have effectively been dislodged. An example is the acquisition of Maxmillon by the Maxwell Corporation, owned by Robert Maxwell, Robert Maxwell actually fought a successful poison pill dislodge, because he proved that his acquisition was effectively better for the shareholders of Maxmillon. Electronic Data Systems adopted a poison pill takeover defence as the General Motors Corporation prepared to spin-off the company. The strategy was to make it prohibitively expensive for an unwanted suitor to buy EDS. Steel Technologies Inc., Louisville, adopted a shareholder rights plan under which a preferred stock purchase right was distributed as dividend on each outstanding share of common stock. The plan would protect shareholders in case of a takeover bid by an outside company. The company's large increase in earnings was a factor for the board's adoption of the plan.

News Corp, the media conglomerate controlled by Rupert Murdoch, announced that it was adopting a poison pill defence, following an unexpected manoeuvre by media investor, John Malone.

Ruias-led Indian conglomerate, Essar Group, has received a boost to its proposed acquisition of US steel firm, Esmark, with the target company adopting a poison pill to shield itself against any hostile takeover. Esmark said that its shareholder rights agreement was designed to help shareholders receive the highest value for their shares in connection with the sale of the company. Esmark was already the target for an unsolicited takeover bid by Russia's Severstal, even as its board endorsed the offer worth over \$1 billion from Essar. Essar has proposed to raise its offer to \$19 a share, after its offer of \$17 per share was matched by Severstal.

India Cement's hostile takeover of Andhra Pradesh based Raasi Cement Ltd. in 1997-98 was the trendsetter in the industry. The promoters of Raasi Cement also had a controlling stake in Vishnu Cement but adopted the 'poison pill' strategy, whereby the promoter share was transferred to a group company to make Raasi's takeover less attractive. But, in the end, India Cement got control of Vishnu Cement.

In some cases, investors send a clear message that do not agree with the management's strategy, by dumping some of their shares. Consider the example of the oil company, Tesoro. When the company adopted a poison pill in November 2007, to defend itself against billionaire Kirk Kerkorian's Tracinda Corp., its stock plummeted almost 14% between the week before the announcement and the week after. In March 2008, Tesoro's management dropped its poison pill with CEO Bruce Smith explaining that the company wanted to act in the best interests of the stockholders.

Poison Pills Related Terms

1. Activist shareholder An investor who uses his stake in the company to influence the management and directors of that company. The rise in shareholder activism is one reason why many large companies have eschewed poison pills in recent years due to their 'shareholder-unfriendly' reputation.

2. Chewable pill A modified poison pill that can appease investors by permitting them to ask for a special shareholder vote to determine whether or not a specific bid can be exempt from triggering the pill. Such policies prevent companies from automatically discouraging takeover bids that may be lucrative for shareholders.

3. Suicide pill A defensive strategy by which a target company engages in an activity that might actually ruin the company rather than prevent the hostile takeover. It is also known as the Jonestown Defence.

4. Poison put It is a provision in an Indenture, giving bondholders the privilege of redemption at par if certain designated events occur, such as a hostile takeover, the purchase of a big block of shares, or an excessively large dividend payout. Poison puts, or superpoison puts, as the more stringent variations are called, are popular anti-takeover devices because they create an onerous cash obligation for the acquirer. They also protect the bondholder from deterioration of credit quality and rating, that might result from a leveraged buyout that added to the issuer's debt.

New bond issues have provided their holders with poison put covenants as protection against risk of takeover related credit deterioration of the issuer. This kind of put may well protect the management but not the bondholders. Under a friendly deal, the put is not exercisable even if control hurts the bondholders. The large price declines of bonds of RJR Nabisco, after the announcement of its leveraged buyout in December 1988, have been a motivating factor for introduction of the superpoison puts.

The Lotus Development Corporation's acquisition by IBM is a significant hostile takeover in the modern era. On June 5, 1995, IBM surprised the market—and Lotus—with an announcement of an all-cash tender offer for all of Lotus's shares at $60 per share, almost twice the stock's pre-offer price. IBM's tender offer was contingent upon Lotus withdrawing its poison pill. At the same time, IBM filed proxy materials with the SEC, asking Lotus shareholders to replace all Lotus directors with IBM-nominated directors, who would have been amenable to the acquisition, and would have redeemed Lotus's poison pill. IBM also filed suit in the Federal Court in Delaware to block the application of Lotus's anti-takeover devices under the Delaware and Massachusetts law. In light of the substantial premium resulting from IBM's offer, and the likelihood that shareholders would vote for nominees supportive of IBM's offer, Lotus's board soon realised that its position was hopeless and, within a week, it acceded to the acquisition, in return for a slightly higher price and a measure of autonomy within IBM.

Targeted Share Repurchases (Greenmail)

Greenmail is a practice in corporate mergers and acquisitions that occurs when a large block of stock held by an unfriendly company or raider is repurchased by the target company at a substantial premium to destroy any takeover attempt. This is also known as a *bon voyage bonus* or a *goodbye kiss*. Thus, greenmail involves a corporation's attempt to stop a takeover bid by paying the price above the market value for the stock held by the aggressor. The purpose of the premium buyback is to end a hostile takeover threat by the large block holder, or greenmailer. The term, greenmailer connotes blackmail, and both the payers and receivers of greenmail have received negative publicity. Greenmail is also known as targeted repurchases. Often, in connection with targeted repurchases, a standstill agreement is written. A standstill agreement is a voluntary contract in which the stockholder, who is bought out agrees not to make further investments in the target company during a specified period of time. When a standstill agreement is made without a repurchase, the large block holder simply agrees not to increase his or her ownership, which presumably would put him or her in an effective control position.

During the great wave of corporate mergers in the 1980s, the practice of paying greenmail became controversial in USA. Some corporate raiders began takeover bids simply to earn profits through greenmail.

Corporate shareholders also protested against the practice. By the mid-1990s, state legislatures had taken the lead in opposing greenmail through legislation. Most states in USA had enacted anti-takeover laws, and several had anti-greenmail provisions. Greenmail is often described as a pact involving embezzlement by corporate directors and blackmail by corporate raiders.

Greenmail proved lucrative for investors like T Boone Pickens and Sir James Goldsmith during the 1980s. In the latter example, Goldsmith made $90 million from the Goodyear Tire and Rubber Company. Occidental Petroleum paid greenmail to David Murdoch in 1984. In 2002, KBF Pollution Management INC, a recycling service provider, repurchased its current shareholders, at substantially high prices.

Greenmail is one of an array of strategies, ranging from changing corporate bylaws to acquiring debt that makes the corporation a less attractive target, that are used to deter raiders. It can be an expensive alternative. In 1984, Saul P. Steinberg attempted to take over the Disney Corporation. Steinberg was known for his concerted efforts in the takeover field, having previously targeted Chemical Bank and Quaker State. In March 1984, his purchase of 6.3% of Disney's stock triggered concern at the corporation that a takeover was in progress. Disney's management quickly announced an approximately $390 million acquisition of its own that would make the company less attractive. After this maneuver failed, Disney's directors ultimately bought Steinberg's stock to stop the takeover. Steinberg earned a profit of about $60 million. The Disney's case illustrates the controversial nature of greenmail. Other stockholders blamed corporate directors for showing undue favouritism to corporate raiders who were paid exorbitant sums for their stock, whereas the stockholders were not. In 1984, Disney stockholders sued the corporation's directors as well as Steinberg and his fellow investors, seeking to recover the amount paid as greenmail. They won an injunction from the Superior Court of Los Angeles County, which placed Steinberg's profits from the sale in a trust. The verdict was upheld on appeal (*Heckmann v. Ahmanson,* 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 [Cal. Ct. App. 1985]). In ordering the profits to be put in a trust, the court sought "to prevent unjust enrichment" that would otherwise "reward [Steinberg] for his wrongdoing." In 1989, Steinberg settled with the plaintiffs for approximately $21.1 million.

Bank Mail

This is an agreement between a company planning a takeover and a bank, which prevents the bank from financing any other potential acquirer's bid. Bank mail agreements are meant to stop other potential acquirers from receiving similar financing arrangements.

White Mail

White mail is a strategy that a takeover target uses to try and thwart an undesired takeover attempt. The target firm issues a large amount of shares at below-market prices, which the acquiring company would have to purchase if it wishes to complete the takeover. If the white mail strategy is successful in discouraging the takeover, then the company can either buy back the issued shares or leave them outstanding.

DEFENCES BY INDIAN FIRMS

The Hindalco Industries promoters, Aditya Birla Group's promoter's stake was 25.95%. This would gradually be increased through the creeping acquisition route to ward off any takeover attempt. Tata Sons, the holding company of Tata Steel, has plans to increase its stake in Tata Steel in two stages, through a preferential issue of shares. DCM Shriram defended itself from a hostile acquirer by allowing its promoters to increase stake via fresh issue of preferential shares. Challenged at the Company Law Board, the offer passed muster, and the hostile bid was defeated. Different Tata companies have, in place, an arrangement with the Tata Sons entity, whereby anyone acquiring any of those entities may not be allowed to use the Tata name, or the brand.

REGULATORY ASPECTS IN INDIA WITH RESPECT TO TAKEOVER DEFENCES

In India, the law pertaining to takeovers is embodied in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, commonly known as the Takeover Code and the SEBI Disclosure & Investor Protection Guidelines, 2000. The takeover code does not present any insurmountable barrier to a determined hostile acquirer. The regulatory framework simply mandates the acquirer to make a public disclosure of his shareholding or voting rights to the target company, as well as the stock exchange on which its shares are listed, if he acquires shares or voting rights beyond predetermined threshold limits. Also, in case he wishes to acquire control over a target company, the acquirer has to make a public announcement of the same, stating clearly various details of the bid, including his intention of acquisition, his identity, details of offer price and the number of shares to be acquired from public, his future plans (if any) and change in control over the target company, amongst others.

SEBI Disclosure & Investor Protection Guidelines 2000 are the nodal regulations for the methods and terms of issue of shares/warrants by a listed Indian company. They impose several restrictions on the preferential allotment of shares and/or the issuance of share warrants by a listed company. Under the DIP guidelines, issuing shares at a discount, and warrants which convert to shares at a discount are not possible as the minimum issue price is determined with reference to the market price of the shares on the date of issue, or upon the date of exercise of the option against the warrants. This creates an impediment in the effectiveness of the shareholder rights plan which involves preferential issue of shares at a discount to existing shareholders.

The DIP guidelines also provide that the right to buy warrants needs to be exercised within a period of eighteen months, after which they would automatically lapse. Thus, the target company would have to revert to the shareholders after the period of eighteen months to renew the shareholder rights plan.

In the event of a takeover bid, all the directors of the target company may be removed in a single shareholders meeting, as permitted under the Companies Act, 1956, thus making irrelevant the Staggered Board defence available to foreign companies.

The Takeover Code also restricts corporate actions of target companies during the offer period, such as transferring assets or entering into material contracts, and prohibits issue of any authorized, but unissued, securities during the offer period. However, these actions may be taken with the approval of the general body of shareholders. Regulation 23, however, makes an exception to the above situation by permitting the target company to issue shares carrying voting rights upon conversion of debentures already issued, or upon exercise of option against warrants, as per pre determined terms of conversion or exercise of option. It also allows the target company to issue shares pursuant to public or rights issue in respect of which the offer document has already been filed with the Registrar of Companies, or stock exchanges, as the case may be.

Other defences, such as 'brand pills' are used by Indian Companies like Tata, who have in place an arrangement whereby anyone who acquires any of its entities, may not be allowed to use its name or brand. By being deprived of the right to use the brand name, the acquirer loses out on considerable portion of the target company's valuation, and this serves as an acquisition deterrent.

Without the ability to allow its shareholders to purchase discounted shares/options against warrants, an Indian company would not be able to dilute the stake of the hostile acquirer, thereby rendering the shareholders' rights plan futile as a takeover deterrent. A mechanism must be permitted under the takeover code and the DIP guidelines which permits issue of shares/warrants at a discount to the prevailing market price.

Empirical Evidence on Takeover Defences

DeAngelo et al. (1983) find statistically significant positive abnormal returns for anti-takeover amendment announcements in the 1960-1980 period for 475 NYSE listed firms. Jarrell and Poulsen (1987) study 649 anti-takeover amendments proposed between 1979 and 1985. Their stock return data show an average abnormal return of –1.25% during the 30 day period surrounding the proxy signing date for the entire sample. McWilliams (1988) reports a positive stock price effect of amendment proposals, and no differences in stock price effects among different types of proposed antitakeover amendments. Pound (1987) compares a sample of 100 NYSE listed firms that adopted supermajority and classified board amendments in the period 1973-1979, and a complementary control group consisting of 100 firms that adopted neither supermajority nor classified board amendments. The results of this comparison show that firms with antitakeover amendments have a 26% lower frequency of takeover attempts in the 1974-1984 period than the control sample. Bhagat and Brickley (1984) analyzed the effect of changes in cumulative voting on stock prices and found an average return of –0.88% during the announcement period. Malatesta and Walking (1988) studied an exhaustive sample of 132 poison pills adopted from 1982 through March 1986. The average abnormal return for a two day announcement period is significantly negative. The study also finds that firms announcing poison pills have an average managerial share ownership of 9.39%, which is significantly smaller than the average managerial ownership of their respective industries. Ryngaert (1988) finds that an unsolicited bid is more likely to be defeated when a poison pill is in place. The study also finds that poison pill defences were frequently employed against existing bids for all the shares of the firm. Bradley and Wakeman (1983) suggest that targeted repurchases inflict greater costs to non-participating shareholders when they are used to thwart takeover attempts. Holderness and Sheehan (1985) and Klien and Rosenfield (1988) find that the initial stock price purchase, that eventually leads to repurchase, produced significantly average abnormal returns, both in the initial 'foothold period' and in the full purchase to repurchase period. Mikkelson and Ruback (1986) find that targeted repurchases do not result in significant decline in stock prices unless they are accompanied by a standstill agreement, or preceded by a control contest. Larger stock price declines associated with repurchases with standstills may reflect the possibility that these agreements reduce the probability of a subsequent takeover. Bhagat and Jefferis (1988) hypothesize and find evidence that the primary role of the anti-greenmail amendments is to hide other anti-takeover agenda items for the annual shareholder meeting. The study also finds that an increase in institutional ownership is associated with a statistically significant decline in the occurrence of anti-takeover amendments for firms proposing anti-greenmail amendments.

SUMMARY

In the market for corporate control, managers or teams of managers compete for the rights to manage corporate resources. Transfers of control between management teams are accomplished either through internal control devices implemented by the board of directors or through external control mechanisms, including proxy contests and hostile takeovers. Differential voting rights allow investors to earn better return in lieu of surrendering their voting rights. Dual class recapitalization is the issue of a second-class of common stock, generally with reduced voting power, in exchange for already outstanding shares of common stock. Proxy contests are attempts for control of a firm in which a dissident group seeks, from the firm's other shareholders, the right to vote their shares in favour of the dissident group's slate of directors. Buyback is reverse of issue of shares by a company, whereby it offers to take back its shares from the investors at a specified price. Takeover Defences are means to make a target firm less attractive to raiders or more difficult to take over. These include asset and ownership restructuring, anti-takeover charter amendments and adoption of poison pill rights plans. Golden parachute is explained as a takeover prevention or takeover impact reduction strategy that gives the top management of the target company large termination packages if their positions are eliminated as a result of a hostile takeover. White

knight is a company (the good guy) that gallops in to make a friendly takeover offer to a target company that is facing hostile takeover from another party (black knight). The Crown Jewel Defence is an anti-takeover strategy in which the target firm sells off attractive assets to a friendly third party or spins off the valuable assets in a separate entity. Anti-takeover amendments are popularly known as shark repellants. These anti-takeover amendments must be voted and approved by shareholders. Under the poison pill strategy, the target company gives existing shareholders the right to buy stock at a price lower than the prevailing market price, if a hostile acquirer purchases more than a predetermined amount of the target company's stock.

DISCUSSION QUESTIONS

1. What do you understand by differential shares?
2. Explain dual class recapitalization.
3. What is meant by proxy contest?
4. Explain the term 'buyback of shares'.
5. What are the different types of takeover defences?
6. Explain the terms 'White Knight','White Squire' and 'Pacman Defence'.
7. Explain the significance of poison pills and anti-takeover amendments.
8. What is Crown Jewel Defence?

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11 Post-Merger Integration

Chapter Objectives

The aim is to make the reader understand

- The importance of post-merger Integration
- The critical success factors for post-merger integration
- The challenges of integration

INTRODUCTION

The process of combining two or more organisations into a single organisation involves several organisational systems, such as people, resources and tasks. The process of combining these systems is known as *integration*. Integration of two organisations involves integration of systems, processes, procedures, strategy, and reporting systems. Integrating organisations also involve change in the mindsets of people, cultures and behaviours.

Integration planning is one of the most difficult tasks of a successful merger or acquisition. Merger teams must process the information from due diligence and develop an integration process that helps to ensure that merger synergies result. Integration can be viewed as a unique and powerful opportunity to decisively change the organisational climates, cultures and working practices of the combining organisations during the merger. It is not a post integration effort.

Peter Ducker has suggested five basic commandments for successful acquisitions. These are: (1) the acquirer should contribute something to the acquired company, (2) a common core of unity is required, (3) the acquirer should respect the business of the acquired company, (4) within a year or so, the acquiring company should provide top management to the acquired company, and (5) within the first year of the merger, managements of both companies should receive promotions across the entities.

CRITICAL SUCCESS FACTORS FOR POST-MERGER INTEGRATION

Successful integration is all about managers being willing to mix their teams in order to find the best combination of experience and expertise.

Issues involved in post-merger integration range from managing cultural differences to integrating employee compensation and benefit systems, to standardising operations. The key elements identified for successful post-merger integration are as follows:

Vision As soon as the merger is announced, the companies ought to form an integration team, which acquires information from the managements of both companies about their expectations. Senior management executives of both companies should hold also discussions about the future vision, goals, values and policies of the new company. This plays a key role in designing the vision for the new entity.

Strategic Leadership The success of the merger depends on the key personnel of the organisation who have the ability to organise resources to carry out a smooth transition and integration. The head of the integration programme should be responsible for the entire integration process, from planning to implementation.

Action Plan Successful mergers have a comprehensive plan and implementation process in common that are effective and also shorten the integration period. The plan should have clear-cut definitions for various responsibilities, and should be periodically reviewed by the integration team. The integration process should be streamlined to increase efficiency. For instance, General Electric's Capital Services has a streamlined integration process, the *pathfinder model*.

Most successful companies link effective strategic formulation, pre-merger planning and post-merger integration. It is essential that companies create teams of people to work on each stage: namely, vision setting, pre-merger targeting, negotiation and planning, and final integration.

A strategically formulated vision is essential for acquirer companies to identify appropriate targets. The pre-merger process involves identification of target companies with right capabilities. A well-defined post-merger process should be able to capture well defined sources of value as quickly as possible.

According to Booze Allen Hamilton Report, four principles are key to success in merger integration.[1] They all start with the CEO before the deal closes.

- Communicate a shared vision for value creation
- Seize defining moments to make explicit choices and trade-offs
- Simultaneously execute against competing critical imperatives
- Employ a rigorous integration planning process
- In most deals, ambiguous leadership and poor execution prevent companies from capturing full value of the merger.

The most successful integration efforts leverage multiple communication channels and do not underestimate the power of daily dialogue between the supervisor and the employee. The senior leadership team must identify and evaluate all options and make explicit choices and trade-offs, recognising the fact that some choices would be very clear while others would require great conviction and fortitude.[2]

Research studies have shown that successful integration is a function of skillfully combining leadership with execution and placing greater emphasis on achieving growth. The other critical factors are professional integration management, integration approach and speed and communication, which are all related to execution. Strong leadership is required to ensure that the merger is on the right track, and all necessary tasks are being executed.

Retaining key talent in the merger is another area of challenge. This acquires more significance when the deal involves preserving intellectual capital. The real expertise for creating innovative products, services and processes is carried around by employees in their heads. And, unlike an assembly line, employees can walk out the door and never return.[3]

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[1]Booze Allen Hamilton Report, Merger Integration, Delivering on the Promise, A series of Viewpoints on Mergers, Acquisitions and Integration, page 1-20.

[2]Booze Allen Hamilton Report, Merger Integration, Delivering on the Promise, A series of Viewpoints on Mergers, Acquisitions and Integration, page 5.

[3]Juergen Rothenbuecher et al, Three Years After the Marriage, Merger Integration Revisited, ATKEARNEY Report 2008.

The new approach in merger integration is to establish the link with *Management by Objectives* (MBO). This establishes the network between compensation and successfully completing the integration, as specified. MBO targets provide strong incentives that keep the entire management team focused on the job at hand.

Completing the integration process as quickly as possible also occupies significance in the context of financial logic of realising synergies sooner for the shareholders. Acknowledging cultural differences and stimulating awareness and acceptance through extensive, timely and well-coordinated communication and exchange of key people is also important for the success of the merger. Corporates have to arrange regular exchange visits for their employees to send out a message about their work culture and create a bonding. Orientation and workshops can be conducted to create a global mindset to take up issues and arrive at common objectives. The parent companies engage in different modes of communication with acquired companies of various regions, depending on their cultures.

The Four Cs[4]

For the success of a merger, people's commitment and involvement are very important. The process of merger engagement has four dimensions.

1. **Coordination**: Informing employees about the combination so that they can see where they fit in.
2. **Cooperation**: Encouraging intellectual buy-in by creating opportunities for people to express their viewpoint and concerns.
3. **Collaboration**: Encouraging intellectual and emotional buy-in through creating opportunities to explore differences and similarities, and appreciate complementary skills and experiences.
4. **Commitment**: Helping people to see the stake they have in the business, and moving them to a position where they want and know how to contribute towards its success.

Any integration effort that tries to help employees move through the stages of coordination, cooperation, collaboration and commitment must be able to have an impact on their mindsets, values, perceptions and behaviours. Integration extends beyond redesigned processes and structures. It also encapsulates a vision about the culture, climate, values and capabilities of the combined business.

Many companies set a target for their integration programme to be completed within a time span. Many companies in the US follow this approach and design an integration process that aims to create operational linkages, such as new accounting processes, an integrated management structure, and shared IT platform within a short, stipulated, time period. Lucent Technologies, the telecommunications and computing company, for instance, has designed an integration programme that aims for completion within 100 days after the merger announcement.

Ingredients of Integration

All elements that affect post-merger integration success, especially the cultures of the companies, must be assessed and rolled into the synergy value (and price to pay) calculations. Pre-merger planning has become especially critical as companies face pressure to deliver synergies as soon as possible. Yet companies often mistakenly believe that few, if any, integration activities can be done pre-close.

Post-merger integration teams should be focused on value drivers, and not just cost functions. These drivers include core processes, such as product design, marketing and supply chain management. There should also be a revenue team.

There are four important areas where integration efforts need to be focused—alignment of values and vision, especially among managements, a unified go-to-market strategy, people integration and operations

[4]Marion Devine, Successful Mergers, Getting the People Issues Right, *The Economist*, 2002.

integration. The relative importance of each would be determined by the level of integration being considered. Often, highly simplistic approaches are taken—for instance, compensation rationalisation is equated with HR integration, while merging websites and printing new business cards and signage are thought to be sufficient integration at a marketing level. Talking of marketing integration, it is also necessary to set practical expectations. Change in business model needs to be preceded by change in mindsets, and this is an important task of post-merger integration. The level of integration needed between the companies also decides the post-merger integration strategy. There are many cases where the acquired company keeps its original identity, and more or less continues to work independently.

Strategy and Structure is probably conceptually the easiest but the most critical part, which has a process bearing on the rest of the integration. Some key elements of this are leadership consolidation, vision and business philosophy alignment, cultural alignment, consolidation of business reporting and organization structure definition.

Market integration is a more involved exercise and encompasses issues across a broad spectrum-brand integration (visual and messaging), sales force integration and retraining, product and service integration, channel integration and supplier integration. If done well, this could lead to tremendous synergies, and even, not so obvious, cost benefits.

People integration, the most sensitive area, comprises compensation rationalization, creation and deployment of a communication plan, devising employee retention mechanisms as well as employee feedback processes.

Last, *delivery or operational integration* includes process and system alignment, technology integration, consolidation of support functions and workplace branding.

Vision and operating strategy must be supported by proper systems and processes to align the behaviour of managers with corporate objectives. The merger of Burroughs and Sperry in 1986 to form Unisys was meant to generate economies of scale and improve efficiency. But the integration of the distribution system was a disaster. The companies had different order entry and billing procedures. Customers were frustrated by delayed deliveries. Similarly, the acquisition of Republic Airlines by North West Airlines in 1986 created integration problems in computer systems, crew and gate scheduling and human resource functions.

Critical Elements of Post-Merger Integration

Basically, an acquirer integrates five core functions: a) Information Technology, b) Research and Development, c) Procurement, d) Production and Networks, and e) Sales and marketing.

According to BCG Report, of more than 4000 deals, more than 71% of the acquisitions in 2006 were driven by a quest for economies of scale. It is essential that, in order to unlock the full potential of a merger, the acquirer treat integration as a strategic opportunity to reformulate each function's role so that each plays a full and complementary part in optimizing the combined entity's long-term growth.

Different types of mergers require different speeds and styles. A *consolidation merger* is usually rapid and top-down, whereas a *growth merger* requires a more gradual and collaborative approach.

An important initial step in the PMI (Post-Merger Integration) is the establishment of a team which would analyse the potential synergies and draw-up a provisional integration plan before the deal is closed. A PMI implementation team is also essential to convert potential synergies into realistic goals. An acquisition announcement creates a sense of uncertainty among the acquirer's and the target's staff. These anxieties need to be addressed proactively by the management of the acquirer. A well-considered communication plan, based on the surveys of hopes and fears of the staff, is a perquisite for the success of the integration plan. The systematic understanding of cultural differences of the two companies is also essential.

Integrating procurement into the decision-making process of R&D and other functions can lead to greater synergies. Introduction of cross-functional teams to identify hidden synergies and adopting global benchmarked best practices also lead to value creation.

An essential step to retain top talent is to reach out to key individuals as soon as the deal is announced. The true strategic measure of any acquisition is its ability to measure long-term growth and value. Hence, along with the evaluation of cost synergies, it is imperative to evaluate potential revenue synergies.

Information Technology plays a critical role in enabling other parts of the business to deliver synergies. In banking, for example, more than 50% of all synergies, across all functions, are dependent on IT. A plan is essential to ensure that basic connectivity and appropriate security are available. Particular attention should be paid to systems which are critical for business continuity, such as branch network information system in retail bank. In addition, an inventory of ongoing IT investments and vendor relationships should be taken and viewed to determine which investments and contracts need to be retained. The best application from each company, based on operational and financial criteria, has to be selected. This approach may increase the risk of failure as different technical platforms require different links. Another option is to select one company's system landscape over the other. This strategy may not work in large scale mergers. The pragmatic approach is to seek commonalities through clustering, which involves IT teams grouping all applications from both companies into clusters on the basis of the applications' technical ability, to be isolated from surrounding systems, including their architecture, age, flexibility and business alignment.

Most successful serial acquirers establish and nurture dedicated IT integration teams. These teams are involved from the beginning of the M&A process, and have tested packages of tools, which include well-documented corporate-wide standards for IT architecture and application portfolios, as well as established processes for implementing them.

The main difficulty faced during R&D integration is with respect to managing the most precious human assets. On an average, companies lose at least 10% of their R&D talent base. The key issue with respect to R&D integration is to understand the competitive core strength of the target company. If the target's key strength is intellectual property, people issues will be critical and integration can occur relatively rapidly. Conversely, the project must be handled sensitively if the target's core assets are closely linked to employees' knowledge and expertise, such as project pipeline. A clean team must evaluate the target's strengths before the deal is finalised. In order to determine which R&D projects are to be supported and which are to be managed and allocated resources, acquirers need to conduct detailed analyses of the industry landscape, focusing on markets that offer long-term value creation.

In industries with products that tend to have long life, spans such as power and automotive industries, acquirers should factor-in significant human and financial resources to support legacy products.

When two companies' R&D are integrated, systems and processes should be introduced to facilitate sharing and cross-fertilizing knowledge and expertise. Cross-functional multidisciplinary teams should be formed to explore ways through which the combined entity's R&D capability can exploit technical and scientific synergies. A merger of a small biotech firm with a large pharmaceutical firm provides the biotech firm with global development capabilities and an extensive library of compounds, while the pharmaceutical company gains specialist knowledge and expertise in such fields as antibody production. R&D site closures must be handled with extreme sensitivity and supported by a well-crafted public relations and communication plan.

One of the biggest advantages of M&A from the procurement perspective is the opportunity to rethink how to buy and from whom, and not just how much to purchase and what price to pay. The post-merger integration for procurement must be viewed from both the cost reduction and the organisational perspective. The process involves understanding the potential synergies in depth, challenging long established supplier relationships and assumptions, questioning products' technical specifications and repositioning procurement as the crucial element of the strategic decision making process. Involving preferred suppliers in the design and development of products is an efficient way to reduce costs.

The biggest challenge in sales and marketing is striking the right balance between cost and revenue synergies. One of the difficulties is that the acquirer and the target sales teams often lack knowledge and customer relationships to cross-sell each others' products and services. This is especially true in highly specialised markets, such as pharmaceuticals. The combined sales team needs to be educated about all products in the portfolio and a clear and well-communicated sales plan that defines the role of each product in the company's long-term strategy, be provided along with incentives to cross-sell the products. The key to success in any post-merger integration is to treat the integration of different functions as strategic opportunity, and not a mechanical merger of organisational units and processes.

Adapted from: *Boston Consulting Group Report 2007. Thinking laterally in PMI, Optimising Functional Synergies.*

Speed of Integration

The success of merger integration also depends on the speed of integration.

Companies should measure integration speed—and the resulting benefits—against the average rate at which the industry as a whole captures integration benefits. When it comes to merger integration strategies, understanding industry consolidation *clock speed*—the pace at which consolidation and integration is taking place—is critical. The industry pace will help determine the company's position relative to acquiring new companies, integrating previous acquisitions, growing organically and increasing competitiveness through business improvements.[5]

As industries pass through their consolidation life cycles, companies face a different set of merger integration priorities. In the early stages, in which leading players get big quickly in order to stay in the game, the goal of merger integration is to get ready to acquire the next company. For example, during the 1990s, Cisco Systems acquired companies almost on a weekly basis. Cisco postponed full integration, which would have been too disruptive, preventing the company from focusing on its next acquisition. Instead, it established business control, included the acquired company's offering into its own offerings, minimised the business risks, and moved on.[6]

Major players, like Heineken, Inbev and SABMiller, have gone through a hectic M&A phase of acquiring strings of smaller brewing companies. Most have been selective in their merger integration efforts. For example, Heineken focused on injecting its global premium brands, Heineken and Amstel, into new markets through acquisitions. It has a well-oiled brewing machine set-up in Zoetermeer, the Netherlands, and a capable international organization. So, after acquiring a company, Heineken sought to establish effective business control and align commercial operations in potentially overlapping geographic regions. But it did not spend much effort on truly integrating different local brewing activities into a single efficient machine—a time-consuming task. Instead, it took the quicker route of bringing best practices and brewing competencies to various local brewers. The result was to create value quickly and effectively.[7]

[5]Not so fast, http://www.atkearney.com/main.taf?p=5,1,1,115,1,1
[6]Not so fast, http://www.atkearney.com/main.taf?p=5,1,1,115,1,1
[7]Not so fast, http://www.atkearney.com/main.taf?p=5,1,1,115,1,1

When two strong branded companies merge, they need to assess how to leverage their most valuable parts—their brand equity and distribution—as quickly as possible—for example, by using each others' products and brands in specific geographic regions. Another benefit might be to use each other's supply chains so as to provide more options to retailers without heavy investments. Also, being able to tap into each others' innovation pipelines can give a welcome boost to the overall process.

APPROACHES TO INTEGRATION

Absorption and Preservation

In the framework of models involving trade-off between the need for strategic interdependence and the need for autonomy, the approaches for integration can be classified into complete preservation and complete absorption. The *absorption model* implies full consolidation of operations, organisation and culture of both firms over time. In *preservation acquisition*, there is great need for autonomy. In an absorption approach, operational resources need to be pooled to eliminate duplication. An example is an acquisition aimed at reducing production capacity in a declining industry. In the preservation approach, the acquirer nurtures the acquired firm through a series of interactions. In symbiotic integration, no sharing of operational resources takes place, but there may be gradual transfer of functional skills. A telecommunications firm acquiring a computer firm in order to create multimedia products needs to preserve each firm within its boundary, but also needs to allow interaction across its boundary.[8]

Project Management Approach

M&A integration is like managing a large complex project. The managerial challenge would be to break down the integration into a series of tasks, each with its own set of accountabilities, milestones and critical success factors. Integration is fundamentally an operational matter and success depends on the fulfillment of objectives by the project team.

When Lloyds TSB acquired Scottish Windows in 1999, it decided to adopt certain parts of Scottish Windows' IT Systems. Following that decision, Lloyds TSB shifted much of its IT resource to Scotland. The bank affected a smooth transition in terms of processes and people, yet it paid little attention to how these changes were perceived by its own IT employees. Project management based integration will certainly result in swift creation of new or shared processes, or perhaps a new organisational structure.

Hybrid Approach[9]

When the acquisition is intended to help develop new platforms, the integration usually proceeds with a hybrid approach. The hybrid companies support functions–human resources, finance, manufacturing, sales and marketing—are integrated into the central equivalents of the acquirer. This process may proceed in phases if the acquired company is big, or sells a different kind of product. But the engineering teams, which are the source of key capability, are kept together within the acquiring business unit. In pursuing the appropriate level of integration, the business development staff can serve as a buffer to keep the acquiring company from overwhelming the new employees, as it provides necessary support.

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[8]Sudi Sudarsanam, Creating Value from Mergers and Acquisitions, Organizational and Human Aspects of Integration, Chapter 22, Page 528.

[9]Saikat Chaudhuri and Behnam Tabrizi, Capturing the Real Value in High-tech Acquisitions, Harvard Business Review, September–October 1999, Page 130.

ESSENTIAL STEPS IN IMPLEMENTING TAKEOVERS

The following are the spectrum of changes in business activities:

- Rationalisation of core functions, e.g., manufacturing and sales/distribution activities
- Integration of the support functions of the target into the acquirer firm
- Removal of overheads related to the business
- Implementing the systems and controls of the purchaser into the purchased business
- Implementing the standards and specifications of the purchaser into the purchased business
- Standardising working conditions and conditions of employment, including remuneration
- Implementing the business culture of the purchaser into the purchased business
- Implementing the use of intellectual property and technical expertise belonging to the purchased business into that of the purchaser.

It is essential that the senior personnel whose task would be to implement the take-over are fully aware which criteria are important to the decision to purchase. They should be involved, as far as possible, in the negotiation process, and be party to all legal documentation relating to the transaction. This type of exposure during the early stages of the process would help them to understand:

- Expectations and likely areas of focus of the purchaser
- How to leverage the strengths of the business that has been acquired
- Specific aspects of the agreement to purchase that will impact directly on the day-to-day operation of the business being purchased in the short term.

The importance of rationalisation of core functions is to prevent duplication of resources which would otherwise create overcapacity. There would also be a need to rationalise administrative functions.

With respect to implementing systems and controls, there is a need to communicate and expose relevant staff to the systems, as practiced in the purchaser's environment, before making changes. Standardising conditions of employment is essential in order to prevent disruption, and to enable both management and labour to do detailed homework on issues where standardization would ultimately become necessary.

The change processes need to be divided into four categories:

- Non-negotiable immediate change, necessary for the business to operate on day-to-day basis
- Non-negotiable change whose implementation can, however, be phased-in over the period following the take-over
- Change initially seen by the purchaser as desirable but whose nature may be altered or even abandoned once greater mutual understanding has been achieved
- Change in the purchaser resulting from the study of practices in the purchased business

Core Integration Team

Members of the due diligence team should always be included in the core integration team as they have gained a deep knowledge of the acquired company, or the merger partner. They may have a detailed knowledge of potential barriers to engagement, and hopefully would have ideas about how creating synergies for the combination. Due diligence team, especially functional specialists and operational managers, often return to their jobs after the transaction is completed. In the case of serial acquirers, they may form part of a dedicated resource, and simply move on to the next deal. It is always appreciable to include in the integration team, employees from the acquiring company who joined the company through a merger or acquisition. Cisco Systems, the global provider of Internet works, estimates that it has a pool of over 4000 employees that can be seconded to the company's dedicated integration team. Mimi Gigoux, head of the integration team, joined Cisco through its acquisition of Kalpana in 1994.

CHALLENGES OF INTEGRATION

Resistance to Change

The reality of many M&As is that they are often extremely difficult and stressful for many people. Merger studies reveal that employees need emotional support and practical skills in managing change in order to survive the upheaval. People may resist change by clinging to their old behaviours and work practices even though they are no longer appropriate. In many cases, people leave during the period between M&A announcement and its legal completion because of the fear of losing their job or assume that the effects on their job and career would be adverse.

Cultural Incompatibility

Cultural incompatibility leads to diverse problems, such as poor productivity, wrangles among the top team, high turnover rates, delays in integration and overall failure to realize the synergies of the deal. Analysing cultural issues and traits becomes essential to select a partner, and to resolve cultural misunderstandings. Cross-border deals need to focus on differences in national culture. Culture must be discussed in the early stages of the merger process. Cultural auditing could be a part of the due diligence process. There is a tendency among managers to assume that a single homogenous culture exists throughout the organization, which is a myth. In reality, many subcultures exist at the operating level, and these may even become major barriers for a successful combination.

Most often, cultural differences exist between pre-merger entities. Understanding these differences is the first step in integration. The UK based Beecham and the US based Smithkline involved two national as well as business cultures. Beecham was more scientific and academic oriented while Smithkline was more commercially oriented. The American pharmaceutical company, Upjohn's, centralised and aggressive culture clashed with Swedish major, Pharmacia's, decentralised, laid-back management style. Cultural differences existed in the case of merger between Time and Warner. Citicorp's staid, buttoned-down world of traditional commercial banking was different from Traveler Group's free-wheeling, deal making investment banking culture. The Exxon Mobil merger was the fusion of two contrasting cultures which created problems for integration. Cultural clashes existed when Indiainfo.com took over several websites during the year 2000. The entrepreneurs, whose websites were taken over, led frugal lifestyles whereas Indiainfo's managers were used to lavish ways. The acquisition of IPCL by Reliance also witnessed cultural problems. It is said that many employees of IPCL left because of the differences in management styles between the public sector company and the private sector aggressive, growth-oriented company.[10]

MANAGING NEW PEOPLE

Convincing people in the acquired company to accept changes is essential to make high-tech purchases work. Successful acquirers make their transition as smooth as possible, and keep their development energies focused. Most high-tech acquirers designate a team of experienced employees to plan and carry out the integration process. Successful acquirers show how the purchased company fits in, and they communicate their enthusiasm and respect for the new people. In a merger process, all employees have to ponder over issues like why the acquisition happened, the future and the new reporting structure. What is the new reporting structure? The acquiring company brings in high level employees, who

[10]A V Vedpuriswar, 'Managing the Risk in Mergers and Acquisitions', M&As, Indian Management, March 2004, Page 23.

themselves had come from acquisitions, to answer these questions and temper down the fear. Effective acquirers usually keep the new people together in a separate division, and they try to keep the leader of the purchased company in charge, and also in the integration team. When Cisco acquired Crescendo, the head of Crescendo, Mario Mazola, accepted Cisco's offer to stay on rather than retire. Instead of treating him as an outsider, Cisco welcomed him, and he proved to be so successful in his work that he eventually became the head of all enterprise products at Cisco.

Acquirers need to send out the message that there will be consistency and openness in the new environment. Intel learned this lesson when it acquired Chips & Technologies in the year 1997. Intel had bought the manufacturer of graphics accelerator chips to enhance its visual computing capabilities. Intel decided that C&T's people would form a separate division within Intel's desktop products group. During the period between the announcement and the closing of the deal, Intel rearranged itself internally and moved the C&T division into the computer enhancement group. Intel's people were used to regular organisational realignments, but C&T's people were shocked by the abrupt change. The new employees weren't involved in the deliberations and they felt like second class citizens. This negative signal prompted quite a few key people to leave, undermining some of the expected benefits of the purchase.

Acquirers also need to resist the temptation to tell new people how to run their operations, as IBM learned when it bought the telecommunications equipment maker, Rolm, in 1984. IBM was careful to announce that Rolm's expertise in telephone exchange switching would be a critical asset as IBM expanded into telecom opportunities. To preserve Rolm's technological competence, IBM formally set it up as an independent subsidiary. Though IBM bought the company for new technological capability, they believed that they knew how to run Rolm better. Even though IBM lacked insight into Rolm's PBX product and market, it tried to force Rolm to fit into a mainframe computer business model. IBM's managers also required its new subsidiary to fill open positions with IBM personnel. Many key employees of Rolm left and the takeover produced poor results. After four years, IBM sold Rolm to Siemens.

Successful acquirers usually base the actual level of integration on the type of capability being acquired: The greater the innovation, the less the integration.

Adapted from: Saikat Chaudhuri, Behnam Tabrizi, Capturing the real value in High-tech acquisitions, Harvard Business Review, September–October 1999, Page 128-129.

Business Consulting Literature[11]

Beginning in the mid-1990s, several consulting firms commissioned surveys concerning the outcome of recent mergers. A number of other financial and organisational aspects of post-merger integration are found to be important in the consulting firm surveys. Early integration planning is almost universally recognised as a way to increase the probability of success in a merger. Similarly, many studies emphasise the need to define corporate goals and clearly transmit these goals from the management team to the new merged entity, while simultaneously addressing differences in the corporate cultures of merging businesses. The importance of retaining customers and key staff during the initial transition period is another highlighted factor, as is timely handling of regulatory issues. In terms of enhancing shareholder value, authors lay varying amounts of stress on maintaining or expanding revenue growth after the merger, and identifying and achieving cost synergies. Some of the important findings of these surveys can be summarised as follows:

[11]Paul A. Pautler, 'The Effects of Mergers and Post-Merger Integration: A Review of Business Consulting Literature,' Bureau of Economics Federal Trade Commission, January 21, 2003 version, Working Paper.

1. Early planning for the integration of the new physical and human assets improves the chances of success[12].
2. Fast-paced integration and early pursuit of available cost savings improves outcomes[13].
3. Managers must designate the merger integration leader and provide appropriate incentives[14].
4. Managers must be cognizant of cultural differences between organisations and avoid conflicts, in part, via frequent, tailored communication with employees, customers, and stakeholders[15].
5. Particularly in mergers involving technology and human capital, managers must retain the talent that resides in the acquired firm[16].
6. Customer and sales force attrition must be minimised[17].

CULTURAL INTEGRATION

Importance of Culture[18]

It is often stated that cultural differences between partners of a merger are the most common reasons for failure of mergers. This may happen during pre-merger negotiations or during post-merger integration. The development of a new, shared culture is a critical factor for merger success. Corporate culture is embedded deeply in the organisation and in the behaviour of its people.

Corporate culture is determined by a variety of factors, like artifacts, management styles, norms, values, beliefs and assumptions.

There are three types of cultural differences:

- Cross-national differences (especially in cross-border mergers)
- Cross-organisational differences
- Cross-functional differences.

According to an AT Kearney research study, it is a problem in many mergers that the more powerful partner imposes his culture on the less powerful one. This is done without any evaluation about which culture would be more suitable for the new organisation. It is important to analyse and describe the existing cultures. The differences and common elements of both cultures show up only in direct comparison. Identification of cultural barriers, and differences in communication are also essential.

Corporate culture influences the performance of an organisation, since it determines organisational values, such as:

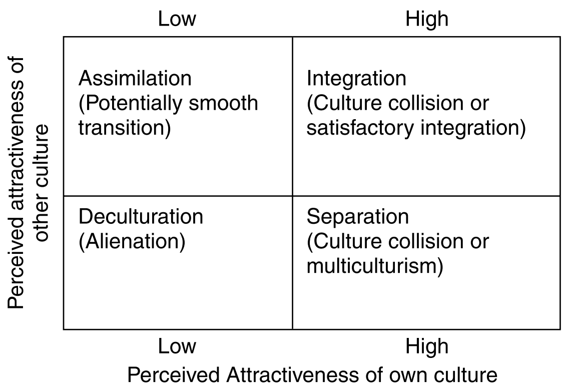
- Management culture and leadership styles
- Organisational myths and stories
- Organisational taboos, rituals
- Cultural symbols

A perfect integration (which is rarely achieved in practice) would develop a new culture from the cultures of the partners. Ideally, this new culture should include the best elements from both organisations. Reality often looks different. We can distinguish the following types of cultural integration: Cultural Pluralism, Cultural Blending, Cultural Takeover, and Cultural Resistance.

[12]KPMG (1999, pp. 2-4), Accenture (2001), A.T. Kearney (1999), and Booz-Allen & Hamilton (1999, pp. 4-5, and Adolph et al. 2001, p. 9).
[13]PwC (2000, pp. 8-15), Booz-Allen & Hamilton (1999), Conference Board (2001, p. 15), McKinsey (2002, p. 10), and CSC Index Genesis (1997).
[14]McKinsey (2001), Booz-Allen & Hamilton (1999, p. 4), and KPMG (World Class 2001, p. 13).
[15]Conference Board (2001, pp. 12-13), KPMG (1999), A.T. Kearney (1999), Booz-Allen & Hamilton (2001)
[16]Conference Board (2001, pp. 12-13), and CSC Index Genesis (1997).
[17]McKinsey (2001) Survey.
[18]Oliver Recklies, 2001 Recklies Management Project GmbH, www.themanager.org

1 **Cultural Pluralism**: This will not work in most organisations. The results are cultural resistance followed by cultural takeover. The problem in mergers is that people from very different organisations (and cultures) are expected to work together, to discuss, and to solve complex strategic and operative tasks. It is very difficult to impose a new culture that does not have the acceptance of the people. This perceived attractiveness of cultures can have the following impact on the integration process:

Figure 11.1 *Effects of Perceived Attractiveness of Cultures*



Source: Recklies Management Project GmbH (www.themanager.org)

The cultural analysis is a tool for identification and overcoming cultural differences between partners in mergers. Another important step is establishment of a new cultural basis on which the new culture can develop. The name of the new organisation may play a key role in this process. The new name is a symbol for the changes that come along with the merger, and it indicates how much both companies contribute to the new one. Moreover, it is necessary to harmonise and to communicate all other elements that influence culture, e.g., reward systems, systems for performance measurement. Organisations that want to integrate both old cultures have to take care that no partner gets the advantages or disadvantages. In order to avoid the backward looking, ‘us vs. them’ thinking, it is advisable to form new teams with people from both organisations. Practical experience has shown that at least 25% of the staff should be allocated to new/other teams.

Table 11.1 *Name Changes in Mergers*

Old Company	New Company	Name of New Organisation
Traveler’s	Citicorp	Citigroup
Daimler-Benz	Chrysler	Daimler-Chrysler
Hoechst	Rhone-Poulenc	Aventis
Ciba-Geigy	Sandoz	Novartis
SmithKline Beckman	Beecham	SmithKline Beecham
Coopers & Lybrand	Price Waterhouse	PricewaterhouseCoopers

In another perspective, there are four dimensions in cultural integration: (a) Cultural preservation—the acquired company retains its cultural autonomy, (b) Cultural assimilation—the acquired company adopts the culture of its new owner, (c) Cultural integration—the two companies create a new culture, and (d) Cultural transformation—based on new practices and behaviours.

RULES OF M&A INTEGRATION[19]

1. Selection of Leadership Selection of leadership, based on guiding principles, is essential for successful integration. The faster the merged entity strengthens the management team, the better and sooner it can exploit growth opportunities. It is vital to establish the entire organisational structure, and slots be allotted to people according to specific tasks and divisions.

2. Establish Clear Goals and Manage Expectations The best integrators create a sense of urgency by immediately rolling out the highest priority projects and quick-win synergy projects, which would enable to create value. Achieving sales pull through of key product lines is a standard quick-win strategy. The closure of under utilised facility, or rationalisation of redundant R&D programmes is another quick-win strategy. The expectations have to be realistic. Tyco International's stock plummeted owing to perception of lost management confidence. Tyco became so big and diversified that it was unable to extract synergies from its far flung portfolio of acquisitions. Well Fargo was plagued with employee defections when it brought First Interstate into its fold.

3. Build a Strong Integration Structure It is vital to establish a merger steering committee made up of the company's senior executives. These executives then delegate the integration efforts to individual decentralized teams in the various business units and functions. The integration team at Bank of America had developed an integration template for each core function and process of business, and deluged a newly acquired company on Day One with integration specialists. These specialists completely integrated the new company in all areas, from IT to lending systems and processes, to credit scoring systems. Legal or regulatory matters may also hamper merger integration efforts.

4. Establish Open and Timely Communications There should be an earnest attempt for open communication to allay the fears of employees who are concerned about losing jobs. Attentive managers must watch for employee turnover and carefully monitor key staff losses to preserve the organization's ability to manage the transition and conduct business.

5. Address Culture Issues The future of the company depends on retaining capable people, sustaining a dynamic knowledge base and promoting an open culture. Companies with a closed and uniform culture often experience difficulties in taking over other companies.Walmart overestimated its capability in Germany when it tried to enter the German market through acquisitions. In 1998, it bought 21 Wertkauf stores and added 74 Interspar units in 1999. Unfortunately, its culture turned out to be incompatible to the beliefs and convictions of the management team of the acquired stores. The Walmart's culture is built on strong cost controls. Managers on business journeys traditionally share a common hotel room to keep expenses low. This was unacceptable to German managers. Furthermore, the Germans perceived the motivation exercises at the beginning of a normal day as silly. Most members of the German management team quit their jobs shortly after the acquisition, leaving Walmart with insufficient knowledge about the German way of doing business[20].

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[19]Arthur Bert, Timothy Macdonald, Thomas Herd, 'Two Merger Integration Imperatives: Urgency and Execution', Strategy and Leadership, Vol 31, No 3, 2003, Page 42-49.

[20]Arthur Bert, Timothy Macdonald, Thomas Herd, 'Two Merger Integration Imperatives: Urgency and Execution', Strategy and Leadership, Vol 31, No 3, 2003, Page 42-49.

6. Customer Focus The acquiring companies should focus on high level plans for customer retention and enforce the use of metrics to determine customer service and satisfaction levels. When International Flavors & Fragrances (IFF) acquired Bush Boake and Allen, the company established market facing geographic teams to make sure that the cost cutting initiatives did not degrade product quality or damage relationships with customers.

7. Manage Risks The acquirer's strategies also need to focus on ways to manage risks. The complexity of risks would grow in proportion to the opportunities large deals offer. It is desirable to establish a merger integration dash board, preferably with four main metric categories: economic (benefits), project risks, customers and employees. Such dash boards would allow managers to quickly identify problems and to agree on the appropriate actions.

In business, the of quoted view is that culture is 'the way we do things around here.' The three visible attributes of corporate culture are: the way we deal with customers, the way we treat each other as employees, and the way leaders and managers in the organisation motivate, reward and develop people.

In the context of mergers, it could be pointed out that culture has the uncanny ability to resist change because it is deeply ingrained in the mindset of its protective owners. The basic dilemma of organisational change is that it must be freely adopted by the people that it affects, who are likely to be against its introduction. In a merger, as two cultures meet, it becomes apparent that one way of working has to prevail, or that neither speed nor quality would prevail. Cultures may appear to be similar but, in fact, no culture is a true replica of another. For example, French and German cultures are almost identical. Both are European neighbours with comparable standards of living and traditions. But it has to be noted that France had existed as a fairly homogenous country for 2000 years whereas Germany only became a nation in the 19th century. The same principle applies to organisational icons and processes. They may look identical but emotional architecture that fuels the organisations is certainly distinct, perhaps opposite. Cultural integration is, perhaps, the most difficult part of the integration of two or more organisations of varied cultures. In Europe, the degree of openness has been found to be higher in some areas, and lower in others. On the other hand, openness and frankness comes easy to Americans, but it is difficult to touch upon their softer side. For instance, unlike in India, asking questions on personal details, like marital status, during interviews is not acceptable in many western cultures. Ego problems also crop up in such cross-culture scenarios.

Managing Culture

Creating a shared culture requires a subtler blend of art and science. It involves prudent discovery, inventing, reseeding and letting go. The objective of discovery is to gain understanding and formulate original thoughts for the future culture. By collecting anecdotes, opinions and facts, and paying attention to the organisation's daily rituals, executives and managers can articulate the culture and, more importantly, the questions of beliefs and assumptions that have developed over the past few years around customers, people and leaders. The process of inventing or crafting an intended culture is one of the most difficult tasks during a merger or acquisition. In the case of the merger of Dai-Ichi, Japanese banks with dissimilar cultures, it was decided to retain two separate human resources functions to look after each of the two entities. Managers and employees might need to unlearn what they have thought to be lasting values of the organisation in order to create a new and fresh order. This unlearning allows the culture to find its place as a living partner with organisational strategy and structure. Reseeding involves creation of the new culture in an iterative process. Ideas must be re-examined, fine tuned, discarded and redrawn again, against a different backdrop, before they are finally adopted. The process of reseeding involves adjusting people or human resources practices so that they reinforce the new culture as it evolves. This includes rewards and recognition practices, selection, development and performance management. Communicating progress on the cultural front, for instance, by designing balanced scorecard type measures will help employees to recognise the importance of non-financial performance indicators.

The most difficult task for the organization, in the act of inventing new culture, is letting go of the old one. In practical terms, it is not healthy if employees bottle up their feelings about the old culture. These feelings must be vented and validated. Helping managers work through this dilemma is a challenge the organisation must face. Evolving of culture should be seen as an important learning opportunity.

Source: *Eric B and Greg Smith, Corporate Culture–Asset or Liability, Ivey Business Journal 2000.*

CULTURAL INTEGRATION IN INDIAN M&A

When companies acquire foreign entities, they also acquire diverse talent. For example, when the Aditya Birla Group bought Novellis, it acquired about 12,500 people, spanning five continents. Overcoming human capital challenges is more important for successful integration than any other aspect. Most companies conduct due diligence before and during the process of acquisition. Tata Group's approach of 'post-merger integration before due diligence' assesses how the combined entity is likely to create value.

When Gurgaon-based Sona Group acquired the precision forging business of German steel maker, ThyssenKrupp, in January 2008, the takeover posed great challenges for Sona Chairman, Surinder Kapur. ThyssenKrupp had a unionised workforce that resisted the takeover due to concerns about job security. Kapur, on his part, decided to proactively resolve the issue. He communicated to the union that the idea of acquisition was to expand Sona's footprint globally and, for that, the company needed all existing employees working with ThyssenKrupp. Kapur also formed a special group to analyze the production process, cultural differences and employees' performance at ThyssenKrupp for the next six months before taking a call on restructuring the organisational structure.

Standard Chartered Bank acquired the private banking business of American Express Bank in March 2008. Even before it completed the acquisition, it put multiple measures in place to ensure smooth integration. Human resource issues, such as rewards, harmonization, compensation and benefits integration, job grades and appraisal harmonisation, and training programmes were addressed in a phased manner. In Amtek Auto, there is a special task force that deals with issues related to HR at the time of acquisitions. Amtek Auto acquired UK based Triplex-Ketlon Group, an automotive precision machining company. The task force, subsequently, made sure that it communicated to all employees that a successful merger would offer growth prospects for every employee in the new combined company. Since every acquired company has different cultural values, Amtek also went into the nitty-gritty of cultural issues that emerge during the early days of an acquisition, because during this time most people show maximum resistance. During the Alcatel-Lucent merger, a series of meetings were held between top HR executives of both companies to discuss issues like salaries and benefits, designations and other structural matters. The cost of living in each country is also different. Hence, compensation and benefit planning becomes country-specific. In many cases, a MoU takes care of the pay packets of foreign employees. Global HR firms are hired for global talent search.

How Tatas Manage Integration

For a group with the stated objective of growing via the inorganic route, the Tatas have mastered the art of acquiring companies overseas. According to the Tata philosophy, the key is to lock-in the commitment of the target company's management towards future growth.

Tatas have always opted for negotiated acquisitions. They plan the entire integration process during the negotiation phase, with emphasis on constant communication between top managements of both companies. They work with the managements of target companies to identify areas of synergy, and then set up joint teams for each identified area to execute the game plan. Tata Steel had to integrate operations spread across seven countries during its acquisition of Singapore based Natsteel. It started out by creating platforms where learning could be shared between companies. Tata Steel was superior in steel making while Natsteel had better products and solutions for the construction sector. In both Natsteel and Thailand based Millennium Steel acquisitions, Tata Steel retained the top management. The Tatas also succeeded in keeping back the CEOs and all employees.

Tata Chemicals had faced bitter experience when it acquired UK based Brunner Mond in December 2005 through a negotiated process. The acquisition made Tata Chemicals the third largest soda ash manufacturer in the world (up from number 14). While there were few cultural issues in the Netherlands, the headquarters of Brunner Mond, Tata Chemicals faced resistance from employees in Kenya (Brunner also owned natural soda ash reserves at Lake Magadi in Kenya), who were not willing to work for an Indian group. Their bias was based on previous bitter experiences with Indians in Kenya. Tata Chemicals handled the problem by meeting the local Masai leader and the company's senior management in Kenya. Twenty senior managers of the company were invited to India to literally show them the legacy of the Tatas. Tatas emphasised their commitment towards corporate social responsibility programme in Kenya.

Source: *Speaking the Same Language, Business Today, December 3, 2006, Page 80-86.*

Cultural Issues in Cross-border Deals

Cross-border deals have the added complexity of involving different national as well as corporate cultures. These differences become apparent during negotiations. For example, when MD Foods, Denmark's biggest diary company, merged with Arla, one of Sweden's largest diary firms, in 2000, cultural differences emerged immediately. The statement of Henrik Nygaard, product business unit controller, was quite interesting, 'The Danish and Swedish mentalities are very different.' At the first couple of meetings, language was a problem. To us Danes, yes means yes. To the Swedes, however, it means, 'yes, let's think some more about it'.

Source: *Marion Devine, Successful Mergers, Getting the People Issues Right, The Economist, May 2002.*

The Daimler-Chrysler Merger—A Cultural Mismatch?

Despite the booming U.S. economy, Daimler-Benz's luxury vehicles had captured less than 1% of the American market. Its vehicle production method was particularly labour intensive—requiring nearly twice as many workers per unit produced over Toyota's Lexus division. It recognised that it could benefit from an economy of scale in this capital-intensive industry. Daimler was on the lookout for a partner. With $2.8 billion in annual profits, remarkable efficiency, low design costs, and an extensive American dealership network, Chrysler appeared to be the perfect match. The merger that took place in the year 1998 was the largest trans-Atlantic merger. The merged company with 442,000 employees was expected to take advantage of synergy savings in retail sales, purchasing, distribution, product design, and research and development. But problems came up in the way. In the year 2000, Chrysler lost heavily. There was an undercurrent of tension, which was amplified by the fact that American workers earned appreciably more than their German counterparts, sometimes four times as much. It seemed quite apparent that culture clash had been eroding the anticipated synergy savings. Much of this clash was intrinsic to a union between two companies which had such different wage structures, corporate hierarchies and values. At a deeper level, the problem was specific to this union: Chrysler and Daimler-Benz's brand images were founded upon diametrically opposite premises.

Chrysler's image was one of American excess, and its brand value lay in its assertiveness and risk-taking cowboy aura, all produced within a cost-controlled atmosphere. Mercedes-Benz, in contrast, exuded disciplined German engineering coupled with uncompromising quality.

These two sets of brands, were they ever to share platforms or features, would have lost their intrinsic value. Thus the culture clash seemed to exist as much between products as it did among employees.

Distribution and retail sales systems had largely remained separate as well, owing generally to brand bias. Mercedes-Benz dealers, in particular, had proven averse to including Chrysler vehicles in their retail product offerings. The logic had been to protect the sanctity of the Mercedes brand as a hallmark of uncompromising quality. This had certainly hindered Chrysler Group's market penetration in Europe, where market share remained stagnant at 2%. Potentially profitable vehicles such as the Dodge Neon and the Jeep Grand Cherokee had been sidelined in favour of the less-cost-effective and troubled Mercedes A-Class compact and M-Class SUV, respectively.

Differing product development philosophies continued to hamper joint purchasing and manufacturing efforts as well. Daimler-Benz remained committed to its founding credo of 'quality at any cost', while Chrysler aimed to produce price-targeted vehicles. This resulted in a fundamental disconnect in supply-procurement tactics and factory staffing requirements.

Apparent from Day One Daimler-Benz was the majority shareholder in the conglomerate. It controlled the majority of seats on the Supervisory Board; yet the Daimler-Chrysler name and two parallel management structures under co-CEOs at separate headquarters lent credence to the 'merger of equals' notion.

Owing to culture clash and a poorly integrated management structure, Daimler-Chrysler was unable to achieve its objective of profitable automotive production.

Adapted from: The DaimlerChrysler Merger, Working Paper no. 1-0071 Tuck' School of Business Dartmouth.

POST-MERGER IT INTEGRATION

Mergers result in synergies, such as reduced operating costs, reduced risks, increased market share, or the ability to enter or create new markets. Synergies are captured by sharing overhead functions, integrating operations, jointly creating new capabilities, and exploiting economies of scale.

The assumed role of Information Technology (IT) in generating synergy is that economies of scale will drive most savings. IT could deliver significant strategic business value, like better processes for financial management, or shared sales and operations planning processes, or an integrated procure-to-pay process, or a collaborative new product development process.

A three-step IT value chain is a good framework for prioritising IT post-merger integration efforts.[21] Through the IT value chain, IT spend is transformed into IT resources; IT resources are transformed into IT outputs; and IT outputs are transformed to business value. The IT value chain reveals three levers of IT-enabled business value: resource management, work management, and business-IT alignment.[22] In order to capture the full potential of M&A opportunity, the management must use all three mutually exclusive and collectively exhaustive drivers of IT business value. These levers can substantially improve the overall ratio of IT expenditure to IT-enabled business results.

Resource Management: The resource management lever may include reducing overhead in contractor services or negotiating a greater discount based on purchase volume. This is primary area for economies of scale. By aggregating the purchasing power of two merging organisations, IT can increase negotiation leverage, positioning the combined organisation to obtain more favourable commercial terms from its suppliers.

Work Management: The effectiveness of transforming IT resources into IT outputs is measured by the amount of resources required to put in place, operate, and support delivered IT capabilities. The ratio of inputs to outputs can be improved, for example, by solving more user problems per hour, delivering functionality with less rework or operating systems with fewer servers. Pulling this lever includes streamlining the workflow within the IT organisation, training and motivating employees and rationalising architectures. For mergers in transaction-based industries, such as financial services or physical distribution, IT may be able to deliver the combined service volumes of the new enterprise from the infrastructure of just one of the original companies. In the acquisition of a travel service company, for example, the buying company was fully able to subsume the target's customer operations into its own infrastructure, effectively increasing revenue while holding costs steady, leading to immediate profit improvements.[23]

A merger also gives the IT organisation the opportunity to cross-fertilize, to apply the practices from the most efficient and effective organisation, and to stimulate innovation in IT practices and tools.

Business IT alignment: The business-IT alignment lever can be pulled by increasing the business use of existing capabilities, or by discontinuing low-value IT deliverables. In a merger, many business functions would be combined. For example, the new organisation may not need two sales forces, two warehouse managers, two HR departments and two accounting departments. When one of the two is eliminated, usually its IT systems are also eliminated. In addition, the merger itself may lead to the discontinuance of some operations and their IT support. A merger provides an opportunity for IT to re-evaluate the service levels provided to the business.

Market research indicates that, post M&A, companies typically spend 30% of their IT budgets to address systems integration issues. Therefore, the challenge is to integrate different technologies and systems while protecting them. For this, it is critical that M&A processes have well-defined IT integration strategies.

Each of the companies may have made substantial investments in technology before the merger. In these circumstances, the key issues would be the extent to which the systems are compatible and the cost of the integration or reinvestment required to make them work together.

The major steps involved in IT integration are:

- Develop IT fact base-staff, projects, budgets, systems and processes
- Define new IT organisation structure and governance processes

[21]Eugene Lukac and Jeff Benesch, 'Leveraging IT's Ability to Drive Post-Merger Business Value', M&A Consultative Services, Deloitte, 2008, Page 1-3.

[22]Eugene Lukac and Jeff Benesch, 'Leveraging IT's Ability to Drive Post-Merger Business Value', M&A Consultative Services, Deloitte, 2008, Page 1-3.

[23]Eugene Lukac and Jeff Benesch, 'Leveraging IT's Ability to Drive Post-Merger Business Value', M&A Consultative Services, Deloitte, 2008, Page 1-3.

- Plan migration to new organisation structure
- Refine business cases and prioritise key initiatives
- Implement quick wins
- Define future IT architecture and create an integration plan.

The key steps to the merger include:

- *Merge IT organisations, operations and platform*: This would result in fewer wasted investments and cost synergies would be achieved. This may also result in smoother integration process.
- *Enable business to meet merger goals*: This would result in business synergies and improved customer/supplier interaction and satisfaction.
- *Support running of base business during transition*: The advantage is that cross-enterprise data can support integration analysis. It clears processes/systems to support short-term operations.

There could often be relatively straightforward capital investments, such as installation of SAP to improve performance, upgrade of tea packeting machinery to reduce costs, or investment in new software to route voice traffic more efficiently.

Post-Merger IT Challenges[24]

1. *Lack of streamlined IT infrastructure and system support*: Infrastructure set-ups are often not standardized. Hence, a certain level of due diligence is required prior to streamlining IT infrastructure and system support.
2. *Incomplete visibility to customers*: Information flow to customers could be hampered by decisions on visibility and pace of system integration. This could impact customer planning, forecasting, delivery and satisfaction.
3. *Disjointed financial processes and systems*: Financial systems need to be integrated immediately to ensure uninterrupted payment to suppliers.
4. *Post-merger supplier network collaboration*: Integration with supplier systems is essential to maintain continuity of information flow within and across the enterprise, to enable visibility of inventory and service levels.
5. *Fragmented and disparate IT systems*: Identification and rationalisation of IT applications portfolio and activities performed is a critical area of focus during IT system integration.
6. *Lack of technology standardisation*: Technology standardisation and output quality are key issues in disparate IT systems. Aspects, such as vendor management, outsourcing and in-house development could pose additional integration challenges.

M&A IT Integration at Infosys

Logistics Service Providers are realising that post-M&A, integrating business systems are often more complicated than integrating physical location, fleets and assets. Services, such as freight management, warehouse management, value-added services and reverse logistics, are all information intensive, and IT integration is vital for their uninterrupted functioning.

Infosys have developed a unique and comprehensive IT integration and transition framework. The key focus of this framework is to rationalise applications and improve total cost of ownership (TCO) by portfolio optimisation. There are three phases in the M&A IT integration:

[24]J Satya S Kumar, Harish Rajan, Vikas Dewangan, 'Navigating Post-Merger IT Integration in the Logistics Industry', Infosys IT Integration & Transition Framework, Infosys Perspective, May 2006, Page 2-3.

(a) Early Integration—As a basic step towards IT integration, it is important to undertake a set of activities to ensure that critical business functions do not suffer. The early integration stage consists of infrastructure integration and application integration. In the basic infrastructure integration phase, integration of business-essential communication networks, hosting, telecom (data and voice lines), IT security, desktop, e-mail, directory of services, service desk and technical support takes place. Another highlight of this stage is the re-organisation of IT staff across the merged organisation, and allocation of roles and responsibilities to ensure smooth IT integration. This phase also involves steps to merge physical locations of data centres.

— Application Integration involves integration of business applications critical to customer services. The core applications that require early integration include:

- *Billing/finance applications*: To ensure that invoicing and rating mechanisms are not impacted
- *Customer facing/web based applications*: To announce and advertise the new, merged brand
- *Customer data*: To facilitate leveraging a larger customer database
- *Core operational data*: To continue data mapping, routing and message translation.

(b) Pick & Go—This stage focuses on identifying and selecting core business applications and systems best aligned with future organisational needs. The following steps take place during infrastructure integration:

- *Data centre consolidation*: Identification of opportunities for consolidation of data centres, technologies and vendors are explored.
- *Leveraging synergies:* Opportunities for leveraging synergies in terms of networks, servers and software licensing are explored.

Application integration involves system appreciation and application alignment for the Pick & Go stage. The system application phase involves understanding the applications of functionality and technology. This helps to identify opportunities for offshore application maintenance and development. The application alignment phase involves alignment of IT applications portfolio with business priorities to improve cost effectiveness.

(c) Rationalization—Portfolio rationalization and implementation involves the following four stages:

1. *Consolidation*: This stage involves identifying existing applications in the merged organisations and preparing a list of 'as is application portfolio'. The process application matrix, based on the business process area classification and hierarchy, is listed and the applications are mapped against these processes. The critical success factors for this activity include: a) information availability with respect to the applications deployed across organizations, b) clear and precise process area definition to enable effective application classification and mapping, and c) definition of project charter.
2. *Investigation*: A set of pre-defined critical success factors are prepared in consultation with business and IT teams. A questionnaire is designed based on the technical and functional strategy, or application, and distributed to the stakeholders. Responses are collated and evaluated.
3. *Evaluation*: This step focuses on business functionality and technology assessment to arrive at a list of selected candidate applications and a comparison score sheet of the same. The identified candidate applications are put through Infosys detailed functional and technical assessment framework. The critical factors for the evaluation phase are domain knowledge, application knowledge, consolidation of knowledge across geographies and visibility of current and future business direction.
4. *Implementation/Rollout*: This step involves the shut-down of legacy and redundant applications, and enhancement of selected applications. A phased, run-down approach is suggested for legacy applications, and a clear transition strategy for the chosen application would ensure successful IT implementation.

Adapted from: J S S Kumar, Harish Rajan, Vikas Dewangan, Infosys Perspective, Win in the flat world – Navigating Post-Merger IT Integration in the Logistics Industry, May 2006, Page 1-8.

CASES OF POST-MERGER INTEGRATION (PMI)

PMI AT PwC

PricewaterhouseCoopers was formed by the merger of Price Waterhouse and Coopers & Lybrand in June 1998. These companies merged their accountancy and consultancy businesses. The new company used the nine months before it gained regulatory approval in America and the EU to design much of the new business structure, and to select the top two management tiers of the merged partnership. The merger was highly complex, given the need to gain approval from each firm's partnership in 150 countries, as well as clearance from regulators in America and the EU. The merged business had approximately 146,000 employees and annual revenue of $15 billion in its first year. To gain approval of the two firms' partners, the merger team, composed of approximately 20 senior partners from both firms, circulated a merger prospectus outlining the benefits of the merger, the new business strategy and an outline of the organization structure. Following a secret ballot in November 1997, both partnerships approved the merger. The first step involved the appointment of a global leadership team for the new business. The team, identified in January 1998, concentrated on defining various global product lines and agreeing on their scope and performance objectives. The global integration team was also selected in January 1998, and was headed by David Hadfield. Senior managers decided to keep the central integration team as small as possible–around a dozen people with the aim of devolving integration to the business units at the earliest. The global leadership and the integration team together developed a set of value drivers for the integration process. These included ensuring revenue growth, finding ways to 'energise people and keep them on board and excited, staying focused and in control of the business partnership, constantly communicating to employees and the marketplace, and controlling costs. A communication strategy was designed in line with these values, and included, at one point, weekly newsletters to employees and a regular random survey of 200 employees that acted as 'spot checks' on how well they understood various aspects of the merger integration. A high level organization structure was also designed, based on a matrix structure that proved difficult to implement. Both the firms were historically based on geography, which meant that the practices in various countries differed. PwC's new global team aimed to create a global partnership, so they tried to regroup activities around industry sectors (for example, financial services), line of service (such as auditing, tax advice and management consultancy) and geography (national countries). By May 1998, regulators in both America and Europe had cleared the merger, and it was legally completed in June 1998. In fact, the global integration team achieved its target before schedule and was disbanded in May 1999. Much of the integration process focused on standardizing critical processes, especially auditing methods. By December 1998, around 65,000 employees were trained in the new methodology. Integrating various support processes, such as human resources and financial systems, was a lengthier and complex task than expected. Achieving cultural integration between two firms was seen as a continuing task. People were encouraged to focus on delivering high quality global service to clients. They were also encouraged to use informal networking and technology based procedures to share their knowledge and expertise.

Sources: Creating Shareholder Value from Acquisition Integration, PW Consulting Group, 2000; Marion Devine, Successful Mergers, Getting the People Issues Right, Creating a New Nucleus: The Integration Process, The Economist, May 2002, Page 127.

GE Capital's Pathfinder Model for Integration

GE capital was founded in 1933 as a subsidiary of the General Electric Company to provide consumers with credit to purchase GE appliances. Since then, the company has grown to become a major financial services conglomerate with 27 businesses.

GE Capital adopted a new way of thinking about acquisitions after its acquisition of Gelco during the mid 1980s. GE realised that the integration framework that it had developed for the Gelco acquisition could be applied to other acquisitions. The acquisitions come in different sizes and shapes. These include, a) Portfolio purchases that add volume to a business without adding people, b) Consolidating acquisitions that add an acquired business into an existing GE capital business, c) Platform or strategic business where the acquisition operates in a sector that is new to GE capital, and d) Hybrid purchases where parts of the acquisition are slotted into one or several GE Capital businesses, while other parts become joint ventures or remain standalone companies.

GE Capital Services' acquisition integration process has been codified as the *Path Finder Model*. The model divides the process into four action stages, each of which is subdivided into specific sub-processes. There are two or three sub-processes in each action stage, such as due diligence during the pre-acquisition stage and strategy formulation during the foundation building stage. Finally, each action stage includes several best practices and practical steps that managers can take to support the process.

The following are the major components of the Path Finder Model and its guiding principles.

- **Pre-acquisition:** In this stage, emphasis is placed on cultural issues. Cultural issues and cultural compatibility are considered high priority. Assessment of strengths/weaknesses of business and function leaders is also very important. Developing communication strategy also occupies place of prominence.
- **Foundation Building**: In this stage, the emphasis is on development of the integration plan by GE and the target company. The new executives are oriented towards GE Capital's business policy. This stage will also witness the involvement of senior managers.
- **The Rapid Integration Phase**: This integration phase would be rapid and involve continual assessment of progress and adjustment of the integration plan.
- **Assimilation**: This post-implementation phase is viewed as the assimilation phase where the integration effort is assessed, the long-term business plan is further refined and evaluated.

GE Capital offers the following lessons based on its integration experience.

1. Acquisition integration is not a discrete phase of a deal, and does not begin when documents are signed. It is a process that begins with due diligence and runs through the ongoing management of the new enterprise.
2. Integration management is a full time job and needs to be recognised as a distinct business function, just like operations, marketing and finance.
3. Decisions about management, structure, key roles, reporting relationships, layoffs, restructuring and other career affecting aspects of integration should be made, announced and implemented as soon as possible after the deal is signed.
4. A successful integration melds not only the technical aspects of the business but also different cultures. The best way to do this to get people working together to solve business problems.

Source: Ronald N A, Lawrence J, Suzanne C, 'Making the Deal Real: How GE Capital Integrates Acquisitions', Harvard Business Review, January-February 1998.

Post-Merger Integration: The Success of Novartis

In 1996, Sandoz Ltd and Ciba-Geigy Ltd merged to form the world's largest pharmaceutical company, Novartis. The name change was emblematic of the management's desire to create a company that was not only bigger but also different. The $30.09 billion merger of Sandoz and Ciba-Geigy, which was announced in early 1996, came amid a flurry of big deals in the pharmaceutical industry. These included the combination, in 1995, of Glaxo with Wellcome in Britain, of Hoechst Roussel with Marion Merrell Dow, and of Pharmacia of Sweden with Upjohn. Sandoz, the world's fourteenth largest drug maker, in terms of sales, had a 2.1% share of the international pharmaceutical market, and Ciba, the ninth largest, had an international market share of 2.3%. At the time the merger was announced in March 1996, their combined 4.4% global share formed the world's second largest drug company, just behind Glaxo Wellcome. By the time the deal was closed in December, the new company had replaced Glaxo from the top position.

Value creation in the pharmaceutical industry is a function of translating breakthrough science into novel drugs. To create an environment for such innovation, implementation of integration of the two companies was a great challenge.

Using the merger as a catalyst for change, Novartis' management called for a companywide review and, where appropriate, re-engineering of all processes, from research and development to marketing and sales. The focus was for a change from 'leader in size' to 'leader in performance'. To support the change process, Novartis revised its compensation system from a traditional seniority-based process of regular increases to a results-oriented package, with special incentives for specific goals. Novartis encouraged bottom-up ambition by delegating the re-engineering process to division and workgroup level managers throughout the company. Managers were encouraged to evaluate their units for opportunities to increase efficiencies, and were rewarded where they succeeded. Worldwide, Novartis deployed 600 task forces, each assigned to find cost synergies in a specific area, to identify possible cuts, and to create a time plan.

Sandoz had a distributed model, with each division responsible for turning science into products, while Ciba-Geigy maintained a central organization, almost like an academic institution, with a charter to do pure research that the divisions could then commercialize. In the new model, research was divided into seven therapeutic areas, and the head of each area has global responsibility. The strategic plan involved decisions on the relative weight of the therapeutic areas, and to fund them accordingly. Of 165 research projects between Ciba and Sandoz, Novartis kept 150.

Novartis, through a combination of internal efforts and partnerships with biotechnology companies, had the broadest technology base in oncology for any major pharmaceutical company.

The merger was expected to result in downsizing of employees to the extent of 10,000 to 12,000. Novartis' management decided to take an innovative approach. The company created a venture capital fund of 100 million Swiss Francs (about $71 million) to help the employees, who had lost their jobs, to start their businesses. In those cases where the sector lacked the critical mass needed to maintain the service, Novartis outsourced, often to a former employee turned entrepreneur.

Differences existed between the two companies with respect to the way they managed the strategic alliances. Both had created a network of partnerships with small biotechnology companies to augment their internal research efforts. But, while Ciba had, for the most part, taken minority equity positions in its partnerships and refrained from active management, Sandoz had typically taken larger stakes, often involving board seats, and had, in several cases, subsequently acquired the companies. Novartis moved to a management model much more like that of Sandoz.

Differences existed with respect to the management of development projects. For each new drug candidate, Sandoz assigned a professional project manager whose only role was to manage that drug's development; Ciba had parttime project managers who also retained line functions, like clinical studies or toxicology work. Novartis has adopted the Sandoz approach.

The merger made Novartis, by far, the largest producer of plant protection chemicals, with a large business in seeds as well. The new company was also No. 2 worldwide in medical nutrition products, and in baby nutrition, through its ownership of the Gerber Company, which Sandoz acquired in 1994.

The company has outperformed the market since its inception. Executives credit the success of the integration to the speed and decisiveness with which it was executed.

Source: Lawrence M Fisher, Post-Merger Integration, How Novartis Became No.1, Technology, New York Times, Second Quarter, 1998, Issue 11, Page 70-78.

Post-Merger Integration in Banking Sector

In 1997, NationsBank acquired Florida-based Barnett Banks Inc. for $15 billion, an amount that was worth 4 times the book value of Barnett, and was a high purchase premium. Nations Bank was under pressure to carry out the post-acquisition integration in the shortest time possible. It adopted a shortcut to create value by cutting costs. However, the strategy did not work, and further, most of Barnett's customers left. In April 1998, NationsBank merged with Bank of America to create a nation-wide banking company. NationsBank's strength lay in Southeast USA, Texas and the MidWest, while Bank of America dominated in California and the Pacific Northwest. Moreover, Bank of America also had a good presence in credit cards, mutual funds, Internet banking and corporate finance.

The merger, finalised in September 1998, did not succeed immediately. In August 1998, the Russian debt crisis caused Bank of America to write off $372 million from a $1.4 billion unsecured loan to D.E.Shaw & Co, an investment firm. Bank of America suffered further trading losses, amounting to $350 million, in the third quarter of 1998. However, Hugh McColl, the CEO of NationsBank, having learnt from previous failures, was determined to make the merger succeed. Since it was a merger of equals, no purchase premium was paid, and there was, therefore, no immediate pressure to deliver. Therefore, the post-merger integration process was implemented in a phased manner. The developments until date include the consolidation of large corporate businesses and asset management businesses of both banks, conversion of branches in southern US to adhere to a uniform model, and a new corporate logo. Branches in California (the largest and the most critical market), Oregon and Texas were converted to the new model by 2001.

The IBM-Lotus Integration

IBM had acquired Lotus in an all cash offer of about $3.5 billion. Analysts claim that the IBM-Lotus deal met all strategic and financial projections over a period of time. High-tech companies are turning more towards M&A as a preferred path to grow in the context of shortening of product and technology life cycles, increased need for scale in both manufacturing and distribution, and the proliferation of the internet and consolidation of certain industry segments. IBM achieved a leadership position in a key market segment. For Lotus, the arrival of IBM provided the resources to jump-start the sales of its flagship product, Notes, without sacrificing its corporate mission or culture. More importantly, the merger helped Lotus to gain

significance in the market which was increasingly dominated by Microsoft Corporation. The Notes—the groupware technology of Lotus—was challenged by technology on the internet and worldwide web.
According to observers, the success of the deal could be attributed to the right mix of personalities and industry conditions. The offer of $64 per share was both non-negotiable and impossible to spurn. The new arrangement also served to reinforce the autonomy that Lotus was being granted by IBM. Rather than subsume Lotus into the company, IBM decided to make it a wholly owned subsidiary, and remain a visible, viable brand. Its employees would continue to receive Lotus paychecks and benefits. IBM would not impose its corporate regulations or culture on Lotus.
IBM consolidated its own software manufacturing into Lotus' facilities, noting that it offered operating efficiencies that the new parent did not have. Instead of feared layoffs, employment steadily rose. In three years, the strength of employees increased to nearly 9,000, almost double of the strength at the time of the acquisition. The attrition rate, which was 11% before the acquisition had dropped to 6%. IBM retained all Lotus systems, such as benefits, compensation plans, and stock options.

SUMMARY

Integration of two organisations involves integration of systems, processes, procedures, strategy, and reporting systems. Integrating organisations also involve change in mindsets of people, cultures and behaviours. It is essential that companies create teams of people to work on each stage: namely, vision setting, pre-merger targeting, negotiation and planning, and final integration. The approaches for integration can be classified into complete preservation and complete absorption. The absorption model implies full consolidation of operations, organisation and culture of both firms over time. In preservation acquisition, there is great need for autonomy. The major challenges to integration are resistance to change and cultural incompatibility. It is often stated that cultural differences between partners of a merger is one of the most common reasons for its failure. The assumed role of Information Technology (IT) in generating synergy is that economies of scale would drive most savings. IT could deliver significant strategic business value, like better processes for financial management, shared sales-and-operations planning processes, an integrated procure-to-pay process, or a collaborative new product development process.

DISCUSSION QUESTIONS

1. What is the significance of post-merger integration?
2. What are the different approaches to integration?
3. What are the major challenges faced in post-merger integration?
4. Explain the significance of cultural and IT integration.

ADDITIONAL REFERENCES

1. CIO Insight White Board, Merger Integration Blueprint.

12 Regulatory Framework of Mergers and Acquisitions

Chapter Objectives

The aim is to make the reader understand

- The evolution of takeover regulations in India
- The provisions of SEBI Takeover Code

INTRODUCTION

Corporate governance broadly refers to the set of rules designed to govern the behaviour of firms. The governance mechanisms normally considered pertain to the regulations monitoring product market competition and industry policy, the capital market, the market for corporate control and institutional supervision through various government bodies (like Department of Company Affairs, Securities and Exchange Board of India (SEBI), and also the internal monitoring and control systems of the firm headed by the board of directors.

MARKET FOR CORPORATE CONTROL

The economic reforms initiated in 1991 have resulted in radical change in the environment for the private sector, in the process boosting the market for corporate control, characterised by mergers, acquisitions and takeovers.

Corporate control is the right to determine the management of corporate resources, the right to determine the composition of the management team, including the right to hire, fire and compensate senior managers. According to Jensen, market for corporate control is the scenario in which alternative management teams compete for the right to manage corporate resources and make offers to the shareholders for the business, which they own.

Prior to 1991, mergers and acquisitions were restricted under the Indian law, in terms of industrial licensing laws, and restrictive statutory provisions. But, business houses like Goenka and Manu Chabria Group grew largely through acquisitions.

The first attempt in regulating takeovers in India were made by incorporating *Clause 40* in the *Listing Agreement* that provided for making a public offer to the shareholders of a company by any person who sought to acquire 25 per cent or more of the voting rights of the company. M&A and takeovers were also regulated by *Companies Act 1956*, *Industries (Development and Regulation) Act 1951*, *MRTP Act 1969*, *FERA 1973*, *Sick Industrial Companies (Special Provisions*) *Act 1985*, *Section 72A of the Income tax Act 1961 and SCRA 1956* (with respect to transfer of shares of listed companies vide clauses 40A and 40B. In case of MNC related acquisitions, the provisions of FERA applied which imposed a general limit on foreign ownership at 40 per cent. In addition, MRTP gave powers to the union government to prevent an acquisition if it was considered to lead to ‘concentration of economic power to the common detriment’. In the event of hostile bid for a company, the board of the company, under Section 22A of the SCRA, had the power to refuse transfers to a particular buyer, thereby making it difficult for the takeover to take place without the acquiescence of the existing set of managers. The refusal to transfer shares of the company by the company board could be on two grounds: The transfer was (a) against the interest of the company, (b) against public interest.

Regulations After Liberalisation

The policy and regulatory framework governing the M&As gradually evolved in the 1990s. Before 1990, an open offer was mandatory for acquiring 25 per cent stake in the company. In 1990, this threshold was reduced to 10 per cent of the company’s shares. The government announced the *New Industrial Policy* (NIP) in July 1991.

In 1992, the government created SEBI with powers vested in it to regulate the Indian capital market and to protect investors’ interests. SEBI also took over the functions of the Office of the Controller of Capital Issues (CCI). In November 1994, with the view to regulate the takeovers, SEBI promulgated the Substantial Acquisition of Shares and Takeover (SAST) Regulations Act, which was modelled closely along the lines of the UK City Code of TOs and Mergers. A committee chaired by Justice P N Bhagwati was appointed in November 1995 to review the 1994 Takeover Code. The committee’s report formed the basis for the revised Takeover Code that was adopted by SEBI in February 1997. The revised SAST Regulation 1997 was amended in 2002, 2004, 2006 and 2008.

The new code provides for the acquirer to make a public offer for a minimum of 20 per cent of the capital as soon as 10 per cent ownership and management control has been acquired. The creeping acquisitions, through stock market purchases of over 2 per cent over a year, also attracted the provisions of the code. The price of the public offer depended on the high/low price for the preceding 26 weeks, or the price for preferential offers. In order to ensure compliance of the public offers, the acquirers are required to deposit 50 per cent of the value of the offer in an escrow account. Later, through amendments, the threshold limit of 2 per cent per annum for creeping acquisitions was raised to 5 per cent in a year. The 5 per cent creeping acquisition limit has been made applicable to those holding stock above 51 per cent, but below 75 per cent, of a company.

The main objective of the regulations governing takeovers was to provide greater transparency in the acquisition of shares and the takeover of ownership and control of companies through a system based on disclosure of information.

In 2004, RBI circular stated that any transaction where foreign multinationals buy into Indian companies or where fresh issue of shares is made to a foreign company, approvals from the Foreign Investment Promotion Board (FIPB) and the apex bank need not be sought by the foreign entities. This is, of course, subject to the Foreign Direct Investment (FDI) sectoral caps.

Elements of the Indian Legal and Regulatory Framework[1]

Any takeover in India needs to comply with the provisions of SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997 (‘Takeover Code’). The regulatory framework governing Indian capital market does not pose any insuperable impediment to a determined hostile acquirer. It mandates the acquirer to make public disclosure of his shareholding or voting rights to the target company as well as the stock exchange on which its shares are listed, if he acquires shares or voting rights beyond the predetermined threshold limit.

[1]http://www.legalserviceindia.com/article/l274-Combating-Hostile-Takeovers.html2008

The term '*target company*' refers to is a listed company, whose shares or voting rights are acquired/being acquired, or whose control is taken over/being taken over by an acquirer, either directly or by acquiring control of its holding company, or a company which is controlling it, which is not a listed company.

As per Regulation 2(1)(b), the term '*acquirer*' means any person who, directly or indirectly, acquires or agrees to acquire control over the target company, either by himself or with any person acting in concert with the acquirer. The term acquirer has been given a wide meaning as the definition takes into account not only substantial acquisition of shares by a person, but also takeover of control of the company.

As regards the term '*control*', there is no exhaustive definition. It is dependent on the circumstances of the case which determines who has control over the organisation. However, the term control shall include:

1. The right to appoint majority of the directors, or
2. To control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding, or management rights, or shareholders agreements, or voting agreements, or in any other manner.

An explanation was inserted in the definition of the term 'control' vide SEBI (Takeovers) Second Amendment, Regulations, 2002. The explanation provides that transfer from joint control to sole control over a company is not to be considered as change in control if it has been effected in accordance with Regulation 2(1)(e), i.e., through *inter se* transfer of shares among promoters.

The *Takeover Code* makes it difficult for the hostile acquirer to just sneak up on the target company. It forewarns the company about the advances of an acquirer by mandating that the acquirer make a public disclosure of his shareholding or voting rights to the company if he acquires shares or voting rights beyond a certain specified limit. However, the Takeover Code does not present any insurmountable barrier to a determined hostile acquirer.

However, the regulation provides for certain exceptions such as the right of the company to issue shares carrying voting rights upon conversion of debentures already issued, or upon exercise of option against warrants, according to pre-determined terms of conversion or exercise of option. It also allows the target company to issue shares pursuant to public or rights issue in respect of which the offer document has already been filed with the Registrar of Companies or stock exchanges, as the case may be.

However, this may be of little respite as the debentures or warrants contemplated earlier must be issued prior to the offer period. Further, the law does not permit the Board of Directors of the target company to make such issues without the shareholders' approval either prior to the offer period or during the offer period, as it is specifically prohibited under Regulation 23.

During a takeover bid, it may be critical for the Board to quickly adopt a defensive strategy to help ward off the hostile acquirer or bring him to a negotiated position. In such a situation, it may be time consuming and difficult to obtain the shareholders' approvals, especially where the management and the ownership of the company are independent of each other.

The Takeover code, along with the SEBI (Disclosure and Investor Protection) Guidelines 2000 (DIP Guidelines) are the nodal regulations for the methods and terms of issue of shares/warrants by a listed Indian company. They impose several restrictions on the preferential allotment of shares and/or the issuance of share warrants by a listed company. Under the DIP guidelines, issuing shares at a discount and warrants, which convert to shares, at a discount is not possible as the minimum issue price is determined with reference to the market price of the shares on the date of issue, or upon the date of exercise of the option against the warrants. This creates an impediment in the effectiveness of the shareholders' rights plan which involves preferential issue of shares at a discount to existing shareholders.

The DIP Guidelines also provide that the right to buy warrants needs to be exercised within a period of eighteen months, after which they would automatically lapse. Thus, the target company would then have to revert to the shareholders after the period of eighteen months to renew the shareholders' rights plan.

Also, the FDI Policy and the FEMA Regulations have provisions which restrict non-residents from acquiring listed shares of a company directly from the open market in any sector, including sectors falling under automatic route. There also exist certain restrictions with respect to private acquisition of shares by non-residents. It is permitted under automatic route only if Press Note 1 of 2005 read with Press Note 18 of 1998 is not applicable to the non-resident acquirer. This has practically sealed any hostile takeover of any Indian company by any non-resident.

The DIP Guidelines do not stipulate any pricing restrictions on the issue of non-convertible preference shares, non-convertible debentures, notes, bonds and certificates of deposit. Thus, companies may consider structuring a poison pill in place whereby backend rights, which permit the shareholders to exchange the rights/shares held for senior securities with a backend value as fixed by the Board, are issued to existing shareholders when the hostile acquirer's shareholding crosses a predetermined threshold.

Another method is where a company puts a provision in its Articles of Associations to the effect that a hostile acquirer, who succeeds in taking control of that company and/or its subsidiaries, is prohibited from using the company's established brand name. An example is of the Tata companies who have put in place an arrangement with the Tata Sons holding entity, whereby any hostile (or otherwise) acquirer of any of those entities is not permitted to make use of the established 'Tata' brand name.

The Takeover Code also restricts the corporate actions of target companies during the offer period, such as transferring assets or entering into material contracts and prohibiting issue of any authorised but unissued securities during the offer period. Furthermore, the shareholder rights plan sanctions the target companies to issue shares at a discount and warrants which convert to shares at a discount, even without shareholder approval, which is illegal in the Indian context unlike the US where companies are permitted to do so. The Disclosure and Investor Protection Guidelines 2000 (DIP) require the minimum issue price to be determined with reference to the market price of the shares on the date of issue or upon the date of exercise of the option against the warrants. Shareholders must also approve such issue. Without the ability to allow its shareholders to purchase discounted shares/options against warrants, an Indian company may not be in a position to dilute the stake of the hostile acquirer, and, also, seeking shareholder approval in the event of a takeover attempt is a very time consuming process, thereby making difficult poison pills to operate within the existing Indian legal framework. Apart from this, in the event of a takeover bid, all the directors of the target company may be removed in a single shareholders meeting, as permitted under the Companies Act, 1956, thus making futile the Staggered Board defence available to foreign companies.

Competition Law The Competition Law Committee was set up under the Chairmanship of SVS Raghavan for the evolution of sound corporate governance practices from the perspective of consumers. The new competition law was required to be an effective instrument for engendering and protecting competition in the markets in the interests of the consumers. The salient proposals of the committee regarding mergers and acquisition were:

1. Dismantling of MRTP Commission and its replacement by the establishment of a new Competition Law Regulatory Authority 'christened' *Competition Commission of India* (CCI) to enact and implement the Indian Competition Act in replacement of the MRTP Act.
2. Mandatory pre-notification to the proposed CCI for all cases of mergers where the assets of the merged entity exceeds Rs 500 crore, or if the assets of the business group to which the merged company belongs exceed Rs 2,000 crore. The proposed commission will have 90 days from date of notification to either accept or reject the merger.
3. Predatory pricing not be always taken adversely as lower prices by a firm sometimes constitute a gain for consumers.
4. Agreements both between competitors (horizontal agreement) and actual or potential relationship between buyers and sellers (vertical agreement) to be covered under the competition law.

5. State monopolies, government procurement and foreign companies proposed to come under the competition law.

Competition Act 2002 The new competition law formulated by Competition Commission of India (CCI) called the *Competition Act* was enacted in the year 2002 to replace the Monopolies and Restrictive Trade Practices (MRTP) Act of 1969. The Competition Act 2002 seeks to prohibit anti-competitive agreements, abuse of dominant positions, and regulate mergers and acquisitions. The Act defines a *combination* as any merger or acquisition in which the firms' combined assets or turnover exceeds Rs 1,000 crore (approximately $250 million) and Rs 3,000 crore (approximately $750 million), respectively, in India or $500 million and $1,500 million, respectively, worldwide. M&As that fall below these thresholds are not considered combinations and are outside the ambit of the Act. The original Act provided for voluntary notification of combinations to the CCI but, on the recommendation of the Parliamentary Standing Committee that reviewed the amendment bill, the Amendment Act now provides for mandatory notification.

These merger regulation provisions, in particular, the mandatory notification requirement, and the lack of *domestic nexus** criterion for foreign mergers have been sore points for the domestic as well as international business communities. It has been argued that the mandatory notification system will require notification of foreign mergers with little or no nexus to India and add to the cost of doing business[2]. Accordingly the thresholds for worldwide turnover or assets have been amended so that only those combinations where at least Rs 500 crore of the combined worldwide assets, or at least Rs 1,500 crore of combined worldwide turnover of the merging parties is in India would come under the purview of the Act. According to the amendment, a multinational firm whose Indian operations are substantial enough to satisfy the domestic nexus test would still have to notify its offshore acquisition of a firm with no Indian interests whatsoever, if the combined operations of the parties crossed the threshold for worldwide assets or turnover.

In order to address the procedural objections and merger review, the CCI published draft combinations regulations in January 2008. A modified two firm domestic nexus test was suggested according to which combinations in which at least two parties do not each have a minimum of Rs 200 crore of assets, or Rs 600 crore of turnover in India, will be considered benign. Other features of the draft regulations include the option for merging parties of filing merger notifications in either short form or long form, a merger review process with a minimum review time of 30 days and a maximum time of 210 days depending upon the complexity of a combination, and fairly substantial filing fees.

International experience shows that 80-85 per cent of mergers and acquisitions do not raise competitive concerns and are generally approved between 30-60 days. The *International Competition Network*, an association of global competition authorities had recommended that straightforward cases should be dealt within six weeks and complex cases within six months[3].

The tax laws facilitate restructuring overseas. There is great deal of flexibility allowed in the US and the UK tax codes. For instance, for all practical purposes, the acquiring company can even set off the interest on borrowed funds against the income of the acquired company. Hence, often a special purpose vehicle, thinly capitalised, but financed by high yielding bonds makes the takeover bid. If successful, the two are merged and the acquirer then sets about reorganising or selling the assets of the takeover target to pay down the debt. This exercise then delivers huge gains.

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*A domestic nexus is a nexus with assets and operations in India which is applicable to acquisition in which a foreign entity and an Indian entity are involved.

[2]Manish Agarwal, Aditya Bhattacharjea, 'Are merger regulations diluting Parliamentary Intent', June 28, 2008, Economic & Political Weekly, Page 10

[3]Amitabh Kumar, 'Regulating Mergers and Acquisitions', Economic Times, December 20, 2007

Salient Features of Substantial Acquisition of Shares and Regulation Act[4]

1. DISCLOSURES OF SHAREHOLDING AND CONTROL IN A LISTED COMPANY

1.1 Transitional Provision

1.1.1 Any person, who holds more than five per cent shares or voting rights in any company, shall, within two months of notification of these Regulations, disclose his aggregate shareholding in that company, to the company.

1.1.2 Every company whose shares are held by the persons referred to in sub-regulation (1) shall, within three months from the date of notification of these Regulations, disclose to all the stock exchanges on which the shares of the company are listed, the aggregate number of shares held by each person.

1.1.3 A promoter, or any person having control over a company, shall, within two months of notification of these Regulations, disclose the number and percentage of shares or voting rights held by him and by person(s) acting in concert with him in that company, to the company.

1.1.4 Every company, whose shares are listed on a stock exchange, shall, within three months of notification of these Regulations, disclose to all the stock exchanges on which the shares of the company are listed, the names and addresses of promoters and, or person(s) having control over the company, and number and percentage of shares or voting rights held by each such person.

1.2 Acquisition of 5% or More Shares of a Company

1.2.1 Any acquirer, who acquires shares or voting rights which (taken together with shares or voting rights, if any, held by him) would entitle him to more than five per cent, or ten per cent, or fourteen per cent, or fifty four per cent, or seventy four per cent shares or voting rights in a company, in any manner whatsoever, shall disclose at every stage the aggregate of his shareholding or voting rights in that company to the company and to the stock exchanges where shares of the target company are listed.

1.2.2 Any acquirer who has acquired shares or voting rights of a company under sub-regulation (1) of regulation 11, shall disclose purchase or sale aggregating two per cent, or more, of the share capital of the target company to the target company and the stock exchanges where shares of the target company are listed within two days of such purchase or sale along with the aggregate shareholding after such acquisition or sale.

1.3 Continual Disclosures

1.3.1 Every person, who holds more than [fifteen] per cent shares or voting rights in any company, shall, within 21 days from the financial year ending March 31, make yearly disclosures to the company, in respect of his holdings as on 31st March.

1.3.2 A promoter or every person having control over a company shall, within 21 days from the financial year ending March 31, as well as the record date of the company for the purposes of declaration of dividend, disclose the number and percentage of shares or voting rights held by him and by persons acting in concert with him, in that company to company.

1.3.3 Every company whose shares are listed on a stock exchange, shall, within 30 days from the financial year ending March 31, as well as the record date of the company for the purposes of declaration of dividend, make yearly disclosures to all the stock exchanges on which the shares of the company are listed, the changes, if any, in respect of the holdings of the persons, and also holdings of promoters or person(s) having control over the company as on 31st March.

[4]www.sebi.org

2. SUBSTANTIAL ACQUISITION OF SHARES OR VOTING RIGHTS IN AND ACQUISITION OF CONTROL OVER A LISTED COMPANY

2.1 Acquisition of Fifteen Per Cent or More of the Shares or Voting Rights of Any Company

No acquirer shall acquire shares or voting rights which (taken together with shares or voting rights, if any, held by him or by persons acting in concert with him), entitle such acquirer to exercise fifteen per cent or more of the voting rights in a company, unless such acquirer makes a public announcement to acquire shares of such company in accordance with the Regulations.

2.2 Consolidation of Holdings

2.2.1 No acquirer who, together with persons acting in concert with him, has acquired, in accordance with the provisions of law, 15 per cent or more, but less than fifty five per cent (55%), of the shares or voting rights in a company, shall acquire, either by himself, or through, or with persons acting in concert with him, additional shares or voting rights entitling him to exercise more than 5% of the voting rights, in any financial year ending on 31st March, unless such acquirer makes a public announcement to acquire shares in accordance with the Regulations.

2.2.2 No acquirer, who, together with persons acting in concert with him, holds fifty five per cent (55%) or more, but less than seventy five per cent (75%), of the shares or voting rights in a target company, shall acquire, either by himself or through persons acting in concert with him, any additional shares or voting rights therein, unless he makes a public announcement to acquire shares in accordance with these Regulations.

2.2.3 Where an acquirer who (together with persons acting in concert with him) holds fifty five per cent (55%) or more, but less than seventy five per cent (75%), of the shares or voting rights in a target company, is desirous of consolidating his holding while ensuring that the public shareholding in the target company does not fall below the minimum level permitted by the Listing Agreement, he may do so only by making a public announcement in accordance with these regulations.

2.3 Acquisition of Control Over a Company

2.3.1 Irrespective of whether or not there has been any acquisition of shares or voting rights in a company, no acquirer shall acquire control over the target company, unless such person makes a public announcement to acquire shares and acquires such shares in accordance with the Regulations.

2.4 Appointment of a Merchant Banker

Before making any public announcement of offer, the acquirer shall appoint a merchant banker in Category-I, holding a certificate of registration granted by the Board, who is not associate of, or group of, the acquirer or the target company.

2.5 Timing of the Public Announcement of Offer

2.5.1 The public announcement shall be made by the merchant banker not later than four working days of entering into an agreement for acquisition of shares or voting rights, or deciding to acquire shares or voting rights exceeding the respective percentage specified therein. In the case of disinvestment of a Public Sector Undertaking, the public announcement shall be made by the merchant banker not later than four working days of the acquirer executing the Share Purchase Agreement or Shareholders Agreement with the Central Government or State Government for the acquisition of shares or voting rights exceeding the percentage of share holding, or the transfer of control over a target Public Sector Undertaking.

2.5.2 In case of an acquirer acquiring securities, including Global Depositories Receipts or American Depository Receipts which, when taken together with the voting rights, if any already held by him or persons acting in concert with him, would entitle him to voting rights, exceeding the percentage, the public announcement shall be made not later than four working days before he acquires voting rights on such securities upon conversion, or exercise of option, as the case may be.

2.5.3 In case of indirect acquisition or change in control, a public announcement shall be made by the acquirer within three months of consummation of such acquisition or change in control or restructuring of the parent or the company holding shares of or control over the target company in India.

2.6 Public Announcement Offer

2.6.1 The public announcement to be made shall be made in all editions of one English national daily with wide circulation, one Hindi national daily with wide circulation and a regional language daily with wide circulation at the place where the registered office of the target company is situated, and at the place of the stock exchange where the shares of the target company are most frequently traded.

2.6.2 A copy of the public announcement in the newspaper shall be (i) submitted to the Board through the merchant banker, (ii) sent to all the stock exchanges on which the shares of the company are listed for being notified on the notice board, (iii) sent to the target company at its registered office for being placed before the Board of Directors of the company.

2.7 Contents of Public Offer

2.7.1 The public announcement shall contain the following particulars, namely:

(i) The paid up share capital of the target company, the number of fully paid up and partly paid up shares;

(ii) The total number and percentage of shares proposed to be acquired from the public;

(iii) The minimum offer price for each fully paid-up or partly paid up share;

(iv) Mode of payment of consideration;

(v) The identity of the acquirer(s) and in case the acquirer is a company or companies, the identity of the promoters and, or the persons having control over such company(ies) and the group, if any, to which the company(ies) belong;

(vi) The existing holding, if any, of the acquirer in the shares of the target company, including holdings of persons acting in concert with him;

(vii) Salient features of the agreement, if any, such as the date, the name of the seller, the price at which the shares are being acquired, the manner of payment of the consideration and the number and percentage of shares in respect of which he acquirer has entered into the agreement to acquire the shares or the consideration, monetary or otherwise, for the acquisition of control over the target company, as the case maybe;

(viii) The highest and the average price paid by the acquirer or persons acting in concert with him for acquisition, if any, of shares of the target company made by him during the twelve month period prior to the date of public announcement;

(ix) Object and purpose of the acquisition of the shares and future plans, if any, of the acquirer for the target company, including disclosures whether the acquirer proposes to dispose of or otherwise encumber any assets of the target company in the succeeding two years, except in the ordinary course of business of the target company;

Provided that where the future plans are set out, the public announcement shall also set out how the acquirers propose to implement such future plans.

(x) The 'specified date' as mentioned in the Regulation;

(xi) The date by which individual letters of offer would be posted to each of the shareholders;

(xii) The date of opening and closure of the offer and the manner in which and the date by which the acceptance or rejection of the offer would be communicated to the shareholders;

(xiii) The date by which the payment of consideration would be made for the shares in respect of which the offer has been accepted;

(xiv) Disclosure to the effect that firm arrangement for financial resources required to implement the offer is already in place, including details regarding the sources of the funds whether domestic, i.e., from banks, financial institutions, or otherwise, or foreign, i.e., from non-resident Indians or otherwise.

(xv) Provision for acceptance of the offer by person(s) who own the shares but are not the registered holders of such shares;

(xvi) Statutory approvals, if any, required to be obtained for the purpose of acquiring the shares under the Companies Act, 1956 (1 of 1956), the Monopolies and Restrictive Trade Practices Act, 1969 (54 of 1969), The Foreign Exchange Regulation Act, 1973 (46 of 1973) and/or any other applicable laws;

(xvii) Approvals of banks or financial institutions required, if any;

(xviii) Whether the offer is subject to a minimum level of acceptance from the shareholders; and

(xix) Such other information as is essential for the shareholders to make an informed decision in regard to the offer.

2.8 Brochures, Advertising Material, etc.

The public announcement of the offer or any other advertisement, circular, brochure, publicity material or letter of offer issued in relation to the acquisition of shares shall not contain any misleading information.

2.9 Submission of Letter of Offer to the Board

2.9.1 Within fourteen days from the date of the public announcement, the acquirer shall, through its merchant banker, file with the Board, the draft of the letter of offer, containing disclosures as specified by the Board.

2.9.2 The letter of offer shall be dispatched to the shareholders not earlier than 21 days from its submission to the Board under sub regulation (1). Provided that if, within 21 days from the date of submission of the letter of offer, the Board specifies changes, if any, in the letter of offer, (without being under any obligation to do so) the merchant banker and the acquirer shall carry out such changes before the letter of offer is dispatched to the shareholders. If the disclosures in the draft letter of offer are inadequate, or the Board has received any complaint, or has initiated any enquiry or investigation in respect of the public offer, the Board may call for revised letter of offer with or without rescheduling the date of opening or closing of the offer and may offer its comments to the revised letter of offer within seven working days of filing of such revised letter of offer.

2.9.3 The acquirer shall, while filing the draft letter of offer with the Board, pay a fee as mentioned in the following table, by bankers' cheque or demand draft drawn in favour of the 'Securities and Exchange Board of India', payable at Mumbai:

Offer Size	**Fee (Rs)**
Less than or equal to one crore Rupees	1,00,000
More than one crore Rupees, but less than or equal to five crore Rupees	2,00,000
More than five crore Rupees, but less than or equal to ten crore Rupees	3,00,000
More than ten crore Rupees	0.5% of the offer size

2.10 Specified Date

The public announcement shall specify a date, which shall be the specified date for the purpose of determining the names of the shareholders to whom the letter of offer should be sent, provided that such specified date shall not be later than the thirtieth day from the date of the public announcement.

2.11 Offer Price

2.11.1 The offer price shall be payable:

(a) In cash;

(b) By issue, exchange and, or transfer of shares (other than preference shares) of acquirer company, if the person seeking to acquire the shares is a listed body corporate; or

(c) By issue, exchange and, or transfer of secured instruments of acquirer company with a minimum ‘A’ grade rating from a credit rating agency registered with the Board;

(d) A combination of clause (a) (b) or (c).

2.11.2 In case the offer price consists of consideration payable in the form of securities issuance of which requires approval of the shareholders, such approval shall be obtained by the acquirer within seven days from the date of closure of the offer. In case the approval is not obtained, the acquirer shall pay the entire consideration in cash.

2.11.3 (a) The offer price shall be the highest of the price paid by the acquirer or persons acting in concert with him for acquisition, if any, including by way of allotment in a public or rights or preferential issue during the twenty six week period prior to the date of public announcement, whichever is higher.

(b) The average of the weekly high and low of the closing prices of the shares of the target company as quoted on the stock exchange where the shares of the company are most frequently traded during the twenty six weeks, or the average of the daily high and low of the deleted prices of the shares as quoted on the stock exchange where the shares of the company are most frequently traded during the two weeks preceding the date of public announcement, whichever is higher. In case of disinvestment of a Public Sector Undertaking, the relevant date for the calculation of the average of the weekly prices of the shares of the Public Sector Undertaking, as quoted on the stock exchange where its shares are most frequently traded, shall be the date preceding the date when the Central Government or the State Government opens the financial bid.

2.11.4 Where the shares of the target company are infrequently traded, the offer price shall be determined by the acquirer and the merchant banker taking into account the following factors:

(a) the highest price paid by the acquirer or persons acting in concert with him for acquisitions, if any, including by way of allotment in a public or rights or preferential issue during the twenty six week period prior to the date of public announcement.

(b) Other parameters including return on net worth, book value of the shares of the target company, earning per share, price earning multiple *vis-à-vis* the industry average.

2.11.5 In case of disinvestment of a Public Sector Undertaking, whose shares are infrequently traded, the minimum offer price shall be the price paid by the successful bidder to the Central Government or the State Government, arrived at after the process of competitive bidding of the Central Government or the State Government for the purpose of disinvestment.

2.11.6 The offer price for partly paid up shares shall be calculated as the difference between the offer price and the amount due towards calls-in-arrears or calls remaining unpaid together with interest, if any, payable on the amount called up but remaining unpaid.

2.11.7 The offer price for indirect acquisition or control shall be determined with reference to the date of the public announcement for the parent company and the date of the public announcement for acquisition of shares of the target company, whichever is higher.

2.11.8 An acquirer who has made a public offer and seeks to acquire further shares shall not acquire such shares during the period of 6 months from the date of closure of the public offer at a price higher than the offer price.

2.12 Minimum Number of Shares to be Acquired

2.12.1 The public offer made by the acquirer to the shareholders of the target company shall be for a minimum twenty per cent of the voting capital of the company.

2.12.2 If the acquisition made in pursuance of a public offer results in the public shareholding in the target company being reduced below the minimum level required as per the Listing Agreement, the acquirer shall take necessary steps to facilitate compliance of the target company with the relevant provisions thereof, within the time period mentioned therein.

2.12.3 The minimum size of the public offer shall be the lesser of the following:
- (a) Twenty per cent of the voting capital of the company; or
- (b) Such other lesser percentage of the voting capital of the company as would, assuming full subscription to the offer, enable the acquirer, together with the persons acting in concert with him, to increase his holding to the maximum level possible, which is consistent with the target company meeting the requirements of minimum public shareholding laid down in the Listing Agreement.

2.12.4 When the number of shares offered for sale by the shareholders are more than the shares agreed to be acquired by the person making the offer, such person shall, accept the offers received from the shareholders on a proportional basis, in consultation with the merchant banker, taking care to ensure that the basis of acceptance is decided in a fair and equitable manner and does not result in non-marketable lots.

2.13 General Obligations of the Acquirer

2.13.1 The public announcement of offer to acquire the shares of the target company shall be made only when the acquirer is able to implement the offer.

2.13.2 Within 14 days of the public announcement of the offer, the acquirer shall send a copy of the draft letter of offer to the target company at its registered office address, for being placed before the Board of Directors and to all the stock exchanges where the shares of the company are listed.

2.13.3 The acquirer shall ensure that the letter of offer is sent to all the shareholders (including non-resident Indians) of the target company, whose names appear on the register of members of the company as on the specified date mentioned in the public announcement, so as to reach them within 45 days from the date of public announcement.

2.13.4 The date of opening of the offer shall be not later than the fifty fifth day from the date of public announcement.

2.13.5 The offer to acquire shares from the shareholders shall remain open for a period of twenty days. The shareholder shall have the option to withdraw acceptance tendered by him up to three working days prior to the date of closure of the offer.

2.13.6 In case the acquirer is a company, the public announcement of offer, brochure, circular, letter of offer, or any other advertisement or publicity material issued to shareholders in connection with the offer must state that the directors accept the responsibility for the information contained in such documents.

2.13.7 During the offer period, the acquirer or persons acting in concert with him, shall not be entitled to be appointed on the Board of Directors of the target company.

2.13.8 Where an offer is made conditional upon minimum level of acceptances, the acquirer or any person acting in concert with him:

(i) Shall, irrespective of whether or not the offer received response to the minimum level of acceptances, acquire shares from the public to the extent of the minimum percentage specified. Provided that the provisions of this clause shall not be applicable in case the acquirer has deposited in the escrow account, in cash, 50 per cent of the consideration payable under the public offer.
(ii) Shall not acquire, during the offer period, any shares in the target company, except by way of fresh issue of shares of the target company.
(iii) Shall be liable for penalty of forfeiture of entire escrow amount, for the non-fulfillment of obligations under the Regulations.

2.13.9 If any of the persons representing or having interest in the acquirer is already a director on the Board of the target company, or is an 'insider' within the meaning of Securities and Exchange Board of India (Insider Trading) Regulations, 1992, he shall refuse himself and not participate in any matter(s) concerning or 'relating' to the offer including any preparatory steps leading to the offer.

2.13.10 On or before the date of issue of public announcement of offer, the acquirer shall create an escrow account.

2.13.11 The acquirer shall ensure that firm financial arrangements have been made for fulfilling the obligations under the public offer and suitable disclosures in this regard shall be made in the public announcement of offer.

2.13.12 The acquirer shall, within a period of fifteen days from the date of the closure of the offer, complete all procedures relating to the offer, including payment of consideration to the shareholders who have accepted the offer, and, for the purpose, open a special account.

2.13.13 Where the acquirer, or persons acting in concert with him, has acquired any shares at a price equal to or less or more than the offer price, he shall disclose the number, percentage, price and the mode of acquisition of such shares to the stock exchanges on which the shares of the target company are listed, and to the merchant banker, within 24 hours of such acquisition, and the stock exchanges shall forthwith disseminate such information to the public.

2.14 General Obligations of the Board of Directors of the Target Company

2.14.1 Unless the approval of the general body of shareholders is obtained after the date of the public announcement of the offer, the Board of Directors of the target company shall not, during the offer period:
(a) Sell, transfer, encumber or otherwise dispose of, or enter into an agreement for sale, transfer, encumbrance or for disposal of assets otherwise, not being sale or disposal of assets in the ordinary course of business, of the company or its subsidiaries; or
(b) Issue or allot any authorised but unissued securities carrying voting rights during the offer period; or
(c) Enter into any material contracts.

2.14.2 The target company shall furnish to the acquirer, within 7 days of the request of the acquirer or within 7 days from the specified date, whichever is later, a list of shareholders or warrant holders or convertible debenture holders, as are eligible for participation, containing names, addresses, shareholding and folio number, and of those persons whose applications for registration of transfer of shares are pending with the company.

2.14.3 Once the public announcement has been made, the board of directors of the target company shall not:
(a) Appoint as additional director or fill in any casual vacancy on the Board of Directors, by any person(s) representing, or having interest in the acquirer, till the date of certification by the

merchant banker. Provided that upon closure of the offer and the full amount of consideration payable to the shareholders being deposited in the special account, changes, as would give the acquirer representation on the Board or control over the company, can be made by the target company.

(b) Allow any person or persons representing or having interest in the acquirer, if he is already a director on the Board of the target company before the date of the public announcement, to participate in any matter relating to the offer, including any preparatory steps leading thereto.

2.14.4 The Board of Directors of the target company may, if they so desire, send their unbiased comments and recommendations on the offer(s) to the shareholders, keeping in mind the fiduciary responsibility of the directors to the shareholders and, for the purpose, seek the opinion of an independent merchant banker or a committee of independent directors.

2.14.5 The Board of Directors of the target company shall facilitate the acquirer in verification of securities tendered for acceptances.

2.14.6 Upon fulfillment of all obligations by the acquirers under the Regulations, as certified by the merchant banker, the Board of Directors of the target company shall transfer the securities acquired by the acquirer, whether under the agreement or from open market purchases, in the name of the acquirer and, or allow such changes in the Board of Directors as would give the acquirer representation on the Board or control over the company.

2.15 General Obligations of the Merchant Banker

2.15.1 Before the public announcement of the offer is made, the merchant banker shall ensure that:

(a) The acquirer is able to implement the offer;

(b) The provision relating to escrow account has been made;

(c) Firm arrangements for funds and money for payment through verifiable means to fulfil the obligations under the offer are in place;

(d) The public announcement of offer is made in terms of the Regulations.

2.15.2 The merchant banker shall furnish to the Board a due diligence certificate which shall accompany the draft letter of offer.

2.15.3 The merchant banker shall ensure that the public announcement and the letter of offer is filed with the Board of the target company, and also sent to all the stock exchanges on which the shares of the target company are listed in accordance with the Regulations.

2.15.4 The merchant banker shall ensure that the contents of the public announcement of offer as well as the letter of offer are true, fair and adequate and based on reliable sources, quoting the source wherever necessary.

2.15.5 The merchant banker shall ensure compliance of the Regulations and any other laws or rules as may be applicable in this regard. The merchant banker shall not deal in the shares of the target company during the period commencing from the date of his appointment in terms of Regulation 13 till the expiry of the fifteen days from the date of closure of the offer.

2.15.6 Upon fulfillment of all obligations by the acquirers under the Regulations, the merchant banker shall cause the bank, with whom the escrow amount has been deposited, to release the balance amount to the acquirers.

2.15.7 The merchant banker shall send a final report to the Board within 45 days from the date of closure of the offer.

2.16 Competitive Bid

2.16.1 Any person, other than the acquirer who has made the first public announcement, who is desirous of making any offer, shall, within 21 days of the public announcement of the first offer, make a public announcement of his offer for acquisition of the shares of the same target company.

2.16.2 No public announcement for an offer or competitive bid shall be made after 21 days from the date of public announcement of the first offer. No public announcement for a competitive bid shall be made after an acquirer has already made the public announcement under the proviso to sub pursuant to entering into a Share Purchase or Shareholders Agreement with the Central Government or the State Government, as the case may be, for acquisition of shares or voting rights or control of a Public Sector Undertaking.

2.16.3 Any competitive offer by an acquirer shall be for such number of shares which, when taken together with shares held by him along with persons acting in concert with him, shall be at least equal to the holding of the first bidder, including the number of shares for which the present offer by the first bidder has been made.

2.16.4 Upon the public announcement of a competitive bid or bids, the acquirer(s) who had made the public announcement(s) of the earlier offer(s), shall have the option to make an announcement revising the offer provided that, if no such announcement is made within fourteen days of the announcement of the competitive bid(s), the earlier offer(s) on the original terms shall continue to be valid and binding on the acquirer(s) who had made the offer(s) except that the date of closing of the offer shall stand extended to the date of closure of the public offer under the last subsisting competitive bid.

2.16.5 The acquirers who have made the public announcement of offer(s), including the public announcement of competitive bid(s), shall have the option to make upward revisions in his offer(s), in respect to the price and the number of shares to be acquired, at any time up to seven working days prior to the date of closure of the offer, provided that the acquirer shall not have the option to change any other terms and conditions of their offer except the mode of payment following an upward revision in offer.

2.16.6 Where there is a competitive bid, the date of closure of the original bid, as also the date of closure of all the subsequent competitive bids, shall be the date of closure of public offer under the last subsisting competitive bid and the public offers under all the subsisting bids shall close on the same date.

2.17 Upward Revision of Offer

2.17.1 Irrespective of whether or not there is a competitive bid, the acquirer who has made the public announcement of offer, may make upward revisions in his offer in respect to the price and the number of shares to be acquired, at any time up to seven working days prior to the date of the closure of the offer. Any such revision of offer shall be made only upon the acquirer:

(a) Making a public announcement in respect of such changes or amendments in all the newspapers in which the original public announcement was made;

(b) Simultaneously with the issue of such public announcement, informing the Board, all the stock exchanges on which the shares of the company are listed, and the target company at its registered office.

(c) Increasing the value of escrow account.

2.18 Withdrawal of Offer

2.18.1 No public offer, once made, shall be withdrawn except under the following circumstances:

(a) The statutory approval(s) required have been refused;

(b) The sole acquirer, being a natural person, has died;
(c) Such circumstances as in the opinion of the Board merits withdrawal.

2.18.2 In the event of withdrawal of the offer under any of the circumstances specified under Regulation 2.18.1, the acquirer or the merchant banker shall:
(a) Make a public announcement in the same newspapers in which the public announcement of offer was published, indicating reasons for withdrawal of the offer;
(b) Simultaneously with the issue of such public announcement, inform – (i) the Board; (ii) all the stock exchanges on which the shares of the company are listed; and (iii) the target company at its registered office.

2.19 Provision of Escrow

2.19.1 The escrow amount shall be calculated in the following manner:
(a) For consideration payable under the public offer,–upto and including Rs.100 crore–25%; exceeding Rs.100 crore - 25% upto Rs.100 crore and 10% thereafter.
(b) For offers which are subject to a minimum level of acceptance, and the acquirer does not want to acquire a minimum of 20%, then 50% of the consideration payable under the public offer in cash shall be deposited in the escrow amount.

2.19.2 The total consideration payable under the public offer shall be calculated assuming full acceptances and at the highest price if the offer is subject to differential pricing, irrespective of whether the consideration for the offer is payable in cash or otherwise.

2.19.3 The escrow account shall consist of:
(a) cash deposited with a scheduled commercial bank; or
(b) bank guarantee in favour of the merchant banker; or
(c) deposit of acceptable securities with appropriate margin, with the merchant banker; or

When the escrow account consists of deposit with a scheduled commercial bank, the acquirer shall, while opening the account, empower the merchant banker appointed for the offer to instruct the bank to issue a banker's cheque or demand draft for the amount lying to the credit of the escrow account, as provided in the Regulations.

2.19.4 When the escrow account consists of bank guarantee, such bank guarantee shall be in favour of the merchant banker and shall be valid at least for a period commencing from the date of public announcement until twenty days after the closure of the offer.

2.19.5 The acquirer shall, in case the escrow account consists of securities, empower the merchant banker to realise the value of such escrow account by sale or otherwise, provided that if there is any deficit on realisation of the value of the securities, the merchant banker shall be liable to make good any such deficit.

2.19.6 In case the escrow account consists of bank guarantee or approved securities, these shall not be returned by the merchant banker till after completion of all obligations under the Regulations.

2.19.7 In case there is any upward revision of offer, consequent upon a competitive bid or otherwise, the value of the escrow account shall be increased to equal at least 10% of the consideration payable upon such revision.

2.19.8 Where the escrow account consist of bank guarantee or deposit of approved securities, the acquirer shall also deposit with the bank a sum of at least 1% of the total consideration payable, as and by way of security for fulfillment of the obligations under the Regulations by the acquirers.

2.20 Payment of Consideration

2.20.1 For the amount of consideration payable in cash, the acquirer shall, within a period of seven days from the date of closure of the offer, open a special account with a Bankers to an Issue registered with the Board and deposit therein, such sum as would, together with 90% of the amount lying in the escrow account, if any, make up the entire sum due and payable to the shareholders as consideration for acceptances received and accepted in terms of these Regulations and for this purpose, transfer the funds from the escrow account.

2.20.2 The unclaimed balance lying to the credit of the account at the end of 3 years from the date of deposit thereof shall be transferred to the investor protection fund of the regional stock exchange of the target company.

2.20.3 In respect of consideration payable by way of exchange of securities, the acquirer shall ensure that the securities are actually issued and dispatched to the shareholders.

3. BAIL OUT TAKEOVERS

3.1 Takeover of Financially Weak Companies

The provisions of this Chapter shall apply to a substantial acquisition of shares in a financially weak company, not being a sick industrial company, in pursuance to a scheme of rehabilitation approved by a public financial institution or a scheduled bank, referred to as lead institution.

3.1.1 The lead institution shall appraise the financially weak company, taking into account the financial viability, and assess the requirement of funds for revival and draw up the rehabilitation package on the principle of protection of interests of minority shareholders, good management, effective revival and transparency.

3.1.2 The rehabilitation scheme shall also specifically provide the details of any change in management.

3.1.3 The scheme may provide for acquisition of shares in the financially weak company in any of the following manner:

(a) Outright purchase of shares, or
(b) Exchange of shares, or
(c) Combination of both.

3.2 Manner of Acquisition of Shares

3.2.1 Before giving effect to any scheme of rehabilitation the lead institution shall invite offers for acquisition of shares from atleast three parties.

3.2.2 After receipt of the offers, the lead institution shall select one of the parties having regard to the managerial competence, adequacy of financial resources and technical capability of the person acquiring shares to rehabilitate the financially weak company.

3.2.3 The lead institution shall provide necessary information to any person intending to make an offer to acquire shares about the financially weak company, and particularly in relation to its present management, technology, range of products manufactured, shareholding pattern, financial holding and performance and assets and liabilities of such company for a period covering five years from the date of the offer, as also the minimum financial and other commitments expected of from the person acquiring shares for such rehabilitation.

3.3 Manner of Evaluation of Bids

3.3.1 The lead institution shall evaluate the bids received with respect to the purchase price or exchange of shares, track record, financial resources, reputation of management of person acquiring shares, and ensure fairness and transparency in the process.

3.3.2 After making evaluation, the offers received shall be listed in order of preference and, after consultation with the persons in the affairs of the management of the financially weak company, accept one of the bids.

3.3.3 The person acquiring shares who has been identified by the lead institution shall, on receipt of a communication in this behalf from the lead institution, make a formal offer to acquire shares from the promoters or persons in charge of the affairs of the management of the financially weak company, financial institutions and also other shareholders of the company at a price determined by mutual negotiation between the person acquiring the shares and the lead institution.

3.4 Person Acquiring Shares to Make Public Announcement

3.4.1 The person acquiring shares from the promoters or the persons in charge of the management of the affairs of the financially weak company or the financial institution shall make a public announcement of his intention for acquisition of shares from the other shareholders of the company.

3.4.2 Such public announcement shall contain relevant details about the offer, including the information about the identity and background of the person acquiring shares, number and percentage of shares proposed to be acquired, offer price, the specified date, the date of opening of the offer and the period for which the offer shall be kept open, and such other particulars as may be required by the Board.

3.4.3 If the offer results in the public shareholding being reduced to 10% or less of the voting capital of the company, the acquirer shall either:

(a) Within a period of three months from the date of closure of the public offer, make an offer to buy out the outstanding shares remaining with the shareholders at the same offer price, which may have the effect of delisting the target company; or

(b) Undertake to disinvest through an offer for sale or by a fresh issue of capital to the public which shall open within a period of 6 months from the date of closure of public offer, such number of shares so as to satisfy the listing requirements.

3.5 Competitive Bid

No person shall make a competitive bid for acquisition of shares of the financially weak company once the lead institution has evaluated the bid and accepted the bid of the acquirer who has made the public announcement of offer for acquisition of shares from the shareholders other than the promoters or the persons in charge of the management of the financially weak company.

3.6 Acquisition of Shares by a State Level Public Financial Institution

Where proposals for acquisition of shares in respect of a financially weak company is made by a state level public financial institution, the provisions of these Regulations in so far as they relate to scheme of rehabilitation prepared by a public financial institution, shall apply except that in such a case the Industrial Development Bank of India, a corporation established under the Industrial Development Bank of India Act, 1964 shall be the agency or ensuring the compliance of these Regulations for acquisition of shares in the financially weak company.

4. INVESTIGATION AND ACTION BY THE BOARD

4.1 Board's Right to Investigate

The Board may appoint one or more persons as investigating officer to undertake investigation for any of the following purposes, namely:

(a) To investigate into the complaints received from the investors, the intermediaries or any other person on any matter having a bearing on the allegations of substantial acquisition of shares and takeovers;

(b) To investigate suo-moto upon its own knowledge or information, in the interest of securities market or investors interests, for any breach of the Regulations;

(c) To ascertain whether the provisions of the Act and the Regulations are being complied with.

4.2 Notice Before Investigation

4.2.1 Before ordering an investigation, the Board shall give not less than 10 days notice to the acquirer, the seller, the target company, the merchant banker, as the case may be.

4.2.2 Notwithstanding anything contained where the Board is satisfied that in the interest of the investors no such notice should be given, it may, by an order in writing direct that such investigation be taken up without such notice.

4.2.3 During the course of an investigation, the acquirer, the seller, the target company, the merchant banker, against whom the investigation is being carried out, shall be bound to discharge his obligation.

4.3 Obligations on Investigation by the Board

4.3.1 It shall be the duty of the acquirer, the seller, the target company, the merchant banker whose affairs are being investigated, and of every director, officer and employee thereof, to produce to the investigating officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to his activities as the investigating officer may require, within such reasonable period as the investigating officer may specify.

4.3.2 The acquirer, the seller, the target company, the merchant banker and the persons being investigated shall allow the investigating officer to have reasonable access to the premises occupied by him or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the acquirer, the seller, the target company, the merchant banker or such other person, and also provide copies of documents or other materials which, in the opinion of the investigating officer, are relevant for the purposes of the investigation.

4.3.3 The investigating officer, in the course of investigation, shall be entitled to examine or to record the statements of any director, officer or employee of the acquirer, the seller, the target company, the merchant banker.

4.3.4 It shall be the duty of every director, officer or employee of the acquirer, the seller, the target company, the merchant banker to give to the investigating officer all assistance in connection with the investigation, which the investigating officer may reasonably require.

4.4 Submission of Report to the Board

The investigating officer shall, as soon as possible, on completion of the investigation, submit a report to the Board: Provided that if directed to do so by the Board, he may submit interim reports.

4.5 Communication of Findings

4.5.1 The Board shall, after consideration of the investigation report referred to in Regulation 41, communicate the findings of the investigating officer to the acquirer, the seller, the target company, the merchant banker, as the case may be, and give him an opportunity of being heard.

4.5.2 On receipt of the reply, if any, from the acquirer, the seller, the target company, the merchant banker, as the case may be, the Board may call upon him to take such measures as the Board may deem fit in the interest of the securities market and for due compliance with the provisions of the Act and the Regulations.

4.6 Appointment of Auditor

Notwithstanding anything contained in this Regulation, the Board may appoint a qualified auditor to investigate into the books of account or the affairs of the person concerned.

4.7 Directions by the Board

The board may, in the interest of securities market or for protection of interest of investors, issue such directions as it deems fit, including:

(a) Directing appointment of a merchant banker for the purpose of causing disinvestment of shares acquired in breach of regulations, either through public auction or market mechanism, in its entirety or in small lots or through offer for sale;

(b) Directing transfer of any proceeds or securities to the investors protection fund of a recognised stock exchange;
(c) Directing the target company or depository to cancel the shares where an acquisition of shares pursuant to an allotment is in breach of regulations;
(d) Directing the target company or the depository not to give effect to transfer, or further freeze the transfer of any such shares, and not to permit the acquirer or any nominee or any proxy of the acquirer to exercise any voting or other rights attached to such shares acquired in violation of the regulations;
(e) Debarring any person concerned from accessing the capital market or dealing in securities for such period as may be determined by the Board;
(f) Directing the person concerned to make public offer to the shareholders of the target company to acquire such number of shares at such offer price as determined by the Board;
(g) Directing disinvestment of such shares as are in excess of the percentage of the shareholding or voting rights specified for disclosure requirement under the regulations;
(h) Directing the person concerned not to dispose of assets of the target company contrary to the undertaking given in the letter of offer;
(i) Directing the person concerned, who has failed to make a public offer or delayed the making of a public offer in terms of these Regulations, to pay to the shareholders, whose shares have been accepted in the public offer made after the delay, the consideration amount along with interest at the rate not less than the applicable rate of interest payable by banks on fixed deposits.

4.8 Penalties for Non-compliance

4.8.1 Any person violating any provisions of the Regulations shall be liable for action in terms of the Regulations and the Act.

4.8.2 If the acquirer, or any person acting in concert with him, fails to carry out the obligations under the Regulations, the entire or part of the sum in the escrow amount shall be liable to be forfeited and the acquirer or such a person shall also be liable for action in terms of the Regulations and the Act.

4.8.3 The Board of Directors of the target company failing to carry out the obligations under the Regulations shall be liable for action in terms of the Regulations and the Act.

4.8.4 The Board may, for failure to carry out the requirements of the Regulations by an intermediary, initiate action for suspension or cancellation of registration of an intermediary holding a certificate of registration under Section 12 of the Act. Provided that no such certificate of registration shall be suspended or cancelled unless the procedure specified in the Regulations applicable to such intermediary is complied with.

4.8.5 For any mis-statement to the shareholders, or for concealment of material information required to be disclosed to the shareholders, the acquirers or the directors, where the acquirer is a body corporate, the directors of the target company, the merchant banker to the public offer and the merchant banker engaged by the target company for independent advice would be liable for action in terms of the Regulations and the Act.

4.8.6 The penalties referred to in sub-regulation (1) to (5) may include:
(a) Criminal prosecution under Section 24 of the Act;
(b) Monetary penalties under Section 15H of the Act;
(c) Directions under the provisions of Section 11B of the Act;
(d) Directions under Section 11(4) of the Act;
(e) Cease and desist order in proceedings under Section 11D of the Act;
(f) Adjudication proceedings under Section 15HB of the Act.

4.9 Appeal to the Securities Appellate Tribunal

Any person aggrieved by an order of the Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, (i.e., after 16th December 1999), under these regulations may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter.

SUMMARY

The policy and regulatory framework governing the M&As gradually evolved in the 1990s. In 1992, the government created SEBI, with powers vested in it to regulate the Indian capital market and to protect investors' interests. SEBI also took over the functions of the Office of the Controller of Capital Issues (CCI). In November 1994, with a view to regulate takeovers, SEBI promulgated the Substantial Acquisitions of Shares and Takeover (SAST) Regulations Act. The revised SAST Regulation 1997 was amended in 2002, 2004, 2006 and 2008. The main objective of the regulations governing takeovers was to provide greater transparency in the acquisition of shares and the takeover of ownership and control of companies through a system based on disclosure of information. The Competition Act 2002 seeks to prohibit anti-competitive agreements, abuse of dominant positions, and regulate mergers and acquisitions. The salient features of the Substantial Acquisition of Shares and Takeover Regulation Act include the requirements of disclosure of shareholding and control in a listed company. The Act also deals with substantial acquisition of shares or voting rights, and acquisition of control over a listed company. The Act also includes the general obligation of the acquirer, the Board of Directors, and the merchant bankers. The Act also deals with provisions of bail out takeovers and investigations taken by the Board.

DISCUSSION QUESTIONS

1. What is the significance of DIP guidelines?
2. Discuss the significance of the Competition Act.
3. What are the provisions of disclosures of shareholding and control in a listed company under the SEBI Act?
4. What are the requirements for acquisition of five per cent or more shares of a company?
5. Discuss the Regulation with respect to offer price.
6. Discuss the general obligations of the acquirer, Board of Directors and the merchant bankers.
7. What are the salient features of the Regulation with respect to bail out takeovers?

ADDITIONAL REFERENCES

1. Aloka Majmudar, M&A, Playing by the Rules of the Game, Business India, November 13-26, 2000
2. Nandita Dasgupta, Corporate Governance Structure, 'Mergers and Takeovers in India in the Post Liberalisation regime—Proposals and Policies', Working Paper
3. Nagesh Kumar, 'Multinational Enterprises and M&As in India: Patterns and Implications', Economic and Political Weekly, August 2000, Vol 35, No. 32, pp: 2852-58
4. Manish Agarwal, Aditya Bhattacharyjea, 'Are Merger Regulations Diluting Parliamentary Intent', Economic & Political Weekly, June 28, 2008, Page 10-13
5. Vinu Lala & R Subramanyam, M&A Deals Do Not Need FIPB Okay', The Economic Times, Friday, October 08, 2004

APPENDIX

Format for Filing the Information with SEs by Acquirer as Required u/r 3(3)

Name of the Target Company (T.C)				
Name of acquirer(s) alongwith PAC {Referred together as 'acquirers' hereinafter}				
Share holding / voting rights of acquirer(s) in T.C	Before the said Acquisition		Proposed after the said Acquisition	
	No. of Shares	% (Shares/ Voting Rights)	No of shares	% (Shares/ Voting Rights)
Type of acquisition (By way of public/rights/preferential allotment/*inter-se*-transfer). Please specify				
In case, the acquisition is by way of *inter-se* transfer as per the regulations, disclose names of transferers or send their shareholding in T.C before transfer				
No and % of shares / voting rights of T.C proposed to be acquired through the acquisition				
Acquisition price per share				
Date of proposed acquisition				

Legal Aspects of M&A

The words 'mergers' (M), 'amalgamation' (A), 'demergers' (D) are not defined in the Companies Act, 1956. The words used in the Companies Act are '*compromise and arrangements*'. These words 'MAD' are therefore to be understood in the general context and from judicial pronouncements.

Amalgamation and *Demergers* are defined in the Income Tax Act 1961 in Sections 2(1B) and 2(19 AA). But these definitions are for the purposes of the Income Tax Act.

Mergers, amalgamation and demergers of companies under the Companies Act 1956 are governed by Sections 391 to 394 of the Act.

S. 391. Power to compromise or make arrangements with creditors and members.
S. 392. Power of High Court to enforce comprises and arrangements.
S. 393. Information as to compromises or arrangements with creditors and members.
S. 394. Provisions for facilitating reconstruction and amalgamation of companies.

The operative sections: Sec 391(1)(a)/(b), 391(2), 394(1) and 394(2) are analysed separately in detail. The remaining sections and sub-sections are mainly procedural to these operative sections: Sec 391(3) states that Court order shall have no effect until a certified copy is filed with the Registrar; Sec 391(4) requires every order of the Court to amend to every copy of the Memorandum of the company issued after the order; see 391(5) states penal provisions for default; Sec 391(6) is an enabling clause; Sec 391(7) is for appeals against the order. Sec 392 gives power to the High Court to enforce compromises and arrangements; Sec 393 covers the procedures to be followed and the manner in which information is to be given to the members and creditors. Although procedural, it is an important section as a faulty procedure, or lack of information, or incorrect information can be fatal to the sanction of the scheme; Sec 394(3) requires the order to be filed within 30 (thirty) days with the Registrar, and defines penal provisions for non-compliance.

Operative Sections

S. 391. Power to compromise or make arrangements with creditors and members.

1. Where a compromise or arrangement is proposed:
   (a) Between a company and its creditors, or any class of them; or
   (b) Between a company and its members, or any class of them;
   the 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.
2. If a majority in number representing three-fourths in value of the creditors, or class of creditors, or members, or class of members, as the case may be, present and voting either in person or, where proxies are allowed [under the rules made under Section 643], by proxy, at the meeting, agree to any comprise or arrangement, the compromise or arrangement shall, if sanctioned by the Court, be binding on all the creditors, all the creditors of the class, all the members, or all the members of the class, as the case may be, and also on the company, or in the case of a company which is being wound up, on the liquidator and contributories of the company.
   [Provided that no order sanctioning any compromise or arrangement shall be made by the Court unless the Court 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 auditor's report on the accounts of the company, the pendency of any investigation proceedings in relation to the company under Sections 235 to 251, and the like.]

The following may be noted:

- There should be a '*compromise or arrangement*' which is proposed. A scheme that contains no compromise or no arrangement and is in the nature of winding up cannot be considered.
- The compromise can be with all creditors/members or any class of them.
- The application can be made by the company, or any creditor, or any member, or the liquidator, or any class of them.
- Three-fourth majority of classes of creditors and classes of members have to approve. This is an area where considerable judicial intervention has taken place. Each class of creditors (e.g. secured, unsecured, etc.) and each class of member (equity, preference, etc.) are required to meet separately and three-fourth of each class have to approve the scheme.

  The issues that arise are:
  - How are the separate classes determined?
  - If a class opposes the scheme, can it still be sanctioned?
  - Even if a class approves the scheme, can the objection of a dissenting creditor/shareholder still be considered, or is it binding on all?
  - Are three-fourth majority of all class of creditors or members required to approve, or three-fourth of those 'present and voting'?
  - Court is satisfied that full disclosure of 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 pending of any investigation proceedings has been made.

The following issues arise:

- What are the material facts referred to?
- To what extent is the disclosure is to be made?

S. 394. Provisions for facilitating reconstruction and amalgamation of companies.

1. Where an application is made to the Court under Section 391 for the sanctioning of a compromise or arrangement proposed between a company and any such persons as are mentioned in that section, and it is shown to the Court:
   (a) that the compromise or arrangement has been proposed for the purpose of, or in connection with, a scheme for the reconstruction of any company, or companies, or the amalgamation of any two or more companies; and
   (b) that under the scheme, the whole or any part of the undertaking, property or liabilities of any company concerned in the scheme (in this section referred to as a transferor company) is to be transferred to another company (in this section referred to as the transferee company);

   the 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;

   [Provided that no compromise or arrangement proposed for the purposes of, or in connection with, a scheme for the amalgamation of a company, which is being wound up, with any other company or companies, shall be sanctioned by the 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;

   Provided further 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].
2. Where an order under this section provides for the transfer of any property or liabilities, then, by virtue of the order, that property shall be transferred to and vest in, and those liabilities shall be transferred to and become the liabilities of, the transferee company; and in 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.

   The following may be noted:
   - The Court has specific powers on certain matters u/sec 394 (1) (b) (i) to (v).
   - The Court has general powers u/sec 394(1(b)(vi) to cover any matter of relevance to the scheme.

- The Court receives a report from the Regional Director that the affairs of the company are not being constructed in a manner prejudicial to the interest of the company or public interest. The words 'public interest' is of very wide import and would cover even criminal activities of a company.
- Where it is proposed to dissolve the transferor company, an additional report from the Official Liquidator, based on the scrutiny of the books of accounts, is required. (The investigative audit being conducted by a Chartered Accountant).

Other Issues

1. Position of unregistered transferor, successors to shares for making an application u/s 391
   A person whose name is not entered in the register of members does not have right to raise objection to the scheme or apply.
2. Contingent creditors: Whether they are creditor and have a right to objects
   'Creditors,' in this section, would also include a contingent creditor such as the government, sales tax, income tax or other tax liability which has arisen but may not have become final on account of pending appeals.
3. Workers: whether they have a right to object
   Workers are neither creditors nor members.
4. Reduction of capital
   Schemes which provide for reduction of capital do not need a separate court order or proceeding contemplated u/secs 100/101. The reduction can be ordered as part of the compromise or arrangement while sanctioning the scheme u/sec 391/394.
5. Court has wide power
   The Court has wide and discretionary powers and will examine the merits and demerits of the scheme as a reasonable man would do. Even if a scheme is approved by a majority of members and creditors, the courts would examine the scheme to see it is fair, just and reasonable, as is not contrary to any provisions of law and does not violate public policy.
6. S. 393 requires full disclosure along with notice calling for a meeting
   The notice calling for a meeting shall be accompanied by a statement disclosing all material interest of its directors and managing directors. Further, Sec 393(1)(a) requires an explanation of the material interest involved. Therefore, the statement contemplated under this section is quite different from the explanatory statement u/sec 173.
7. Issues of valuation
   The Supreme Court, in Miheer H. Mafatlal v/s Mafatlal Industries Limited (1996) 87 Company Cases 792, held that where Chartered Accountants value shares and they are accepted by the members, the court will not interfere with the valuation. Similar were the views of Supreme Court in Hindustan Lever Employees Union Vs. Hindustan Lever Limited (1995) 83 Company Cases 30 (SC).
   The fact that the Chartered Accountant firm are the auditors of the company, or are linked to the group, has no effect on the valuation and exchange ratio.
8. Creditors' right of objection
   In an arrangement between members, a close reading of Sections 391 to 394, the court has powers to transfer the liabilities to the transferee company. But there are no provisions providing for objections by creditors. Strictly speaking, there is no provision for holding a creditors meeting and a recognition of their votes. However, the court has recognised these interests to overcome these lacunae. It is recognised that creditors have a very significant role to play, as they have to deal with a new management to recover their dues. Union of India Vs. Asia Udyog (P) Ltd. (1974) 44 Com Cases 359 (Del.).

9. Amalgamation of unlisted company with listed company
   Effect on listing agreement:
   Where a unlisted company is amalgamated with a listed company, there is no effect on the listing agreement. The fresh shares issued would, however, be required to be listed in terms of the existing listing agreement.
10. Amalgamation of listed company with an unlisted company
   Where a listed company is amalgamated with an unlisted company, the listing agreement does not survive and will lead to delisting of shares. The unlisted company after merger can, however, apply for listing.
   In case of delisting, the procedure prescribed by the Stock Exchange for delisting is required to be followed separately.
   Shares held by Non-Residents:
   General permission for issue and acquisition of shares after merger, or demerger, or amalgamation of Indian companies under FEMA, 1999.
   Under Reg. 7 of FEMA (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, general permission has been granted to the transferee company or a new company consequent on the merger, or demerger, or amalgamation of Indian companies, subject to the conditions specified in that regulation. Reg. 7 provides as follows:
   Where a scheme of merger or amalgamation of two or more Indian companies, or a reconstruction by way of demerger or otherwise of an Indian company, has been approved by a Court in India, the transferee company or, as the case may be, the new company may issue shares to the shareholders of the transferor company resident outside India, subject to the following conditions, namely:
   (a) the percentage of shareholding of persons resident outside India in the transferee or new company does not exceed the percentage specified in the approval granted by the Central Government or the Reserve Bank, or specified in these Regulations:
   Provided that where the percentage is likely to exceed the percentage specified in the approval or the Regulations, the transferor company, or the transferee, or new company may, after obtaining an approval from the Central Government, apply to the Reserve Bank for its approval under these Regulations;
   (b) the transferor company, or the transferee, or new company shall not engage in agriculture, plantation or real estate business or trading in TDRs; and
   (c) the transferee or the new company files a report within 30 days with the Reserve Bank giving full details of the shares held by persons resident outside India in the transferor and the transferee or the new company, before and after the merger/amalgamation/reconstruction, and also furnishes a confirmation that all the terms and conditions stipulated in the scheme approved by the Court have been complied with.
11. Sales Tax
   The concept of '*appointed date*' and '*effective date*' has been recognised by the SC in Marshall Sons & Co. India Ltd. 223 ITR 809. As per this decision, even though the scheme actually becomes effective from the date of amalgamation, it relates back to the '*appointed date*', as per the scheme of amalgamation.
   The transferor company, during the period of 'appointed date' and 'effective date', operates on account, on behalf and in trust for the transferee company. Suitable provisions are usually seen in every scheme.
   The transactions between the 'transferor company' and 'transferee company', during this period, are an issue which needs consideration. Are the transactions of purchase and sale during this period

cancelled and, accordingly, no liability arises towards purchase tax/sales tax? On a literal interpretation of Marshall Sons case, this could be the case. However, it must be remembered that the Supreme Court, while considering Marshall Sons case, did not address this specific issue. The issue considered was in the context of 'income' during the period, and under the Income Tax Act 1961. Further, under sales tax laws, the sale by agents would be their sale, which is why agents are liable to pay tax as dealers. Therefore, purchase tax/sales tax on cross sales/purchase during this period would attract tax and, in practice, this continues to be the position.

12. Excise Duty

    In an amalgamation, the entire business is taken over, therefore, except for procedural formalities of substituting the name of the amalgamated entity in place of the amalgamating entity, there would be no consequences/implications under excise law on amalgamation. The amalgamated company would have to inform the Excise Department for change in ownership and carry forward of balances in the amalgamating company's register. To this the Excise Department would agree, where it is satisfied that all liabilities, past and present are being taken over by the amalgamated company.

13 Success of Mergers and Acquisitions: Review of Research Studies

Chapter Objectives

The aim is to make the reader understand

- And review major M&A Research Studies
- The major research approaches to analyse value creation in M&A.

INTRODUCTION

An efficient capital market hypothesises that share prices fully and instantaneously reflect all information. Thus, stock prices provide unbiased signals for efficient resource allocation. An *efficient market* is one in which the market price is an unbiased estimate of the true value of the investment. Definitions of market efficiency are also linked with the information available to investors and reflected in price. A strict definition of market efficiency that assumes that all information, public as well as private, is reflected in market price would imply that even investors with precise inside information would be unable to beat the market. Information efficiency examines three questions, (1) What information affects prices? (2) How quickly do prices react to this information? (3) How appropriate is the price adjustment to the information. The question of what information affects prices is a broad one, for any information that affects any aspect of value should also affect prices. This includes firm specific information on future earnings, cash flows and growth prospects; macro economic information on inflation, interest rates and the economy; and industry specific information. Research has extensively chronicled the impact of market reaction to announcement of earnings, dividends, projects, acquisitions, joint ventures, etc. When firms announce restructuring packages that involve changes in every aspect of the firm, from its asset base to its capital structure, the market responds instantaneously by adjusting the price to reflect the changes.

RESEARCH APPROACHES TO M&A PROFITABILITY

Basically there are two main research approaches that deal with M&A profitability. They are:

1. Event Studies

The first method, *event studies*, examines the abnormal returns to shareholders in the period surrounding the announcement of a transaction. The return on stock is the change in share price divided by the closing share price the day before. The *abnormal or excess return* is the raw return less a benchmark of what investors required that day, which typically would be the return on a large market index, or the benchmark return specified by the capital asset pricing model. The analysis involving the difference between return on stock and return on market index is known as *market return method.*

In the market model method, the expected rate of return on security is found using the market model. The model parameters are estimated by regressing daily stock return on market index over the estimation period.

The market model is given by $R_t = \alpha + \beta R_{mt} + \varepsilon_t$, where R_{mt} is the return on Sensex for day t, β measures the sensitivity of the firm to market (this is a measure of risk) and ε_t is a statistical error term, where $\Sigma \varepsilon_t = 0$. Thus, the predicted return for the firm in the event period is the return given by the market model on that day using these estimates. Market model method is the most widely used method since it takes explicit account of both the risk associated with the market and mean returns.

The market's reaction to an event is measured using daily stock return data to compute excess stockholder returns. These excess returns are a measure of the stockholder's return from the new information, which has become available to market. The daily excess return for security is estimated by

$$XR_t = R_t - E(R_t)$$

where t = Day relative to an event

XR_t = Excess return on security for day t

R_t = Actual Return on security for day t

$E(R_t)$ = Predicted or Expected rate of return on security for day t.

Firstly, the *average excess returns* (AAR) for each relative day t are calculated across the securities. *Daily average cumulative excess returns* (CAR) are sums of average excess returns over event time. In other words, CAR is defined as the sum of previous daily average residuals for each trading day. The t statistics are then calculated.

In event time, the day on which an event's announcement appears in the press is designated as 0. Trading days prior to the event's announcement are numbered event days –1, –2, and so on. The event days following the event are numbered +1, +2, and so on. For announcements which occur before the stock market closes, the proper event date t = –1. For events which are announced after the market closes, the proper event day t = 0.

Residual analysis basically tests whether the return to the common stock of individual firm or groups of firms is greater or less than that predicted by general market relationships between return and risk. One problem involved is the choice of reference period for obtaining the parameters to be used in calculating excess returns caused by the events. If the reference period chosen is too long or far removed from the event, then the risk characteristics of the sample firm may have changed in the interval. If the reference period is too short, it may not represent a valid benchmark.

Event studies yield insights about market based returns to target firm shareholders, buyers and the combined entity. The findings of twenty-five empirical studies show that target firm shareholders earn returns that are significantly and materially positive, despite variations in the time period, type of deal (merger or tender offer) and observation period. In short, the M&A transaction delivers a premium return to target firm shareholders. The pattern of findings about market based returns to the buyer firm's shareholders is mixed. About 40% of the roughly 50 studies report negative announcement returns to the buyers and 60% report positive returns. When statistical significance is taken into account, the studies of returns to buyer firm shareholders show an even stronger positive bias: +26% (14 studies) show value destruction (significantly negative returns); 37% (17 studies) show value preservation (insignificantly different from zero); and 46% (23 studies) show value creation (significantly positive returns).

A number of studies have examined the abnormal returns to buyer and target firms, combined by forming a portfolio of the buyer and target firms and examining their weighted average returns (weighted by the relative sizes of the two firms) or absolute dollar value of returns. Almost all of a group of 24 studies on combined returns report positive returns, with 14 of the 24 being significantly positive. These findings suggest that M&A activity does create gains for the investors in the combined buyer and target firms.[1]

Mandelker (1974) examined the market for acquisitions and the impact of mergers on the return to stockholders of the constituent firms. The results were consistent with the hypothesis that the market for acquisitions is perfectly competitive. The study by Asquith et al. (1983) examines the effect of mergers on the wealth of bidding firms' shareholders. Bidding firms gain significantly during the twenty-one days leading to the announcement of each of their first four merger bids. The results fail to support the capitalization hypothesis that bidder's gains are captured at the beginning of the merger programmes. Selden et al. (2003) in their article cite that 70% to 80% of acquisitions fail, meaning they create no wealth for the shareholders of the acquiring company.

In a review of scientific literature on market for corporate control, Jensen and Ruback (1983) indicate that corporate takeovers generate positive gains, that target firm shareholders benefit, and that bidding firm shareholders do not lose. Moeller et al. (2004) examined the announcement returns using a sample of 12,023 acquisitions by public firms during the period 1980-2001. The results of this study show that equally weighted abnormal announcement return is 1.1% but acquiring firm shareholders lose $25.2 million on an average upon announcement. Stegemoller (2001) examines the long-term performance of 542 US firms making five or more public, private or subsidiary acquisitions during the period 1990-1999. The evidence shows that frequent acquirers outperform comparable firms in both accounting and stock return measures. Conn et al. (2004) empirically examine the relative performance effects of single and multiple acquirers, and their results are consistent with diminishing returns effect for successful first acquirers, and with some learning effect for unsuccessful acquirers. Asquith et al. (1983) analyze the abnormal returns for successive merger bids (upto four) of 156 firms that initiated the programmes in the period 1963-1979. The results show that bidder returns remain positive at roughly 2.5% through the fourth bid. Fueller et al. (2002) examine the short-term returns to 539 acquirers that carry out at least five acquisitions over a 3 year period from 1990-2000. The results show that shorter the time period surrounding acquisitions, lower are the acquirer returns. Ettore (2005) studies the performance persistence of 591 bidding firms that completed at least five acquisitions within a five-year interval during the period 1990-2002. The study finds that serial bidders do not show evidence of either superior or inferior performance persistence, nor do they show evidence of predictable performance reversal. Gregory (1997) finds that both single and multiple acquirers experience significantly negative returns.

Table 13.1 *Some Major Studies, Related Hypothesis and Methodology*[2]

(a) Studies in the Period 1974–1982

Study	Hypothesis	Methodology: Expected Return	Explanations
Mandelker G (1974)	*PCAM, ECMH, CLH, GMH	Two factor Market Model	Results signify that market for acquisitions is perfectly competitive

(*Contd*)

* The Perfectly Competitive Acquisitions Market Hypothesis (**PCAM**), The Efficient Capital Market Hypothesis (**ECMH**), The Abnormal Gains Hypothesis (**AGH**), The Growth Maximisation Hypothesis (**GMH**), Collusion Hypothesis **(CH)**

[1]Robert Bruner, 'Where M&A Pays and Where it Strays: A Survey of the Research', Journal of Applied Corporate Finance, Vol 16, Number 4 Fall, 2004, Page 63-76.

[2]B Rajesh Kumar et al, Mergers, Acquisitions and Wealth Creation–A Comparative Study in Indian Context, (2009), (IIMB Management Review, Sep. 2009).

(*Contd*)

Franks (1977)	PCAM, ECMH	Market Model, Market index in combination with Industry indices	Gains on combined shareholdings in acquiring and acquired companies appear to reflect net gains from merging within the industry
Langeteig (1978)	Value creation, ECMH	Employed four alternative two factor Market-Industry Models in combination with a matched non-merging control group; Statistical test, Standardized Excess Return test, Per cent Positive test, Per cent Significant test	The introduction of third factor, the non-merging control groups have substantial impact on performance measurement
P Dodd (1980)	Wealth Creation	Market Model	Swift and large positive market reaction to the first public announcement; positive reaction to approval of completed proposals; negative reaction to cancelled proposals

(b) Studies in the Period 1982-83

Asquith & H Kim (1982)	Value creation, Diversification effect, Incentive effect	Monthly abnormal returns for sample bonds calculated using a paired comparison technique; Monthly stockholder returns–Ibbotson Model.	The results show that while the stockholders of target firms gain from a merger bid, no other security holders either gain or lose
Asquith et al. (1983)	Value creation, Capitalisation effect, Size effect and Time effect	Grouped securities into ten equal control portfolios, ranked according to Scholes William Beta Estimates; Regression Analysis for size, time and capitalisation effect	Bidding firm's abnormal returns are positively related to the relative size of the merger partner
Asquith (1983)	EMCH, Synergy Theory for target firms, Management Inefficiency Hypothesis	Grouped securities into ten equal control portfolios, ranked according to betas	Increase in the probability of merger harm the stockholders of both target and bidding firms; Stock Market forecasts probable merger targets in advance of any merger announcement
Eckbo (1983)	Collusion Hypothesis	Market Model	Antitrust law enforcement agencies systematically select relatively profitable mergers for prosecution. The evidence indicates that the mergers would not have had collusive, anticompetitive effects

(*Contd*)

(*Contd*)

K Schipper & Rex Thompson (1983)	Size maximisation, Share value maximisation	Market Model	Results support the hypothesis that acquisition activity had a favourable ex-ante impact on the value of firms announcing an intention to engage in acquisitions
James & et al. (1983)	Value creation	Market Model Discriminant analysis	The evidence suggests that complex formulas derived from financial variables could have been used successfully in portfolio selection
P Malatesta (1983)	Value Maximisation, Size Maximisation, Improved Management Hypothesis, ECMH	Market Model	The immediate impact of merger per se is positive and highly significant for the acquired and negative for the acquiring firms

(c) Studies in the Period 1986-87

Dennis et al. (1986)	Co-insurance Hypothesis, Redistribution Hypothesis	Market adjusted returns procedure	Acquired companies common stockholders, convertible and non-convertible preferred stockholders, and convertible bondholders gain in merger
P R Allen et al. (1987)	Wealth Maximisation	Mean Adjusted Return	Primary source of value gain is attributed to improved management of the acquired trust assets
Lubatkin (1987)	Value creation	Market Model, Paired difference procedure	Mergers led to permanent gains in stockholder value for both acquirer and target firms
Harbir (1987)	Value creation	Market Model	Related acquisitions are found to have greater total dollar gains than unrelated acquisitions

(d) Studies in the post-1990s period

Franks (1991) Study on Takeovers	ECMH, Size effect	Market Model, Ten Factor Model (Lehman Model), Eight Portfolio Model (Grinbiatt Model)	The traditional single factor benchmark generates significant differences in post-merger performance related to medium of exchange, the relative size of bidder to target and whether or not to bid is contested
Anup et al. (1992)	Long-term performance–Wealth creation; Market is slow to adjust to the merger event	Dimson & Marsh Model, RATS Ibbotson Methodology Regression Analysis for relation between announcement period returns and post-merger returns	Results suggest that neither firm size effect nor beta estimation problems are the cause of negative post-merger returns

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Fueller et al. (2002)	Value creation	Modified Market Model	Results indicate that multiple bidder shareholders gain when buying a private firm or subsidiary but lose when purchasing a public firm
Yuanzhi Luo (2005)	Learning Hypothesis	Probit Regression Model	The market reaction to a M&A announcement predicts whether the companies would later consummate the deal
Sara et al. (2005)	Value creation	Market Model	Acquiring firms lose around acquisition announcements 12 cents per dollar spent on acquisitions

Table 13.2 *Abnormal Returns associated with Mergers and Acquisitions*[3]

(a) Period: 1970-1980

Study	Sample Period	Event Period	Bidding Firm (%)	Target Firm (%)
Mandelker (1974)	1941-1962	Month after through 12 months after the effective date Seven months preceding merger	+0.60*	14**
Franks (1977)	1955-1972	40 months before through 40 months after announcement for acquirer, -40 to +2 months for acquired firms	-0.004	0.179
Langetieg (1978)	1929-1969	Month after through 12 months after effective date	-6.59	12.9
Dodd (1980)	1970-1977	The day before and the day of offer announcements	-1.09	+13.41
Dodd (1980)	1970-77	20 days before through the first public announcement	+0.80	+21.78
Dodd (1980)	1970-77	Ten days before offer announcement through ten days after outcome date	-7.22	+33.96
Pieter (1980)	1957-1975	24 months before through 24 months after announcement	0.097	0.426

*Statistical significance at 10%
**Statistical significance at 5%

[3]B Rajesh Kumar et al, Mergers, Acquisitions and Wealth Creation–A Comparative Study in Indian Context (2009), IIMB Management Review, September 2009.

(b) Period: 1982-83

Study	Sample Period	Event Period	Bidding Firm (%)	Target Firm (%)
Asquith & Kim (1982)	1960-1978	10 days before through 10 days after the public announcement	1.8	14.9
K Schipper (1983)	1960-1967	12 years before to 6 years after announcement of acquisition programmes	15.1	NA
Asquith (1983)	1962-1976	The day before and day of offer announcement	+0.20	+6.20
Eckbo (1983)	1963-1978	The day before through the day after the offer announcement	+0.07	+6.24
Asquith (1983)	1962-1976	19 days before through the first public announcement, 480 days before a merger bid until 240 days after a merger bid, 480 days before a merger bid until outcome day (The day in which the outcome of merger reported in Press)	+0.20 +7.0	+13.30 +8.5*
Eckbo (1983)	1963-1978	20 days before through ten days after public announcement	+1.58	+14.08
Asquith Bruner and Mullins (1987)	1963-1979	20 days before the announcement day through the announcement day	+3.48	+20.5
Malatesta (1983)	1969-1974	Public announcement month	+0.90	+16.8
Asquith (1983)	1962-1976	The day before announcement through outcome date	-0.10	+15.50
Asquith (1983)	1962-1976	Day after through 240 days after outcome announcement	-7.20	-9.60
Malatesta (1983)	1969-1974	Month after through 12 months after approval for entire sample	-2.90	NA
James et al. (1983)	1973-1977	Seven month prior to merger	NA	29.1

*Statistical significance at 10%

(c) Period: 1986-87

Dennis (1986)	1962-1980	19 days before through 20 days after merger announcement	3.40	18.63
Asquith (1987)	1977-1983	40 days before through 40 days after announcement	8.71	NA
Harbir (1987)	1975-1980	5 days before through 25 days after announcement (Related)	-0.006	0.359
Harbir (1987)	1975-1980	5 days before through 25 days after announcement (Unrelated)	-0.019	0.219
Allen et al. (1987)	1977-1983	40 days before through the day of announcement	8	NA

(d) Period: 1990-2005

Franks et al. (1991)	1975-1984	Five days before the first announcement of a bid and ending five days after the last bid.	–1.02	28.04
Cornett (1992)	1982-1987	One day before through the day of announcement	–0.8	8
Anup et al. (1992)	1955-1987	One month to sixty months after merger completion	–10.26	NA
Singal (1996)	1985-1988	One day before through the day of announcement	1.843	18.42
J F Houston et al. (2001)	1985-1991	Four days before through one day after announcement	–3.47	20.80
Y Amihud et al. (2002)	1985-1998	Ten days before through one day after merger announcement	–1.0	NA
Fueller et al. (2002)	1990-2000	Two days before through two days after the announcement date	1.77	NA
Sara et al. (2005)	1998-2001	Acquisitions in two year windows immediately before and immediately after the first large loss deal a firm made	–0.65	NA

Table 13.3 *Cross-Sectional Studies*[4]

Study	Event Period	Model Description	Results
William et al. (2004)	Two day interval from Day 1 to Day 0	The dependent variable of the bidder's actual 2 day CAR based on market model was regressed upon variables that represent the benefits and costs of acquisitions for stock and cash. The independent variables included the variables of personal tax benefit of an acquisition for stock, the net corporate tax benefit of an acquisition for stock, the market to book value ratio of bidder and target equity, the variable of size measured by the market value of target's equity to market value of bidder's equity, percentage of bidder's outstanding shares owned by managers, and finally dummy variables representing the feasibility of an acquisition for cash; same industry sector; target being the first company in its industry to be acquired, bidder making other acquisition attempts	The bidders are concerned about the effect of taxes when they choose the method of payment. Bidders consider the importance of contingent pricing when choosing the method of payment for an acquisition. The hypothesis is that the bidders' managers consider the signalling implications of their choice of payment method. The results do not support the hypothesis that bidders were concerned about the competitive disadvantage of an acquisition for stock.

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[4]B Rajesh Kumar et al., Mergers, Acquisitions and Wealth Creation–A Comparative Study in Indian Context 2009, IIMB Management Review, September 2009.

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Mark Walker (2000)	Interval of -2 days to +2 days relative to the takeover announcement	The cumulative market adjusted return (CMAR) was regressed upon independent variables that included the relative size of transaction (size) and dummy variables that control for the method of payment (cash or stock), mode of acquisition (tender offer), industry relatedness, multiple bidders and strategic objectives	The results support the asymmetric information and strategic alignment hypotheses. Changes in shareholder wealth are related positively to cash offers, relative transaction size and two strategic objectives–expanding geographically and increasing market share.
Lang et al. (1991)	Five day before the tender offer announcement to five days after the final revision by the bidder	The cumulative abnormal return was regressed upon variables of cash flow, leverage, size (ratio of target to bidder size), liquid assets and dummy variable for Tobin q, for values greater than 1	The results support free cash flow hypothesis. The effect of free cash flow on bidder's returns explains a larger fraction of the cross-sectional variation in returns than the nature of the control contest.
Henri Servaes (1991)	From announcement date of takeover until the effective date or the delisting date, whichever comes first	The weighted average of target and bidder returns were regressed upon dummy variables indicating target and acquirer q ratio, cash payment, multiple bidder, hostile takeover and relative size measured by the ratio of the market value of target and bidder	Overall the evidence indicates that the magnitude of the target firm's q ratio is an important determinant of takeover gains.
Travlos (1987)	One day before to the day of takeover announcement	The two day average standardised cumulative abnormal return is regressed on the variables which represent the proportion of the transaction funded through common stock, the bid premium as a percentage of the bidding firm's stock price one month prior to the first announcement of the bid, relative size of target and acquirer	The findings indicate that the only significant variable is the proportion of the acquisition financed through an exchange of stock. The results suggest that the announcement period abnormal returns to bidding firms reflect information effects associated with the method of payment used to finance acquisitions.
Asquith et al. (1983)	Twenty-one days prior to and including the announcement day	The cumulative abnormal return for bidding firms were regressed on the log of merger size, time period, success of the merger bid and merger number	The log of size, the time period and the success of the merger are all statistically significant variables in explaining excess returns for bidding firms. Most of the information about first merger reaches the market during the first announcement day.

2. Financial Performance Studies of M&A

The accounting studies examine the reported financial results of acquirers before and after the acquisition to see how financial performance changes. The focus of these studies is on variables, such as net income, return on equity or assets, EPS, leverage or liquidity. These studies are structured as matched sample comparisons in which acquirers' performance is set against that of non-acquirers of similar size that operate in the same industry.

Out of a group of 15 M&A studies on profit margins, growth rates and return on assets, capital and equity two reported significantly negative post acquisition performance, four reported significantly positive performance and the rest showed insignificant results. An early collection of studies of M&A profitability in seven countries concluded that mergers have 'modest effects' on firm profitability in three to five years after the merger[5]. A 1987 study of 471 acquirers between 1950 and 1977 by Ravenscraft concluded that the buyer's profitability was one to two percentage points lower than that for a group of control firms.[6] Another group of five studies found that the performance of buyers is not much different from that of non-buyers.[7] B Lev and G Mandelker (1970) examined the profitability of mergers along such aspects as risk, growth, capital structure, income tax savings, earnings per share, etc. The conclusion drawn is that the long-run profitability of acquiring firms is probably somewhat higher than that of comparable non-merging firms. Krishna Palepu (1985) finds that there is no significant cross-sectional difference between, 1) the profitability of firms with predominantly related and unrelated diversification, and 2) profitability of firms with high and low total diversification. Moreover, the study finds that the superior profitability growth of related diversifiers is significantly greater than that of unrelated diversifiers. Herman and Lowenstein (1988) examined the post-merger performance of a sample of hostile acquisitions between 1975 and 1983. The study by Paul M Healy and Krishna G Palepu (1992) examines the post-merger cash flow performance of acquiring and target firms, and explores the sources of merger induced changes in cash flow performance based on 50 largest US mergers between 1979 and mid 1984. The study finds that merged firms show significant improvements in asset productivity relative to their industries, leading to higher operating cash flow returns. These improvements were particularly strong for transactions involving firms in overlapping business. The study further suggests that post-merger cash flow improvements do not come at the expense of long-term performance since sample firms maintain their capital expenditure and R&D rates relative to their industries after the merger. The study also finds strong positive relation between post-merger increases in operating cash flows and abnormal stock returns at merger announcements, indicating that expectations of economic improvements explain a significant portion of the equity revaluation of the merging firms.[8] Cornett and Tehranian (1992) examine the post-acquisition performance of large bank mergers between 1982 and 1987. The results of their study indicate better performance for merged banks due to the improvements in their ability to attract loans and deposits, in employee productivity and in profitable asset growth. Further, the study finds a significant correlation between announcements period abnormal return and the various performance measures, indicating that the market participants are able to identify in advance the improved performance associated with bank acquisitions. Switzer (1996) examined the change in operating performance of merged firms using a sample of 324 combinations, which occurred between 1967 and 1987. The results indicated that the performance of the merged companies following their combinations and also the results are not sensitive to factors such as offer size, industry relatedness between the bidder's and target's businesses or bidder's leverage. The study also found positive association between the abnormal revaluation of the firms involved around the merger and changes in operating performance observed. The study by Healy et al. (1997) finds that strategic takeovers which are generally friendly transactions involving stock and firms in overlapping business are more profitable than financial deals which are usually hostile transactions involving cash and firms in unrelated business. The results of this study also show that the acquiring companies did not generate any additional cash flows beyond those needed to recover the premium paid.

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[5]D Mueller, 'The Determinants and Effects of Mergers: An International Comparison', Cambridge, Oeleschlager, Gunn & Hain, 1980.

[6]D Ravenscraft and F M Scherer, 'Life After Takeovers', Journal of Industrial Economics, Vol 36 (1987), pp 147-156.

[7]Robert Bruner, 'Where M&A Pays and Where it Strays: A Survey of the Research', Journal of Applied Corporate Finance, Vol 16, Number 4, Fall 2004.

[8]P Healy, K Palepu and R Ruback, 'Does Corporate Performance Improve After Mergers', Journal of Financial Economics, Vol 31 1992, pp 135-175.

Hogarty (1970) finds that the investment performance of heavily merging firms is generally worse than the average investment performance of firms in their respective industries. Aloke Ghosh (2001) compares the post- and pre-acquisition performance of merging firms relative to matched firms to determine whether operating cash flow performance improves following acquisition. The result finds no evidence of improvement of operating performance following acquisitions. Moreover, the study also indicates that cash flows increase significantly following acquisitions that are made with cash, but decline for stock acquisitions. Rovit and Lemire (2003) examine the performance (actual return minus cost of equity) of 742 large US companies that made 7,475 acquisitions between 1986 and 2001. They find that acquirers carrying out more than 20 deals in 15 years outperformed firms that had made1-4 deals by a factor of 1.7 and non-buyers by a factor of 2.

INDIAN STUDIES ON OPERATING PERFORMANCE OF M&A

The study by Pawaskar (2001) compares the pre- and post-merger operating performance of Indian companies involved in merger by identifying their financial characteristics. With a sample of 36 cases of mergers between 1992 and 1995, the study finds that the mergers seem to lead to financial synergies and a one time growth.

The study by Rajesh et al.[9] (2007) examine the post-merger operating performance of merged firms using a sample of 57 large mergers in the period 1995-2002. The pre- and post-acquisition operating cash flow performance of merging firms relative to matched firms are compared to determine whether operating performance improves following mergers. Merging firms are matched on the basis of pre-acquisition performance and size. Three alternate methodologies were utilised for the study in which cash flow was deflated by market value of assets, book value of assets and the sales value. The results based on book value of assets and sales model provide some evidence to suggest that corporate performance improves after mergers. The model based on market value of assets doesn't support the hypothesis that operating performance improves after mergers.

Studies Based on Predictive Models

Early financial ratio studies (Altman, 1968; Beaver, 1967) examined the ability of financial ratios to identify financially distressed firms. Although not directly related to M&A activity, these studies laid the foundation for choosing specific variables to represent the characteristics of firms and established the relationships of financial ratios to underlying dimensions, such as liquidity, profitability, and size. Several researchers have attempted to build models to predict M&A. A summary of some of the significant studies showing the variables chosen and dimensions represented is presented in Table 13.4.

The general conclusion of studies based on the US and UK data covering the 1950's and early 1960's is that acquired firms tend to be relatively unprofitable, overly liquid, and generally sluggish (Singh, 1975, Kuehn, 1969, Hayes and Taussig, 1967 and Hindley, 1970). The studies by Monroe and Simkowitz (1971) and Stevens (1973), covering the mergers in mid and late 1960s, consider the relevance of multiple motives for mergers, and focus on the financial attributes of acquired firms. Monroe and Simkowitz also conclude that acquired firms relative to non-acquired firms are smaller, have lower price earning ratios, lower dividend payout, and lower growth in equity. Steven uses discriminant analysis to study the acquired firms and reports that they tend to have more liquidity and use less debt as compared to non-acquired entities. The study used data for 80 firms to look into the merger decision. In contrast to Monroe and Simkowitz's study, Steven finds that neither dividend payout nor price earning ratios are significant variables. Steven's choice of research design (matching acquired and non-acquired firms by size) prevents him from addressing the question of whether or not size plays a crucial role. A number of researchers focused on the data from the next major merger period — the 1970s and the 1980s. Levine and Aaronovitch (1981) suggest that the important factors considered while selecting a potential target are the relative ease with which they can be purchased coupled with the potential to perform well. The study by Harris, et al. (1982) examined two classes of variables — financial and product—to capture the characteristics that have been associated with the likelihood of a firm being acquired in the time period 1974-1977. The study, which was based on fixed coefficient probit specification, indicates that size and financial variables have statistical significance while product market variables, like industry concentration and advertising intensity, have very little explanatory power. The study reports that firms with lower price-earnings ratio and smaller size are more likely to be acquired.

Wansley (1984) found that target companies, during the period 1975-1976, used less leverage and had higher growth than other companies. Wansley's study examined different linear discriminant models used in merger studies to determine whether the selection of variables differs according to the type of model used. His study showed that the results of past research using MDA may have been sample-sensitive; it provided a sound basis for using a large sample and logit and probit analyses when the dependent variable is binary. Dietrich and Sorensen (1984) overcame some of the criticisms of prior merger research by utilising logit analysis and confining their study to four industries. The study found that the probability of a company becoming an acquisition target increases when the company has a low asset turnover, low payout ratio, low trading volume and low leverage. The sample period was 1969-1973. Palepu (1986) employed logit analysis to investigate the usefulness of six acquisition hypotheses in predicting takeover target and found clear support for size hypothesis. The six dimensions were inefficient management, growth-resource imbalance, industry disturbance, firm size, asset under-valuation and price-earnings ratio. The key features of the Palepu study — multiple ratios and industries — create an excellent testing ground for exploring the importance of the ratio distribution issue.

Palepu found that target companies, in the 1971-1979 period, were characterized by low growth and low leverage. His work is considered pivotal to binary prediction model. Pastens (1986) studied the decision to merge as an alternative to bankruptcy, and used probit analysis to test the importance of three variables of revenues, financial leverage and the magnitude of tax carry-forwards in explaining the merger/bankruptcy decision. The results showed size and leverage as important variables because larger firms with lower financial leverage tended to opt for merger to avoid bankruptcy.

The paper by Ambrose and Megginson (1992) extends the Palepu (1986) acquisition model by incorporating measures of insider and institutional shareholdings, by examining the deterrent effect of various takeover defences, and by considering the effect of varying proportions of fixed (tangible) assets in a firm's total asset structure. The results suggest that the probability of receiving a takeover bid is positively related to tangible assets and negatively related to firm size and net change in institutional holdings.

Trahan and Shawky's (1992) was the first attempt to investigate the characteristics of acquiring firms on an industry-specific basis using logit probability model. Their results suggest that acquiring firms possess some characteristics that are different from non-acquiring firms. They vary across industries, and better fitting models are obtained when they are estimated on an industry specific basis. This study finds that the utilisation of unused debt capacity appears to be an acquisition motive for firms in the petroleum refining and chemical industries. The results are consistent with the argument that firms in the petroleum industry were generating free cash flows that were funneled into value reducing investments in exploration and development. Berkovitch and Narayanan's (1993) study reports that synergy is the primary motive in takeovers with positive total gains, and agency is the primary motive in takeovers with negative total gains.

Meador, Church and Rayburn (1996) use logit binary regression for determining the factors which predict merger and acquisition target companies for the total sample, and for the horizontal and vertical subsamples of merged firms. The model for horizontal acquisitions showed the strongest predictive ability with variables, such as long-term debt/total assets, long-term debt/market value, market value/book value and asset growth and sales growth showing significance.

Barnes (1990) examined the use of MDA and related techniques from the perspective of predictive ability. He advocates the use of industry relative ratios by means of some UK data, and gives a reasonably high prediction rate. Zanakis and Zopounidis (1997) reported only modest success in identifying the characteristics of Greek target companies between 1983 and 1990, but found that leverage was a factor. Powell (1997) used multivariate logit model to examine acquisition targets in both hostile and friendly takeovers.

Using logit regression, Owen (1995) analyses the characteristics of both acquired and acquiring firms, and finds that acquired companies are young companies with potential for future. His study finds that the P/E ratio of target firms is higher than might be expected, indicating that the stock market has positive expectation about these firms.

The paper by Barnes (1998) examines the methodological issues of using accounting ratios to predict takeover targets in the UK. The results suggest the use of industry-relative ratios and determination of an ex ante cut-off point which maximises returns.

Based on the study of some acquirer, target and non-merging firms, Sorensen (2000) found that financial ratios are much less useful for predicting companies that merge.

The study, however, reports that acquiring firms are more profitable than target and non-merging firms. The findings of this study support the view that modern mergers are primarily motivated by companies with above average margins seeking profit improvement by rapid expansion of sales.

The study by Cudd and Duggal (2000) replicates the Palepu study and explores the importance of capturing industry-specific distributional characteristics in analyses based on financial ratios. After adjustment for industry-specific distributional characteristics, the results were consistent with four acquisition hypotheses, namely, size, inefficient management, growth resources mismatch, and industry disturbance hypothesis.

On the basis of different studies, it can be concluded that liquidity, leverage and growth were useful identifiers of target companies in the 1960s, financial leverage was the most important identifier in the 1970s and the 1980s, and profitability was an overall significant identifier in the 1990s.

Table 13.4 *Summary of Significant Studies based on Predictive Models*

Research	Statistical Techniques	TRN	LIQ	PR	SZ	LEV	ACT	GR	PE	SM	MV	DP	IND
Simkowitz and Monroe (1971)	MDA				*			*	*			*	
Stevens (1973)	Factor Analysis and MDA		*	*		*	*						
Harris (1982)[a]	Probit				*	*			*				
Wansley (1984)	MDA				*	*	*	*	*				
Dietrich and Sorenson (1984)	Logit	*				*				*	*	*	

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Palepu (1986)	Logit			*	*	*		*					*
Pastena and Ruland (1986)	Probit				*	*							
Megginson (1992)[b]	Logit				*								
**Trahan (1992)[c]	Logit				*		*					*	
Anna Lee (1996)	Logit					*							
Cudd and Duggal (2000)	Logit			*	*		*	*					*
Sorenson (2000)	Logit			*									

*Significance at 1-10%
**Statistical significance at 5%
a- Harris also used product market characteristics.
b- Study included ownership variables.
c- Study on characteristics of acquirer firms on industry-specific approach.
MDA-Multiple Discriminant Analysis LEV–Leverage SM–Stock Market Characteristics
TRN-Turnover ACT- Activity MV-Market Value/Book Value
LIQ-Liquidity GR-Growth DP-Dividend Policy
PR-Profitability PE-Price/Earning Ratio IND-Industry Dummy

Indian Studies Based on Predictive Models

P K Panigrahi (2004) proposes an artificial neural network for predicting domestic corporate mergers and acquisitions. The work discusses the explanatory and predictive capabilities of the artificial neural network, and compares them with the traditional methods of looking at Indian corporate M&As.

A study[9] in 2007 focuses on the characteristics that make a firm an acquirer, and on identifying those characteristics of a firm, which will have a significant impact on the probability that firm will be acquired. The ratios involved in the study were reflective of the financial and product market characteristics. The sample firms, consisting of 227 acquirer and 215 target firms represented the mergers during the period 1993-2004. Logit regression was used to examine the likelihood that a given firm would be the target of an acquisition attempt. The size of the target firms was much smaller as compared to the acquirer firms. The acquirer firms had higher cash flows, higher PE ratios, higher book value, higher liquid assets, and lower debt to total assets

[9]B Rajesh Kumar et al., Characteristics of Merging Firms in India : An Empirical Examination, Vikalpa, Vol 32, No 1, Jan-March 2007, Page 22-44.

ratio, which were statistically significant when compared to the target firms. Some evidence points out higher leverage for the target firms, especially for measures of market leverage. The lesser the liquidity position, greater the probability of a firm becoming a target. The larger firms are less likely to become acquisition targets. Logit coefficients were consistent with the size hypothesis and inefficient management hypothesis.

Another study[10] in 2007 analyses the financial characteristics of firms that engage in multiple mergers. In this context, multiple mergers are defined as mergers in which acquiring firms have engaged in three or more mergers. The study attempts to determine the characteristics of the acquiring firms, and observe whether multiple merger firms showed superior corporate performance as compared to a matched control group. The results show that for acquirer firms, which had undergone multiple mergers, the average sales, profit and cash flows for a period of ten years were higher as compared to a control group matched by industry and size. The mean of the average of the sales of control firms was only 40.5% of the sales average for the merger firms. Also, the multiple merger firms' mean of profits was about 200% higher than that of control firms. The study also finds evidence consistent with the market power and size hypotheses of merger theories. The negative relationship of LTD/TA may be interpreted to indicate that firms generating free cash flow and having low debt levels have a tendency to incur agency costs by investing cash flows in acquisitions. The negative relationship between solvency and interest coverage ratio, found by the study, suggests that firms with the capacity to increase debt, or service debt, are more likely to engage in multiple mergers. The higher the stock market performance of the firms, the higher is their probability of involving in multiple mergers. Also, the higher the ratio of sales to assets, the lower is the probability of acquisition. In other words, an important factor affecting the firm's probability of going for multiple mergers is the inability of the incumbent management to generate more sales per unit of assets. The results of regression also indicate that the main shareholder power variable is negatively related to the probability of multiple mergers. The results indicate that low financial leverage and unused debt capacity would be a motive for firms to use multiple mergers as a strategic business tool. Thus, a firm's capital structure appears as an especially important variable in the decision to go in for multiple mergers.

Table 13.5 *Selected Studies from the Business Consulting Literature on Mergers and Post-Merger Integration*[11]

Sponsor	Selected Results	Sample Methods, Comparison Group
KPMG 2001	82% considered successful in executive survey. 30% added value, 39% no change, 31% lowered value. A focus on synergy attainment increased chances of success by 28% relative to the average deal	Survey of executives for 118 companies doing 700 cross-border deals from 1997-1999. Compares equity price trends relative to industry trend just before, and one year after the deal.
KPMG 1999	75% considered successful in executive survey. 17% add value, 30% no change, 53% reduce value.	107 companies surveyed for 1996-1997 cross border deals. Same comparison as above. Basis of certain percentage comparisons are not always fully explained.

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[10]B Rajesh Kumar et al., Analytical Study on Multiple Mergers in India, IIMB Management Review, Vol 19, No 1, March 2007 .

[11]Paul A. Pautler, 'The Effects of Mergers and Post-Merger Integration: A Review of Business Consulting Literature', Bureau of Economics Federal Trade Commission, January 21, 2003 version, Working Paper.

(*Contd*)

	Firms that focused on choosing a strong deal management team and performed in-depth integration planning did 66% better than average. 45% pursuing synergies vigorously and communicating well-improved performance. A focus on cultural issues improved the chances of success by 26%. Early action was a key for successful firms.	
Booz-Allen & Hamilton 2001	53% of the deals do not meet expectations 47% of the deals fail to attain the objectives stated in the merger announcement; 55% of same-industry deals met expectations, only 32% of cross-industry deals met expectations. 42% of CEOs of disappointing mergers were gone within 2 years as against 16% for successful CEOs.	Methods not fully described.
Business Week/ Mercer 1995, Sirower BCG 2002	Mercer Mgt 1995 results: 27% increase value, 33% no change, 50% reduce value. Non-acquirers outperformed acquirers, and experienced acquirer's outperformed tyros. Sirower/BCG 2002 results: 61% reduce shareholder value one year later, on an average, buyers do 4% worse that industry peers and 9% worse than S&P500. The study examined 302 large, 1995-2001, deals.	Reviews 150 large, 1990-1995, deals. Share value three months before versus three months after compared to S&P500. Results regarding types of deals that work best are inconsistently reported. Some comparisons to non-acquiring firms.
Mercer Consulting 2001	Over half of trans-Atlantic mergers work. Managers of successful deals credit acquirer and target complementarities, especially careful planning, and speedy, well-directed implementation.	152 trans-Atlantic deals from 1994 to 1999 using 2-year post deal comparison to industry specific S&P stock price index.
McKinsey 2000, 2001	65%-70% of deals fail to enhance shareholder value; 36% target firms maintained revenue growth in 1st post-merger quarter, only 11% by 3rd quarter; revenue growth 12% below industry peers, 40% of mergers fail to capture cost synergies. In a related study, 42% of acquiring firms had lower growth than industry rivals for 3 years following the merger.	193 deals from 1990 to 1997. Industry-specific benchmarks are used. Earlier, related study examined 160 deals by firms in 11 sectors in 1995-1996.
Price Waterhouse Coopers 2000	Acquirer's stock 3.7% lower a year after a deal relative to peer group stock changes. 39% of firms reached their cost-cutting goals, while 60-70% achieved their market penetration goals. Success rates were uniformly higher if the firm moved early and quickly with transition teams, communications, and integration. Vast majority (79%) of executives regretted not moving faster in integration.	Survey of executives in 125 companies across a broad range of industries in 1999; 72% of firms were US-based.

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Accenture 2000, 2001	39% fully achieved their anticipated gains from alliances in the oil industry. In the finance industry, the best deals improved revenues by 14%-19%, and shareholder value 65% above industry share values.	Oil industry and financial industry focus. Financial study reviews 72 deals from the 1990s.
A.T. Kearney 1999	58% of deals reduced shareholder value. Top performing deals were done in closely related businesses and had a higher percentage of assets in the firm's core areas. 74% of successful deals were run by managers with deep merger experience.	115 large, 1993-1996, deals; total shareholder returns 3 months before versus two years after the deal. No explicit non-merger comparison group – comparisons made to average or quartiles in the sample.
CSC Index Genesis 1997	Slightly more than 50% beat the benchmark, with a wide variance in post-deal performance.	71 large deals from 1989 to 1993 compared to peer group market value change from one year before to two years after the deals.
MAPI 1999	54% successful, 24% little change, 11% failures.	Survey of 80 senior executives; criteria for success unclear.
Boston Consulting Group 2000, 2001	Doubling of asset size for financial firms leads to 20% reduction in unit cost of servicing accounts. For industrial firms, savings of 10-15% in materials and components are common as a result of scale gains.	Based on BCG internal research.

SUMMARY

Two main approaches deal with M&A profitability. The first method, called event studies, examines the abnormal returns to shareholders in the period surrounding the announcement of a transaction. Studies have revealed that the M&A transaction delivers a premium return to target firm shareholders. The pattern of findings about market based returns to the buyer firms' shareholders is mixed. A number of studies have examined the abnormal returns to buyer and target firms, combined by forming a portfolio of the buyer and target firms, and examining their weighted average returns. The second method, involving accounting studies, examines the reported financial results of acquirers before and after the acquisition to see how financial performance changes. The focus of these studies is on such variables as net income, return on equity or assets, EPS, leverage or liquidity. These studies are structured as matched sample comparisons in which acquirers' performance is set against that of non-acquirers of similar size that operate in the same industry.

There is no rigorous, comprehensive, theoretical model of the acquisition process. Several studies have investigated the characteristics of firms that have been acquired through the models of multivariate discriminant analysis, probit and binary logit model. In these studies, publicly available financial information is used to determine the characteristics of firms that are acquired by comparing the characteristics of acquired firms to those of firms that are not acquired. On the basis of different predictive model studies, it can be concluded that liquidity, leverage and growth were useful identifiers of target companies in the 1960s, financial leverage was the most important identifier in the 1970s and 1980s, and profitability was an overall significant identifier in the 1990s.

DISCUSSION QUESTIONS

1. Discuss the major findings of event studies involved in M&A.
2. Discuss the major findings of operating performance studies with respect to M&A.
3. Highlight the implications of findings of predictive models of M&A.

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Case Study 1

STRATEGIES FOR RESTRUCTURING GROWTH IN PHARMA SECTOR

ALLIANCES, MERGERS & ACQUISITIONS

Since the mid-1990s, the global pharmaceutical industry has been witnessing a spate of consolidations. The critical drivers have been rising R&D costs, decline in number of new product launches, pressure due to expiry of patents on existing products, need for improvement in sales and marketing, access to new markets and healthcare cost containment efforts by many governments which result in pricing power of companies and economies of scale. The key drivers for mergers and acquisitions are the desire for greater scale, market share, enhanced geographical expansion and increased technological capabilities. The 10 leading international players account for over 45% of the global market, with no single company's share exceeding 10% share of the total global pharmaceutical sales. One of the reasons for a spate of mergers in the global big pharma industry is hunt for pipelines and synergies in R&D. Major pharma companies go shopping to shore-up their drug pipelines. They scour labs, universities and research-based companies worldwide for new and interesting molecules. The increasing cost of cycle of development of a new chemical entity and the drying pipeline of blockbuster drugs forced companies to consider alternative options.

The merger of multinational giants Glaxo Wellcome and Smithkline Beecham Plc reflects the importance of research for survival of pharma companies. The rationale for mergers, like Glaxo-Smithkline Beecham, Pfizer-Amercian Home Products and Ciba–Geigy-Sandoz (Novartis), is based on the perception that present day R&D-based large MNCs are still subcritical in size in context of investment needs for new drugs. Pfizer's acquisition of Warner Lambert in 2000 and Pharmacia in 2002, and the merger of Glaxo Pharmaceuticals with Smithkline Beecham Pharmaceutical in 1999 led to major phase of consolidation. In 2004, Aventis was acquired by Sanofi Synthelabo. The two largest deals, till date, took place in the year 2005 when Teva bought the US drug maker, Ivax, and Sandoz acquired Hexal for $8.3 billion. The resultant consolidation in the global generic industry following these two acquisitions has created a huge gap between the top two generic players and the remaining industry players. However, the industry still continues to be fragmented with the world's largest generic player Teva having only a 19% of the global market share.

Mergers and acquisitions often lead to synergy in scale and operations. In the global context, the story of Teva is worth emulating in the context that the Israel based generics leader, Teva, doubled its sales to $2 billion, of which 42% of the growth was through acquisitions. In 1996, Teva paid $53 million for APS/Berck, that catapulted Teva to the number one position in the combined US and UK market. In 1998, it bought Pharmachemie of Netherlands for $83 million, and in 2002, it bought Bayer Classics for $97 million. In 2003, Teva acquired for $3.4 billion, US based Sicor, in the largest generics deal .

The process of consolidation, a generalised phenomenon in the world pharmaceutical industry, has also been reflected in Indian context. The future of the industry will be determined by the factors like how well it markets its products to several regions and hence distrbutes risk, its forward and backward integration capabilities, its R&D and consolidation through mergers and acquisitions and licensing agreements. The rate of growth of the Indian market is not as fast as it was a decade ago. Indian firms concentrated on strong process development skills and low cost manufacturing. But their foreign competitors are increasingly leveraging India through supply deals tie-ups and local manufacturing. To utilise the immense opportunities for introducing off-patent drugs in the lucrative US and Western Europe markets, particularly during the next four to five years, the acquisitions will facilitate the impetus to sustain growth and attain critical mass in a big way. Compared to the global pharma industry's market size of $550 billion in 2004, the Indian pharmaceutical market is relatively small, with an estimated size of $4.6 billion. The Indian pharma industry ranks fourth in terms of volume, and 13th in terms of value globally. The low market share with respect to value is due to relatively lower prices of drugs. The lower prices are partly on account of recognition of process patents that allowed multiple players to manufacture the same drug. This led to the emergence of numerous players, which resulted in the fragmented nature of the Indian pharma industry. Indian companies have diversified into overseas markets, especially in the generics markets of developed countries. Mergers and acquisitions have emerged as a strategy for overcoming this limiting factor of size for Indian companies for achieving the required scale to be globally competitive. Scale of economies is essential to maintain a healthy pipeline of products. Thus, access to R&D skills, complementary therapeutic profile of products, access to new markets and synergies in business operations are critical factors that facilitiate the process of mergers and acquisitions as a strategic option to emerge as a player with presence in the entire value chain of the pharma business. Indian pharma mergers and acquisitions accounted for about $250 million in the past decades. From 1995 onwards, Indian companies have been involved in over 15 overseas deals, of which 11 were in the last few years. For pharma companies, acquisitions abroad are a means of strengthening their front end. Through acquisitions, these companies gain access to foreign clients along with their skill sets and marketing and distribution networks in regulated markets. During 2003-04, Indian pharma spent around $200 million on acquisitions in the West. In 2004, Indian pharma companies made 18 international acquisitions, with an aggregate deal value of more than Rs 2100 crore. In fact, the two biggest overseas acquisitions were undertaken by domestic pharma companies—Matrix Lab's buyout of Belgium's Docpharma for $263 million and Ranbaxy's takeover of RPG Aventis for $84 million. By June 2006, out of the seven deals announced, four were domestic deals. Sanofi, Smithkline Beecham and Warner Lambert are some of the companies involved in mergers and acquisitions. Zydus Cadila acquired 29 products when it bought Alpharma France in 2003 for about Rs 29 crore, and later renamed it Zydus France SAS. In the year 2006, the Zydus Group sold its entire acquired brands for an estimated sum of Euro 7 million or Rs 55 crores.

Acquisitions of sizable businesses began in the 1990s. Most of the acquisitions were of generics firms, and were intended to give Indian drug firms wide geographical areas of operation. These acquisitions will allow Indian firms to have manufacturing facilities in trade areas like the European Union.

Analysts believe that Indian companies will be important participants in the M&A sector. It is expected that, in the short term, Indian companies will focus more on European companies, because their price value would be less as compared to Indian companies.

Indian pharma companies have used a number of strategies, like strategic tie-ups and marketing arrangements with local players in regulated markets. Big generic players like Sandoz, Teva, Apotex and Ratio pharma have either started manufacturing units or R&D facilities in India, or are planning to do so in the near future. While these companies integrate backwards into India, Indian companies will have to acquire local companies in regulated markets.

ALLIANCES, MERGERS AND ACQUISITIONS BY INDIAN COMPANIES

Acquisitions by Indian pharma companies seem to be part of strategic long-term need. M&A in pharma industry is becoming increasingly important for exploring newer markets and products for future growth.

Acquisitions also act as mechanisms to alleviate regulatory constraints in penetrating overseas markets. Hence, it is observed that Indian pharmaceutical companies are adopting the strategy of acquiring existing generic drug marketing companies that hold valid drug licences. The Indian pharmaceutical industry has been aggressively making acquisitions overseas, especially in the US and Europe. Indian firms are gaining access to manufacturing facilities in potential areas like the European Union.

For multinational companies, Indian contract research segments have become attractive outsourcing centres owing to their lower costs and better infrastructure. Top pharma companies like Ranbaxy, Sun Pharma, Wockhardt, DRL and Cipla have adopted the consolidation strategy of M&A.

In July 2007, Elder Pharmaceuticals acquired 20% stake in Neutra Health of UK for £5.63 million. Elder Pharmaceuticals has a good presence in the niche areas, viz., nutraceuticals. Its part-acquisition of Neutra Health's stake will enrich its portfolio as Neutra's products include vitamins, vitamin supplements, and specialized health supplements. In June 2007, Zydus Cadila acquired a privately owned mid-sized Brazilian company, Nikkho, for $26 million. Wockhardt bought out Negma Laboratories of France for $265 million in May. By acquiring Negma in France, Wallis and CP Pharmaceuticals in UK, Esparma in Germany and Pinewood Laboratories in Ireland, Wockhardt became the largest Indian pharmaceutical company in Europe. The Negma buyout also gave it rights to 172 patents held by the French company.

Dr Reddy's Laboratories (DRL) acquired Betapharm of Germany for €480 million, the biggest acquisition by an Indian pharma company. Betapharm's acquisition gave DRL the large product basket of the German major—more than 150 APIs covering treatments for cardiovascular systems, central nervous system, gastrointestinal tract and metabolism, systemic anti-infectives, and musculoskeletal system. Ranbaxy, India's largest pharma company has made 18 acquisitions since 2004. In 2005, Sun Pharma acquired US-based Able Laboratories and manufacturing facilities of ICN in Eastern Europe.

The major drivers for acquisitions by Indian pharma companies are given below:

- Enhancing revenue through global presence
- Better market access
- Widening product portfolios
- Strengthening R&D capabilities
- Strengthening distribution networks
- Increasing efficiencies through leveraging economies of scale
- Gaining access to new technologies
- Establishing new areas in pharma value chain

European companies have emerged as hot targets for acquisitions by Indian pharmaceuticals, as about 60% of the targets are European pharma companies. Europe has two strategic advantages. The valuations of US-based majors are way above the European companies. Moreover, most of the acquisition targets, including those from Europe, have strong presence in the US generics market. Thus, acquiring a target company in Europe gives the Indian acquirer control of two key geographical regions, Europe and USA.

M&A: CASES OF INDIAN PLAYERS

M&A Story of Ranbaxy

In 1995, Ranbaxy entered the US market by buying Ohm Labs. In 2004, Ranbaxy Laboratories acquired RPG Aventis from Aventis Pharma. It was the largest overseas acquisition by an Indian drug company. France is considered the fifth largest generic market in the world after US, Japan, Germany and UK. Ranbaxy reportedly paid Aventis $84 million, which was nearly 1.4 times Aventi's 2003 sales for a 100% stake. Interestingly, though US is the largest generics market in the world, more overseas acquisitions have happened in Europe. In 1999, Ranbaxy bought out Bayer's generics business, Basics GmbH and Proctor & Gamble's hypertension drug, Veratide, for $5 million. Ranbaxy has entered into an agreement with Novavax Inc, a speciality biopharmaceutical company, to evaluate a transdermal product which has been formulated using Novavax's proprietary micellar nanoparticle (MNP) technology. Novavax's micellar nanoparticle technology involves the use of patented oil and water nanoemulsions that allow the topical delivery of drugs. The company sells, markets and distributes a line of women's health prescription pharmaceuticals, through its speciality sales force who target obstetricians and gynaecologists throughout United States. Ranbaxy has entered into a collaboration with GlaxoSmithkline for global alliance in the area of drug discovery and development, and in areas of infection, inflammation and diabetes. Ranbaxy had partnered with GSK at a much earlier stage. Some skill set and technologies required in the early stage of drug discovery, like identifying new targets – proteins and enzymes in the body that play a role in a disease—are not easily available in India. So GlaxoSmithkline scientists will provide Ranbaxy with targets or leads, that can act on them. On their part, Ranbaxy scientists, using their chemistry skills, will attempt to shape the lead into a drug that can work on the target, through a process known as *lead optimization*. If it is finally launched, GSK will have exclusive rights to sell it in significant markets like the US, Europe and Japan, while, in India, it will co-market the drug with Ranbaxy. Ranbaxy and Dr Reddy's Lab have licensed promising new drugs from their labs to transnational firms like Schwarz Pharma and Novartis. Ranbaxy has also entered into an agreement with MMV, Geneva, for development of an anti-malarial drug.

In order to increase its size and consolidate its market position, Ranbaxy acquired GSK (Italy), Terapia (Romania) and Ethimed (Belgium). Belgium based Ethimed's business is focused on Benelux. Terapia has 157 marketing authorisations and strong broad-based product portfolio. About 70% of its products are focused on the central nervous system, musculo-skeletal diseases, and 30% are focused on cardio-vascular system. The acquisition of Terapia was significant for Ranbaxy as 30% of its products were registered in 15 countries in Europe, and CIS (Commonwealth of Independent States), including Russia, Ukraine and Poland, were important markets. Ranbaxy aims to have a strong manufacturing presence in Romania, once the country enters the European Union.

Ranbaxy Ltd has a licensing agreement with Netherlands based Eurodrug Lab for its asthma product 'Doxophylline'.

Daiichi's Takeover of Ranbaxy

The circle became complete in 2008. In the third week of June 2008, Japan's third largest drug maker, Daiichi-Sankyo, agreed to buy out 50.1% share of Ranbaxy in an all cash deal, valuing India's largest drug maker at $48.5 billion, or over five times its 2007 revenues. It became the largest deal recorded in Indian pharmaceutical industry. The deal added about $1.6 billion to Daiichi's $8.2 billion topline, and gave the Japanese major a foothold in over 60 markets. The deal worth $44.6 billion was concluded at Rs 737 a share, which was at 31% premium to the ruling market price. The combined entity will be bigger than Teva, the world's largest generics company at $9.4 billion. But the combined firm will still be smaller than $40 billion Novaritis Group which owns Sandoz, the second largest generics player. The acquisition saw the combination of generics powerhouse with Japanese innovator company, that deals in premium-priced patented medicine.

On account of safety concerns and traditional markets like the US, Western Europe and Japan getting genericised—the governments and insurers have started giving more emphasis to low cost copy-cats over high priced innovator drugs. In Japan, the ageing population and rising healthcare costs have led the government to allow generics substitutes for branded innovator drugs. Daiichi lacks the low cost development and manufacturing back-end needed to supply them. Hence, the acquisition will facilitate the process. Indian companies are yet to acquire the scale required to survive in a competitive global market. Ranbaxy has been under pressure because of falling prices and expensive lawsuits in the US.

Ranbaxy has been the undisputed king in terms of revenues. The company had embarked upon a string of acquisitions to enter new markets, or to strengthen its presence in old ones. But the company was unable to enter into the top five in the global generics pecking order. In contrast, Teva and Sandoz consolidated their position at the top with big deals, and widened the gap between them and the rest. Ranbaxy's attempt at big ticket deals came a cropper. Ranbaxy's stock has fallen by 10.29% since 2005, whereas the BSE Sensex has more than doubled, and the BSE Healthcare has increased by 44%. With this deal, the Singh family had dealings between $2 billion and $3 billion for its holdings. At almost 21 times earnings before interest, tax, depreciation and amortisation, Ranbaxy was more expensive than Merck Generics, at 14 times, and Matrix, at 18 times, were to Mylan. Analysts have expressed their view that the global market in generic drugs would peak in about four to five years and it was the right time for the Ranbaxy Group to come out of business. The Ranbaxy deal gave Daichi access to about 60 countries. With a share of 34.8% in Ranbaxy, Daichi had to make an open offer to acquire another 20% to comply with the guidelines laid down by SEBI.

After the acquisition, Ranbaxy has had its share of difficulties. It ran afoul of US regulators, losing the right to import some 30 medications manufactured in India. In 2010, the Japanese company replaced Ranbaxy chief Malvinder Singh.

Dr Reddy's Laboratories

In 2000, Dr Reddy's Lab merged with the group company, Cheminor Drugs Ltd, and the ailing Chennai based American Remedies Ltd (ARL). This consolidation made DRL the third largest pharmaceutical company in the country, after Glaxo and Ranbaxy, with interests in branded finished formulations, biotechnology and diagnostics. Cheminor has evolved from a small drug manufacturer to a pioneer player in the world generic market. It was the first Indian pharmaceutical company to file positions for Ciprofloxacin, Fluoxetin and Omeporzole. Among the bulk drugs in the antiulcerant and antibacterial therapeutic segments, ranitidine and ciprofloxacin were the highest revenue earners. At least 70% of its intermediates are exported to the US and European markets. As a result of this merger, bulk drugs constituted 53% of DRL's turnover. Cheminor had a marketing contract with Schien Pharmaceuticals, which was later terminated due to latter's acquisition by Watson's Pharmaceuticals. Other Cheminor marketing partnerships are with PAR (Pharmaceutical Resources Inc) for prescription products and Leiner Health Products for OTC drugs in the US. American Remedies Ltd added about Rs 100 crore to DRL's bottomline along with 400 representatives-strong field force and complementary product portfolio. American Remedies Ltd had a strong presence in the anti-oxidants and nutraceuticals segments of the co-prescription segment. These, in fact, complement DRL's primary prescription products. After restructuring at American Remedies Ltd, Dr Reddy's Lab has shifted its formulation manufacturing to Pondicherry. In 2002, Dr Reddy acquired a small company, BMS Labs, and its subsidiary in the UK for $16 million. This was aimed to get distribution network in the UK and act as corporate headquarters in Europe.

Dr Reddy's had a 15-year exclusive agreement for product development and marketing of the over-the-counter drugs with California based Leiner Health Products. The agreement included: an exclusive marketing partnership with Leiner to distribute OTC products, a comprehensive Rx-to-OTC product pipeline, development of innovative private label OTC products and establishment of an executive steering committee to manage product development. The agreement came to an end in 2003.

DRL has also grown through brand acquisitions. It bought brands like Riflux and Clamp from the ailing SOL Pharma. This was followed by Becelac (Pfimex) and five brands of Dolphin Laboratories.

In 2004, Dr Reddy's Lab acquired the US company, Trigenesis, specialising in dermatology, for $11 million (Rs 50 crore) as part of their strategy for differentiation. Trigenesis has a technology platform to make a new drug delivery system for dermatological products, which is a $6 billion market in the US. It has no drugs in the market, but holds licences for products being developed by other companies. Dermatology leaders are usually small niche players. Dr Reddy's Lab will use the former's proprietary technology to develop skincare drugs. Dr Reddy's Lab have a strategic alliance with Pharmascience Group for multi-product development and marketing of 11 generic products in Canada. Under the terms of agreement, Dr Reddy's and the Pharmascience Group would share the costs and benefits associated with the commercialisation of the products.

In 2005, DRL signed a deal with ICICI Venture to raise $56 million for the launch of generic drugs in the US. ICICI Venture will give $22.5 million in the first phase, and a possible additional $33.5 million in the second phase. ICICI Venture will fund the development, registration and legal costs, and DRL will pay it royalty on net sales for a period of five years. Then ICICI Venture, Citigroup Venture and DRL formed an integrated drug development company, Perclecan Pharma, with equity capital commitment of $52.5 million for drug research. The venture capital were to cough up $22.5 million each, with the remaining $7.5 million coming from DRL, which had already transferred four NCE assets to the company in the area of cardiovascular and metabolic diseases. Thus, the risk of discovery of four new chemical entities is spread across three partners.

In December 2005, DRL acquired Roche Pharma of Mexico for $59 million for custom pharmaceutical services.

In 2006, Dr Reddy's Lab acquired Betapharm, the fourth largest German generic pharma company, for an enterprise value of Euro 480 million, or about Rs 2500 crore, in cash. DRL acquired 100% stake in the all cash deal. This is the largest acquisition by an Indian company in the pharma sector. These figures are large by Indian standards, but are substantially lower than Watson's $1.9 billion acquisition of Andrx, and $1.8 billion bid for Pliva and Sindan by Activis. DRL outbid Ranbaxy Lab, Israeli pharma major, Teva, and French firm, Sanofi Aventis, for the acquistion. Betapharm is the company's entry into the generics market. The acquisition is a part of the inorganic growth strategy of the company. It will give DRL control of Betapharm's portfolio of 146 products, with 60 more to be added in the next five years. It is expected to add $200 m to DRL turnover. Betapharm markets high quality generic drugs, with focus on long-term therapy products with high precription rates. The process of integration is expected to be easier since Betapharm does not have manufacturing or product development overloads. Betapharm is strong in areas like cardiovascular system, central nervous system, gastrointestinal system, etc. These belong to the chronic care category which means high levels of prescription over a long period of time. Being in business for 13 years, with a 250 strong sales force, Betapharm has built strong relationships and brand equity. The German market is similar to the Indian market where doctors, chemists, medical salesmen and insurance companies form a mutually beneficial motley. Betapharm has a strong intellectual property and regulatory infrastructure which gives faster access to European markets. DRL could use Betapharm's regulatory infrastructure for future filings in Germany and Europe. With 25% growth, Betapharm has been the fastest growing generic company for the last five years.

Dr Reddy's Lab had formalised a $56 million (an estimated Rs 245 crore) agreement with ICICI Venture Funds Management Company for development and commercialisation of generic drugs filed in the US in 2004-05 and 2005-06. This unique deal was aimed at mitigating the risks faced by the company in research initiatives, and in patent related litigation. In China, DRL has a joint venture with Kushan Double Crane Pharmaceuticals (1.59%) and Canada Rotam Enterprises (47.1%).

In 2006, Dr Reddy's lab had tied up with the UK based Clin Tec International for joint development of anti-cancer compound, DRF 1042, of the topoisomerase inhibitor class. The compound could be a potential drug for the treatment of various types of cancer, and is expected to touch the market by 2010.

DRL has also tied up with UK based Argenta Discovery for development and commercialization of a novel approach for the treatment of chronic obstructive pulmonary diseases (COPD).

Panacea Biotec has signed a marketing arrangement with Dr Reddy's Lab, which will distribute Nimulid (Panacea's brand of nimesulide) in transgel form in Russia.

In 2008, Dr Reddy's Lab completed three acquisitions, Dow pharma's small molecules business from Dow chemical Company, BASF's pharmaceutical contract manufacturing business and of Jet Generici, a company that sells generic finished dosages in Italy. The acquisition of Dow Chemical Company's small molecules business, associated with the two UK sites, includes the relevant business, customer contracts, associated products, process technology, intellectual property and trade marks, as well as transfer of the Mirfield and Cambridge facilities. The acquisition of BASF's pharmaceutical contract manufacturing business and related facility includes the relevant business, customer contracts, related NDAs (new drugs applications) and Abbreviated NDAs, as well as the manufacturing facility and assets at Shreveport, Louisiana. As part of the agreement, about 150 employees will be transferred from BASF to Dr Reddy's Lab. BASF's contract manufacturing activity for finished pharmaceuticals is limited to North America, and is not linked to the technological growth area of the company's pharma ingredients and service business. The acquisition will help Dr Reddy's to get an additional platform to further expand the portfolio of prescription generics, OTC capabilities and product portfolio and ability, to supply generic products to US government agencies.

Sun Pharma

Sun Pharma began operations on a small scale in Vadodara in 1991-92. It became public during the period, 1992-1993. In 1995-96, the company acquired M J Pharma and Gujarat Lyka, and started research activities for the US market. In 1997, the company acquired US based Caraco, a loss making generics company. During 1998-1999 the company acquired Tamil Nadu Dhadha Pharma, Natco Pharma and Milmet Laboratories.

Sun picked up 36.5% in the loss-making US company Caraco for $7.5 million in 1997-1998. Sun Pharma raised $350 million through convertible debentures and bonds from markets overseas to fund acquisitions primarily in the US. It hiked its stake to 63% in Detroit based, Caraco Pharma. After the acquisition, Caraco notched up $45.5 million in revenues and $11.2 million in net income. In 2004 Sun Pharma paid a modest $23 million from its $400 million reserve for assets of a bankrupt US healthcare company, Able Labs. Out of the 40 products of Able, Sun acquired two brands. In 2005, the company bought manufacturing facility in Hungary and Ohio from Valentant Pharmaceuticals. Sun bought the Hungarian factory to facilitate production of psychotropic drugs whose import into Europe and US is tightly regulated.

Sun's Acquisition of Taro

Taro is a multinational generic manufacturer, established in 1959 and headquartered in Haifa Israel. Taro operates mainly through three entities: Taro Pharmaceuticals Industries Ltd, or Taro Israel, and its two subsidiaries, Taro Pharmaceuticals Inc, or Taro Canada, and Taro USA. Taro had strong franchise in dermatology and topical products, in addition to products in cardiovascular, neuropsychiatric and anti-inflammatory therapeutic categories. It has more than 100 ANDA (abbreviated new drug application) in the US alone. Taro had invested over $190 million in R&D. It manufactured API, including complex chemistry and steroids, at its site in Israel. In 2006, Taro had run into substantial losses. Sun Pharma acquired Taro for $454 million in an all cash deal. Sun Pharma had funded the acquisition with internal accruals and proceeds from its earlier $350 million FCCBs. The deal valued Taro's equity at $230 million, or $7.75 per share, which was at 27% premium to its May 18, 2007 closing price of $6.10. Franklin Templeton had opposed Sun Pharma's $454 million acquisition of Israel's Taro Pharmaceuticals, which held 9% stake in Taro. The company felt that Sun's offer of $7.75 a share was too low and unjust to the minority shareholders of Taro. The lawsuit moved through Israeli legal system and landed in the Supreme Court, which upheld the validity of the agreement with Sun Pharma.

Alliances of Wockhardt Ltd

Wockhardt is building a sustainable business model through acquisitions abroad. It has acquired three companies in Europe over the last five years, and has recently raised $100 million for more acquisitions. Wockhardt has tied up with Ranbaxy and Ivas for marketing. If Wockhardt wanted to take its Hepatitis B Vaccine to the US, it would have needed $1-1.5 million to register the drug with USFDA. Instead, the company tied up with Swiss giant Roche to market the multinational's hightech biotech products. Wockhardt acquired Wallis, a loss making manufacturer and distributor of over the counter drugs, for $9 million in 1998. Wallis, a formulation manufacturing cum marketing unit, gave Wockhardt much-needed presence in the important European market. Wockhardt then acquired Merind for Rs 94 crore. Through this acquisition, Wockhardt increased its therapeutic coverage from 29% to 42% and became the only producer of Vitamin B 12 in the domestic market. In 2003, Wockhardt acquired $61 million worth CP Pharma for $20 million. This buyout catapulted Wockhardt into the category of top ten pharma companies in UK. In 2004, Wockhardt also bought German company, Espharma's business and sales force for $11 million. This acquisition meant entry into the largest branded generics market in the European Union. By 2004, Europe accounted for 40% of its total sales. Wockhardt has two businesses and marketing joint ventures in Mexico and South Africa, respectively, besides a wholly-owned sales and marketing subsidiary in Brazil. In South Africa, Wockhardt South Africa Pty Ltd is a 51:49 joint venture between Wockhardt and Pharma Dynamics. The joint venture uses the regulatory, sales and marketing expertise of Pharma Dynamics to commercialize Wockhardt's portfolio. The company is looking for acquisitions in US.

Nicholas Piramal

Nicholas Piramal has taken the inorganic route of acquisitions for its strategic pursuit of growth. The failure of Piramal Group to reap benefits in textile sector made it turn its attention towards the pharma sector. It began with the acquisition of Nicholas Laboratories from the Sara Lee Group in 1988. Since then, the group has grown through acquisitions. In 1993, the company acquired Roche products and in 1994, Sumitra Pharmaceuticals. In 1997, Boehringer Mannheim was acquired. The Research and Development division of Hoechst was acquired in 1998. Rhone Poulenc was acquired in 2001. In 2002, the pharmaceuticals division of ICI was acquired. NPIL has a presence in practically all major therapeutic categories—antibiotics, cardiovascular, gastrointestinal and dermatology. The three way merger of Nicholas Piramal with Piramal Healthcare and Boehringer took place in 1996. The company acquired Global Bulk Drugs in 2003. Takeovers, alliances and joint ventures gave NPIL access to technology and products. There have been several OTC products distribution joint ventures, such as Reckitt Piramal for products like Dettol, Saridon, Lactocalamine and Boots Piramal. There have also been ayurvedic joint ventures–Solumiks Piramal with Shree Dhootapapeswar and Charak Piramal. Global Bulk Drugs, a NPIL subsidiary, has a tie-up with a US company to tap the export market in speciality chemicals. The strategic alliance with Swiss multinational, Siegfried Pharma, is designed to leverage the latter's skill in the European market. NPIL has acquired the basic research unit of Hoechst Marion Roussel and renamed it, Quest Institute of Life Sciences.

Nicholas Piramal paid $14 million (Rs 61.6 crores) to acquire UK based Rhodia Organique's global inhalation anaesthetics business. Nicholas Piramal has collaborated with Colarado based Nexstar to find leads in life sciences, and is jointly conducting Phase II trials for a peptide-based drug with Seattle based Cytran. The buyout of BioSyntech, Canada based biotechnology company, was a strategic fit for Nicholas Piramal to gain expertise in discovery and development of therapeutic thermogels for regenerative medicines. The financing by NPIL gave BioSyntech sufficient funds to reach all of their fiscal year 2006 targeted clinical trial milestones. NPIL has acquired exclusive rights for marketing, sales and distribution of current and future products of BioSyntech for India, Pakistan, Sri Lanka, Bangladesh, Laos, Cambodia, Vietnam and the Philippines. NPIL has entered into collaboration with GlaxoSmithkline for a global alliance in the area of drug discovery and development. The company has also entered into an agreement with MMV, Geneva, for the development of an anti-malarial drug. Nicholas Piramal has a joint venture with Advanced Optics for supplying opthalmic products to regulated markets. Nicholas Piramal has a well-established record of partnerships with international companies like Roche, Allergan and Boots, etc. Nicholas Piramal entered into a 60:40 joint venture with Allergan Inc to manufacture their opthalmology products in India. It bought out UK based Avecia Pharmaceuticals for a consideration of Rs 76 crore. Avecia Pharmaceutical's focus was on providing custom chemical synthesis and manufacturing services for innovator pharmaceutical and biotechnology companies. The acquisition complemented the Indian drug manufacturer's operations in custom manufacturing. Nicholas Piramal has also acquired four brands—Dermatology brand, Lovir, mucolytic agent, Mucokef, Cephalosporin and Keroxime. Nicholas Piramal further consolidated its position in the custom manufacturing area by acquiring Pfizer's UK manufacturing plant. Nicholas had earlier acquired Lactocalamine skin lotion brand from Duphar Interfran, followed by the antiseptic brand, Burnol from Knoll Pharma. These two brands were transferred to its over the counter joint venture company, Reckitt Piramal. In 2007, Nicholas Piramal hived-off its drug discovery arm into a separate company.

Glenmark

In 2004, Glenmark Pharma bought Laboratories Klinger of Brazil for $5.2 billion to expand its operations in the Latin American markets. The Sao Paolo based company gave Glenmark an entry to the $7 billion Brazilian market. Glenmark had to file six product dossiers for registration with the Australian regulatory authority, and 11 dossiers with the Brazilian authorities. The company sold 16% of its equity to UK based Springhill Bioventure Fund and UTI Venture Fund in 2005 through private placement route for around $5 million. The Switzerland based subsidiary of Glenmark had entered into a $53 billion deal with Teijin Pharma of Japan by licensing its asthma and chronic obstructive pulmonary disorder drug. The agreement allows Teijin Pharma exclusive right to develop, register and commercialise GRC3886. The Brazilian subsidiary of Glenmark Pharma Ltd, Glenmark Farmaceutica Ltd (GFL) acquired the hormonal brand, Uno-Ciclo, from the Instituto Biochimico Industria Farmaceutica Ltd for $4.6 million (Rs 20 crore). GFL was established in 2003 with the objective of facilitating Glenmark's entry into the Latin American market. Glenmark also acquired an Argentine marketing company, Servycal, with a focused oncology portfolio. Brazil is the largest pharmaceutical market in South America. Glenmark pharmaceuticals bought Glaxosmithkline's (GSK) manufacturing facility in Ankleshwar, Gujarat, for Rs 14 crore, for entry into the US. The company has tie-ups with US generic firms—like Apotex, Eon Labs and KV pharma—to supply bulk drugs. In 2006, Glenmark acquired Bouwer Barlett Pty (Bouwer Barlett), a South African sales and marketing company with major presence in dermatology segment. This acquisition provided Glenmark a strategic entry point into the South African market.

Glenmark Laboratories Ltd and Tasc Pharmaceuticals Ltd had amalgamated their operations in 2005 to form a combined entity, inorder to have a presence in the entire pharmaceutical value chain. The amalgamation was meant to plug the bulk drug requirement of the company. In March 2007, Glenmark Pharmaceuticals acquired 90% stake in Medicamenta, a pharma marketer and manufacturer in Czech Republic. Through the Medicamenta acquisition, Glenmark gained the control of OTC and other prescription-drug brands of the Czech player. These included Ataralgin, Medicamenta's flagship product for headache, cold and pain. With this, Glenmark also secured entry into two European countries, Czech Republic and Slovakia.

Glenmark Labs was incorporated in 2000 as a wholly-owned subsidiary of Glenmark Pharmaceutical Ltd. Later, in 2003, it was spun-off into a separate entity. The company has a presence in central nervous system and psychiatry products, besides the cardiovascular and diabetes segments. Glenmark Pharmaceuticals and

Shasun Chemicals & Drugs Ltd have a pact for joint development, filing and marketing of 12 generic drugs for the US market. The product list includes a mixture of off-patent and patent protected molecules. Under the agreement, Shasun will develop and license 12 generic products to Glenmark. Glenmark is responsible for filing the abbreviated new drug applications (ANDAs) and obtaining regulatory approval in the US market. Glenmark also has two partnership agreements with the US based companies, Interpharm and Konec. In 2003, Glenmark made a $190 million deal with Forest Lab for the development and commercialisation of asthma drug in the North Amercian market.

Matrix Labs

Matrix, is one of the fastest growing API (Active Pharmaceutical Ingredients) manufacturers in India, focused on regulated markets such as US and EU. Matrix Labs have taken the route of acquisitions in strategic pursuit of growth. In June 2000, the company bought out Herren Drugs and Pharmaceuticals at an undisclosed price. Herren was later renamed as Matrix Labs. In May 2002, Matrix acquired 54.89% equity in Medicorp Technologies, an API manufacturer, which was the subsidiary of Chennai based Shri Ram Group, with US FDA and TGA (Australia) approvals. In September 2002, Matrix further consolidated by merging with Vorin Laboratory and its subsidiary, Fine Drugs and Chemicals, promoted by Ranbaxy. Vorin Lab was an API manufacturer.

Matrix had made three significant acquisitions in the span of two and half years. The first was Belgian Doc Pharma, in which Matrix acquired a 22% stake for $263 million (Rs 1144 crore). At that time, Doc Pharma had about 130 products in the EU market, with presence in Belgium, the Netherlands, Italy and France. In 2005, Matrix had a strategic joint venture alliance with MCHEM Pharma (Group) Ltd of China. MCHEM Pharma Group, based in Xiamen on the east coast of China, manufactures pharmaceutical products ranging from basic chemicals, intermediates, active pharmaceuticals and finished dosage forms. It is a major supplier of finished dosage forms of anti-AIDS products to the Chinese Government. The Chinese joint venture for Matrix was aimed to facilitate its long-term strategy to become an end to end player, strengthen backward integration and supply chain. This acquisition helped Matrix Lab to gain entry into the manufacture of anti-AIDs drugs and the fast expanding Chinese market. In December 2005, Matrix took over the Ahmedabad based Concord Biotech and got a foothold in the rapidly growing stain drugs market (for lowering cholesterol) and access to Concord's fermentation technology facilities. The acquisition of controlling stake in Concord Biotech added to the technology and manufacturing strengths of Matrix.

Matrix Lab Ltd and South Africa based $321 million Aspen Pharmacare Holdings Ltd have an alliance for strengthening their business through joint venture in India and South Africa. Both companies have signed two separate memoranda of understanding to enable them to hold cross-country ownership in two pharmaceutical manufacturing units through the joint venture route. Matrix had a portfolio of 160 drugs and 10 manufacturing plants, of which six were approved by the US FDA.

The Mylan–Matrix Merger

In 2006, one of the biggest takeover deals took place in the Indian pharmaceutical industry when US generic giant Mylan Laboratories acquired Matrix Lab. Earlier, Matrix Lab had acquired loss making companies like Medicorp and Fine Chemicals & Drugs and turned them around.

Mylan paid Rs 306 per share for 71.5% holding in Matrix which came to a total of $736 million.

This acquisition strategy of Mylan was aimed at establishing a global platform and expand its dosage forms and therapeutic categories. This acquisition was also meant to deepen Mylan's vertical integration and enhance its supply chain capabilities. Mylan had practically no foot hold outside the US. Through the merger, the subsidiaries of Matrix provided Mylan the opportunity to access Europe, China and India. The fusion of Matrix helped Mylan consolidate its share in the anti-AIDS product market.

Cipla

Cipla has tied up with Ivax and Watson for supply of active pharma ingredients, and with Pentech Pharma to tap the US generics market. Cipla has alliances with the US firm, Biogenerics Inc and the Chinese firm, Dongbao. Cipla has tie-ups with US based Ivax and Watson Pharmaceuticals for the supply of anti-psychotic Zyprexa.

Lupin

In 2009, Lupin acquired a majority stake in Multicare Pharmaceuticals Philippines Inc. In 2008, Lupin acquired 1) Hormosan Pharma Gmbh, a generic company in Germany; 2) a stake in Generic Health Pty Ltd in Australia; and 3) Pharma Dynamics in South Arica.

In 2007, Lupin acquired Vadodara based Rubamin Laboratories Ltd (now rechristened Novodigm Ltd) and Kyowa Pharmaceutical Industry Company Ltd, a leading generic company in Japan.

Torrent Pharmaceuticals

Torrent's takeover of the German generics firm, Heumann Pharma, from Pfizer was aimed at establishing generic businesses. Torrent Pharma has plans to set up joint ventures in Japan and South Korea. In 2006, the company entered into a marketing tie-up with Tasly, a pharma group in China, under which it will market Tasly Group's Cardiotonic in India, while Tasly will market Torrent's formulations in China. Torrent Pharma has made a deal with Novo Nordisk, and has out-licensed a molecule to Novartis.

Other Alliances in the Pharma Sector

Zydus Cadila bought Alpharma of France for Euro 5.5 million. Hyderabad based Suven Pharmaceuticals has acquired New Jersey based Syntheon Chiragenics, which is a leader in carbohydrate based chiral technology, to give thrust to its eventual aim of discovering a new drug.

JB Chemicals & Pharmaceuticals, which focuses on therapeutic segments, has marketing tie-ups across geographies—such as Europe, the US and Australia. In April 2002, JB Chemicals and Pharmaceuticals and Spectrum formed NeoJB LLC to enable Spectrum to benefit from JBCPL's high quality, lower cost drug manufacturing capabilities through the sale of JBCPL's generic drugs in the United States.

Indian companies are routinely out-licencing new promising molecules—for example, Bayer or Novo Nordisk. Atlanta Pharma was acquired by Ahmedabad based Cadila Healthcare. Several of the pharma MNCs have tie-ups with Indian companies as well.

Indoco Remedies Ltd has tied up with the consultant company, Strategic Resources USA, to support its foray into the US. Strategic Resources will collaborate with Indoco in research and manufacturing. It will also act as an agent for Indoco and its products in the US market.

Aurobindo pharma, in the year 2006, acquired a US FDA-compliant current good manufacturing practices (CGMP) facility in New Jersey. This facility would serve as Aurobindo's headquarters in the US. Two group companies, Ranit Pharma Ltd and Calac Pvt Ltd, amalgamated with Aurobindo.

Orchid Chemicals & Pharmaceuticals has an exclusive agreement with Alpharma Inc for marketing its select non-antibiotic generic formulations in the US and Europe. Under this agreement, Orchid will exclusively develop and manufacture 10 non-antibiotic formulations in specific dosage forms and strength for exclusive distribution and marketing by Alpharma in the US and Europe. These 10 oral formulations fall under speciality, chronic therapeutic segments—such as cardiovascular (CVS) and central nervous system (CNS). The current market size of these 10 products in the US and Europe aggregates to around $10 billion (Rs 4300 crore). Orchid would commence supply of these products once they go off-patent progressively from 2007 onwards based on Orchid's regulatory filings and approvals. Alpharma would provide the development funding needed to meet development costs and expenses related to filings and approvals. Orchid, a global leader in cephalosporin antibiotics, has chalked out plans to replicate its regulated generics model in diverse therapeutic groups. Orchid is establishing a new US FDA compliant infrastructure to develop and manufacture drugs in these non-cephalosporin segments.

Elder Pharma has tied up with Blistex of US to produce lip care products, and with an Italian company, Zambon, to launch drugs in the cerebro-neuropsychiatry and respiratory segments.

Shashun Chemicals formed a 50:50 venture with US based Austin Chemicals, the sourcing agents for global majors like Eli Lily and Pfizer. Austin–Shasun has the right of refusal for any research project that comes to Austin. The Chennai based Shasun Chemicals and pharmaceuticals Ltd has a tie-up with Israeli pharma giant, Teva, for exporting Refecoxib to the regulated markets after Merck's patent expires.

Eisai Pharmaceuticals India and GlaxoSmithkline Pharmaceuticals have a co-promotion agreement to market GSK's anti-ulcer drug, Paritec, in India which was developed by Japanese drug major Eisai Co. The drug is used for the treatment of acid related disorders—like peptic ulcers—and reflux gastric disorders. Eisai Co was the first Japanese pharmaceutical major to enter India through its 100% subsidiary. Esai's presence in India will be important for its global plans. GSK's strong field force was one of the drivers for the deal. Eisai has a similar deal with Wockhardt for Methycobal, used to treat debilitating nerve disorders. The estimated Rs 600 crore anti-peptic ulcer market is growing at 14%.

The Kopran Group had formally demerged into three separate companies. The formulation and bulk drug business, other than penicillin-G, has been retained by Kopran Ltd, the flagship company. The penicillin-G business was spun off into Kopran Drugs Ltd, and research into Kopran Research Laboratories Ltd. The company had signed an MOU with Synpac Laboratories for the supply of penicillin-G bulk.

ACQUISITIONS IN THE CRAM SEGMENT

The largest driver for the phenomena of outsourcing is the compulsion to bring down the costs. Developing and licensing intellectual property is one route for growth for a contract research firm. The focus seems to be on customer driven solutions, largely driven by partnerships. The cost of manufacturing, conducting clinical trials and research are at least 50% lower in India than those in the US. The global pharma outsourcing market-spanning API, research, formulation and manufacturing—is estimated at $120 billion. The All India Contract Research Organisation, representing just a segment, adds up to less than one percent of the total market. In the formulation area, India is now considered a viable manufacturing centre. It has to be noted that, over the years, formulation plants have come up only in Japan, Canada and Mexico. No MNC, or any Indian company, imagined that India could emerge as a possible base for bulk drug exports till, in 1988, Ranbaxy's Toansa plant was approved by the US Food and Drug administration, and started exporting APIs. Mexico, Canada and Italy were the most favoured destinations for setting up plants among the MNCs. Initially, even the API supplied from India was not directly bought by innovators. Speciality companies, like the US based Austin, Honeywell Speciality Chemicals, GE and Alfred E Tieffenbacher, supplied it to the innovators or the generic companies looked at the API opportunity for off-patent products. Now, some of the world's largest generic companies–like Teva, Ivax and Ratiopharmowns–have strong presence in India. There is scope for Indian pharma companies to move up the value chain, from APIs to patented NCE intermediates.

Most of the domestic pharma companies are sourcing intermediaries from China, be it the basic pencillin used for antibiotics, or other inputs for antiretroviral drugs. Aurobindo Pharma has a stake in a fermentation facility in China. Other pharma major–like Ranbaxy, Dr Reddy's Lab and Orchid Chemicals have presence in China. The reason for China being an atttractive import centre is that importing intermediaries from there is cost effective, as the country does not levy any duty on naptha, a basic ingredient. At the same time, the chemical industry has to pay a 10% custom's duty on this product. The collaboration between China and

India provides immense opportunities for co-marketing. China is well known for manufacturing bulk drugs while India is known for its formulations. The proof comes from the number of Drug Master files and the Abbreviated New Drug filed by these two countries. India could also associate with China for clinical research. The gene types of the population in both countries are different. Hence, the trials will get legitimacy if clinical trials are conducted in both countries.

There has been a spate of tie-ups and acquisiitions by companies in the CRAMS segment in India. In 2005, Nicholas Piramal acquired UK's Avecia Pharmaceuticals for £95 million (Rs 76 crore). Avecia Pharamceuticals–a global custom manufacturing player focuses on providing custom chemical synthetics and manufacturing services for innovator pharmceutical and biotechnology companies. In October 2005, Jubilant acquired 100% equity in Target Research Assoicates, a US based clinical research organisation, for $ 33.5 million (around Rs 145 crore) in an all cash deal. The acquisition made Jubilant the largest Contract Research Outsourcing company with operations in India and the US. This was the first ever acquisition of an American CRO by an Indian company. Dishman Pharmaceuticals and Chemicals, in April 2005, acquired Synoprotec, a Manchester based contract research company, through its wholly owned UK based subsidiary company, Dishman Europe Ltd. The acquisition was a major step for the company in contract research and manufacturing strategy.

ALLIANCES IN THE BIOTECH INDUSTRY

Biocon, too, inked a contract with Bristol Myers Squibb to supply insulin for nine years. Strides Arcolab is the only Indian Company to have a formulation plant in Brazil. The Lucknow based Central Drug Research Institute has developed and licensed drugs to companies like Cipla, Wockhardt and Torrent Pharma. Bharat Biotech has tied up with International Centre for Genetic Engineering & Biotech for a malaria vaccine, besides its partnership with Centre for Disease Control, Atlanta and National Institute of Health, Washington. Shantha Biotech is collaborating with ICMR and National Institute of Health for developing an HIV vaccine. Bangalore based Biocon has a joint venture with Cuba's CIMAB to develop a basket of drugs. Biocon will import drugs–like EPO–from CIMAB till its own manufacturing facility is established. Biocon has a tie-up with Nobex for oral insulin, and with Vaccinex for human antibodies. Wockhardt entered into a tie-up with Sidmak Labs in the US for distribution of its products, and took a stake in Wallis Lab UK to sell its products in that market.

As regards drug research, it is a known fact that the pharma, biotech, bioinformatics and biological labs in India have to work together to exploit the competitive advantage. Drug discovery research demands close coordination of several disciplines–like biological insight, data analysis, molecular modelling, clinical research, genomics, proteomics population genetics and computer science. Collaboration for research in drug discovery industry leads to the formation of a network that is often described as the bio-pharma informatics network. The Centre for Biochemical Technology (CBT) has formed a joint venture, Genomd, with Nicholas Piramal to research the manner in which genetic variations in Indian population can be exploited to discover new drugs. Bangalore based Aurigene has two alliances—one with Israeli firm, Biostrix, to study structural biology and the other with Singapore based Kent Ridge Digital Labs (KRDL) to research computational immunology. The Hyderabad based Centre for Cellular and Molecular Biology has relationships with several IT companies. The Centre for Drug Research Institute has collaborations with Lupin Labs, Dabur Research Foundation and Dr Reddy's Research Foundation to develop drugs for cancer and tuberculosis. Astra Zeneca has collaborated with the Pasteur Institute of France for gaining expertise in genomics. Centre for Cellular amd Molecular Biology has partnership with Biological Evans for diagnostic kits for genetics diseases, with Dabur for anti-cancer synthetic peptides, and with the IT company, Satyam, for training. Biocon and Shantha Biotechnics have formed the joint venture, Biocon–Shantha Biotech, to make genetically engineered human insulin. Biocon's skills are in large-scale fermentation. Shantha Biotechnics expertise is in developing cell lines and in regulatory matters. In 2002, two start-up firms, Genomics India and Strand Genomics, joined together for the development of microarrays, which are used to analyse DNA or proteins. Biocon entered into a joint venture with Cimab SA to manufacture Cimab's biotech products based on monoclonal antibodies. Kee Pharma acquired Centro de Ingeneria Genetica Biotechnologia, owned by the Cuban government, for its ability to produce high technology products at affordable prices.

The bioinformatics sector has also witnessed major deals. In 1997, Millenium signed a $343 million genomics alliance with Monsanto. In 1998, Millenium signed a $465 million deal with Bayer. In 2001, Bayer and VuraGen agreed to be equal partners and share $1.3 billion in drug development costs for the next 15 years. TCS has teamed up with the Centre for DNA Fingerprinting and Diagnostics. Satyam Computers has a joint project with the Centre for Cellular and Molecular Biology in Hyderabad. Nichola Piramal has made a deal with Delhi based Centre for Biochemical Technology to collaborate on drug discovery. Orchid, through Bexel Pharma, its joint venture in US, is working on the diabetic molecule that will attack the problem of weight gain associated with the prevailing diabetic treatments. Strides Arcolab has agreements with Mayne Group of Australia, Akorn and Stada. Bangalore based Aurigene Discoveries Technologies has entered into a collaboration with Novo Nordisk in the area of metabolic disorders. This was described as a pioneering collaboration between a discovery organization and an innovation driven global pharma company. This agreement is part of Novo Nordisk's strategy to have a network of alliances in India. Novo Nordisk will also work with Aurigene on the optimization of some of its lead series of compounds on the same target. Foreign majors, like Teva, Ivax and Apotex, have sourcing pacts with Indian companies, like Cipla and Lupin. Ratiopharma, a leading German generics player, had acquired 68,000 sq m of land in Goa's Verna Industrial Estate. Canada's largest generics company, Apotex, is investing about $10 million in a manufacturing facility and research centre in Bangalore. The low manufacturing and product development costs and the ability to hire scientists are the main attractions.

In addition to the marketing agreement with Dr Reddy's Lab, Panacea has also entered into a tie-up with NVI Netherlands for the manufacture of IPV (Inactivated Polio Vaccine) in India, and has set up a 50:50 joint venture with Chiron Corporation (now a part of Novartis Group of Companies) for marketing of innovative combination vaccines in India.

ALLIANCES IN HEALTH SERVICES

Wockhardt Hospitals have a long-term association with the Hyderabad based Kamineni Group, engaged in medical education and healthcare services. Wockhardt Hospitals are also associated with Harvard Medical International, the global arm of Harvard Medical School. The association provides Wockhardt access to the latest clinical protocols, innovations and patient care practices.

INTERNATIONAL MERGERS AND ACQUISITIONS

International mergers and acquisitions have become strategically important for Indian pharma companies as almost all target firms have regulatory approvals needed to operate in markets like EU and the US. Moreover, the strength of these target companies lie in their steady distribution system. This could be utilised to leverage the acquirer firm's technical skills and low manufacturing cost advantage. The Indian companies are also entering into R&D alliances with international pharma majors. In 2003, Ranbaxy entered into an alliance with the pharmacy major, GlaxoSmithKline (GSK), for research on new chemical entities. GSK will provide leads on prospective new chemical entities, while Ranbaxy will be responsible for the activities from optimisation of a lead compound to generation of a development candidate. Once the candidate is selected, GSK will complete the development work. Glaxo also benefits from the former's drug discovery and early product development skills. Ranbaxy has a mutual agreement with Teva Pharmaceuticals to sell Quinapril HCL tablets in the US market. The product produced by Ranbaxy is sold under the Teva label and is marketed by Teva USA. The two companies distribute the product. The launch followed Teva's relinquishment of its right to a 180-day period of marketing exclusivity for Quinapril HCL tablets. Some of the mergers effected among the MNCs operating in India include:

- The Glaxo – Burroughs Wellcome merger
- The Hoechst – Marion Merrell Dow merger
- The Ciba – Sandoz and Wyeth-Cynamid mergers

Table CS1.1 *Top Five Mergers and Acquisitions in the year 2005*

Acquirer	Target	Size ($ million)
Matrix Lab	Doc Pharma	263
Fortis Healthcare	Escorts	130
Dr Reddy's Lab	Roche	59
Jubiliant Organosys	Target Research Associates	33
Actavis	Lotus Laboratories	26

Source: Business World, 30 January 2006.

Table CS1.2 *Key drivers for Foreign Acquisition by Top Pharma Companies*

Acquirer	Target	Country	Key driver
Ranbaxy	RPG Aventis	France	Market Entry Strategy
Ranbaxy	Nihon Pharma	Japan	Increasing Stake to 50% to take advantage of Japanese Generic Opportunity
Ranbaxy	GSK's Generics Unit	Spain	Entry to Spanish Generics Market
Ranbaxy	Veratide	Germany	Marketing Consolidation
Ranbaxy	Signature	USA	Manufacturing Expertise
Ranbaxy	Allen	Italy	European Market; Generics
Ranbaxy	Terapia	Romania	Romanian Market-presence, Generics Business
Dr Reddy's Lab	Betapharm	Germany	Front End in Germany
Dr Reddy's Lab	BMS	UK	Market Entry Strategy
Dr Reddy's Lab	Roche's API Facility	Mexico	Increasing presence in Contract Manufacturing
Wockhardt	Wallis&C P Pharma	UK	European Market
Wockhardt	Espharma	Germany	Complementary Porfolio; European Market
Wockhardt	Pinewood Labs	Ireland	OTC & Renal Therapy Drugs; European Market
Wockhardt	Negma Laboratories	France	Portfolio of Patented Drugs; European Market
Sun Pharma	Caraco Pharma	USA	Distribution and Manufacturing Facility

(*Contd*)

(*Contd*)

Sun Pharma	Able Labs	USA	Manufacturing Facility in US; Turnaround Potential
Sun Pharma	Valeant Manufacturing	USA	Controlled Substance Manufacturing Facility
Sun Pharma	Taro	Israel	Access to Dermatology and Topical Products
Aurobindo Pharma	Milpharm	UK	Generic Formulations Business; UK Market
Dishman Pharmaceuticals	Carbogen Amcis AG	Switzer-land	R&D Facilities In Switzerland
Dishman Pharmaceuticals	Synprotec	UK	CRAMS Capabilities, Facility in UK
Glenmark	Bouwer Bartlett	South Africa	Front End in South Africa
Glenmark	Uno Ciclo	Brazil	Hormonal Brand Portfolio, Brazilian Market Entry
Glenmark	Medicamenta	Czech Republic	European Market
Matrix Lab	Explora Labs SA	Switzer-land	Expertise in Bio-catalysis would help in development of High-Potency API's
Matrix Lab	Doc Pharma NV	Belgium	Front-end in Europe
Matrix Lab	Mchem Pharma Group	China	Backward Integration, ARV Manufacturing in China
Jubilant Organosys	Target Research	USA	Capitalising on CRO Opportunity
Jubilant Organosys	Trinity Labs Inc	USA	USFDA Approved Facility in USA; Pipeline of ANDAs
Nicholas Piramal	Avecia	UK, Canada	Increasing Presence in Contract Manufacturing
Nicholas Piramal	Rhodia's Anaesthetic Business	World-wide	International Product-line
Shasun Chemicals	Rhodia's Pharma Unit	France	CRAMS
Strides Arcolab	Biopharma	Latin America	Entering Venezuela, Emerging Market
Strides Arcolab	Strides Latina	Brazil	To Establish Presence in Brazil
Torrent	Heumann Pharma	Germany	Entry into German Market

Source: www.expresspharmaonline.com (Oct 1-15, 2007).

Table CS1.3 *Foreign Deals by Indian Drug Companies*

Year	Acquirer	Target	Country	Deal Size (Estimated $ Million)
1995	Ranbaxy	Ohm Labs	US	NA
1997	Sun Pharma	Caraco*	US	7.5
1998	Wockhardt	Wallis	UK	9
2000	Ranbaxy	Basics	Germany	8

(*Contd*)

(*Contd*)

2002	Ranbaxy	Veratide**	Germany	5
2002	Ranbaxy	Signature ***	US	NA
2002	Unichem	Niche Generics	UK	5
2002	Dr Reddy's	BMS	UK	16
2003	Wockhardt	CP Pharma	UK	20
2003	Zydus Cadila	Alpharma	France	6.6
2003	Sun Pharma	Caraco*	US	42
2004	Ranbaxy	RPG Aventis	France	84
2004	Glenmark	Lab Klinger	Brazil	5
2004	Dr Reddy's	Trigenesis	US	11
2004	Jubiliant Organosys	PSI Group	Belgium	16
2005	Ranbaxy	Terapia	Romania	324

*Sun in its stake increased Caroco from 36.5% in 1997 to 63% in 2003
**A brand bought from P&G
***Only manufacturing, Not all deals involved 100% stake.
Source: Business World, 28 June 2004.

Table CS1.4 *Major Cross Border Acquisitions by Indian Pharma Companies in 2005-2006*

Period	Acquirer	Target	Country	Deal Size ($ million)
2005	Glenmark	Bouwer Barlett	South Africa	Undisclosed
2005	Sun Pharma	Able Labs	US	23.15
2005	DRL	Roche's API unit	Mexico	59
2005	Nicholas Piramal	Avecia Pharma	UK	16.25
2005	Sun Pharma	Valeant Pharma Unit	Hungary	10
2005	Jubilant Organosys	Trinity Labs	US	12.3
2005	Torrent	Heumann Pharma	Germany	30
2005	Matrix Lab	Docpharma	Belgium	263
2005	Ranbaxy	Efamers SA	Spain	18
2005	Dishman Pharma	Synprotec	UK	3.48
2005	Strides Arcolab	Strides Latina	Brazil	16
2006	Ranbaxy	Terapia SA	Romania	324
2006	Ranbaxy	Allen SPA	Italy	Undisclosed
2006	Ranbaxy	Ethimed NV	Belgium	Undisclosed
2006	DRL	Betapharm	Germany	570
2006	Aurobindo	Milphar Ltd	UK	Undisclosed

Source: Business Standard, Feb 17, 2006.

Table CS1.5 *Deals by Global Generics Companies*

Year	Acquirer	Target	Country	Deal Size ($ Million)
1996	Teva	APS-Berck	UK	53
1996	Watson	Oclassen Pharma	US	135
1997	FH Faulding	Faulding	Australia	276
1998	Teva	Pharmachemie	Holland	83
1998	Alpharma	Cox Pharma	UK	200
1999	Alpharma	Schwarz	Germany	150
1999	Teva	Copley	US	216
1999	Teva	Novopharma	Canada	285
2000	Watson	Schein Pharma	US	701
2000	Cephalone	Anesta Corp	US	454
2001	Mayne Group	FH Faulding	Australia	1,151
2001	Barr Labs	Duramed Pharma	US	590
2002	Baxter	ESI Lederle	US	305
2002	Bio Tech Corp	Rosemont Pharma	UK	99
2002	Pliva	Sidmak	US	153
2002	Teva	Bayer Classics	France	93
2002	Sandoz	Lek	Siovania	746
2003	Teva	Sicor	US	3,400
2004	Sandoz	Sabex	Canada	565
Total				9655

Source: Business World, 28 June, 2004.

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DISCUSSION QUESTIONS

1. What are the reasons for the consolidation in Indian pharma sector?
2. Compare the strategic growth pursuit of the top two pharma players in India.

Case Study 2

MERGERS AND ACQUISITIONS IN THE BANKING SECTOR

WORLD SCENE

The commercial banking industry accounted for more volumes of M&A than any other industry worldwide during the year 1998. More than a fourth of the total merger and acquisition deals involved banks and were worth $102 billion[1].

The trend started in the US in the 1980s. The US banking industry saw more than 7000 mergers between 1980 and 1998. The nineties saw some of the largest mergers in banking history in the US. The number of banks in the US declined by more than a third from 1980 to 1997. Moreover, between 1994 and 2002, more than 1300 new banks were opened in the US in direct response to the perceived decline in service resulting from a bank merger. Simultaneously, the proportion of banking assets, accounted for by the 100 largest banking organisations, increased from over 50% in 1980 to nearly 75% in 1997. The reasons for the mergers were a new statutory environment that allowed interstate ownership and branching; banks seeking scale economies, geographical diversification, and increased competitive pressures.

M&A within the European financial sector has changed the European banking landscape in the past decade. The number of European banks decreased from 12,670 in 1985 to 8295 in 1999.[2] This development is mostly driven by M&As among European banks. The European (EU-15) market concentration, measured by the market share of top five banks in terms of total assets, grew by 12% over the last ten years to 57.1% in 1999. The number of banks per one thousand inhabitants in Europe is almost twice as large (0.49) as in the US (0.27), indicating more concentration potential through M&A transactions in the future.[3]

MERGERS IN INDIAN BANKING INDUSTRY

Banking is the mirror reflection of an economy. The performance of any economy, to a large extent, is dependent on the performance of its banks. Banking has undergone a metamorphosis globally as well as in India. The concept of banks, financial institutions and NBFCs is getting merged. The financial services sector is seeing a consolidation, with all segments of players offering a plethora of services. With the maturing of debt and capital markets, the dependency on banks for loans is diminishing. Mutual funds, insurance and NBFCs have dug into the coffers of bank deposits. Distribution of financial products through multiple delivery channels will be one of the key success factors in the next millennium. In 1969, there were 73 scheduled commercial banks (SCBs). Today, there are about 100 scheduled commercial banks, four non-scheduled commercial banks and 196 regional rural banks (RRBs). The State Bank of India and its seven

[1]The Economist, March 13, 1999.
[2]European Central Bank Report 2000.
[3]European Central Bank Report 2000, Berger et al. (1999).

associates have about 14,000 branches. Other 19 nationalised banks have 34,000 branches, the RRBs 14,700 branches and foreign banks around 225 branches. The old and new private banks collectively account for about 68,000 branches across the country. However, only the State Bank of India is among the top 200 banks in the world. Consolidation of the industry will help banks raise capital for growth from the financial market without further liquidating the public sector character of ownership and management.

Over the past few decades, 36 banks and non-banking finance companies have been merged. Most of these mergers were bail-out operations forced by RBI to protect depositors' money. Examples of mergers are New Bank of India with Punjab National Bank in 1989-1990, Bank of Karad with Bank of India in 1993-1994, Global Trust Bank with Oriental Bank of Commerce in 1994, Nedungadi Bank with Punjab National Bank, and United Western Bank takeover by IDBI. The notable exceptions were HDFC Bank's takeover of Times Bank, the unification of IDBI Bank with IDBI, the merger of SCICI, Anagram Finance, ITC Classic, Bank of Madura and ICICI with ICICI Bank. ING integrated its banking operations in India with Vysya Bank and formed a common umbrella brand ING-Vysya for its banking, asset management and insurance business in India. ABN Amro Bank NV acquired the retail banking operations of Bank of America and enhanced its presence in the country. Bank of Baroda took over the Benares State Bank. The takeover of private banks with strong presence in certain defined geographical regions makes good sense for foreign banks that are seeking to expand their Indian presence.

A recent example of inorganic growth in banking sector is the recent merger of Centurion Bank and Bank of Punjab to form Centurion Bank of Punjab. Centurion Bank later merged with Lord Krishna Bank. Weak and private sector banks are being taken over by stronger banks as part of regulatory requirements. Ganesh Bank, which lost its net worth due to accumulated losses, was taken over by Federal Bank. The United Western Bank was taken over by IDBI Bank.

Strategic Role of M&A

The Indian banking system has undergone major changes that have affected both its structure and the nature of strategic interactions among banking institutions. The demands of the new operating environment have made consolidation via mergers and acquisitions a strategic necessity. In addition to its traditional savings cum lending functions, the banking industry is moving to other financial services–including bank-assurance and security trading. M&A, as a preferred route for inorganic growth, becomes more significant when the banks work as total financial service providers.

Fragmentation of the banking system is leading to a situation where no player would have the critical mass necessary to compete in globally. During the financial period 2001-2005, only four banks had been able to cross the market capitalisation of Rs 50 billion. Smaller fragmented banks, with no economies of scale, low capabilities to manage risks and poor market power, cause irreparable loss to their depositors. This fact is evident from the forced mergers of troubled banks by the regulator. Global Trust bank had significant exposure to high risk mid-size corporates and an excessive exposure to capital market operations. In the case of Madhavpura Mercantile Cooperative Bank, nineteen customers had unsecured loans worth more than Rs 10 billion. The South Indian Cooperative Bank had non-performing assets (NPAs) from excessive lending to a small group of clients. Nedungadi Bank had significant exposure to plantation industry, and had weak credit risk management systems and processes. United Western Bank and Sangli Bank became targets for acquisition due to their risk profile.

Regulatory changes may also facilitate the process of M&A in the Indian banking sector. The RBI regulation stipulates that the Capital to Risk Weighted Asset Ratio (CRAR) be at 9%. Some banks may be forced to undertake the restructuring route of M&A in order to meet the regulatory requirement. Moreover, there are banks whose growth is restricted due to unavailability of capital. Though these banks have a significant depositor base, the market perception does not encourage them to further raise funds. These banks can also become targets of acquisition.

In a strategic perspective, mergers and acquisitions in the banking sector helps to increase economies of scale and scope, and provide synergistic benefits. Economies of scale would be achieved when an acquirer has the capabilities to improve the collections, service processes, distribution, infrastructure and IT of the target bank. Economies of scope result when the acquirer bank earns enhanced revenue due to new products, segments and the opportunity to cross-sell. Synergy benefits will result when treasury performance improves due to reduction in the cost of funds. The bank will be able to leverage its scale and improve its trading income.

The concept of universal banking, or financial supermarket, has made the relevance of M&A more important. A classical example, often cited, is the reverse merger of ICICI with ICICI Bank.

Technological reasons may also facilitate the process of M&A in Indian Banking industry. It is relatively easier for larger State-owned banks to adopt sophisticated core banking solutions. While it may not be sustainable for smaller banks to adopt technology platforms, which could result in M&A.

M&As have largely been bail-out operations where a weak bank has been merged with a stronger one to avoid its closure. Examples are, New Bank of India was merged with Punjab National Bank and mergers of tottering cooperative banks with healthy public sector banks. This explains the majority of post-liberalisation mergers, barring the mergers of Times and HDFC banks, and Bank of Madura and ICICI, where faster growth dynamics dictated the moves. Presently, the acquiring entity need only seek RBI's acknowledgement on taking over 5% in any bank, while the SEBI governs the swap ratio of the takeover. The issue of management takeover, however, is a gray area. Narasimham Committee has suggested a tiered structure with an oligopolisitic uppermost layer of national/global large banks followed by regional and local area banks. Apart from structural objectives, the RBI is also likely to deploy its knowledge of each bank, which it acquires owing to its supervisory status, in deciding consolidation proposals. RBI's aim in seeking clear statutory provisions on these issues is to enhance its powers to achieve size and scale for the Indian banking industry.

Banks in India want a bigger role in the M&A scene. Some banks have survived on government support over the past decade in the form of thousands of crores of recapitalisation bonds. These banks are keen to take over other banks to become more strong. Strong public sector banks, too want to acquire banks with an overseas presence as to become global entities. Banks are also increasing their domestic presence. For example, Bank of Baroda, with solid presence in western India, is focusing on opportunities in the north, east and south. Vijaya Bank, based in the south, and Punjab National Bank, based in Delhi, would also like to improve their domestic presence.

Review of the Scenario

The next banking revolution foretells a wave of global consolidation, mergers and acquisitions. During the period 1994-2002, there were more than 3300 mergers and $3 trillion in banking assets were acquired.

The international banks, keen to grow inorganically, have been lobbying for change in the norms governing local acquisitions. Foreign banks in India have been focusing more on corporate banking and foreign exchange instead of retail finance. The competitive environment has been forcing banks across the globe to grow through mergers and acquisitions, as bigger banks can afford to provide a broad range of products, apart from attaining capital adequacy norms. Geography will play a key role in M&As in this sector. In international context, size is increasingly the trend. The fifth largest bank in China is probably bigger than the top five Indian banks put together in terms of assets. As net margins get thinner, the need for sophisticated products and low cost technology will be felt. Unless consolidation takes place in the banking industry, substantial cut in cost per unit of production cannot be achieved.

Table CS2.1 *Major M&A in Banking/NBFC Sector in India*

Year	Acquirer	Target
1969	State Bank of India	Bank of Behar
1970	State Bank of India	National Bank of Lahore
1971	Chartered Bank	Eastern Bank
1974	State Bank of India	Krishnaram Baldeo Bank Ltd
1976	Union Bank	Belgaum Bank Ltd
1984-85	Canara Bank	Lakshmi Commercial Bank
1984-85	State Bank of India	Bank of Cochin
1985	Union Bank	Miraj State Bank
1986	Punjab National Bank	Hindustan Commercial Bank
1988	Bank of Baroda	Trader's Bank
1989-90	Allahabad Bank	United Industrial Bank
1989-90	Indian Overseas Bank	Bank of Tamil Nadu
1989-90	Indian Bank	Bank of Thanjavur
1989-90	Bank of India	Parur Central Bank
1990-91	Central Bank of India	Purbanchal Bank
1993-94	Punjab National Bank	New Bank of India
1993-94	Bank of India	Bank of Karad
1995-96	State Bank of India	Kasinath Seth Bank
1996	ICICI	SCICI
1997	ICICI	ITC Classic
1997	Oriental Bank of Commerce	Bari Doab Bank
1997	Oriental Bank of Commerce	Punjab Cooperative Bank
1998	ICICI	Anagram Finance
1999	Bank of Baroda	Bareilly Corporation Bank
1999	Centurion Bank	20th Century Finance Corporation
1999	HSBC	British Bank of Middle East
1999	Union Bank	Sikkim Bank
2000	HDFC Bank	Times Bank
2000	Standard Chartered Bank	Grindlay's Bank
2001	ICICI Bank	Bank of Madura
2002	ICICI Bank	ICICI
2002	Bank of Baroda	Benares State Bank
2002	ING	Vysya Bank
2003	Punjab National Bank	Nedungadi Bank
2004	Bank of Baroda	South Gujarat Local Bank
2004	Oriental Bank of Commerce	Global Trust Bank
2004	IDBI	IDBI Bank
2006	United Western Bank	IDBI Bank
2006	Centurion Bank	Lord Krishna Bank
2006	The Federal Bank	Ganesh Bank of Kurundwad

HDFC–Times Bank The HDFC–Times Bank merger took place in the year 2000. It was driven by the market forces. The merger helped HDFC Bank to become one of the largest private sector banks in the Indian banking industry. The Bennett Coleman Group, which promoted the Times Bank, had about 7.5% shares in HDFC Bank after the merger. The merged entity continued to function as HDFC Bank. The merger helped HDFC Bank to increase its customer base by 2,00,000. It also provided cross-selling opportunities to the increased customer population. The branch network increased from 68 to 107. With this merger, HDFC saved on costs associated with technology upgradation, as Times Bank had technology in place. Product complementarity was more for ATM card networks. HDFC Bank had Visa network while Times Bank had Master card network. On account of the merger, the merged bank became part of both the networks.

Merger in the period 2002-2006

In 2002, Reserve Bank of India unveiled a draft scheme to merge Kerala based Nedungadi Bank with the public sector Punjab National Bank after putting it under moratorium for three months. Nedungadi Bank was guilty of violating arbitrage norms. It wanted to make a killing on the price difference of shares on the BSE and NSE, an activity forbidden by the regulator. A string of brokers were holding substantial stake in the bank, which had given loans to companies fronted by brokers.

In 2004, Reserve Bank of India announced the merger of Global Trust Bank with Oriental Bank of Commerce, 48 hours after imposing a moratorium on the beleaguered private bank. The reasons often cited by the management for collapse of Global Trust Bank were the 2001 stock market fall and violations of internal procedures in sanctions. Oriental Bank of Commerce was expected to recover 40-45% of Rs 1500 crore non-performing assets of Global Trust Bank within one year of the merger. Oriental Bank of Commerce got 104 branches and 275 ATMs besides 1200 employees and an asset book of Rs 6800 crore. Technology will play a dominant role in the consolidation. RBI chose Oriental Bank of Commerce to merge with Global Trust Bank because both banks shared the same technology platform.

In 2005, the boards of Bank of Punjab and Centurion Bank approved the merger of the two banks to create Centurion Bank of Punjab. The merger gave Centurion Bank access to 120 branches in the north which increased its total branch network to 220, and asset base to Rs 10,000 crore. Later, the Kerala based Lord Krishna Bank (LKB) was merged with Centurion Bank of Punjab. The merged entity had a network of 361 branches and 12 extension counters across the country, with employee strength of over 6500. It had a deposit base of Rs 12,650 crore and a loan book of Rs 8,873 crore. The combined balance sheet size was Rs 15,080 crore. For the unlisted LKB, this was the second proposal, as the first one with Federal Bank fell through, reportedly due to differences with respect to valuation and opposition from the Federal Bank Staff Union. The merger gave Centurion Bank of Punjab an expanded retail presence in the southern states like Kerala.

On January 19, 2006, the Reserve Bank of India announced an amalgamation scheme for merging the family controlled Western Bank of Kurundwad with Federal Bank. The Aluva based bank was willing to invest Rs 30 crore capital into Ganesh Bank from its Rs 657 crore reserves, as it would give the bank greater exposure to Maharashtra, and help build its agriculture loan portfolio.

In February 2006, Indian Overseas Bank board cleared a proposal to buy 70% stake of six banks in Bharat Overseas Bank, to take over the old private bank in which it held 30% stake. The six banks were Bank of Rajasthan, Vysya Bank, Karur Vysya Bank, Federal Bank, South India Bank and Karnataka Bank. This was the first instance of an old private bank being taken over by a PSU bank without the moratorium route.

Again, in 2006, Lord Krishna Bank merged with Centurion Bank of Punjab. Mohan Puri who held 65% stake in Lord Krishna Bank was under pressure from the Reserve Bank of India to bring down his stake. On an earlier occasion, it entered into an MoU with Federal Bank for stake sale but the deal did not materialise due to serious differences on valuation. In 2006, with this merger, Centurion Bank of Punjab's asset base rose close to Rs 16,000 crore.

In 2006, United Western Bank was taken over by IDBI. United Western's failure to find a partner for capital infusion conforming to Reserve Bank of India's fit and proper promoter criterion was the main reason behind RBI's action.

SELECT CASES OF BANK MERGERS

Standard Chartered Bank Acquisition of Grindlay's Bank[4]

Standard Chartered Bank was created in 1969 when Standard Bank of British South Africa, founded in 1863, merged with the Chartered Bank of India, Australia and China.

Stanchart is the largest foreign bank in India. By the year 2006, the bank had 81 branches across 31 cities with a customer base of 2.1 million in consumer banking, and over 1000 top corporate relationships. For the Standard Chartered Bank, India is the third largest market after Hong Kong and South Korea. In 2005, India accounted for nearly 9% of the bank's total income of $6.86 billion. India is among StanChart's five standalone markets, along with Hong Kong, Korea, Singapore and Malaysia. The big shift in StanChart's geographical focus came in 1986 when Lloyds Bank made a hostile bid for it. After defeating the move, the bank decided to make provisions against the third World debt and borrowers' defaults. It also began a series of divestments in the US and South Africa. In 1993, under the chairmanship of Sir Patrick William, the bank decided that Asia, West Asia and Africa would be its focus areas. It acquired Korea First Bank for $43.3 billion, outbidding HSBC's $2.7 billion offer. Earlier, it had purchased Indonesia's Bank Permata through a joint venture for $366 million. The StanChart bought out the $1.33 billion JP Morgan Chase's retail and credit card assets in Hong Kong, and made a $320 million deal for Thailand's Nakornthon Bank. The acquisition of Grindlays Bank in West and South Asia, and the Chase's consumer banking business in Hong Kong were the two largest acquisitions in the history of the bank. The former acquisition made Standard Chartered Bank the largest bank in the South Asian region, overtaking Citi Bank and HSBC. The latter acquisition made Standard Chartered Bank the largest credit card issuer in that market. The global CEO, Rana Talwar, was scouting for acquisitions that would make it the leading bank in emerging markets. In India, the bank's consumer banking operations were headed by Harpal Duggal, and its corporate banking issues by Jaspal Bindra. Jaspal Bindra became the CEO of the merged entity.

The first branch of ANZ Grindlays had opened for business in India in Kolkata in 1854. By 2000, Grindlays was the third largest foreign bank in India in terms of assets. It strengths included strong brand recall, broad distribution channel and large corporate banking business. The ANZ Group brought in Anuroop Tony Singh as CEO in December1998 to restructure the bank. The ANZ Group had been looking to sell its Grindlays business in order to concentrate on its main market in Australia and New Zealand.

In 2000, StanChart acquired Grindlays Bank. Though StanChart was the acquirer, Grindlays was the bigger of the two. Grindlays had nearly 60% of the 5200 workforce.

The bank paid $1.3 billion for Grindlays' business in West Asia, along with the private banking part. The Grindlays deal happened when Rana Talwar was CEO at StanChart Plc. The Standard Chartered and Grindlays were merged in India as part of a larger $1.34 billion global deal between the two banks. In the year 2000, the merger created India's largest foreign bank with assets of Rs 20,000 crore plus, surpassing Citibank's Rs 15,000 crore. With 1.1 million members, it also piped Citibank as the biggest credit card issuer in the country. As a result of the merger, StanChart added 41 branches to its existing 17, and over 270,000 customers to its existing base of 350,000 customers. Its home loan portfolio swelled almost tenfold. Two years after the completion of the integration process, the new Standard Chartered Bank had assets worth

[4]Avinash Celestine, Cover Story, 'Standard Chartered, Rana Talwar's Big Gamble', Business World, 22 October, 2001 page 34-42; Roshini Jayakar, 'Super Bank, The Sequel', Business Today, page 40-48.

Rs 29,291 crore and 61 branches and 74 ATMs across 15 cities. The cost of the acquisition was 2.3 times Grindlays' book value, reflecting goodwill of $750 million. The Indian operations were valued at around $530 million. The Grindlays deal gave StanChart a better presence in countries–such as Bangladesh, Sri Lanka, Nepal, Pakistan, UAE, Qatar, Bahrain, Iran, Jordan and Greece. During early 2000, StanChart derived most of its profits from a small number of so-called core countries–Hong Kong, Singapore and Malaysia besides India—though it was operating in about 50 countries. Through the merger, Standard Chartered aspired to be among the top three players across products—such as credit cards, loans and investment services. Its retail strategy included

- To increase participation in existing markets
- Expand presence to 25 cities
- Reduce the cost income ratio
- Balance portfolio by focusing on secured products, NRI business and SMEs.

StanChart also emerged stronger in the area of corporate banking business with over 800 top corporates, courtesy Grindlays' Bank. The bank's large capital base enabled it to provide highest local currency limits amongst private sector banks.

Integration Issues The two banks had a number of cultural differences. It was said that StanChart was more aggressive. There were differences in compensation and benefits systems. Grindlays offered huge benefits–like housing loans, children's education loans and club memberships. It also had a liberal leave policy. On the other hand, StanChart doled out more cash, and had performance-linked bonuses. There was lot of difference in the profile of two banks. Till 1997, StanChart's retail businesses were focused on liabilities. It picked up low cost deposits to finance its corporate banking business. The scenario changed when large corporations were flush with funds. Consumers also found mutual funds more attractive. Globally, the credit card business contributed much to the profitability of banks. StanChart focused on its retail assets by ramping up its credit card, personal and share finance and car loan businesses. The credit card base rose from 250,000 in 1997 to 650,000 at the time of merger. The bank choose to use a large outbound sales team instead of relying on its branches.

Grindlays was focused on leveraging its 41 branch banking network to mobilize customers. It tried to acquire customers by selling them deposits, and then trying to cross-sell them other products, like credit cards. Grindlays was more relationship oriented than StanChart.

In wholesale banking, Grindlays had a strong presence among the top five hundred companies in India. Its fixed income and asset management divisions were its assets.

In the period before the merger, StanChart's retail business was built around an aggressive credit card business. It also had a share of personal loans and mortgage businesses. The merged entity focused on building a massive branch and ATM network. StanChart offered its customers choice of using other bank ATMs. The merged entity focused on opportunities for cross selling retail products—like accounts, credit cards and deposits. The merged bank restructured into five value centres, namely a) Unsecured business (cards and personal loans), b) Secured products business (auto and home loans), c) Wealth Management business (accounts and deposits), d) Mutual funds and insurance sales and e) Corporate Advisory Services. Within a period of two years, the merger was expected to result in a mix of cost and revenue synergies of atleast $110 million.

The Process of Integration As a result of merger, two people were available for each position. The new CEO, Bindra, followed the guideline that neither of the two banks would account for more than 60% of the jobs. The people offered separations were outplaced. The integration committee insisted on hiring afresh. Everyone had to re-apply for his or her job. Standard Chartered lost only two key employees.

The Reserve Bank of India was concerned about the Standard Chartered-Grindlays' integration. RBI carried out an inspection of the bank in July 2002. In May 2002, the bank had submitted a scheme of amalgamation to the RBI. The regulator approved the scheme in mid-August, and on August 31, 2002 Standard Chartered announced the completion of its merger process. As a result of the integration process of managing real estate, Standard Chartered Grindlays' Bank had to change nearly 350 document formats, 500 lease agreements, and 800 items of stationary and marketing merchandise. Branches in cities like Guwahati, Kanpur and Shimla were closed. The divestment of 10,00,000 sq.ft of real estate fetched the bank Rs 110 crore.

Standard Chartered followed a centralised processing model while Grindlays had a decentralised model. The new Standard Chartered Bank did not follow sweeping guidelines. On September 2002, the liabilities of the two banks were merged, and close to 600,000 accounts were moved into one network.

StanChart is one of the foreign banks to have grown inorganically in India. In 2005, it acquired stakes in Sumitomo Mitsui's local branches. The bank had more than doubled its balance sheet size to Rs 48,000 crore from Rs 20,605 crore at the time of the Grindlays' transaction.

The bank was involved in Tata Steel's $ 486 million acquisition of NatSteel in Singapore, and of Millennium Steel in Thailand. The bank was also involved in Perot Systems Inc's purchase of the 50% stake held by HCL in HCL Perot Systems, and the Scandent Group's acquisition of Cambridge Integrated Services in the US.

The other banks which had taken the inorganic deal route include ING Bank and ABN AMRO. In 1999, ABN AMRO purchased BankAm's retail portfolio. In 2002, ING Bank acquired the GMR Group's stake in Vysya Bank, now ING Vysya Bank.

Mergers by the ICICI Group

The Industrial Credit and Investment Corporation (ICICI) was founded in the year 1955 at the initiative of the World Bank, the Government of India and representatives of Indian industry. The principle objective was to create a developmental financial institution for providing medium-term and long-term project financing to Indian businesses.

During the period 1997-98, ICICI announced three mergers—with Shipping Credit and Investment Corporation of India (SCICI), with ITC Classic and with Anagram. On acquiring ITC Classic, ICICI's own network improved by 10 branches, 12 franchisees and depositor base of almost 7,00,000. Through its merger with Anagram, ICICI gained 50 branches and depositor base of 2,50,000 in western India. ICICI was attracted by the retail portfolio of Anagram, which was active in lease and high purchase, car finance, truck finance and consumer finance. ITC Classic Finance Ltd was the beleaguered non-banking financial arm of ITC Ltd. ITC Ltd was desperately scouting for a buyer for ITC Classic, which had accumulated losses of over Rs 300 crore. As a pre-condition to the merger, ITC had committed to inject Rs 350 crore into ITC Classic by way of preference capital of 20 years maturity, carrying a nominal dividend. The merger of SCICI helped ICICI to gain strength in infrastructure financing, and in the shipping line of credit, which formed 27% of SCICI's business.

ICICI Bank–Bank of Madura Merger ICICI Bank was established in 1994 by the Industrial Credit and Investment Corporation of India (ICICI) as a new generation private sector bank. It was the first Indian bank to be listed on New York Stock Exchange. By 2002, ICICI Bank had total assets of about $79 billion, a network of over 950 branches, 3500 ATMs and 24 million customers. Bank of Madura was a South Indian bank, established in 1943, with a track record of 57 years and strong brand equity. Bank of Madura was a profitable and well capitalized private sector bank. It had low cost of deposits, at 7.3% and high return on equity, 21.3%. At the time of the merger, the Bank had total assets of Rs 39.88 billion, and deposits of Rs 33.95 billion.

ICICI Bank went for merger with Bank of Madura, basically to enhance its customer base, geographical base and shareholder value. Bank of Madura had strong presence in the South. With the merger with Bank of Madura, ICICI Bank became richer by almost 260 branches, 2500 personnel, deposit base of around Rs. 37 crore and strong presence in South India. The synergy for the merger was in terms of financial capability also. With combined assets of Rs 16,000 crore, ICICI Bank would be amongst the largest private sector banks in India, with strong financial and operational structure which have given the bank greater capability for resource/deposit mobilisation. The combined customer base enabled ICICI Bank to offer banking and financial services and products. It also facilitated cross selling of products and services of the ICICI Group. The merger enabled ICICI Bank to provide ATMs, Phone and Internet banking and financial services and products to a large customer base, with expected savings in costs and operating expenses. The merger also proved advantageous for ICICI bank with respect to priority sector lending. ICICI Bank, through the merger was able to get access to 87 rural and 88 semi-urban branches. ICICI Bank was also able to lend for micro-finance activities through self-help groups and agricultural sectors under its priority sector initiatives.

The Reverse Merger of ICICI with ICICI Bank Development financial institutions have been facing huge problems with respect to business activity and resource mobilisation. State Government owned financial institutions had to borrow from markets at relatively high cost of funds. Moreover, the funding of long-term projects was done with short-term funds, which led to critical asset-liability mismatch.

The reverse merger of ICICI with its offspring, ICICI Bank, was aimed at becoming a universal bank, and the merger made it the second largest bank in India. The merger caused ICICI Bank to gain critical mass and major thrust on the retail front.

This merger brought development institutions into the domain of retail banking. ICICI Bank wanted to wipe out its huge portfolio of bad assets and make retail account for 45% of the total loans. The merger obtained the consent of some 70-odd foreign institutional investors who own 47% of the merged entity.

K V Kamath's universal banking project was internally code named *Project Dream*.The development financial institutions–such as IDBI and ICICI–had been created in the 1950s to meet the financial requirements of Indian industry.

The date of the merger was 31st March 2002. The merged entity, ICICI Bank Ltd, with an asset base of over Rs 95,000 crore, emerged as the country's second largest bank after the State Bank of India. The merger of two wholly owned subsidiaries of ICICI–ICICI Personal Financial Services and ICICI Capital Services–also took place in 2002. The merged entity also had 396 branches/extension counters, 140 retail finance offices and centres and 8275 employees. ICICI Personal Financial Services was into distribution and servicing of various retail credit products–including auto and home loans–and had around 40 offices across the country. ICICI Capital was into distribution of financial products of the ICICI Group, and had around 100 offices across the country.

In the organisational revamp, ICICI defined the role and structure of over 30 major groups. The new entity had a new board with N Vagul as the non-executive chairman, and the executive management comprised of K V Kamath as MD and CEO, H N Sinor and Lalitha D Gupte as joint MDs, and Kalpana Morparia, S Mukherji, Chanda D Kochhar and Nachiket M Mor as executive directors. The elements of new strategy included focus on the following issues: aggressive capital management, optimal size, technology intensive multi-channel delivery architecture, world class skill bases and enduring customer relationships.

Before the merger, ICICI held 46% of the paid up equity share capital of ICICI Bank. This holding constituted 15% of the merged entity. The swap ratio had been fixed at one share of ICICI Bank for every two shares of ICICI. This was based on the valuation by ICICI's advisors, JM Morgan Stanley and DSP Merrill Lynch. The regulator appointed audit and consultancy firm AF Ferguson as an independent evaluator. The merger was approved by 99.9% plus ICICI shareholders at a court convened meeting.

Regulatory Issues At the time of the merger, one of the critical issues for the merged bank was concern about the priority sector lending norms. While the norms specify that 40% of the net bank credit has to be aimed at the priority sector, ICICI was far short of that level. It required Rs 23,000 crore by way of Statutory Liquidity Rights (SLR) for the combined entity. The bank had Rs 5000 crore in its SLR portfolio. ICICI mobbed up SLR aggressively, funding it through a combination of retail deposits and asset swaps.

Regulations did not allow the merged bank to have any subsidiary that was involved in non-banking activities. In fact, ICICI had already reduced the number of subsidiaries from 33 to 11 in the run-up to becoming a universal bank. The core subsidiaries included ICICI Prudential Life Insurance, ICICI Lombard General Insurance, ICICI Venture Funds Management and ICICI Securities and Finance. ICICI had to lower its stake in ICICI InfoTech to 30% from 92%. RBI stipulates that 25% of a bank's branches have to be located in semi-urban and rural areas. ICICI Bank was able to meet this criteria due to its merger with Bank of Madura. At the time of the merger, the capital adequacy situation was under control. ICICI Bank's capital adequacy ratio stood at 14.1% and ICICI's at 14.8%. The merged entity had a capital adequacy ratio of 12.1%.

The merged entity had 358 branches, of which 173 were semi-urban and rural branches, which was 49% of the total. At the time of the merger, the Bank had an impressive 1000 ATMs.

Merger Gains The major gains may be classified as follows:

- Economies of scale through volumes in operating costs and technology development
- Economies of scope through large product suite and cross selling potential
- Optimisation of human and financial capital.

For ICICI: The merger helped to improve its ability to diversify its portfolio and revenue. It also lowered cost of funds by offering access to retail funds. It also provided opportunity to ICICI to grow fee income. The key impact of the merger was on ICICI's cost of funds. As a financial institution, ICICI had been raising funds on an incremental basis, at an average rate of 10.5%. The ICICI Bank was raising funds, at an average rate of 7.2%. The cost of borrowing for the new entity was expected to come down by at least 100-150 basis points. ICICI got access to cheap retail funds. ICICI was constrained in exploiting its corporate relationships to develop fee income as it was not a part of the banking system, and was precluded from broad based access to trade and forex related services. Though ICICI Bank could pursue these businesses, it did not have sufficient capital. The combined entity had significant capital to extract synergies in fee income after the merger.

For ICICI Bank: The merger catapulted ICICI Bank to the number 2 position in the banking industry, and it became the largest private sector bank in India. The bank gained critical size in assets and distribution. The expected merger benefits include improved access to low cost retail deposits, and a more unified organisation structure that would enable better penetration of the group's customer base and better utilisation of resources. The ICICI Bank could achieve size and scale operations by leveraging ICICI's capital and client base for higher fee income and higher profitability, by leveraging on technology and low cost structure and access to its talent pool. The bank would be able to provide a complete product suite with immense cross selling opportunities through ICICI's presence in retail finance, insurance, investment banking and venture capital.

ICICI Group has a strong distribution network and technology platform. This would enable ICICI to cross-sell a suite of products in the most cost effective manner.

The merged portfolio consist of two major service segments:

(a) Retail Services: ICICI; ICICI Bank; ICICI Capital; ICICI Prudential; ICICI Web Trade; ICICI Personal Finance; ICICI Home.

(b) Corporate Services: ICICI; ICICI Bank; ICICI Securities; ICICI Brokerage; ICICI Venture; ICICI InfoTech; ICICI Lombard.

At the time of the merger, ICICI had Net NPAs at around Rs 3000 crore or 5.3% while ICICI Bank had net NPAs at 1.36%.

Before the merger, the bank had 70% in retail deposits and 30% in corporate deposits. The aim of the merger was to bring retail to 60%, with corporate deposits and bonds accounting for 40%. In 2002, ICICI had highest number of auto and consumer loans in the country, second highest number of home loans and third highest number of credit cards. The bank also had leadership position in Internet banking. The retail sector was poised to become the largest distribution powerhouse in the country by distributing a range of products–like third party products, mutual funds, insurance (life and non-life), pension products and bonds issued by RBI and other entities. The major focus of the bank was on cross selling. In 2002, the cross selling ratio was 1.1, that is, every ICICI customer held 1.1 ICICI products. The major advantage of the cross selling is that customer acquisition cost comes down massively and credit quality increases.

Table CS2.2 *Bank Mergers in India During the Period 1961-2008*

	Target	Acquirer	Year	No.	Target	Acquirer	Year
1	Prabhat Bank Ltd	National Bank of Lahore Ltd	1961	40	Bareilly Bank Ltd	Benarus State Bank Ltd	1964
2	Indo Commercial Bank Ltd	Punjab National Bank	1961	41	Thiya Bank Ltd	Lord Krishna Bank Ltd	1964
3	Bank of Nagpur Ltd	Bank of Maharashtra	1961	42	Allahabad Trading & Bkg Corp	State Bank of India	1965
4	New Citizen Bank Ltd	Bank of Baroda	1961	43	Vettaikaran Mahajan Bank	Bank of Madura Ltd	1965
5	Travancore Forward Bank	State Bank of Travancore	1961	44	Malnad Bank Ltd	State Bank of Mysore	1965
6	Bank of Kerala Ltd	Canara Bank	1961	45	Josna Bank Ltd	Lord Krishna Bank Ltd	1965
7	Bank of Poona Ltd	Sangli Bank	1961	46	Amrit Bank Ltd	State Bank of Patiala	1968
8	Bank of New India Ltd	State Bank of India	1961	47	Chawla Bank Ltd	New Bank of India	1969
9	Venadu Bank Ltd	South Indian Bank Ltd	1961	48	Bank of Behar Ltd	State Bank of India	1969
10	Wankaner Bank Ltd	Dena Bank	1961	49	National Bank of Labore Ltd	State Bank of India	1970
11	Seasia Midland Bank Ltd	Canara Bank	1961	50	Miraj State Bank Ltd	Union Bank of India	1985
12	Kottayam Orient Bank Ltd	State Bank of Travancore	1961	51	Lakshmi Commercial Bank Ltd	Canara Bank	1985
13	Bank of Konkan Ltd	Bank of Maharashtra	1961	52	Bank of Cochin Ltd	State Bank of India	1985

(*Contd*)

(*Contd*)

14	Poona Investors Bank	Sangli Bank	1961	53	Hindustan Commercial Bank Ltd	Punjab National Bank	1986
15	Bharat Industrial Bank Ltd	Bank of Maharashtra	1961	54	Traders Bank Ltd	Bank of Baroda	1988
16	Rayalaseema Bank Ltd	Indian Bank	1961	55	United Industrial Bank Ltd	Allahabad Bank	1989
17	Cuttack Bank Ltd	United Bank of India	1961	56	Bank of Tamilnad Ltd	Indian Overseas Bank	1990
18	Pie Money Bank Pvt Ltd	Syndicate Bank	1961	57	Bank of Thanjavur Ltd	Indian Bank	1990
19	Moolky Bank Ltd	Syndicate Bank	1961	58	Parur Central Bank Ltd	Bank of India	1990
20	Merchants Bank Ltd	Tanjore Permant Bank Ltd	1961	59	Purbanchal Bank Ltd	Central Bank of India	1990
21	Tezpur Industrial Bank Ltd	United Bank of India	1961	60	New Bank of India	Punjab National Bank	1993
22	G Raghunathmull Bank Ltd	Canara Bank	1961	61	Bank of Karad Ltd	Bank of India	1994
23	S S Commercial Bank Ltd	United Western Bank Ltd	1961	62	Kashinath Seth Bank	State Bank of India	1996
24	Catholic Bank Ltd	Syndicate Bank	1961	63	Punjab Co-op Bank Ltd	Oriental Bank of Commerce	1997
25	Phaltan Bank	Sangli Bank	1961	64	Bari Doab Bank Ltd	Oriental Bank of Commerce	1997
26	Jodhpur Commercial Bank Ltd	Central Bank Ltd	1961	65	Bareilly Corp Bank Ltd	Bank of Baroda	1999
27	Bank of Citizen Ltd	Canara Banking Corporation Ltd	1961	66	Sikkim Bank Ltd	Union Bank of India	1999
28	Karur Mercantile Bank Ltd	Laxmi Vilas Bank Ltd	1961	67	Times Bank Ltd	HDFC Bank	2000
29	Peoples Bank Ltd	Syndicate Bank	1961	68	Bank of Madura	ICICI Bank	2001
30	Pratap Bank Ltd	Lakshmi Commercial Bank Ltd	1961	69	ICICI	ICICI Bank	2002
31	Unity Bank Ltd	State Bank of India	1962	70	Benaras State Bank Ltd	Bank of Baroda	2002
32	Bank of Algapuri Ltd	Indian Bank	1963	71	Vysya Bank	ING	2002
33	Metropolitan Bank Ltd	United Industrial Bank Ltd	1964	72	Nedungadi Bank Ltd	Punjab National Bank	2003
34	Cochin Nayar Bank Ltd	State Bank of India	1964	73	South Gujarat Local Bank	Bank of Baroda	2004

(*Contd*)

(*Contd*)

35	S K Parameshwari Bank Ltd	Karur Vysya Bank Ltd	1964	74	Global Trust Bank	Oriental Bank of Commerce	2004
36	Unnao Commercial Bank Ltd	Bareilly Bank Ltd	1964	75	IDBI	IDBI Bank	2004
37	Latin Christian Bank Ltd	State Bank of Travancore	1964	76	Centurion Bank	Bank of Punjab	2005
38	Southern Bank Ltd	United Industrial Bank Ltd	1964	77	Lord Krishna Bank	Centurion Bank of Punjab	2006
39	Shri Jadeya S Bank	Belgaum Bank Ltd	1964	78	Ganesh Bank of Kurundwad	Federal Bank	2006

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DISCUSSION QUESTIONS

1. Explain ICICI Group's strategic M&A perspective for growth.
2. Discuss the scope of M&A in the Indian banking industry.

Case Study 3

MERGERS AND ACQUISITIONS IN THE INFORMATION TECHNOLOGY INDUSTRY

The information technology segment includes business process outsourcing and IT enabled services. This sector is witnessing a spate of mergers and acquisitions by Indian IT companies. Many companies have undertaken M&A to increase in size by adding manpower, and to facilitate overall expansion. M&A drivers could be customer acquisition and topline growth, new market entry or competence building. M&As also facilitate significant changes in the business model.

Wipro's acquisition of Spectramind, Nerve Wire and Quantech are all related to acquiring or augmenting competencies. Zensar's acquisition of Hyderabad based OBT Global is another example of the company strengthening its skills in SAP. Valtech's acquisition of Majoris and EDS' take over of Mphasis are examples of companies using acquisition as a strategy to bring about quick changes to their existing business or delivery models.

SOME SIGNIFICANT MERGERS IN THE IT INDUSTRY

Polaris-Orbitech Merger

This merger was aimed at increasing size. The Polaris-Orbitech merger added 1400 employees to Polaris, and increased the merged entity's revenue from $60 million to $125 million. The merger helped in combining skill sets of both companies, which, in turn, led to growth and expansion of the merged entity. While Polaris Software was looking for a specialised product suite, Orbitech needed efficient marketing and service support for its products. Post-merger, Polaris got the Orbi suite framework and combined it with its service expertise to win more customers. After the merger, Polaris has become a large, specialised company in banking, financial services and insurance (BFSI) space; offering solutions, products and transaction services. Polaris' post-merger wins include ABN-AMRO Bank, Kuwait Commercial Bank and Deutsche Leasing. This happened after it acquired the Intellectual Property Rights (IPR) of Orbitech's Orbi suite framework of banking solutions. One of the reasons for Orbitech going in for the merger was that it wanted to shed its image of a Citigroup subsidiary and access the global market.

Acquisition by Wipro

The acquisition of Spectramind by Wipro helped the software giant to expand into BPO space. This strategic acquisition helped Wipro Technologies to offer integrated solutions for all BPO needs of its clients worldwide. Wipro also acquired GE Medical Systems Information Technology (India) to leverage its specialisation in the health science domain. The intellectual property acquired by Wipro from the medical systems software company provided it a platform to expand its offerings in the Indian and the Asia-Pacific healthcare IT market. Through the acquisitions of American Management System and the R&D division of Ericsson, Wipro acquired skilled professionals and strong customer base in the areas of energy consultancy and telecom R&D. Wipro's acquisitions were more inclined towards achieving competencies and geographical reach than achieving scale. The acquisitions of Nerve Wire and AMS and Mpower buyout provided skills to Wipro in the areas of financial securities, utility consulting and niche technologies in payment space. Wipro was involved in acquisition of mid-sized European specialist companies–like Enabler for its retail solutions, Newlogic for wireless IPs and Saraware for embedded technology capability and access to Nordic countries. By buying out AMS, Wipro entered the area of utility consulting and strengthened its business relationship with Shell. Its Nerve Wire acquisition translated into a multi-year contract with General Motors. This acquisition was expected to bring in $65 million in revenues for the next ten years. The acquisition of Enabler was expected to boost its retail practice, which contributed about $200 million (13%) to its overall revenues. Wipro also acquired US based Quantech Global Services for $10 million in an all cash deal to strengthen its mechanical engineering design and analysis services. The target company also had expertise in aviation design. Quantech's strength in mechanical design services complements Wipro's core strength of embedded software capabilities.

Table CS3.1 *Major Wipro Deals*

Target	Cost	Value
Spectramind	Over $5 million	Addition of new service line, end to end positioning
American Management System	$26 million	Domain expertise in niche products, services and existing client relationship
Ericsson's R&D Unit		Expertise in core technologies for cellular switching and transmission equipment
Nerve Wire	$18.7 million	Front-end consulting presence in the US
Quantech	$10 million	Competence in mechanical engineering design and analysis services

Source: News Analysis–Express In.

M&A by Infosys

Infosys have been a conservative player in the area of mergers and acquisitions. The company bought Expert Information Services to strengthen its presence in Australia. Infosys also bought 23% stake in Progeon, an outsourcing company, from Citicorp.

Acquisitions by Tata Consultancy Services (TCS)

TCS has been the most systematic player in the M&A game. In December 2001, the company put in place a specialist M&A team that would function as a think-tank on strategic acquisitions, both in India and overseas. TCS sold its stake in Intelenet, a joint venture with HDFC, and merged the Tata Group's holding in Airline Financial Services, WTI and Phoenix Global Solutions to create TCS BPO in 2004. The CMC acquisition gave TCS a foothold in the government sector. From TCS' point of view, the takeover of CMC was for strategic reasons. CMC had significant market share for software development in India. Also, TCS had little exposure in domain knowledge areas in railway, ports, power, utilities, and oil and gas, while CMC had large and comprehensive exposure in these areas. Though technically Tata Sons have taken over CMC, TCS managed the company.

Tata Consultancy Services had acquired UK based Pearl Group's BPO division, which was the second largest player in the UK life and pension industry. TCS paid about £55 million to acquire 75% stake in the BPO division, while the parent company retained 25% stake. TCS had also acquired Comicrom of Chile for $26 million. This acquisition was in line with TCS' strategy of being in platform based vertical BPOs. Through this acquisition, TCS wanted to leverage Comicrom's relationships to offer banking solutions in both IT and BPO services. TCS later acquired the banking product company, FNS, in Australia. Tata InfoTech was merged into TCS. The merger was basically made for exploiting the various synergies that existed between the two Tata companies. Tata InfoTech, for instance, fitted nicely with four of TCS' primary businesses-IT solutions, where Tata InfoTech brought 15 Fortune 500 clients to the table; infrastructure services, where Tata InfoTech had a highly skilled team of 325; products like the Tax mantra; and a manufacturing plant for electronic assemblies which would enable TCS to become an end to end solutions provider in engineering space right from design to manufacture of prototypes. TCS also got access to Tata InfoTech's 3500 IT professionals.

Table CS3.2 *M&A Deal History of Tata Consultancy Services*

Date	Company Acquired	Size of Deal
November 2001	CMC	Rs 157 crore
May 2003	AFS	NA
March 2004	ASDC	Rs 14 crore
May 2004	Phoenix Global	NA
July 2005	Tata Infotech	Stock swap
October 2005	FNS (Australia)	$26 million
November 2005	Comicrom (Chile)	$23 million

Serial Acquisitions by HCL

HCL Technologies is one of India's leading global IT services company, providing software led IT solutions, BPO and infrastructure management services. Making a foray into the services domain in 1997-1998, HCL Technologies focused on technology and R&D outsourcing, working with clients in core areas of businesses.

Starting in 2001 in a span of 18 months, HCL Technologies struck ten deals to acquire, or set up joint ventures. HCL was focusing on reducing its exposure to technology services, and increasing its exposure in enterprise applications business.

Table CS3.3 *Multiple Acquisitions by HCL*

Year	Acquisitions/JV	Investment (in US$ millions)	Equity Stake	Strategic Reasons
2001	Shipara Technologies	0.6	80%	Entry into avionics, air traffic management, embedded systems
2001	HCL Enterprise Solutions	2.9	100%	Computech's 33 clients & 17 consultants
2001	DSL Ltd	25	100%	Critical head start in banking, financial services, insurance sectors
2001	Apollo Contact centre	NA	NA	Brought captive expertise in select domain, including media and transportation
2001	HCL Northern Ireland	11.5	100%	Strengthen BPO space with process support and contact services
2002	HCL Answerthink (JV with Answer think)	1	50%	IT requirement of Answerthink's client to own centres
2002	Zamba Solutions	1	6%	Greater focus in CRM, eCRM and application development
2002	Gulf Computers	9.75	100%	Rare window to crack the US Government sector
2002	HCL Jones		51%	Entry into retail sector
2002	Aquilla Technologies Ltd	1.1	100%	Unique CAD/CAM & engineering skills specific to Automobile sector
2002	HCL MA Partners	0.6	100%	MA Partners' non-consulting business to own centres in India
2005	AnswerCall Direct Contact Centre	239.9	NA	HCL emerged as the single largest outsourced contact/BPO centre

Source: Business World, 7 October 2002.

OTHER MAJOR M&A ACTIVITIES IN IT SECTOR

In the year 2000, the biggest deals involved the mergers of Global Telesystems and Global Electronic Commerce Services, BFL and Mphasis, Sun Infoways and Zap Infotech, and Shyam Telecom and Spanco Telesystems. In 2001, AV Birla Group acquired 50% stake in the Bangalore based PSI Data System from Groupe Bull of France. NIIT acquired AD Solutions in Germany in 2002, to expand its software business to Europe. Philips acquired 51% stake in Ishoni Networks for networking and telecom applications. In 2002, vMoksha Technologies acquired two similar US based companies, Challenger Systems and Xmedia, for a combined price of $4.10 million, for building critical mass.

Hewlett Packard's buyout of Digital GlobalSoft, valued at $378 million, was the biggest deal in the year 2003. HP, which held 51% stake in Digital GlobalSoft, merged it with its 100% owned subsidiary for global IT services ambitions. Post-merger, Digital got 900 people and Rs 240 crore worth of revenues from HP, apart from becoming HP's preferred vendor for outsourcing in India. The service business was a key growth operation for HP globally, and the global resource model is integral to HP's services delivery strategy. Digital became the focal point for HP services global delivery capability in India.

In 2003, Mascot Systems acquired US based eJiva and Hyderabad based Aqua Regia in order to leverage on the technical expertise of the acquired companies.

The largest deal in 2004 was the Singapore based electronics manufacturer Flexitronics' acquisition of 75% stake in Hughes Software System for Rs 13.9 billion from Hughes Network Services (Direct TV Group).

Mphasis BFL had acquired Kshema Technologies. The acquisition of China based Navion Software helped Mphasis BFL to increase its employee strength by 85 people, and expand into the Japanese and Chinese markets.

The takeover of Mphasis BFL by Electronics Data Systems for Rs 16.9 billion ($377 million) happened at 43 times its 2006 profits.

Oracle Corp acquired Citi's 41% stake in i-Flex Solutions, which had over 5500 people. The deal was valued at the Rs 53.7 billion ($1,194 million). Oracle also bought out Siebel Systems for $10.66 a share in a deal that valued Siebel at $5.85 billion. With this deal, Oracle intended to become the world's biggest customer relationship management maker.

In 2006, in the biggest private equity buyout deal in domestic IT services sector, Flextronics International sold 85% stake in its software development and solutions business—including Flextronics Software Systems and Frog Design—to an affiliate of US-based private equity giant, Kohlberg Kravis Roberts and Co (KKR). The deal involved over $600 million in cash consideration and a $250 million face value note with a 10.5% paid-in-kind interest coupon, which matures in eight years. This strategy was to focus on the re-acceleration of growth opportunities in core Electronics Manufacturing Services (EMS) business–which includes design, vertically integrated manufacturing services, components and logistics.

Notable dotcom M&A include smartbahu.com merging with icleo.com, Indianinfoline.com buying India-fin.com, which had bought out musicurry.com, and Satyam Infoway picking up 25% stake in cricinfo.com. During the era of dotcoms, Satyam Infoway acquired India World.

M&A in BPO Industry

Business process outsourcing is the contracting of a specific business task—such as payroll—to a third party service provider. Usually BPO is implemented as a cost saving measure. BPO is often divided into two categories—*back office outsourcing*, which includes internal business functions, such as billing or purchasing, and *front office outsourcing*, which includes customer related services, such as marketing or technical support. The Indian BPO industry provides services to industries like information technology, financial services, communication technology, consumer goods and services and manufacturing.

BPO is one of the fastest growing sectors of the Indian economy. China is emerging as a strong competitor to India in the BPO industry.

In the age of commoditisation of BPO services and low-end work in application and maintenance, Indian companies have realised the need to focus on the non-cost differentiators to compete with MNC service providers. Indian BPO companies are acquiring BPO businesses even from firms that are reluctant to outsource to offshore locations, such as India. Indian BPO companies are also acquiring overseas companies to focus on high margin niche segments, such as healthcare and market research. These acquisitions are basically meant to improve the processes and front end teams. The Indian industry is also witnessing an increase in multi-vendor and Built Operate Transfer (BOT) contracts, which offer customers such advantages as low risk, scalability and competitive pricing. Vendors are focussing on moving up the value chain to offer high end services, such as equity research and analytics, insurance and technology support and development.

Indian IT service providers are acquiring overseas consulting firms for domain expertise, and to acquire existing overseas customers. These acquisitions were meant to improve the value chain. For example, Wipro acquired the energy and utilities divisions of AMS and Nerve Wire in the US. Cognizant acquired Infopulse in Europe and Ygyan in India. Infosys acquired Expert Systems in Australia. These acquisitions were basically positioned for enhancing geographic presence, strengthening verticals for solution expertise or moving up the consulting value chain. In short, the M&A activity in BPO sector is driven by the success of the global delivery model, business and domain growth, and the capacity to build relationships.

Well performing BPO companies have been targets for larger firms, wanting to expand their service portfolio and strengthen their market position. Groups have diversified across many industries or existing IT companies or BPO firms have acquired other units. Indian IT companies acquire BPO companies for a quick entry into the BPO space, and for customer acquisition. On the other hand, foreign companies acquire Indian BPOs for their skills and manpower. Another advantage of the acquisitions or joint ventures with companies abroad is that they result in back to back orders. The acquisition of Apollo Contact Centre by HCL Tech has helped HCL BPO to bag the $160 million BT contract. The joint venture of Datamatics with Cadmus is another instance of such a deal, wherein Datamatics helped to manage costs more effectively. The ever growing market for back end jobs is one of the reasons for acquisitions. Fierce competition among more than 300 BPO companies in India is also propelling BPOs to function as one stop shops for their clients. Acquisitions in the BPO space give the acquiring company the opportunity to strength its position in the market, by cashing in on the strength of established BPO company. These strengths could be in terms of vertical expertise, established client base, greater geographical reach or skilled and trained manpower. For example, WNS acquired Claims BPO for its strong presence in the healthcare industry. In addition to the increased revenues from a bigger client base, higher valuation is also a motivating factor for BPOs. eBay acquired 100% stake in Internet auction website, Baazee.com, with around 1,000,000 registered users for Rs 2.3 billion ($51 million).

The diversified companies acquire to enter high growth business. Companies like Datamatics Technologies acquired BPO outfits to have an onsite production facility. Most of the deals that have taken place are above $10 million, such as the acquisition of Transwork by the AV Birla Group, the acquisition of Customer Asset and First Ring by ICICI One Source, Apollo Contact Centre by HCL Tech and Corpay by Datamatics Technologies. Wipro acquired of Spectramind for Rs 465 crore (around $99 million). Polaris bought iBackOffice. IBM bought 100% business process outsourcing (BPO) services provider, Daksh Services, for Rs 6.75 billion.

The Indian business process outsourcing and knowledge process industry is likely to witness around 100 mergers and acquisitions, worth $3-5 billion, during the period 2006 to 2010. It has been estimated that out of the projected $3-5 billion transactions in BPO and KPO industry, about 80% will be cornered by big players in the industry.[1] According to McKinsey–Nasscom 2005 report, Indian companies will maintain their 45% share of global BPO market and 65% share of the IT outsourcing market through 2010.

According to Forrester Research, nearly 60% of the captives in India are struggling due to spiralling costs, high attrition and lack of integration and management.

Some of the major acquisitions by Indian BPO industry are:

- Hinduja TMT Ltd acquired US based BPO company, AFFINA for $30 million.
- Secova Services, India's first HR BPO merged with Ultralink, a California based HR and Benefits Management Services provider.
- Wipro Ltd acquired US based Infocrossing Inc and its subsidiaries, in an all cash deal of $18.70 per share, totalling $600 million.
- Infosys Technologies Ltd has acquired three divisions of the business process outsourcing division of Royal Philips NV of Netherlands.
- First Source Solutions Ltd acquired MedAssist Holding Inc for $330 million.

[1]Assocham and Evalueserve Report 2005.

- Sundaram Business Services Ltd picked up 74% stake in Profession Management Consultants (P) Ltd, a Chennai based BPO.
- TCS acquired a BPO firm in Chile, Comicrom, for $23 million which deals in banking and pensions business process outsourcing.
- Mumbai based business process outsourcing company, Accentia Technologies, has acquired three US based healthcare BPO companies for Rs 80 crores.

Chrsy Capital backed Ephinay, one of the earliest niche BPO firms to emerge in India, bought the Phoenix based Core 3.

Since 2000, many global companies–like IBM Global services, EDS and Accenture–have been aggressively scaling up their offshore BPO presence in India.

In the past, when a customer wanted an offshore solution, an IBM or an EDS would partner with an Indian vendor. In the scenario of recession in the US industry, it made sense for global companies to set up their own offshore operations in India to take advantage of the cost arbitrage. The example of IBM Global Services' acquisition of Daksh eServices for Rs 700 crore was signal for the change in BPO industry.

Tech research analyst, Gartner, sees India continuing to retain 80% share of the global offshoring market.

Many overseas BPO industries do not have the depth or the maturity that the Indian BPO industry has developed. An exception would be Australia, which has enough BPO firms with the maturity to compete in verticals like high end financial services.

M&A Strategy in BPO industry

The strategy of M&A in BPO industry will provide the momentum to continue to grow at 40-50%. Third party Indian BPO firms now have a chance to move up the value chain and take on more complex and higher margin segments. Players like ICICI One Source and WNS clearly see themselves evolving into large-scale generic players, with global delivery and front end operations in all three major markets–the US, Europe and Asia Pacific.

The strategy of M&A in BPO industry can be categorised in the following manner.

Basically there are two broad categories of Indian players who aim to offer a blended onshore–offshore offering. In the first category, there are generic players pursuing acquisitions to enter new markets and expand their domain capabilities. In the second category are companies, typically known as niche players, mostly started by US based entrepreneurs of Indian origin with back end operations in India.

First generation players, like Wipro Spectramind, Daksh eServices and EXL Services, have used a consistent policy of organic growth to achieve scale.

The second generation of third party BPO companies, like ICICI One Source, have used organic and inorganic growth to reach critical mass. ICICI One Source is focussing on acquisitions to move up the value chain in financial services, telecom and utilities.

The third generation BPO firms have jumped into the M&A race. Scandent acquired the Illinois based Cambridge Integrated Services for $110 million. Cambridge will be merged with People Mind, the Scandent's BPO subsidiary based in Bangalore.

The niche segment would witness a natural consolidation, where many of these companies would find synergies with a large BPO or IT services company.

West Bridge has investments in a number of niche players, including Indecomm.

Three Indian groups–Godrej, Essar and Hinduja TMT–have made their entry into the BPO space.

Citigroup Global Services, earlier known as e-Serve International, is one of the earliest players in the BPO sector. Genpact was a General Electric captive operation, called GE Capital International Services (GEICS). Later GE sold 60% stake in the firm to General Atlantic Partners and Oak Hill Capital Partners, and also took on non-GE businesses to become a third party captive.

Pricing Strategy

Companies like ICICI One Source and WNS have started tweaking the pricing structure from the current full time employee (FTE) model to a per transaction model. The aim is to get into high end non-voice processes. Forty per cent of ICICI One Source's total business is already on the non-FTE model. As a result of this strategy, the percentage of transaction processing services, as a component of the overall service offering, will increase.

Other Noted Acquisitions in BPO Sector

WNS, the former subsidiary of British Airways, started out with historical capabilities in the airline and travel space. In 2002, WNS acquired Ipswitch based Town and Country Assistance to gain a foothold in the auto insurance claims management segment. Prior to the Town and Country acquisition, the travel and airline business accounted for 97% of its revenues. WNS later bought the US based Claims BPO that facilitated its entry into the US healthcare market, which accounted for 20% of the US economy. The company's acquisition strategy focuses on acquiring one or two verticals every year.

In 2003, ICICI One Source, the business provider offering offshore transact processing and contact centre services, acquired First Ring.

Hinduja TMT acquired Affina for $30 million. It was a strategic fit for TMT's global vision. Illinois based Affina had annual revenues of $60 million, with operations in 7 centres in the US and Canada. With this acquisition, the company will be operating from 14 cities, seven of which are in North America.

In 2006, Secova Services, India's first HR BPO and Ultralink, a California based HR and Benefits Management services provider merged together. Through the merger, the companies were able to offer global clients a broader range of HR and employee benefits administration services, while providing incomparable flexibility through customised offerings. This merger enabled the combined company to leverage technology, global delivery centres and best in class processes to deliver an integrated, human resources and benefits administration supply chain at a cost effective price point.

RECENT ACQUISITIONS BY MAJOR IT COMPANIES

Wipro

In 2007, Wipro acquired Infocrossing in the context of identification of global infrastructure services as an important driver of growth for the company. Infocrossing provides integrated managed infrastructure services to premier global clients. This acquisition was aimed at broadening the data centre and mainframe capabilities of Wipro Technologies, to uniquely position it in the remote infrastructure management space. With its platform based solutions, Infocrossing brings in significant expertise in Health Plan and Payer Management segments. Infocrossing's expertise in hosted and managed IT infrastructure services will enhance Wipro's current service offerings. Wipro had earlier acquired the energy and utilities divisions of AMS and Nerve Wire in the US. These acquisitions gave the company an installed base of customers plus strategic consulting expertise in industries which already had lot of offshore outsourcing. Nerve Wire, which brought about 90 domain experts catering to various segments within the banking, financial services and insurance sectors, was a perfect fit for Wipro's growing financial services business.

Infosys

In 2007, Infosys Technologies Ltd acquired three divisions of the business process outsourcing division of Royal Philips NV for $20 million. The three divisions were engaged in Finance and Accounting. Infosys signed a multi-million dollar outsourcing contract with Royal Philips to provide F&A services and processing of purchasing orders. Infosys also acquired three shared service centres located in Poland, India and Thailand from Philips. Earlier, Infosys bought out Citigroup's stake in Progeon.

Tata Consultancy Services (TCS)

TCS acquired the leading BPO firm in Chile, Comicrom, which deals in Banking and Pensions business process outsourcing, for $23 million The company also acquired Sydney based Financial Network Services. (FNS), a leading Australian core banking solutions vendor, for approximately $26 million. TCS acquired Tata Infotech that focussed on system integration. The company also had a joint venture, named Diligenta, with UK based Pearl Group, and C Edge with State Bank of India. The company also had a joint venture, WMNetServ, with Motorola for managed services for public and private network customers.

Wipro

Wipro acquired cMango Inc, a US based technology infrastructure consulting firm, in an all cash $20 million deal. It also acquired European System on Chip (SoC) design firm, New Logic, in a $56 million all cash deal. The company also acquired Finland based Saraware, a telecom design and engineering services company for $32 million. Wipro also bought a Portugal based company, Enabler, a retail integration and solutions company, for Rs 240 crore.

Satyam

Satyam acquired Citisoft, the business and systems consulting firm focused exclusively on investment management, for $23.2 million.

LATEST ACQUISITIONS IN THE BPO SECTOR: OTHER EXAMPLES

Cognizant Technology Solutions, the IT and BPO services company, paid $135 million in cash to acquire New Jersey based marketRx, a provider of analytics and related software services to life sciences companies in 2007. It was the biggest acquisition made by Cognizant. It was also the second high profile deal made in the KPO space, after WNS snapped up Bangalore headquartered, Marketics, for $65 million.

First Source acquired MedAssist for $330 million in August 2007. This acquisition presented significant synergies for the company. First Source already has a presence in the US healthcare BPO space and, as a result of this combination, it could make entry into the provider side of healthcare BPO services. MedAssist had an attractive portfolio of service offerings.

In 2007, Sundaram Business Services Ltd picked up 74% stake in Professional Management Consultants (P) Ltd, a Chennai based BPO. With this acquisition SBS, the BPO arm of Sundaram Finance Ltd, doubled its employee headcount to 1600. PMC offered services to banking and financial service companies in India.

In 2007, Bhilwara Scribe, the IT arm of the LNJ Bhilwara Group, acquired Seattle based Benson Transcription Technologies to create a strong front end in the US market and simultaneously acquired Bangalore based medical transcription outfit, Global Meditrans. Blackstone acquired the Mumbai based BPO, Intelenet.

Secova Services, India's first HR BPO, and Ultralink, a California based HR and Benefits Management service provider, merged in 2006. The combined entity could offer global clients a broader range of HR and employee benefits administration services, while also providing incomparable flexibility through customised offerings. Ultralink's competency in creating customised solutions for each client was in alignment with Secova's strategy of providing complete end to end HRO solutions for organisations seeking to outsource HR administrative services. This merger enabled the combined company to leverage technology, global delivery centres and best in class processes, to deliver an integrated human resources and benefits administration supply chain at a cost effective price point. In 2007, Mumbai based Accentia Technologies acquired three US based healthcare BPO companies for about Rs 80 crore. It has also bought Florida based GSR Physician Billing Inc, GSR Systems Inc and Oregon based medical transcription service provider Den Med inc, in cash cum stock deals.

In September 2006, Hindustan Lever Ltd reached an agreement with Cap Gemini SA to take 51% stake in Unilever India Shared Services Ltd (Indigo). Indigo is currently a fully owned subsidiary of HLL, providing BPO services to a number of companies, including HLL, around the world. The partnership with Cap Gemini was aimed to bring world's leading financial BPO services to a number of Unilever companies including HLL around the world. Indigo's domain knowledge and deep capabilities in the FMCG sector, coupled with Cap Gemini's BPO expertise will enable Indigo to leverage its strengths and offer services to customers outside the Unilever Group. The partnership with Unilever will strongly supplement Cap Gemini's market leading business process outsourcing capabilities in finance and accounting in India, and support Cap Gemini's strategy to enhance the existing BPO global delivery network in Poland, China, India, Australia, USA and Canada. Indigo is the provider of financial shared services and Sarbanes Oxley compliance services to the Unilever Group throughout the world.

Table CS3.4 *Major M&A Deals in Indian ITES–BPO*

Acquirer	Target	Seller	Stake	Details
Wipro	Spectramind	Chrysalls, HDFC	100%	Deal worth $100 million
Citigroup	Progeon	Infosys	20%	Valued $100 million
HCL Tech	Apollo Contact Centre	British Telecom	90%	Valued about $13 million
Oakhil Partners Financial Technology Ventures & Co Mgmt	EXL Service	Conseco Inc, USA	Controlling stake by Oakhil	NA
ICICI One Source	Customer Asset	Promoters	100%	Deal at $19.3 million
Warbug Pincus	WNS	British Airways	70%	NA
WNS	Town & Country Assistance	Promoters	100%	NA
Optimus (Polaris)	Back Office	Global Tech Ventures	Acquisition of customers and assets	NA
Household Credit USA	Intellinet	TCS, HDFC	NA	Valued Intellinet at about $100 million
Indian Rayon	Transworks	Chrys Capital	80%	Rs 60 crore
Datamatics	US Parole Mgmt Co	NA	NA	$10 million in an all cash deal

Source: Media, Companies Merrill Lynch.

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DISCUSSION QUESTIONS

1. List the major mergers and acquisitions in the Indian IT Industry.
2. What are the strategic reasons for M&A in the BPO sector?

Case Study 4

MERGERS AND ACQUISITIONS IN THE CONSUMER GOODS, FOOD AND BEVERAGES SECTOR

Consolidation and acquisitions would help the FMCG sector to grow faster in India. Such activity drives companies to invest in development of new products, and generally augurs well for the market which is, at present, highly fragmented. If there are two to three large consolidated players in each product segment, the consumer would benefit from improved value equation and enhanced product research. The sector consolidation will automatically lead to better pricing power for the consumer.

GROWTH THROUGH M&A–THE STORY OF HINDUSTAN UNILEVER LTD

In the late 18^{th} century, Lever Brothers began an era of marketing branded Fast Moving Consumer Goods (FMCG).The famous Lifebuoy was launched in 1895, and other brands–like Pears, Lux, Vim and Vanaspati–were launched in 1918. The famous *Dalda* was launched in 1937. In 1931, Unilever set up its first Indian subsidiary, Hindustan Vanaspati Manufacturing Company, followed by Lever Brothers India Ltd (1933) and United Traders Ltd (1935). These three companies merged to form Hindustan Lever Ltd in November 1956. Since the time Unilever established its business operations in 1913, the company had adopted an aggressive M&A strategy in India to grow and dominate markets. In the 1980s, HLL acquired a number of companies. In 1983, Stepan Chemicals, producer of detergents was acquired. In 1986, Relish Foods, engaged in marine products, was acquired. In 1988, the detergent units of Union Home Products was acquired. In 1990, Sivalik Cellulose Ltd, engaged in the processing and packaging of soaps, was acquired.

The policy restrictions imposed on M&A by large and foreign controlled undertakings under the FERA and MRTP Acts were removed as the result of the liberalisation policy adopted in the early 1990s. The liberalisation of Indian economy in 1991 clearly marked an inflexion in HUL's, and the Group's, growth curve. The removal of the regulatory framework allowed the company to explore every single product and opportunity segment, without any constraints on production capacity. Simultaneously, deregulation permitted alliances, acquisitions and mergers. HLL focussed on M&A to strengthen its market presence.

HLL is India's largest FMCG company with leadership positions in home and personal care products, food and beverages and speciality chemicals.

Milestones in M&A Activity

Brooke Bond's presence in India dates back to the year 1900. By 1903, the company had launched Red Label Tea in the country. In 1984, Brooke Bond merged with Unilever through an international acquisition. Unilever acquired Lipton in 1972 and, in 1977, Lipton Tea (India) Ltd was incorporated. Pond's India Ltd had been present in India since 1947. In 1986, the parent company, Pond's USA, was merged into the Unilever fold.

Table CS4.1 *M&A in the FMCG Sector by Lever Group*

(a) Food and Beverages:

Year	M&A Activity
March 1993	Acquisition of Kothari General Foods by BBIL
June 1993	Merger of Doom Dooma India (Tea Plantations) with BBIL
June 1993	Merger of Tea Estates India (Tea Plantations) with BBIL
June 1993	Merger of Brooke Bond India and Lipton India to form Brooke Bond Lipton India (BBLIL)
June 1993	Acquisition of Kissan Products by BBLIL
July 1993	Acquisition of Cadbury's Dollops (ice creams) by BBLIL
March 1994	Acquisition of Tata Oil Mills Company (TOMCO) by HLL
May 1994	Acquisition of Merry Weather Food Products by BBLIL
December 1994	Acquisition of Kwality Ice cream by BBLIL
April 1995	Acquisition of Milk Food Ice creams by BBIL
January 1996	Merger of BBLIL into HLL
January 1998	Acquisition of Kwality Frozen Foods by HLL
December 1999	Acquisition of Rossell Industries Ltd (Tea Plantations) by HLL
January 2000	Acquisition of Modern Foods Industries by HLL
	International Best Foods Ltd acquired by HLL

(b) Detergents

March 1995	Restructuring detergents and chemical business with subsidiary Stepan Chemicals and Hind Lever Chemicals
February 1996	Acquisition of Vashisti Detergents by HLL

(c) Personal Care Product

January 1993	Merger of Quest International with Pond's India
October 1995	Acquisition of Lakme Lever Ltd by HLL
September 1996	Acquisition of Lakme's manufacturing facilities
January 1998	Merger of Pond's India Ltd with HLL
January 1999	Industrial Perfumes Ltd by HLL

In 1993, the merger of the erstwhile Tata Oil Mills Company (TOMCO) with HUL became effective on April 1. In 1995, HUL and another Tata company, Lakme Ltd formed a 50:50 joint venture, Lakme Lever Ltd, to market Lakme's market leading cosmetics and other appropriate products of both companies. Subsequently, in 1998, Lakme Ltd sold its brands to HUL and divested its 50% from its joint venture with HUL.

HUL formed a 50:50 joint venture with the US based Kimberly Clark Corporation in 1994. Kimberly Clark Lever Ltd markets Huggies Diapers and Kotex Sanitary Pads. HUL has set up a subsidiary in Nepal.

The NLL factory manufactures HUL's products–like soaps, detergents and personal products–both for the domestic market and exports to India.

The 1990s witnessed mergers and acquisitions on the Foods and Beverages front. In 1992, the erstwhile Brooke Bond acquired Kothari General Foods, with significant interest in instant coffee. In 1993, Brooke Bond acquired the Kissan business from the UB Group and the Dollops ice cream business from Cadbury India.

Tea Estates and Doom Dooma India, the two plantation companies of Unilever, were merged with Brooke Bond, as a part of the process of backward integration. In July 1993, Brooke Bond India and Lipton India merged to form Brooke Bond Lipton India Ltd (BBLIL). BBIL Ltd entered into a strategic alliance with Kwality ice cream. In 1995, the company acquired the marketing and distribution rights of the Milkfood.

In 1996, BBIL merged with HUL. The business logic of the merger was the utilisation of the huge amounts of cash of HLL's HPC business in Brooke Bond Lipton's food business, which was on the threshold of fast growth. In 1999, HLL acquired the Lakme brand and factories, and Lakme's 50% equity in Lakme Lever Ltd, along with the manufacturing rights of Kwality ice cream. Kwality, the original company, was founded in 1956, and was the first to import machinery for the mass production and sale of ice cream on commercial scale in the region. In 1995, in view of the growth potential of the frozen confections market, Kwality entered into an agreement with Lever, and has since been known by its current umbrella name. At the same time, other brands promoted by Hindustan Lever, such as Gaylord Milk Food, were phased out to promote the Kwality Wall's brand. In 1998, Pond's India Ltd merged with HUL. The two companies had overlaps in personal products, speciality chemicals and export business. The amalgamation was basically meant for scale economies for both, in the domestic and export markets.

In the year 2000, the Government of India awarded 74% equity in Modern Foods to HUL, heralding the government policy of disinvestments. HUL's entry into the bread business was a strategic extension of the company's wheat business, as this sector was growing at 40%. In 2002, HUL acquired the government's remaining stake in Modern Foods Ltd. The merger of Modern Food Industries Ltd (MFIL) and its subsidiary Modern Food and Nutrition Industries Ltd (MFNIL) with HUL Ltd became effective from October 2006.

Effective from 21st April 2001, International Best Foods became a subsidiary of HLL. The company had reorganised the foods distribution system by integrating the sales system of Branded Staples and International Best Foods Ltd with the distribution system for Culinary Products and Oils and Fats. This was expected to bring significant synergies in the long term, through improved reach for all foods products, as well as provide critical mass for the same.

In 2003, HUL acquired the Cooked Shrimp and Pasteurised Crabmeat business of the Amalgam Group of Companies.

Hindustan Lever Ltd amalgamated Vashisti Detergents Ltd (VDL) in the share exchange ratio of 1:10.

In the year 2003, HLL entered into a definitive agreement with Wipro Ltd for sale and transfer of Glucovita brand for the territories of India and Nepal. This was part of its strategy to focus on power brands.

In 2001, HLL, ICI and Quest International BV entered into a joint venture to carry on the fragrances and flavour business of the Quest Division of HLL. Under the joint venture, ICI India and Quest International hold 51%, and balance 49% is held by HLL. The advantage for HLL is that the joint venture is in tune with the HLL's clear intent to tie up with a technology partner to secure longer term future viability for the business, post global divestment of Unilever's speciality chemicals businesses in 1997.

Table CS4.2 *Major Deals of the Lever Group*

Merging Company	Merged With	Share Ratio
Kothari General Foods Corporation Ltd	Brooke Bond India Ltd	21:1
Tea Estates India Ltd	Brooke Bond India Ltd	10:12
Doom Dooma India Ltd	Brooke Bond India Ltd	10:11
Kissan Products Ltd	Brooke Bond India Ltd	1:100
Lipton India Ltd	Brooke Bond India Ltd	10:9
Tata Oil Mills Company Ltd	Hindustan Lever Ltd	15:2
BBLIL	Hindustan Lever Ltd	20.9
Pond's (India) Ltd	Hindustan Lever Ltd	4:3
Industrial Perfumes Ltd	Hindustan Lever Ltd	5:2
International Best Foods	Hindustan Lever Ltd	3:2*

*(Swap based on Rs 10 share of IBF for Re 1 share of HLL)

In summary, it can be stated that Hindustan Unilever Ltd has used the M&A strategy to bring about transformation in its business profile, to include more high growth businesses. The merger of Brooke Bond Lipton India in 1996 brought products such as beverages, culinary products, ice-creams, processed foods and dairy products into the HLL fold. The merger of Pond's India and the acquisition of Lakme's business added to the high margin personal products business in 1998. Not all new acquisitions have been unmitigated successes. HLL had to dispose its dairy and animal feed businesses because of disappointing performance, and ice creams have been cash guzzlers.

MERGERS IN LIQUOR INDUSTRY

International distribution alliances are common among mid-sized players who wish to remain independent while gaining merger style economies of scale. In the early 1990s, when India opened its alcoholic beverages industry, a number of global majors entered through joint ventures. The joint venture, Barcadi Martini India Ltd, was established in 1998 between the multinational wines and spirits major, Barcadi Martini, and Indian distiller, Germini Distillers. In 1997, Grandmet (IDV) and Guiness (United Distilleries) merged to form Diageo. In 2001, Pernod Richard, along with Diageo, completed the buyout of Seagram.

Acquisitions by South African Breweries Ltd

In 2002, South African Breweries Ltd (SAB) acquired Miller Brewing from Philips Morris for $5.6 billion and, in the process, became world's second largest beer company after Anheuser Busch. SAB, on its entry into the Indian market, had been on an aggressive acquisition spree, and had acquired Narang Breweries, Mysore Breweries and Pals Breweries Ltd, in addition to Rochees Breweries & Distilleries, during the period 2000-2002. SAB spent over Rs 150 crore towards acquisitions and expansion. These acquisitions gave SAB access to key beer markets in Maharashtra, Delhi, Karnataka, Andhra Pradesh, Uttar Pradesh, Rajasthan and Goa. SAB's India operations was part of its global strategy to consolidate its presence in emerging markets. The company began its operations in October 2000 when it acquired Narang Breweries in Gonda, Uttar Pradesh. The plant was modernised and upgraded to produce 1.5 million cases annually, to cater to the North Indian markets. Through the acquisition of Mysore Breweries, SAB gained access to the important western and southern markets.

Other mergers include the merger of Skol Breweries with Charminar Breweries, and Haryana Breweries Ltd with Sica Breweries Ltd.

SERIAL ACQUISITIONS

Growth of United Breweries (UB Group)

The UB Group, world's third largest liquor producer, has businesses in spirits; beer; aviation; pharma; chemicals and fertilizers; engineering and airlines sectors.

United Breweries Group, the leading player in the Indian spirits market, follows the strategy of in-organic growth for consolidation..By mid eighties, the UB Group, through the combined acquisition of McDowell&Co, Herbertsons and Carew Phipson, had emerged as the leading player in the Indian spirits market. In the nineties, the UB Group brought its entire liquor business under one division, and consolidated its leadership position. In 1995-96, it merged Carew Phipson and Consolidated Distillery with McDowell &Co. Noted mergers of UB Group include with Premier Breweries Ltd, Indo Lowenbrau Breweries Ltd and Coastal Distillery Ltd.

Table CS4.3 *Other M&A of United Breweries Group:*

Brewery	Capacity (million cases per year)	Year of Acquisition	Cost of Acquisition (in Rs crore)
Associated Breweries and Distilleries Ltd	1.5	2000	65
Inertia Industries Ltd	5	2001	100
Mangalore Breweries & Distilleries Ltd	1.8	2001	30
GMR Breweries Ltd	2	2002	57
Empee Breweries Ltd	4	2002	100

In 2004, Shaw Wallace's brewing business and SAB Miller India merged together. This merger provided the combined entity manufacturing capabilities and power brands that are at par with the market leader, United Breweries Ltd. In June 2005, Vijay Malaya acquired Shaw Wallace to become the third largest producer of liquor in the world. The Shaw Wallace acquisition enabled the United Breweries Group to gain operational and managerial synergies which supported in managing the company and its operations on a large scale. In 2007, UB Group acquired Scottish distiller, Whyte & Mackay, for an enterprise value of £595 million (nearly Rs 4819 crore). Whyte & Mackay's brands included Whyte & Mackay blended scotch, Isle of Jura and Dalmore single malts. The company had 9% market share in the Scotch Whiskey segment. The potential for premium Scotch whiskey in India is enormous and UB can introduce a strong portfolio of internationally recognised brands in the Indian market. United Breweries Group will also have access to the global distribution and export market.

The UB Group was also involved in conglomerate merger with Spykar Ferrari in the field of formula racing, and named it Force India. The Kingfisher Airlines of UB Group had acquired the low cost carrier, Air Deccan.

ACQUISITIONS IN THE FMCG SECTOR

M&A by Dabur India

Dabur India acquired Balsara's hygiene and home business products business. Balsara is a leading provider of oral care and household care products in the Indian market. Dabur India Ltd's acquisition of the three Balsara Group companies gave it access to seven well-entrenched brands—Promise, Babool and Meswak toothpastes, Odonil air freshener, Odopic utensil cleaner, Sanifresh toilet cleaner and Odomos insect repellent. Balsara has three oral care brands – Promise, with unique clove oil positioning, Babool in the value segment and Meswak in the premium segment. Together, the company holds 6% share of the oral care market. Balsaras were the pioneers in herbal oral care products launched in the seventies. Balsara's herbal oral care range was a good strategic fit for Dabur – whose products are also positioned on the herbal platform. The acquisition enabled Dabur to enter the Rs 20 crore household care business through well-entrenched brands. Balsara had a diverse portfolio of brands in extremely attractive categories which were growing at a CAGR of 15-25% pa. About 45% of Balsara's revenues were from the west and the south. These would complement Dabur's regional imbalance, as Dabur has higher revenue share in the northern and the eastern markets. Balsara has a direct distribution reach of 340,000 and indirect reach of 1.5 million. The acquisition provided several synergies to Dabur on the manufacturing and marketing front. It provided back end synergies in supply chain, operations, purchase and IT, etc. The acquisition also helped Dabur's entry into niche segment of household care products. The major challenge that Dabur faced was to convert Balsara's losses into profits, and Dabur successfully achieved this goal during 2005-06, when the loss making entity generated profits of Rs 14.9 crore.

Dabur also entered into a joint venture with Agrolimen of Spain, which manufactures and markets confectionery items in India. In 1995, Dabur entered into a joint venture with Osem of Israel for food, and with Bongrain of France for cheese and other dairy products. In 2007, Dabur India merged its wholly owned subsidiary with itself to extract synergies and unlock operational efficiencies. The integration would help Dabur sharpen its focus on high growth business of foods and beverages, and enter newer product categories in this space.

Acquisitions by Marico

The Marico Group has a strategic alliance with Cairo based Pyramids Group for the hair care brand Hair Code. In 2006, Marico acquired the Nihar brand from HLL. The transaction envisaged the transfer of the IPR and other rights associated with the brand in India and other parts of the world. HLL will continue to operate brands, other than Nihar, in the value added hair oil segment. Marico Bangladesh Ltd, the wholly owned subsidiary of Marico Limited had acquired the toilet soap brand, Aromatic, from Aromatic Cosmetics Ltd, a Bangladeshi personal care product company. This acquisition was in line with the company's strategy of being in larger categories in smaller countries. Marico's acquisition was seen as an attempt to get bigger in Bangladesh, where it was already the largest Indian company. In January 2006, Marico acquired the herbal soap brand, Manjal, from Kerala based Oriental Extractions for an undisclosed amount. This move to acquire complementary products was aimed at strengthening its position in the market.

Procter & Gamble's (P&G) Acquisition of Gillette

With the acquisition of Gillette's operations, P&G became the second largest consumer goods company in the world, with sales of $61 billion, next only to Nestle SA (with sales of $65 billion), and ahead of Unilever ($48 billion). P&G expected revenue gains and cost savings of $14-16 billion from the merger, due to elimination of overlapping functions and a planned 6,000 job cuts. According to industry experts, the global acquisition of Gillette Company by Procter & Gamble will catalyse growth, and ultimately help the end consumer. This acquisition had put brands worth $21 billion in P&G's product basket, overshadowing the Unilever's portfolio of 12 brands. The acquisition gave P&G greater bargaining power in its negotiations with raw material suppliers and advertising media. The Gillette acquisition marks a decisive move by P&G to upgrade from a mundane household products maker of soaps, detergents and cleaners, to a company that is into 'lifestyle' products in the personal care and grooming segments. Gillette will also add more high-margin products to the P&G portfolio, making for more robust profit margins than its rivals, and furthering its innovation efforts.

The integration of operations of P&G's Indian arm with Gillette India in the year 2005 did not alter the rankings of consumer goods companies operating in India. P&G's Indian arm, at the time of acquisition, had a limited basket of products, consisting of detergents, shampoos, feminine hygiene products, cough and cold medication and the Wella hair care range. In contrast, Gillette India had a presence in personal care (shaving gels and after-shaves) and toothbrushes (Oral B).The combined entity faced major challenges in restructuring, particularly the integration of sales and distribution department. Gillette had followed the direct sales model whereas P&G used the distributor model. Through the integration of Gillette's operations, P&G used Gillette's distribution network to enter new categories in the Indian marketplace.

Other Acquisitions in FMCG Sector

In 2004, Wipro Consumer Care completed the acquisition of the soap brand Chandrika in June 2004, and has been keen to expand its toilet soap portfolio further. Wipro acquired 100% shareholding in Singapore based Unza Holding Ltd in an all cash transaction of Rs 10102 million ($246 million) for larger presence in South East Asia. Unza is a personal care manufacturing company focused on Asian consumers. It has operations in 40 countries. The merger will enable the combined entities to leverage regional best practices for driving growth and provide opportunities for better sourcing.

In 2005, Parry's Confectionery was acquired by Korean major, Lotte. In 2004, the Hyderabad based Trinethra Super Retail Pvt Ltd acquired Fabmall India Pvt Ltd, a grocery retail chain of Bangalore.

M&A IN TEA INDUSTRY

Rising competition from African countries, such as Kenya and Malawi, where tea production is new and expanding, is a potential threat to tea exports from India. In recent years, tea prices have been falling worldwide because of an over-supply in production. There is no single world market for tea, and prices are subject to strong fluctuations. Production cannot be absorbed by domestic demand and the industry has to rebuild its export base.

Acquisitions by Williamson Magor Group

The Williamson Magor Group has built up an enviable track record of negotiated mergers, acquisitions and takeovers. The merger of Macneill and Barry took place in 1975 to form Macneill & Magor Ltd, and after many other tea companies merged with it, the company's name was changed into Williamson Magor & Co on 12th May 1992. In 1985, Williamson Magor acquired India Foils Ltd and later sold it to Sterlite Industries Ltd. The McLeod Russel acquisition made Williamson Magor the World's largest private tea producer. In 1994, it acquired Eveready Industries Ltd and Bishnauth Tea later merged with Everready Industries Ltd. The merger with Eveready Industries was expected to solve Mcleod Russell's cash crunch. Later, problems separated the two major groups–Kolkata based Khaitans and the UK based Magors of the Williamson Magor group. In 2001, the Magors went ahead with their own bulk tea business, Williamson Tea Assam (earlier George Williamson), and the Khaitans went their way with McLeod Russel India. The Khaitans' relationship with the Magors dates back to the 1960s when Brij Mohan Khaitan joined hands with the Magors in their tea business. In year 2005, Khaitans acquired the Magors stake in Williamson Tea Assam through McLeod Russel India Ltd (MRIL). MRIL indirectly acquired 70% equity stake in Williamson Tea Assam. The Khaitans financed the acquisition through a mix of external commercial borrowings and internal accruals. The buyout of the Magor's stake in Williamson Tea Assam created a single bulk tea entity that became the largest bulk tea operator in the world, with production of 62 million kgs of tea in the year 2005.

M&A by Tata Group

Asian Coffee Ltd merged with consolidated Coffee Ltd. Tata Tea bought Tetley, Good Earth, Eight o Clock Coffee and Himalayan Water, and sold 30% stake in Glaceau.

The major driving force behind the Tata Tetley deal is the fact that Tetley fits perfectly into Tata Tea's globalisation drive. The deal brought together the largest integrated tea company (Tata) and the largest brand (Tetley). The Rs 922.12 crore Tata Tea's acquisition of UK brand Tetley, which produced 20 million tea bags annually, made the company the second largest producer of tea in the world, with 4% market share. The global tea market was highly fragmented and the strategic fit between Tata Tea and Tetley was basically complementary in nature. This acquisition was a win-win situation for both companies as Tata would be able to leverage its significant R&D strengths on the tea bush, while Tetley was the master of tea bag in the developed world, having introduced it as far back in 1953. It was said that Tetley's skill sets, expertise and wherewithal in tea buying, blending, packaging and cutting down inventories were superior to those of Unilever. At the time of the acquisition, Hindustan Lever was the market leader in packaged tea with a 41% market share, while Tata Tea was a distant second with 20% market share. This acquisition generated a lot of interest as it was the first case in which a traditional Indian industrial house acquired a top notch British brand. In the words of Vice Chairman of Tata Tea, Krishna Kumar, "Millions of tea bags will carry the Tata name into countless western homes, thereby establishing an Indian brand name in the hearts and minds of many consumers".

For Tata Tea Tetley, the Good Earth purchase meant a bigger presence in the fast growing speciality tea business in the US.

In 2007, Apeejay Surendra Group purchased UK tea brand Typhoo. Apeejay, till then only in tea plantation business, got a readymade entry into the branded tea market in UK. Tetley followed by acquiring US Tea Company Good Earth Corporation.

Godrej

Since early 2000, the Godrej Group was involved in restructuring. It demerged its consumer products division to unlock shareholder value. Godrej Beverages and Foods, an associate of Godrej Industries, had forayed into the organised confectionary market in India by acquiring 100% share in Nutrine Confectionery Company including its brand and manufacturing unit for Rs 250 crore. It later merged its foods division into Godrej Industries. Godrej Group has acquired companies in UK and South Africa.

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DISCUSSION QUESTION

1. Discuss the strategies for growth of Hindustan Unilever Ltd and the United Breweries Group.

Case Study 5

MARRIAGES MADE IN THE TURBULENT SKY

Throughout its history, the aviation industry has witnessed its share of highs and lows. Four or five years of poor performance are followed by five or six years of gradually improving good performance. The profits in the good years are generally low, in the range of 2 to 3%. The airline industry, as a whole, has made cumulative losses in its 120 years of existence. More than 100 airlines have filed for bankruptcy since 1979. Many of the leading carriers–such as British Airways and US Air–continue to make huge losses. A few carriers–like Lufthansa and Singapore Airlines–are profitable by serving long haul business markets with ultra-premium service, and attracting high business class revenue. Southwest is the only airline with over 30 consecutive profitable years. Southwest had used financial techniques to bolster its profitability, and used to hedge fuel to smoothen out fluctuations in fuel prices. Deregulation in the airline industry has spurred growth, and airline entrepreneurs are vying to compete with established carriers.

In 2008, Delta announced its mega merger with North West Airlines to form the biggest airline company, with a fleet of 800 aircraft and 75,000 employees. In Europe, Air France combined with KLM.

The Indian Aviation industry, amidst accumulated losses of Rs 2000 crore, is plagued by low entry barriers, price wars, duopoly of aircraft suppliers, uncontrolled fuel costs and monopoly of infrastructure providers. The consistent rise in oil prices and increase in number of low cost airlines have made the business non-profitable. According to the Federation of Indian Airlines, ATF prices in India are 70-95% higher for fuel used for domestic operations and 30% more for international operations. This is due to the duties at both the central and the state government levels.

Total seat entitlements under bilateral agreements between India and all countries have increased by 123% between summer 2003 and summer 2006, to reach 46.5 million seats per annum. The frequency entitlements between India and Europe has increased from 70 flights per week to 204 flights during the same period. On the India-US route, annual traffic has increased from 447,000 passengers in 2003-04 to 827,000 in 2006-07, an increase of 85% in just three years. Scheduled domestic air services are now available from 82 airports, as against 75 in 2006.

Domestic passenger traffic grew from 32.7 million in 2006 to 43.3 million in 2007, registering a growth of 32%. There were 13 scheduled airlines in operations in 2007 and about 65 non-scheduled operators. The number of aircrafts have increased from 300 in 2003-04 to 600 now. The year 2006 was significant in the context of the emergence of low cost airlines in the country which happened ten years after its emergence in Europe and North America.

By 2006, the domestic aviation sector was growing at 45% each year. In 2005, Indian carriers placed orders for close to 400 airplanes. According to an Airbus estimate, Indian carriers will have 800-1000 airplanes in the sky by 2023. The number of domestic air seats has grown from 39.86 million in 2004-05 to 50.98 million in 2005-06.

But the ground reality is quite different. The aviation revolution would have proved a boon for the Indian traveller, but the airlines themselves are incurring heavy losses. In 2006, the aviation industry was losing Rs 6 crore daily. According to Damera of Travel Guru Worldwide, the return on capital (ROC) for airlines stands at 3% compared to the pharma industry's ROC of 55% or the IT sector's ROC of 35%. In the airline industry, the cycles of loss are more than the periods of profits. In the battle for market share, airlines have resorted to competitive price wars. So they started to price their tickets lower. On several occasions, the airlines have also introduced the lowest fare challenge offer, wherein, if a passenger gets cheaper fare on a competitive airline, he would receive a free ticket. This resulted in an estimated loss of Rs 2000 crore in the year 2006, with about 200 planes in Indian skies. There is enormous pressure on yields as fuel and input costs have gone up. The cost of aviation fuel in India is said to be the highest in the world. New players, like Indigo, Air One, East West, Magic Air, Indus Air, Star Air, Jagson and Pioneer, have to fight for share in the market. Fuel prices have increased tremendously during the last few years. Unfortunately for airlines, especially the low cost carriers, fuel accounts for almost 40% of an airline's cost. Moreover, due to high sales tax on fuel, India has one of the highest Aviation Turbine Fuel (ATF) prices. In order to fill seats, airlines have been disposing of their extra capacity at rock bottom prices, resulting in huge losses. A low cost carrier is essentially a short haul, low fare, high frequency, point-to-point carrier. High airplane utilisation and a focus on ancilliary revenues are the key to a low cost carrier. All airlines, whether Low Cost Carriers (LCC) or Full Service Carriers (FSC), have three major fixed costs—aircraft lease or financing, fuel costs and labour costs. Distribution costs are higher and internet penetration, the main ticketing medium for budget carriers, is poor. Aircraft utilisation and turnaround times are lower due to poor infrastructure–like runways and hangars–at Indian airports. Many carriers are buying or leasing new generation aircrafts at high price.

The principal issues that any merger needs to tackle are those related to HR, such as integration of seniority lists, terms and conditions of service and compensation structures, systems and procedures, particularly IT systems, integration of training standards and those related to aircraft fleet and other equipment.

THE KINGFISHER–AIR DECCAN UNION

The catch phrase of Air Deccan, India's pioneering low cost airline, was "Every time we fly the economy looks up !".. It had wider coverage of the country than any other carrier. Lower costs were due to lower rentals. The start up costs were lower than competitors in terms of pilot's and other staff salaries.

Deccan Airways faced challenges with respect to flight delays and cancellations. The perception was of poor quality. More aircraft bases was needed to be able to exploit the economies of scale better.

Losses for Air Deccan continued to accumulate as it expanded its network across the country. Jet and Air Deccan's stock prices fell steeply. Experts argued that Deccan was expanding its operations more out of Gopinath's passion to see every Indian fly and less out of reason and logic. By having two types of aircraft (Airbus and Boeing) parked and maintained at all six metros, it failed to exploit economies of scale. Deccan's complex hopping flight schedules meant that a problem at one stop became every subsequent stop's problem. Its inventory and spares were localized in Bangalore, which added to the costs.

Deccan Airlines was strapped for funds. In March 2005, Deccan raised $40 million though convertible debentures from ICICI Venture and US based Capital International. Air Deccan was offering 40–50% cost savings to the consumers, but in actuality, the costs were only 10-15% lower than a FSC, which it saved on distribution costs and by offering minimal services on board. Almost 90% of its costs were fixed, leaving carriers very thin margins to operate on. Deccan operates on a hybrid LCC model. It offers low fares, but operates on four types of aircraft, and flies to 55 destinations. At the managerial level, two of the top team members–Warwick Brady and Mohan Kumar–had resigned in February 2007. Conflicts of ideas came between the MD, Gopinath, and Warwick Brady. On May 31, 2007, Vijay Mallya acquired 26% stake in the Bangalore based Air Deccan for Rs 550 crore. It was stated that the deal was quickly signed and sealed in an incredible three days. Anil Ambani's Mumbai based Reliance Anil Dhirubhai Ambani Group (ADAG) had shown keen interest in picking up stake in Air Deccan and the deal was expected to be finalised. The perception could be that Reliance Infocomm and Air Deccan could have lot of synergies. According to sources, Reliance ADAG had started its due diligence process, and had visited the Air Deccan headquarters in Bangalore.

Vijaya Mallya put forth the conditions that he would have 26% stake in the Air Deccan, three directors on board, a new CEO, and he, himself, would be the Vice Chairman. The investment would come from the parent company, UB Holdings, and not from King Fisher Airlines. The Air Deccan brand and its low cost nature would continue. Mallya did no due diligence before making an offer. He settled for three directors on the board. Gopinath asked Mallya to pay Rs 150 crore in an escrow account before the board meeting to approve the deal was held on Thursday, 31 May 2007.

Air Deccan was considered to be logical for King Fisher. With a fleet strength of 72 planes, the combined entity, with 33% market share, is the second biggest private domestic aviation group after Jet Sahara. Hence, the manpower can be optimally utilised, insurance premiums and lease rentals can be re-negotiated, infrastructure–like engineering, ground handling and training–can be combined. Sharing of resources, aircraft spares and airport infrastructure will definitely lead to decreased costs. Engineering costs, as per cent of sales, can come down by 1-1.5%. King Fisher and Air Deccan can access ground infrastructure at 65 airports, of which 28 are common. On the New Delhi–Mumbai route, which accounts for over half of India's 33 million passenger traffic per annum, the two carriers account for a total of 155 flights. They use the same Airbus fleet, same engines, same brakes, same ATRs, avionics and same maintenance facility with Lufthansa Technik. The combined Airline will have 537 flights per day, connecting 69 destinations. Air Deccan had a paid up capital of Rs 100 crore which will become Rs 140 crore. King Fisher started with a paid up capital of Rs 450 crore.

The share price of Air Deccan rose after the announcement. King Fisher stands to gain more from synergies and cost reduction. The airlines can bring down the costs individually. Both carriers stand to gain from keeping reduced spares (each engine costs $8 million), using same ladders, reducing duplication on routes and selling seats on each others' flights. Air Deccan has new aircrafts, several of which are owned.

The synergies within various departments have helped King Fisher to reduce costs. Following the acquisition, Air Deccan was rebranded Deccan, and its blue colour was stashed away for the trademark Kingfisher red, along with the Kingfisher bird logo.

THE JET-SAHARA MERGER

The Indian aviation industry is one of the fastest-growing aviation industries in the world with private airlines accounting for more than 75% of the sector of the domestic aviation market (as of 2006) with a compound annual growth rate (CAGR) of 18% during 2000-2006 period.

To meet the growing air traffic, the country is in need of 852 additional aircraft over the next two decades worth more than $72 billion.

Jet operates over 320 flights to 44 destinations across the country and six overseas. Jet was incorporated as an 'airtaxi' operator in April 1992, and started its operations in May 1993. Taking advantage of India's open skies policy as part of its economic liberalisation, it diversified into a full service scheduled airline and competed with the state owned Indian Airlines in the domestic market. Jet initiated international operations in March 2004. It was the first private Airline in India to fly international. On account of competition from low cost carriers, Jet's share declined to 27% from 40%.

Air Sahara started its operations in December 1993. From two Boeings, it grew into an airline with 28 aircrafts. It became an international carrier in 2004. Initially, it focused primarily on the northern sectors of India. Competition from new entrants, like Air Deccan, King Fisher, Go Air, Spice jet, Indigo, Indus and Paramount, added to its woes. By 2006, its market share dipped to 8% from 11%. The open skies policy allowed private players to operate in the country, thus increasing the number of players in the industry.

The first round of the Jet Sahara deal ended after almost a year of acrimonious quarrelling and court proceedings. Jet Airways pulled the plug on the deal after realising that the Rs 2300 crore it had pledged for the debt-ridden airline was too high.

In the months preceding the deal, Jet's dominance was challenged. A number of low cost carriers, like Air Deccan with 24 aircraft, Spice jet and Go Air, that offered substantially lower fares entered the industry. Owing to rush of new players, Jet's market share declined from 42% to 37% at the beginning of the fiscal year 2006. Jet could not keep up with the industry capacity expansion also. In the Delhi-Mumbai sector, which accounts for 50% of the country's air traffic, the industry capacity had increased by 70% but Jet's capacity rose by just 7%. During October-November 2005, Jet had to cancel many flights due to pilot shortage. This led to a loss of Rs 21.9 crore. Air Sahara had its own problems. It was making losses. As low cost players and new entrants created confusion in the aviation market, Sahara's revenues and profits started falling. It was estimated that Sahara had accumulated a baggage of Rs 125 crore worth of losses. Its strategy to raise capital from the capital market was not attractive to investors. Spice jet and King Fisher opted out because of higher valuation of Sahara, in the range of $750 million to $1.0 billion. Its aircrafts were not owned but leased. The CRJ fleet of 7 aircraft were losing heavily. Sahara wanted to exit the airline business because of infrastructure bottlenecks, mis-match between demand and supply and high fuel (ATF) prices.

Jet, through the acquisition, had plans for rationalisation of routes, renegotiation of Sahara's leases, replacing part of its fleet and improving asset utilisation. The route rationalisation was expected to happen on several fronts. First, in common profit yielding routes, the enhanced capacity would free seats for the so-called cheap traffic. Loss making routes, on which both operated, could be combined to improve profitability. Jet would use its brand image to renegotiate leases for better prices or aircrafts. Jet intended to bring asset utilisation (number of hours of flying time per aircraft per day) of Sahara at par with itself. Jet had an asset utilisation of 10.5% as compared to Sahara's 7.2%. This rationalisation would help Jet in managing its capacity better.

The race to buy out Sahara Airlines began in late 2005, with King Fisher also in the fray. King Fisher had offered $400 million in two tranches, and equity worth $200 million when the merged entity went in for an IPO. However, Jet's offer was an upfront all cash deal. On January 18, 2006, Jet Airways and Sahara Airlines signed the agreement in Lucknow. In an all cash deal, Jet Airways agreed to pay $500 million (around Rs 2300 crore) for the Sahara buyout. Rs 100 crore was transferred from Jet to Sahara. An escrow for Rs 2000 crore was set up. Most industry observers felt that the Jet offer of $500 million was too high. Sahara wrote to DGCA for permission to transfer its 100% shares to Jet Airways and replace its board members with those of Jet. The clearance from Directorate General of Civil Aviation was delayed. In March, the two airlines agreed to extend the deal of share purchase agreement by 90 days. Then Rs 500 crore were transferred from the escrow to Sahara Pariwar as advance payment against transfer of shares. As the transfer of shares failed to happen, a consulting agreement was worked out between the two airlines. Then, Jet nominated a team of 15 persons across all departments, who were stationed at Sahara's head office and effectively took all decisions. Thus, Jet's takeover of Sahara's day-to-day running was complete. Key management people left the Sahara team. Rono Datta, President and CEO, Air Sahara, left for US, as his contract had expired. Jet rationalized Sahara's flights and operations. In the context of same timings for both the flights, whenever the load factor was not justified, the Sahara flight was withdrawn and passengers were put on Jet. As a result, Sahara's total flights came down from 126 before January to around 87 by July 2006. Sahara's load factor, as well as its market share, fell. Sahara's losses were in the range of Rs 25 crore to Rs 30 crore per month.

The stock market crash would have deterred Jet from going ahead with its foreign currency convertible bonds (FCCB) issue. Goyal of Jet Airways wanted a price of Rs 1300 for the bonds which, with the share price of Rs 600–700, would have been difficult to obtain. Jet also raised $400 million from ICICI Bank and IDFC, as pre-delivery payment for the aircraft it had ordered. There were reports that the money was diverted into the escrow account, which was not legally permitted. Jet could not raise the amount required unless it diluted the equity of its holding company, Tailwinds. Jet walked out of the deal. The Lucknow district court froze the amount. According to the share purchase agreement, Jet would forfeit the money if the deal failed. Jet was in need of funds to add 31 aircrafts at an estimated cost of $2.5 billion.

The Sahara acquisition was expected to push up Jet's share price but the deal precipitated a drop in Jet's Valuation. Jet was planning to raise $800-900 million through equity. Since 19th January 2006, after the deal was announced, Jet's market capitalisation dropped from Rs 9927 crore to Rs 5400 crore, and its share prices dropped from Rs 1145 to Rs 625. Jet was said to be facing a cash crunch. It had raised Rs 1900 crore from its IPO, and had already spend Rs 1260 crore. Allegations were raised that once Goyal changed his mind, he used his influence with the government to hold up clearance till the deal expired.

The deal broke up midway. Rumours were rife about Sahara's severe losses, bad shape of its fleet and its aircrafts' spurious parts.

Legal wrangles followed, and the arbitration panel was proceeding with the case. Finally, after negotiations, an out of court settlement was arrived at. After clearance by the three member arbitration panel, Jet Airways finally struck a deal on April 12, 2007 to buy out Air Sahara for Rs 1450 crore, at about 40% less than the initial offer of $500 million (Rs 2200 crore). Air Sahara was renamed Jetlite, and it was positioned as a value-based carrier that offers value to passengers at low fares, to compete with low cost carriers. The Rs 500 crore paid in 2006 will be adjusted. Another Rs 400 crore was paid by 20th April 2007. The balance of Rs 500 crore would be paid in equal instalments during the period 2008-11. Both Jet and Sahara had been losing market share to new entrants. Jet's market share came down from 34.7% in January 2006 to 25.5% in January 2007. Sahara's market share had dropped from 11.6% in January 2006 to 8.2% in January 2007.

Analysts felt that Jet had a debt of around Rs 5000 crore on its books, and with the capex plans of around Rs 10,000 crore plus, the deal would strain its leveraged balance sheet.

Synergies in the Deal

Table CS5.1 *The Combined Entity*

	Jet Airways	Air Sahara	Combined Entity
Fleet Size	53	27	80
Destinations	44	24	68
Number of seats a day	33,500	13,900	47,400
Number of flights a day	300	134	434
Percentage Market Share	35	12	47

Source: Business World, Feb. 2006.

Post takeover, Jet's market share was expected to increase to 47%. The merger was expected to cut costs and improve efficiency by reducing overlapping flights and commercial activities on the ground.

The acquisition of Sahara would make sense for Jet in three aspects. Theoretically, after the acquisition, the market share of Jet would increase by 11%. The acquisition would give Jet control over substantial part of the available airport infrastructure in key cities. This could restrain the growth of low cost carriers for short-to medium-term. By acquiring Sahara, Jet could be the only private Indian carrier to fly international. The acquisition would give Jet 22 new parking bays, including seven in Mumbai, nine in Delhi and three in Kolkata. Hence, Jet would own 26 parking bays in Mumbai out of a total of 49, and 23 in Delhi out of 46. These additional bays would help Jet to have a strong hub in Mumbai to serve the Southern region, and another in Delhi for the Northern region. Therefore, Jet would be able to change its routing structure to consolidate its southern and western markets, while expanding its northern links. The merged entity would reap the benefits of the international as well as strong domestic network, owing to Sahara's operations in many areas where Jet was not present. In a global scenario, Jet is strong in long haul routes like the US and Europe while Air Sahara was operating effectively in neighbouring countries, like Nepal, Sri Lanka and Thailand. The merger would prove advantageous to Jet Airways as it would have access to Air Sahara's 27 aircrafts as well as landing rights in busy airports, routes, parking slots in London's Heathrow airport and domestic airports. Jet could also use Sahara's pilots.

However, the combined entity would face a number of challenges. They include network and integration challenges, as both Jet and Sahara networks are almost similar and optimum utilisation of aircraft with available parking slots would be difficult. There could also be human resource issues.

At the same time, the combined fleet of Jet and Sahara would be around 90, leading to economies of scale that would benefit both airlines. Jetlite, the new name by which Sahara would be known, would add a new dimension to the industry. The major advantage for Jet is more destinations within the country and overseas.

THE MERGER OF AIR INDIA AND INDIAN AIRLINES

Air India is the national flag carrier of India with a worldwide network of passenger and cargo services. With its main bases at Chhatrapati Shivaji International Airport, Mumbai, and Indira Gandhi International Airport, New Delhi, Air India connects 146 international and domestic destinations around the world, including 12 gateways in India with Air India Express, a fully owned subsidiary of Air India. In 1932, Air India began its journey under the ageis of Tata Airlines, a division of Tata Sons Ltd. Following World War II in 1946, regular commercial service was restored in India, and Tata Airlines became a public limited company under the name Air India. Under the Air Corporation Act of 1953, the Government nationalised the air transportation industry, and Air India International Ltd came into existence. In 1960, Air India flew its first international flight to New York via London. In 1962, it became the world's first all jet airline, and its name was officially truncated to Air India.

Indian Airlines came into being with the enactment of the Air Corporations Act 1953. It was renamed 'Indian' on December 7, 2005. Indian Airlines started its operations from 1st August 1953 with a fleet of 99 aircraft, and was the outcome of the merger of seven former independent airlines, namely Deccan Airways, Airways–India, Bharat Airways, Himalayan Aviation, Kalinga Air Lines, Indian National Airways and Air Services of India. The year 1964 saw Indian Airlines moving into the jet era with the introduction of Caravelle aircraft into its fleet, followed by Boeing 737-200 in early 1970. Along with its wholly owned subsidiary, Alliance Air, it flies a fleet of 70 aircraft, including Airbus A300, Airbus A320, Airbus 319, Boeing 737, Dornier Do 228, ATR-4, Airbus A319, A320 and A321. Besides Indian cities, it flies to many foreign destinations, which include Kuwait, Singapore, Oman, UAE, Qatar, Bahrain, Thailand, Singapore, Malaysia, Myanmar, Pakistan, Afghanistan, Nepal, Bangladesh, Sri Lanka and Maldives. Indian Airlines was the first airline in India to introduce the wide bodied A300 aircraft on the domestic network, it flies to 76 destinations–58 within India and 18 abroad. It has a total employee strength of around 19,300, and carries over 7.5 million passengers annually (both figures inclusive of Alliance Air).

Indian Airline's monopoly over Indian skies ended after the liberalisation of Indian economy in the early 1990s, with the entry of private carriers like Jet Airways, Air Sahara, East West Airlines and ModiLuft. The entry of low cost airlines like Air Deccan, King Fisher Airlines and Spice jet have revolutionalised the Indian aviation sector.

In the fiscal 2006-07, before the merger Air India recorded a loss of Rs 448 crore and Indian Airlines of Rs 240 crore. Interest payments rose from Rs 276 crore in 2006-07 to Rs 712 crore in 2007-08. Depreciation went up from Rs 709 crore in 2006-07 to Rs 809 crore in 2007-08. The figure crossed Rs 1000 crore in 2008-09. Expenses were inevitable due to fleet expansion plans. At the same time, the salary bill had gone up from Rs 2729 crore in 2006-07 to Rs 3360 crore in 2007-08. This was mainly due to payment of arrears for periods ranging back to 10 years. The biggest problem being faced by Air India was the high aviation turbine fuel cost (ATF). Fuel accounts for 40% of Air India's expenses. The average price in 2006-07 was $2 a gallon, which rose to $2.50 a gallon in 2007-08.

In 2007, Air India and Indian Airlines merged into one airline. Post-merger, the new airline was renamed Air India. The new airline is also a member of Star Alliance, the largest air alliance. The merged airline became Rs 15,500 crore entity, almost thrice the size of its nearest domestic rival, Jet Airways. It ranks among the world's top 30 airlines. The empowered group of ministers (eGOM) had approved the civil aviation ministry's proposal. In February 1999, a Parliamentary Standing Committee on Transport and Tourism had recommended the merger of the two airlines in its report on the 'Functioning of Air India'. The process had formally been initiated in September 2006, when the Indian government assigned the duty of preparing the roadmap for the merger to Accenture Inc, the management consultancy, technology services and outsourcing company. A new company, the National Aviation Company of India Ltd (NACIL), was incorporated on March 30, 2007 under sections 391 and 394 of the Indian Companies Act 1956. Under the terms of the merger, all undertakings, properties and liabilities of AI and IA were transferred to NACIL. The finance ministry had already given in principle approval to extend Section 72A benefits, that would allow the merged entity to set off accumulated losses. Indian Airlines had accumulated losses of about Rs 800 crore and unabsorbed depreciation of Rs 350 crore. It has also agreed to waive stamp duty related to the merger. The cost of the merger was around Rs 200 crore. The annual benefits accruing to the merged entity would top Rs 600 crore. The merged entity would have six business units: maintenance, repair and overhaul, jet shop, ground handling, engineering cargo and low cost operations. It would have 33,000 employees and, by 2009, the aircraft to employee ratio would come down to 200, which is comparable to any large airline in the world. The new airline would be among the top ten in Asia. The combined fleet would have 122 aircrafts and 1315 pilots. It would be India's first airline with more than 100 aircrafts. Jet Airways, with a fleet of 44 and King Fisher with a fleet of 23 aircrafts would be its closet rivals. The merger would lead to better connectivity and improved services. The airline is moving to a hub and spoke system. The smaller planes will ferry passengers from smaller centres, who would be shifted to larger Air India flights for international destinations. The alliance will enhance Air India's reach and overall value proposition to the customer by providing end-to-end connectivity. Air India expects an incremental revenue of more than $100 million from this alliance. The new Air India is also focusing on joint ventures in other initiatives–like ground handling and maintenance repair and overhaul (MRO).

Initially, both airlines were being managed by separate managing directors. The position of Joint Managing Director has been done away with. Now, a Chairman is heading the new organization.

Major Reasons for the Merger

The increasingly intense competition faced by AI and IA from private and global airlines was the main reason for the merger between the two airlines. There was scope for considerable synergies by integrating routes and streamlining overlapping facilities and infrastructure. Significant potential synergies also existed between two airlines in the areas of sales and distribution network, fuel procurement, material procurement, passenger amenities, ground handling and parking facilities. According to the report submitted by Accenture in late 2006, the merger could result in 3-4% reduction in costs and increase in revenue of around Rs 6 billion.

India was the fastest growing aviation market in the world, ahead of China, Indonesia and Thailand. The advent of low cost airlines brought air travel within reach of India's large middle class.

The merger faces serious challenges of post-merger integration, particularly integration of its employees. The culture of two airlines was completely different. Both carriers were ridden with human resources problems created by their powerful labour unions. Even before the merger was announced, these unions were extremely disgruntled with the decisions taken by the respective managements. After the merger was announced, some unions went on strike. These unions wanted greater say in the decision-making process. The management is using a top down approach in which senior employees will be integrated before the junior employees.

The two airlines had completely different operational methods before the merger. They also had different fleet compositions, which created complications in inventory management, maintenance and repair establishments and pilot training.

The aviation industry is in the consolidation mode. Jet Airways merged with Air Sahara in 2007. King Fisher Airlines acquired 26% stake in Air Deccan in June 2007. The merger of AI and IA signified more changes in the dynamics of the industry.

Air India's acquisition of new aircraft will go a long way in changing the perception of service levels. It makes no economic sense to improve facilities in old airplanes or leased aircraft, which would go back to the owners after three years. Air India had ordered 68 Boeing jetliners and Indian Airlines 43 Airbuses. The brand new Boeing 777 aircraft have been introduced on the lucrative India-US routes, including the popular daily non-stop Mumbai-New York and Delhi-New York services. Air India has excellent load in this category, and is considered to be the best in class product. Thousands of employees are considered surplus for the new Air India. It is said that both Indian Airlines and Air India have duplicate flights on several sectors in the Gulf and Singapore. For the success of the merger, it is essential that Air India take into confidence the plethora of unions, especially for unsettled arrears. The Airline is planning to go for Initial Public Offering. In the 1980s, Air India's share was 22% and Indian Airlines was 11%, with a total of 33%. But, by 2008, the combined entity's share was 27%, with 18% for Air India and 9% for Indian Airlines. Domestic carriers, like Jet, have started international services relatively recently, and have taken away the market share on routes like London from the national carrier.

Lower jet fuel prices, brand new fleet and marginal savings in the wage bill helped Air india to narrow its operating loss by 36% in the fiscal ended 31st March 2010. The national carrier had piled up a cumulative loss of Rs 8461 crore in fiscal 2007, 2008 and 2009.

The Sequence of Events

May 1993: Jet Airways launched following liberalisation of Indian Aviation Industry
August 2004: Air Deccan, India's first low cost Airline is born
May 2005: Vijay Mallya launches King Fisher Airlines
October 2005: Mallya tries to buy competitor Air Sahara
January 2006: Jet announces intention to buy Air Sahara
December 2006: Cash strapped Air Deccan looks for investors
December 2006: Mallya negotiates with Air Deccan
February 2007: Air India and Indian Airlines merge, forming India's largest airline
March 2007: Anil Ambani tries for controlling stake in Air Deccan
April 2007: Legal pressures force Jet into buying Air Sahara
May 2007: Vijay Mallya buys 26% of Air Deccan.

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DISCUSSION QUESTIONS

1. Discuss the changing dynamics of the Aviation Industry, and the need for consolidation in the sector.
2. What are the main reasons for the Jet-Sahara Merger?
3. What are the striking features of the three major mergers in the Aviation Industry? Differentiate between them.

Case Study 6

MERGERS IN TELECOM INDUSTRY

India is one of the fastest growing telecom markets in the world. The consolidation in the telecom sector has been prompted mainly by competitive pressures and technological and regulatory changes. The National Telecom Policy (NTP) 1994 allowed a duopoly among cellular mobile operators in various non-metro circles. Accordingly, bids were called and licences awarded to various players. The operators soon found that most of the available funds were spent on licence fees, rather than in network roll-out and addition of subscribers. The Government of India, in the larger interest of increasing tele-density and viability of cellular industry, offered a more liberal regime in its NTP 1999.

During the last decade, India had become a centre for telecom mergers and acquisitions. Sweeping reforms introduced by successive Governments have dramatically changed the face of the telecommunication industry. The revolution of the mobile sector was aided by a variety of factors–such as aggressive foreign investment, regulatory support, lower tariffs and falling network costs and handset prices.

The emergence of telecommunication technology has also been a driver for M&A activity. Products and services, formed as a result of convergence of telecom and cable industries, provided the scope for mergers and acquisitions in this sector. The telephone penetration market is expected to reach 250 million by 2010. M&A have acted as catalysts for phenomenal growth in teledensity, 14% in 10 years (1995-2006), as against 2% in 48 years (1947-1994). According to a study conducted by the international agency, OVUM, mobile sector had generated 3.6 million jobs directly or indirectly. By 2006, mobile industry had contributed over Rs 145 billion per annum by way of licence fees, spectrum fees, import duty, taxes, etc. In 2006, out of Hutchison's total global revenue of Rs 13,440 crore, over 45% came from India.

There has been almost saturation of demand in the home market of majority of foreign countries where teledensity ranges from 40% to 100%. The rural teledensity is almost negligible at about 3%. In contrast, India's young and middle class market offers tremendous scope for market expansion and new business. Spectrum was the biggest bottleneck for Indian mobile operators, as they faced network problems, poor voice quality and call dropping. Over a period of time, consolidation has resulted in reduction in the number of players, from 20 to five/six major players.

The data released by the Telecom Authority of India (TRAI) puts the total telecom subscriber base of India at 653.92 million by end of May 2010 and number of mobile subscribers at 617 million.

BASIC MODELS OF M&A IN TELECOM SECTOR[1]

There are three basic models for Indian Telecom M&A activity.

1. In the first model, the investor acquires controlling stake in the acquired company and retains it as separate entity. This is the simplest model and the intent is to avoid the legal hurdle involved in merging the company into the parent company. This route also gives the acquirer flexibility to sell off the operation on a standalone basis, in case the merger is not successful. This mode has been followed

[1]Sanjoy Banko, M&A in Indian Telecom Industry–A Study, Chartered Accountant, December 2006, page 927-941 .

by Hutchison, which retained most of the acquired companies (Usha Martin–Kolkata, Fascel–Gujarat, Aircel Digilink–Haryana, Rajasthan and UP East, Sterling Cellular Delhi, Escotel–Punjab) as separate legal entities.

2. In the second model, the acquirer merges the acquired company with the parent after acquiring controlling stake. This model requires completion of merger formalities with due approval of High courts and also from DoT. It has the advantage of avoiding statutory compliance for several entities and integrate all operations seamlessly into a single legal entity. This model has been followed by Bharti, which has merged most of the acquired entities with the parent in due course of time.
3. The third model entails purchase of assets of the target company on standalone basis, without purchasing the company as a whole. In some cases, if the licence is cancelled by DoT owing to default, the company sells its telecom assets and customer database to the acquirer, who integrates them into his existing licence, and thus strengthens his network and customer base at nominal cost. The seller company, which was stripped of its licence as well as its telecom network, is ultimately wound off.

Some predominant objectives of takeovers in telecom sector can be summarised as follows:

- Acquisition of licences or geographical territory
- Acquisition of spectrum
- Acquisition of telecom infrastructure and network
- Acquisition of customer base to achieve economic base
- Acquisition of brand value.

In 1995, when the Government permitted entry to foreign telecom operators through the Joint Venture route, many multinational giants, including Vodaphone, AT&T, Hutchison Whampoa, Telekom Malaysia and Telestra Australia entered the Indian market. The first M&A deal in India was the sale of Mumbai licence by the Max Group to Hutchison Whampoa Group of Hong Kong. The deal fetched over half a billion dollars for the Max Group.

After Essar's acquisition of Sterling's Delhi licence in 1995, the M&A activity slowed down since the lock in expired in 1999-2000. Soon the momentum of M&A activity started again. In early 2000, the entry of the basic telecommunication companies like MTNL and BSNL as the third cellular operator had let to cut throat price based competition.

Table CS6.1 *Some Significant Acquisitions in the Post 2000 period*

Acquisitions	Area of Operation
Bharti Acquires 45.6% stake in JT Mobile	Karnataka, Andhra
Bharti Acquires 51% in Skycell	Chennai
Hutchison Acquires 49% in Sterling Cellular (Essar)	Delhi
Birla –AT&T and Tata Cellular Merge	Gujarat, Maharashtra, Andhra Pradesh
Hutchison Acquires Majority in Usha Martin Telekom	Kolkata
Singtel Acquires Strategic Stake in Bharti	
Hutchison Acquires Stake in Fascel	Gujarat
Batata Acquires RPG Cellcom	MP

Source: Business India.

In 2003, BPL bought out AT&T's 49% stake in BPL Cellular, which operated mobile services in Kerala, Maharashtra and Tamil Nadu.

In 2005, Hutchison Essar acquired BPL Mobile Communications for $1.2 billion (BPL mobile's Mumbai Circle; BPL Mobile Cellular–the state circles of Kerala, Tamil Nadu and Maharashtra and Essar Spacetel).

The Indian telecom market witnessed much consolidation in 2006. The Aditya Birla Group bought out the Tata Group in Idea Cellular for Rs 44 billion ($979 million). Hutchison Whampoa increased its stake in the Indian subsidiary by 5%, by acquiring Rs 20 billion ($450 million) worth of shares from the Hindujas. Telekom Malaysia was finally able to gain foothold in India by acquiring a 49% stake in Spice Telecom for Rs 8 billion ($179 million). Some other high profile deals were Vodaphone's acquisition of 10% equity in Bharti in 2006 for $1 billion, Maxis' acquisition of Aircel at enterprise value of $1 billion.

Various private equity players invested Rs 44 billion ($970 million) in Idea Cellular for 34.5% stake. The investors included Providence Equity Partners, TA Associates, ChrysCapital, Citigroup, and others. Warburg Pincus invested in Bharti Airtel.

In 2007, Hutchison Whampoa sold out its 67% stake in Hutchison Essar to Vodafone.

Table CS6.2 *Major M&A Deals in Indian Telecom Sector: 1998-2006*

Company/ Service	% Stake Sold	Buyer	Seller	Year	Deal Size ($)	Indicative Enterprise Value ($)	Per Sub Value ($)
Orange, Mumbai	41%	Hutchison Group	Max Group Delhi	1998	560 mn	1.36 billion	NA
Hutch India	8.33%	Max India	Kotak Mahindra	2006	225 mn	NA	NA
Hutch Essar, India	5.1%	Hutchison Group	Hinduja Group	2006	450 mn	9 billion	NA
Hutch Essar	3.17%	Essar Group	Max India	2005	146 mn	NA	570
Command Cellular, Kolkata	100%	Hutchison & India Group	Usha Martin & others	2000	NA	138 million	NA
Idea Cellular	48.14%	Aditya Birla Group	Tata Group	2005	NA	2 billion	400
Modi Telestra, Kolkata	100%	Bharti Group, India	BK Modi and Telestra	2000	NA	160 million	NA
Bharti	9.3%	Private Investors	Warbug Pincus	NA	873 mn	NA	1000
Bharti Airtel	10%	Vodaphone	Bharti Group	2005	1.5 billion	16 billion	1000
Aircel Chennai	79.24%	Sterling Group, Chennai	RPG Group	2003	2.10 billion	NA	NA
Aircel TN, Chennai and NE (North East)	74%	Maxis Malaysia	Sterling Group	2006	750 mn	1.07 billion	496
Spice (Punjab and Bangalore)	49%	Telekom Malaysia	NA	2006	178 mn	363 million	NA
Reliance CDMA	NA	Qualcomm, San Diego, US	Reliance Infocomm	2002	NA	10 billion	NA

Source: 'M&A in Indian Telecom Industry–A Study', The Chartered Accountant, December 2006, page 935.

THE STORY OF BATATA

In 1990, the AV Birla Group teamed up with AT& T of USA for operating cellular services. The joint venture was later merged with the Tata group's cellular venture to become Birla-AT&T-Tata, or Batata, as it was called.

On 27 June, 2001, Birla-AT&T-Tata and BPL signed an agreement to merge their operations. This combination resulted in the creation of the largest cellular joint venture in the country, with a subscriber base of 900,000 that is, 24% of the cellular users. This joint venture covered 38% of the country's population and 51% of all fixed line telephone users. The combined entity was valued at $2.1 billion. Birla-AT&T-Tata held 50.68% (17 per cent) in the new company, the BPL consortium (AIG, CDC, France Telecom) 41.5% and AT&T 8% in the new joint venture. Batata operated in the states of Andhra Pradesh, Maharashtra and Gujarat, but missed out Mumbai and Delhi. It was opined that BPL had heavy debt in its capital structure, which was a compelling reason for the joint venture.

After a botched up attempt to take over BPL group's cellular business, Batata changed its name to Idea and began a massive branding exercise to consolidate its increased services, and clock-up subscriber numbers. It took over Escotel, gaining additional subscribers and entry into newer circles.

Initially, Birlas, the Tatas and AT&T Wireless, each held one third equity in the company. But, following AT&T Wireless merger with Cingular Wireless in 2004, Cingular decided to sell its 32.9% stake in Idea. This stake was bought by both the Tatas and Birlas (each 16.45%). Tata's foray into the cellular market with its own subsidiary, Tata Indicom, a CDMA based mobile provider, resulted in differences between the Tatas and the Birlas. This dual holding by the Tatas also became a major reason for the delay in Idea being granted a licence to operate in Mumbai. As per the Department of Telecom, one promoter could not have more than 10% stake in two companies operating in the same circle. Tata Indicom was already operating in Mumbai when Idea filed for its licence. On April 10, 2006, the Aditya Birla Group acquired the 48.18% stake held by Tatas at Rs 40.51 a share, amounting to Rs 44.06 billion. By this time, the Birla Group had control of 98.3% shares of the company.

By 2008, Idea Cellular became the fifth largest mobile phone company in India. Idea Cellular bought out BK Modi's 40.8% stake in Spice Communications in an all cash deal worth Rs 2700 crore, including non-compete fees. In the final stage of the deal, both Idea and Spice would be merged, which would give an additional 3 to 5% stake to TM International, depending upon the response from small shareholders to the open offer. Idea had successfully launched three more new circles (states) in India, viz, Rajasthan, Himachal Pradesh and UP (East), to make itself a pan-India player.

TATA'S ACQUISITION OF VSNL

VSNL had started its operations in the year 1986 and emerged as the leading provider of global telecommunication and internet services. The company was ahead in its operations in US, Europe and Asia. It had 2,06,356 km of a territorial network fibre and sub-sea cable capacity. The Tatas bought 25% stake in VSNL for Rs 14.39 billion, as part of the Government of India's disinvestment programme. Tata later acquired another 20% through open offer to public shareholders.

In the final stages, there were three bidders for VSNL; the Tatas, Reliance and the Sterling led consortium with two US based companies–Tycom and Century Tel. The consortium withdrew on the closing date. An interesting aspect of the deal was that for the first time Reliance came as close to winning as it could have, the difference was only Rs 13. At the time of the acquisition, Tata, through Birla Tata AT&T (BTAL) had a million-plus consumer base in the cellular section. The acquisition gave Tata National Long Distance (NLD) licence without having to pay Rs 100 crore in fees and a bank guarantee of Rs 400 crore. Moreover, it spared the group Rs 25 crore, being the cost for the right to set up four gateways. With the acquisition, VSNL brought 32 earth stations, 12 international gateways and links to five submarine cables. VSNL had long standing relationships with almost every major international carrier, and exclusive arrangements with a number of other carriers. VSNL provided services to 237 countries. The company's ISP subscriber base was the largest among all ISPs in the country. On account of the acquisition, Tata got assured traffic from the state owned BSNL and MTNL for two years. VSNL had built up a very strong position in the international long distance (ILD) service, Internet services and other value-added services, and possessed NLD licence. This contributed to improvement in Tata's market share. With the VSNL acquisition, Tata was able to accelerate its plans to provide NLD, ILD and other value-added services and become a fully integrated telecom services provider.

Later, VSNL acquired the Tyco Global Network for $130 million in an all cash deal which gave it control over the 60,000 km cable network spanning over the three continents.

Restructuring at Tata Telecom

In 1986, as part of the Tata Group's foray into the telecommunications sector, Tata Industries promoted Tata Telecom (TTL). As an equipment manufacturer, it started manufacturing EPBAX Systems in collaboration with OKI of Japan, and went on to make a variety of telecom equipment from office communication systems to network access systems and transmission system which were introduced in collaboration with the Japan Radio Company. While on its foray into the telecom business, TTL set up Trans India Networks System, a joint venture with AT&T for network access. The restructuring at Tata Telecom Ltd began in fiscal year 1998, when Lucent Technologies of the US picked up equal stake in TTL as the Tatas (25.5%). Since 2000, Lucent has decided to spin off the former enterprise networks business into a separate company, Avaya, worldwide. As a result of this exercise, TTL and Avaya started a new association.

Reliance's Acquisition of Flag Telecomm

Reliance Infocomm Ltd, part of the group founded by Dhirubhai H Ambani, was India's largest mobile service provider. Reliance Infocomm had established a pan-India, high capacity, integrated (wireless and wireline) and convergent (voice, data and video) digital network to offer services spanning the entire country.

Flag Telecom was a US based telecomm company which had more than 180 customers, many of them world's leading telecommunications and internet companies. Its network spanned across countries in Europe, Asia, Western Europe, Japan, West Asia, India, South East Asia and China. It had 50,000 km undersea fibre optic cables, and was the only Trans Oceanic System Company. Flag had a market capital of $7 billion at its peak.

Synergies

This deal gave Reliance entry into the untapped markets in Europe, Middle East and South East Asian regions. Flag's network was well positioned in these markets. In the Middle East and Africa, deregulation had opened the market to private players. Reliance Gateway had initially offered $207 million for Flag Telecomm, but later raised its offer to $211 million when Pivotal, a private equity investor, put in a higher bid of $220 million. The two companies signed a memorandum on October 16, 2003. The outcome was significant for both companies. For Reliance, it is a major step towards its vision of establishing itself as a world class global telecommunications player.

Latest Trend

The telecom industry topped the chart in terms of M&A deals valued at $22.73 billion across all sectors in April-June quarter of 2010-11 according to a study by industry body Assocham. In the telecom sector, the biggest deal was cracked by Anil Ambani Group's flagship company, Reliance Communication Ltd, which merged its telecom tower business with GTL Infrastructure for $11 billion. The other major deals included Bharti Airtel signing a deal to acquire Kuwait based Zain Telecom's African business for $10.7 billion and Reliance Industries acquiring InfoTel Broadband for $1 billion. Infotel Broadband emerged as the sole winner of broadband spectrum for entire country for Rs 12,872 crore (Rs 128.72 billion).

REGULATORY FRAMEWORK

M&A in the telecom industry are subject to various statutory guidelines and industry specific provisions, viz., Companies Act, 1956, Income Tax Act, 1961, Competition Act, 2002, MRTP Act, Indian Telegraph Act, FEMA Act, FEMA Regulations, SEBI Takeover Regulation, etc.

TRAI Recommendations

The Telecom Regulatory Authority of India (TRAI) is of the view that though mergers, on one hand, encourage efficiencies of scope and scale, and hence are desirable, care has to be taken that monopolies do not emerge as a consequence.

Based on the recommendations of TRAI, the Department of Telecommunications (DoT) issued guidelines on merger of licences in February 2004. The important provisions are stated below:

- Prior approval of the Department of Telecommunications will be necessary for merger of the licence.
- The findings of the Department of Telecommunications would normally be given in a period of about four weeks from the date of submission of application.
- Merger of licensee shall be restricted to the same service area.
- There should be minimum three operators in a service area for that service, consequent upon such merger.
- Any merger, acquisition or restructuring leading to a monopoly market situation in the given service area will not be permitted.
- Consequent upon the merger of licences, the merged entity shall be entitled to the total amount of spectrum held by merging entities, subject to the condition that after merger, the amount of spectrum shall not exceed 15 MHz per operator per service area for Metros and category A service areas and 12.4 MHz per operator per service area in category B and category C service areas.
- In case the merged entity becomes a 'Significant Market Power' (SMP) post merger, then the extant rules and regulations applicable to SMPs would also apply to the merged entity. TRAI has already classified SMP as an operator having market share greater or equal to 30% of the relevant market.

The key provisions of the DoT guidelines with respect to foreign equity participation are as follows:

- The total composite foreign holding including but not limited to investments by Foreign Institutional Investors (FIIs), Non-resident Indians (NRIs), Foreign Currency Convertible Bonds (FCCBs), American Depository Receipts (ADRs), Global Depository Receipts (GDRs), convertible preference shares, proportionate foreign investment in Indian promoters/investment companies including their holding companies, etc., referred to as FDI, should not exceed 74%. The 74% investment can be made directly or indirectly in the operating company, or through a holding company, and the remaining 26% will be owned by resident Indian citizens, or an Indian Company (i.e., foreign direct investment does not exceed 49% and the management is with the Indian owners). It is also clarified that proportionate foreign component of such an Indian Company will also be counted towards the ceiling of 74%. However, foreign component in the total holding of Indian public sector banks and Indian public sector financial institutions will be treated as 'Indian' holding.

- The licensee will be required to disclose the status of such foreign holding and certify that the foreign investment is within the ceiling of 74% on a half yearly basis.
- The majority directors on the Board, including the Chairman, Managing Director and Chief Executive Officer, shall be resident Indian citizens. The appointment to these positions from among resident Indian citizens shall be made in consultation with serious Indian investors.
- The merger of Indian companies may be permitted as long as competition is not comprised as defined: "No single company/legal person, either directly or through its associates shall have substantial equity holding in more than one licencee company in the same area for the access service namely; Basic, Cellular and Unified Access Service." Substantial equity, herein, will mean equity of 10% or more. A promoter company/legal person cannot have stakes in more than one licencee company for the same service area.

RBI has issued detailed guidelines on foreign investment in India vide "Foreign Direct Investment Scheme" contained in Schedule 1 of the said regulation. As per the FDI scheme, investment in telecom sector by foreign investors is permitted under the automatic route within the overall sectoral cap of 74% without RBI approval.

The salient features of the FDI scheme, as applicable to the telecom sector, are as follows:

- Industries which do not fall within the ambit of Annexure A can issue shares under automatic route to foreign companies (Para 2). Since telecom sector is not listed in Annexure A hence foreign investment can be made in telecom sector upto 74% cap without prior approval of RBI.
- In case, investment by foreign investor(s) in an Indian telco is likely to exceed cap of 74%, then they should seek approval of Foreign Investment Proposal Board (Para 3).
- FDI scheme permits automatic approval of transfer of shares from one foreign shareholder to another, so long as the transfer is in compliance of FDI scheme and regulation (Para 9).
- However, if the shares are being transferred by a person residing outside India to a person resident in India, it shall be subject to adherence to pricing guidelines, documentation and reporting requirements of RBI. Application seeking RBI approval is to be made in Form TS 1 (Regulation 10 B).
- The issue price of share should be worked out as per SEBI guidelines in case of listed companies. In case of unlisted companies, fair valuation method, as prescribed by erstwhile Controller of Capital Issues, should be adopted and should be certified by a Chartered Accountant (Para 5).
- FDI scheme also stipulates the norms on dividend balancing, whereby the cumulative amount of outflow on account of dividend for a period of seven years from commencement of production or services should not exceed cumulative amount of export earning during those years. The dividend balancing guidelines are applicable to companies included in Annexure E of FDI scheme and annexure (Para 6).
- In case preference shares are issued to a foreign investor, the rate of dividend shall not exceed 300 basis points over the Prime lending rate of SBI prevailing on the date of Board meeting where such issuance is recommended (Para 7).
- The reporting requirements are contained in regulation 9, viz., (a) The Indian company should report the details of receipt of consideration to RBI within 30 days of receipt, and (b) The Indian company should submit report of issuance and allotment of shares in Form FCGPR along with necessary certificates from the Company Secretary and the Statutory Auditor of the Company.
- An Indian Company may also issue shares on Rights basis or issue bonus shares (Regulation 6A) subject to compliance of conditions of FDI scheme and sectoral cap.

- FDI scheme prohibits investments by citizens or entities of Pakistan and Bangladesh (Regulation 5) primarily on security concerns. In the past, DoT had delayed its approval to an Egyptian company's investment in Hutch India on similar grounds.

Due Diligence in Telecom M&A

The due diligence process in Telecom sector can be broadly divided into four issues:

(a) The strategic and business due diligence includes careful analysis of current market share, planned market share, quality of existing customer base, revenue mix, Average Revenue Per User (ARPU) in the service area, per minute revenue (RPM), review of marketing strategy, etc., and the ability of the existing channel partners to promote services and withstand competition.

(b) The technical due diligence includes review of technical aspects, telecom network technology adopted, etc. This process will facilitate investors to find about the quality of network assets, whether the coverage is adequate or not, their maintenance and upgrade status, and status of integration of various systems. In this context, the technical due diligence helps in analyzing the non-compatibility of existing network equipment, if any, with the current system of the acquirer.

(c) The financial due diligence would give insights into issues like accounting policies on intangibles and deferment, contingent liabilities disclosed and undisclosed, statutory and workmen dues, finance cost and possibility of debt restructuring. Other aspects, like delayed payments, list of all contracts and agreements pending export obligations could also be analyzed.

(d) The secretarial and legal due diligence enables the acquirer to understand possible instances of violations and quality of statutory compliances. This includes review of statutory approvals required, approvals taken, and their renewal status.

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DISCUSSION QUESTIONS

1. Explain the major reasons for increased consolidation drive in the telecom sector.
2. Discuss the regulatory aspects of M&A in telecom industry.

Case Study 7

MERGERS AND ACQUISITIONS IN THE CEMENT INDUSTRY

Cement is a capital intensive business and, therefore, a business of scale. Globally, the key players focus on accumulating large cement capacities. The largest player globally is Lafarge with the Swiss company, Holeson in the second position.

The early 1990s had seen substantial expansion in cement capacity, far in excess of demand. With the recession setting in, a shake-out was inevitable. New and marginal players began to sell out to the larger players, and the past few years have seen several takeovers. The consolidation process and the resultant synergy is expected to significantly improve efficiency, productivity, distribution and marketing. The acquisition of Larsen and Toubro's cement division by Grasim Industries, the biggest in cement industry, marked the beginning of the final wave of consolidation process. With the Grasim's acquisition of L&T cement division, the industry has top six players, accounting for 60% of the industry capacity. The consolidation process at the lower end will lead to unviable units being shut down, thus benefitting the industry in the long term, and would give significant pricing power to the bigger players. Lafarge SA, the $11 billion French Cement company took over TISCO's cement unit for Rs 550 crore in an all cash deal. The acquisition of Raasi Cements by India Cements was one of the fiercest takeover battles fought in the M&A history of Corporate India. This acquisition was aimed to gain additional market, share and access to cement deficit regions.

Table CS7.1 *Major Deals in Cement Industry*

Buyer	Target	Capacity (in million tones)	Consideration (in Rs Crore)
India Cements	Visaka Cements	1.2	380
India Cements	Raasi Cements	2.3	445
India Cements	Cement Corporation of India's Yerraguntala Plant	0.4	200
India Cements	Sri Vishnu Cements	0.9	170-180
Grasim	Dharani Cements	0.9	290
Grasim	Shree Dig Vijay Cements	1.3	293
Grasim	Indian Rayon	4.2	750
L&T	Narmada Cement	1.4	260
Lafarge	Raymond Cement	2.2	NA
Italcementi	Zuari Cement	1.7	NA
Italcementi	Sri Vishnu Cement	1.0	Rs 3936 per tonne of cement
Gujarat Ambuja	DLF	1.4	350
Gujarat Ambuja	ACC	12.0	455

Source: SBI Capital Market Report.

Mergers and acquisitions will be triggered by the fragmented nature of the industry, where top six manufacturers control 60% of the market, while remaining 57% operate with combined market share of 40%. The cyclical nature of this industry means only large players are able to withstand the downturn in demand due to their economies of scale, operational efficiencies, centrally controlled distribution systems and geographical diversification.

Lafarge's strategy has been to accumulate capacity piece meal. By 2003, it became the sixth largest player in the country, with a capacity of 4.5 million tonnes per annum, giving it a market share of 3.24%.

ACQUISITION BY AMBUJA GROUP

Gujarat Ambuja Cement acquired Modi Cements, a sick company, in the late 1990s and renamed it Ambuja Cement Eastern. Through this acquisition, Gujarat Ambuja hiked its capacity from 5 million to 6.8 million tonnes per annum. It infused Rs 166 crore to whip the company into shape. The historic merger of ten existing cement companies led to the establishment of ACC–melding into a cohesive organization in 1936, in Maharashtra. The house of Tata was intimately associated with ACC till 1999. After 1999, they sold their stake to the Ambuja Cement Group for Rs 370 crore. The purchase was at substantial premium to the then prevailing market prices. Earlier, the company had bought ACC's 7.2% equity on spot delivery basis. It bought 4.2% in May 2000 and 3.05% in September 2000. To lower its debt burden, Gujarat Ambuja floated Ambuja Cement India and vested its ACC and Ambuja Cement Eastern (98.08%) equity holdings in it. 40% equity of Ambuja Cement India was sold to two strategic financial investors. This cash flow helped prune the debt quickly. In 2000, Gujarat Ambuja Cements Ltd (GACL) merged with Ambuja Cement Rajasthan Ltd (ACRL), formerly DLF Cement Ltd. The exchange ratio was one new share of GACL for every 50 shares of ACRL. The management control of ACRL was acquired by GACL in March 2000. ACRL had a 1.5 million tonne cement plant along with a captive power plant of 21 MW in Rajasthan. The merged firm benefited in terms of marketing strategy and reduction in cost on selling and administrative overheads of the companies. With its acquisition of controlling stake in DLF Cement and its strategic alignment with ACC in key markets of North and West India, Ambuja held leadership position in nine out of 17 states in the North, East and West India, coupled with a market share in excess of 25% in seven states. In this period, at the national level, Ambuja Cements controlled slightly more than one-fifth of the Indian cement market. In addition to the dominant market position and greater geographical sweep, the acquisitions also helped Ambuja Cements to achieve higher operating leverage to cement prices, and greater economies of scale in production and distribution. GACL–ACC combination created a capacity of 21 million tonnes, and helped greatly in cutting administration and selling costs, savings in packing and coal procurement costs, as also savings in freight through joint logistics, despite the rise in petro prices.

Gujarat Ambuja entered into a strategic partnership with Holcim of Switzerland. Holcim acquired the stake held by strategic financial investors leading to a change in management. Holcim also raised its stake in Ambuja Cements India to 67% by infusing funds to bankroll the open offers for ACC and Ambuja Cement Eastern. Gujarat Ambuja Cement's stake in ACC decreased from 60% to 33%. The ACC–Holcim deal was worth around $1.5 billion (Rs 6,600 crore) including debt. Holcim had mounted an aggressive bid on ACC in concert with Gujarat Ambuja Cement for controlling interest in India's largest cement group, with 15 cement plants across the country. Along with ACC, Holcim also got control of 94.5% control in Ambuja Cement Eastern. Holcim got entry into a growing market at less than 40% of the total cost it would have incurred, had it set up green field ventures.

By 2005, four strong players–Grasim Ultra Tech, Gujarat Ambuja Cement, Lafarge India and Holcim controlled around 50% of the total market share.

Table CS7.2 *The Ambuja Acquisition*

Company	Year of Acquisition	Capacity (in Million tpa)	Cost of Acquisition (in Rs Crore)	Presence
Modi Cements	1997	1.8	166	Eastern India
Midigama Cement	1999	0.5	NA	Export Base in Srilanka
DLF Cement	1999	1.5	350.31	North India
ACC Cement	1999	12	910	National

Source: Business Today, February 7, 2000.

In 2005, an association was initiated between ACC and Holcim of Switzerland, and in the same year, the company acquired 98.84% equity shares of Tarmac India Private Ltd. On January 1, 2006, Tarmac India Private Ltd was merged with ACC, which operated two ready-mix plants in Mumbai. ACC Ltd has four subsidiary companies, namely, Bulk Cement Corporation of India (BCCI), ACC Machinery Company Ltd (AMCL), ACC Nihon Castings Ltd (ANCL) and The Cement Marketing Company of India Ltd.

GRASIM'S ACQUISITION OF ULTRA TECH CEMENT

In mid-November 2001, Grasim picked up 10.5% Reliance holding in L&T at a price of Rs 306 per share (47% premium to the then prevailing market price), aggregating to Rs 766.5 crore. This brought about a change in the L&T board representation, with the Ambani brothers, Mukesh and Anil, making way for Kumar Mangalam Birla and his mother, Rajashree Birla. Grasim upped its stake in L&T to around 15% through an open market purchase, thus triggering off an open offer to acquire a further 20% stake. L&T proposed to demerge its cement business and spin it off as a subsidiary, where L&T would hold about 75% and the balance would be held by existing shareholders.

In the year 2003, the Indian cement industry saw one of the biggest acquisitions when Grasim Industries acquired L&T's demerged cement business. With the acquisition, Grasim Cement owned 51% stake in Cemco (demerged business), with a combined capacity of 30 million tonnes. The combined entity became the seventh largest player in cement industry globally and the largest cement company in India. The macro environmental scenario in the cement industry during the acquisition was quite optimistic. The industry witnessed stabilisation of the demand-supply scenario. The industry had been in an oversupply situation for several years. The middle class housing boom and infrastructure spending had rejuvenated the demand conditions. After the acquisition, the Indian cement market-pie was shared by two domestic giants–Grasim's L&T and Gujarat Ambuja–ACC (28.2 million tonnes)–and four smaller players, which included India Cements and Lafarge. The top six players controlled almost 60% of the total domestic cement capacity. With L&T in the bag, Grasim became strong in the South and East India.

Grasim had taken over Dharani Cement for sales tax benefits accruing over a period of six years.

India Cements Takeover of Raasi Cements: The First Hostile Takeover

The acquisition of Raasi Cements by India Cements happened to be one of the fiercest takeover battles fought in the M&A history of corporate India. This acquisition was aimed at gaining additional market share and access to cement deficit regions.

In the late 1990s, the Indian cement industry was highly fragmented. There were 117 plants belonging to 59 companies, spread across the length and breadth of the country, with an installed capacity of 109.97 million tonnes per annum. In the early 1990s, the industry had expanded considerably as new plants with large capacities came up. In the mid and late 1990s, as the demand for cement declined, the share prices of most companies fell. In the late 1990s, acquisitions triggered off consolidation in the cement industry. The process of consolidation started in 1998 with ICL taking over Visaka Cement and CCI's plant at Yerraguntla, and Grasim taking over Dharani Cement and Shri Digvijay Cements.

By January 1998, India Cements had acquired 18.03% stake in Raasi, both through open market purchases as well as by buying out the stake of an estranged faction of the Raju family–the promoters of Raasi. In February 1998, India Cements announced an open offer to acquire an additional 20% of Raasi equity. The company offered Rs 300 per share, 72.41% above the stock market price of Rs 174 on February 26, 1998. In March 1998, the state owned APIDC sold its 2.13% stake in Raasi to ICL. Finally, ICL's stake in Raasi increased to 21.56%.

The takeovers of Raasi and Sri Vishnu Cement Ltd (SVCL) by India Cements Ltd is a good example of a geographic market extension merger, which involves two firms with operations in non-overlapping geographic areas and rationalisation of various markets between two companies. Raasi failed to capitalise on its low production costs because of its weak marketing set up, particularly in Kerala and Tamil Nadu. As a result, Raasi tended to dump the cement in its weak markets, thereby putting pressure on other players in the region.

India Cements had acquired the public sector Cement Corporation of India's (CCI) Yerraguntla plant in Andhra Pradesh with an installed capacity of 0.4 million tonnes. BIFR had declared CCI sick in 1996.

ICL had strategic advantage in taking over Raasi. In 1997, ICL added 2.2 million tonnes per annum (mtpa) to its capacity through acquisitions and expansions. The addition of Raasi's 2 mtpa capacity made ICL leader in south India. The acquisition also meant automatically acquiring 39.5% equity in Shree Vishnu Cement Ltd, another group company.

The south Indian cement industry operates differently from its counterparts in other parts of the country. The south Indian market has historically been dominated by two-three big players, with a number of small players, operating in several smaller pockets. The south Indian cement market has generally been insulated due to absence of the large players, such as Gujarat Ambuja, L&T, Grasim, etc. As a consequence, prices in southern market tend to be on the higher side, even when demand growth is very low. India Cements has been the biggest beneficiary of this.

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DISCUSSION QUESTIONS

1. Why has consolidation activity gained momentum in the cement industry?

Case Study 8

MERGERS AND ACQUISITIONS IN THE AUTOMOBILE SECTOR

The Indian auto component industry is one of the few sectors in the economy that has a distinct global competitive advantage in terms of cost and quality. An average cost reduction of nearly 25-30% has attracted several global automobile manufacturers to set base since 1991. The Indian auto component sector has been growing at 20% per annum since 2000, and is projected to maintain the high growth phase of 15-20% till 2015.

Indian automobile giants have restructured their roles from being exporters to overseas investors. The auto majors wanted to integrate low cost sourcing of components and technical know-how to compete successfully in the international market. The challenge before the auto makers was to build scales and proximity to customers. Domestic auto companies are increasingly opting for acquisitions to gain access to global clients. The acquisition of small and mid sized companies provide Indian auto component majors proximity to regulated markets like the US and Europe, and also provide an opportunity to attain higher margins.

The automobile industry, especially the auto ancillary/component companies, have been at the forefront of the acquisition spree. Various reasons can be attributed for acquiring business abroad. It gives the Indian companies easier access to foreign original equipment. It helps them to broaden customer base, capturing more market share, and enhance product portfolio. Buying a foreign company helps in expanding the client base and orders.

In the forefront, Tata Motors and Mahindra&Mahindra (M&M) are focusing on the globalisation drive.

Tata Motors acquired the Korean arm of Daewoo Motors truck business and M&M acquired the tractor manufacturing assets of Jiangling Tractor, a fully owned company of Jiangling Motor. In 2004, Tata Motors had acquired South Korea's Daewoo Commercial Vehicle Corporation (DCVC) for Rs 459 crore. Daewoo Motors, the parent company of DWCV, was started in 1970, and had gradually become Korea's second largest conglomerate. With increasing debt burden, it became bankrupt in the year 2000. The Daewoo acquisition gave the company entry into China, the world's most lucrative automobile market. Post merger, the new company, Tata Daewoo Commercial Vehicle Ltd (TDCV), recorded a 26% growth in its overall vehicle sales to reach 5,734 units during 2005-06. TDCV also entered the South Korean MCV market in 2006. TDCV exports represented over two-thirds of South Korea's total heavy truck exports.

Auto companies have focused on takeovers in Europe. Amtek Auto took over GWK of UK, while Sundaram Fasteners took over Dana Spicer, again of UK, and Bharat Forge took over CDP GmBH of Germany. Amtek Auto acquired a 70% stake in the German company, Zelter, for Euro 30 million approximately. Bharat Forge had acquired US based Federal Forge for $9.1 million in an all cash deal. Sona Koya Steering Systems acquired 21% stake in Fuji Autotech, France.

Indian auto ancillary companies are increasingly looking at foreign acquisitions to grow and sustain their market competitiveness. Acquiring overseas firms facilitate Indian companies by reducing delivery time. Indian auto component majors' proximity to regulated markets like the US and Europe give them an opportunity to attain higher margins.

Table CS8.1 *Global Acquisition by Indian Automobile Companies*

Period	Acquirer	Target	Value (Rs Crore)
June 2006	Bharat Forge	Federal Forge, US	41
September 2005	Bharat Forge	Imatra Kilsta AB	261
December 2004	Bharat Forge	CDP Aluminiumtechnik, Germany	35.4
January 2004	Bharat Forge	Carl Dan Peddighous, Germany	157.5
July 2005	Amtek Group	Zelter, Germany	157.5
March 2005	Amtek Group	Signa Cast, UK	NA
September 2003	Amtek Group	GWK, UK	42
April 2005	UCAL Fuel Systems	Amtec Precision USA	126
October 2004	Sundaram Fasteners	76% JV with Bleisthal, Germany	20
December 2003	Sundaram Fasteners	Precision Forging, Unit of Dana, UK	11.9
October 2004	Sona Koyo Steering	21% in Fuji Autotech, France	27.7

Source: Financial Express, September 9, 2006.

ACQUISITIONS BY BHARAT FORGE

Bharat Forge came into existence in 1961 to meet the forging demands of the Indian automobile industry. With an emphasis on diversification, Bharat Forge grew from a primarily automobile ancillary to an engineering enterprise focusing on technological supremacy, resilience and total customer orientation.

Bharat Forge, with an annual capacity of 600,000 tonnes, is ranked as the second largest forging company after Germany's ThyssenKrupp. Bharat Forge has manufacturing operations in Germany, Sweden, Scotland, US and China. The company derives 70% sales from overseas markets. It specialises in manufacturing forgings for the automobile industry, like front axle beams, crankshafts, steering knuckles, critical engines and chassis components. Bharat Forge's customers include many top truck and car manufacturers, like Daimler Chrysler, Ford, General Motors, Volkswagen, Toyota, Caterpillar and Iveco. The company's sales grew at a compounded rate of 54% annually, and profits by 25% in the last couple of years.

Bharat Forge had made several strategic acquisitions during the period 2005-06. The company's global acquisition strategy consisted of two key aspects. The company aimed to broaden its customer base by bringing in a wider portfolio of product offering to a larger group of customers. The company also wanted to have global facilities that would assist the company in working with Original Equipment Manufacturers (OEMs) as an engineering and development partner. Thus, the company focused on acquiring such companies that had product complementarities and manufacturing facilities, which could be leveraged for cost effective and flexible production system. The acquired companies, namely Federal Forge in USA, Imatra Kilsta in Sweden, together with Scottish Stampings in Scotland, later became the wholly owned subsidiaries of the company. Bharat Forge had acquired Kirkstal Forge, a small UK company owned by Dana, for £3 million. The biggest asset was its order book –14 key customers, including Renault and Iveco. Forge later targeted Carl Dan Peddinghaus (CDP), a family owned forging firm in deep financial crisis. CDP was making chassis components which Bharat Forge did not have in its portfolio. The acquisition resulted in wider market presence and larger product offering. Bharat Forge successfully turned around CDP, and also made it profitable by retaining the entire original workforce of 800 employees with them. The transaction was concluded at an enterprise value of Euro 6.30 million. This was funded by way of equity of Euro 3.8 million and non-recourse debt of Euro 2.50 million. CDP enhanced Bharat Forge's product range and technical capabilities in both steel and aluminium.

The acquisition of CDP Aluminiumtechnik marked the entry of Bharat Forge into the aluminium auto component segment. CDP Aluminiumtechnik was renamed as Bharat Forge Aluminiumtechnik (BFAT). This acquisition has strengthened Bharat Forge's position in the global passenger car and chassis component business. Aluminium is progressively becoming the preferred material for specialised high-end Automobile applications due to its significantly lighter weight and consequent advantages of fuel efficiency. With BFAT, Bharat Forge had ensured a diverse portfolio of offering with technical superiority both in steel and aluminium. In the process customers were able to source the complete spectrum of forged auto components across steel and aluminium segments from a single source.

In a period of three years, Bharat Forge acquired five companies in quick succession. A 100 day integration programme was set in motion with a view to break cultural barriers.

Table CS8.2 *Foreign Acquisitions by Other Indian Companies*

Indian Company	Target Company
Motherson Sumi	WOCO Group; G&S Kunststofftechnik GmBH
Amtek Auto	GWK, New Smith Jones Inc,Zelter
Sundaram Fasteners	Bleisthal ProduktionsGmBH, Cramlington Forge, CDP GmBH
EL Forge	Shakespeare Forging
TVS Autolec	RBI Autoparts SND BHD
Sona Koyo	Fuji Autotech

Source: Auto Component Manufacturers Association.

ACQUISITIONS BY APOLLO TYRES

Apollo Tyres acquired Dunlop Tyres International Ltd, South Africa, for Rs 290 crore in an all cash deal. Dunlop was headquartered in Durban and owned subsidiaries in Zimbabwe and the United Kingdom. Through this acquisition, Apollo Tyres used Dunlop's distribution network for exports and made entry into Africa. In this process, the products of Dunlop found their way into India. Apollo was also able to enlarge its base of manufacturing units through access to facilities in Durban and Ladysmith in South Africa, and Bulawayo and Harare, in Zimbabwe. These deals also made Apollo one of the largest tyre companies globally, with manufacturing presence in three countries. Synergistic benefits resulted for the company through increase in product profile, market access, R&D, manpower resources and the ability to optimize on cost, product and manufacturing facilities.

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2. Naazneen Karmali, ‘Racing to the Top’, Cover Feature, Business India, December 31, 2006, Page 64-76.

DISCUSSION QUESTIONS

1. What are the driving factors for consolidation in automobile sectors?
2. Discuss the major overseas consolidation drive by Indian companies.

Case Study 9

MERGERS AND ACQUISITIONS IN OIL AND ENERGY SECTORS

On account of concerns of oil security in India, oil giants, such as ONGC and Indian Oil, are scouting for oil fields across nations. ONGC acquired oil fields in Nigeria and Russia. The oil giant has invested in 15 assets in 13 countries, spread across four continents, to secure India's growing need for energy. Oil India Ltd (OIL) had acquired its first overseas oil field in Libya in 2003. It became the first Indian Public Sector Unit (PSU) to set foot in Libya. Some of the top cross border M&A deals are given below:

Table CS9.1 *Some Cross Border M&A Deals in Oil Sector*

Acquirer	Target	Deal Size ($ million)	Region
ONGC	Sakhlin Oil & Gas Fields	1700	Russia
ONGC	Royal Dutch /Shell	660	Angola
Reliance Industries	Trevira	103	Europe

THE RIL-RPL MERGER

Highlights of the Merger

In 2002, Reliance Petroleum Ltd (RPL) merged with Reliance Industries Ltd (RIL), in the largest merger in Indian corporate industry.

The merger of Reliance Petrochemicals with Reliance Industries Limited was formalized in a record time of about 7 months. The merger was aimed to enhance shareholder value by realising significant synergies of both companies. Government's liberalization policy and the accompanying economic reforms created this opportunity for the company's shareholders. During 2002, the Board of Directors of RIL and RPL unanimously approved the merger, with retrospective effect, from April 1, 2001, subject to necessary approvals. The media announcement of the merger was made on March 1, 2002. The Boards of both companies recommended an exchange ratio of 1 share of RIL for every 11 shares of RPL. Shareholders of both companies approved the merger with an overwhelming majority of over 99.9%. Pursuant to the receipt of approvals from the High Court of Gujarat and Mumbai, and filing of requisite documents with the Registrar of Companies, the effective date for the merger was fixed as September 19, 2002. Reliance Petroleum Limited was delisted from the stock exchange by 10 October 2002.

The merger has created India's only world scale, fully integrated energy company, with operations in oil and gas exploration and production (E & P), refining and marketing (R&M), petrochemicals, power and textiles. The merged entity, RIL, enjoys global rankings in all its major businesses and leading domestic market shares. In fact, RIL is probably the only company in the world that will start with crude oil and end up with saris, shirts and dress material. The merger was in line with global industry trends for enhancing scale, size, integration, global competitiveness and financial strength and flexibility to pursue future growth opportunities in an increasingly competitive global environment. The merger was said to have been implemented in the context of the ongoing economic reforms in the country, and took into consideration various factors, such as:

- Continued progress in the hydrocarbon sector reforms and regulations
- Dismantling of the administered pricing mechanism (APM) in the refining industry
- The Government's decision to grant marketing rights for the transportation fuels to the private sector
- The proposed disinvestments of domestic public sector oil companies.

The merger gave RIL the distinction of becoming India's first private sector company to be placed in the internationally tracked Fortune Global 500 list of the world's largest corporations. Based on available data in 2002, RIL ranks:

- Amongst the top 200 companies in terms of net profits
- Amongst the top 300 companies in terms of net worth
- Amongst the top 425 companies in terms of assets
- Amongst the top 500 companies in terms of sales.

The merger also ranks RIL amongst the top Asian oil and gas and chemical companies, where it ranks:

- 4^{th} in terms of profit
- 7^{th} in terms of sales.

The merger has resulted in accretion of over Rs 2450 crore (US $500 million) to RIL's cash flows, and acquisition of facilities valued at over Rs 21000 crore (US $4.3 billion) by leading international industry consultants, Chemsystems. The merger was aimed to contribute the following substantial benefits for RIL, thereby substantially enhancing shareholder value.

- Scale • Integration • Global Competitiveness • Operational Synergies
- Logistics Advantages • Cost Efficiencies • Productivity Gains
- Rationalisation of Business Processes • Optimization of Fiscal Incentives
- Reduction of Volatility in the Earning Stream.

Reliance's leadership position in India is reflected in its all round contribution to the national economy. Its contribution at the time of merger was:

- 3% of India's GDP
- 5% of India's Exports
- 9% of Indian government's indirect tax revenues
- The group has also accounted for 2.3% of the gross capital formation in the country in the five years surrounding the year of merger.

Reliance also accounted for:

- Nearly 25% of the total profits of the private sector in India
- Nearly 10% of the profits of the entire corporate sector in India
- 7% of the total market capitalisation
- Weightage of 16% in the Sensex
- Weightage of around 13% in the NIFTY index
- 1 out of every 4 investors in India is a Reliance shareholder.

The merger has led to 32% increase in RIL's equity, from Rs 1054 crore to Rs 1396 crore. Reliance, in another strategic move, acquired Indian Petrochemicals Corporation Ltd (IPCL). IPCL is India's second largest petrochemical company, and is amongst India's top 25 companies in terms of sales. Reliance acquired 26%

equity stake held by the Government of India in IPCL. The acquisition of BSES for Rs 743 crore made it one of the largest power companies in the country.

The Indian economy is generally forecast to grow by 5 to 6% per annum over the next few years. Per capita consumption in India for most products and services remains amongst the lowest in the world. Domestic demand growth in most of Reliance products has been at double-digit levels for the past several decades. There are also increasing opportunities for Reliance products in the export market. In the year 2002, RIL sold 20% of its production for the exports market. RIL continues to be ranked amongst the top 10 producers globally in all its major petrochemicals products. Reliance is the second largest producer of POY and PSF, the third largest producer of paraxylene (PX), the fourth largest producer of PTA and the seventh largest producer of polypropylene (PP) in the world at the time of merger. Reliance's integrated refining, petrochemicals, power and port complex at Jamnagar, Gujarat, set up at a capital outlay of Rs 25,000 crore ($6 billion), represents the single largest investment ever made by a private sector company in India at a single location. RIL is India's largest private sector player in E&P, with over 177,000 sq kms of awarded exploration acreage, in 26 offshore and onshore deep and shallow water blocks, including one at Yemen. Reliance faces challenges of competing with low cost producers from the Middle East and parts of Asia Pacific. Its continued domestic market leadership, even after the opening up of the Indian market to imports and steep decline in import duties, reflects the global competitiveness of its operations.

Business Review

Oil and Gas: India's consumption of crude oil was 2.2 million barrels per day. The country produces just about 32% of this requirement and imports balance 1.5 million barrels per day. Consumption of natural gas in India is about 68.5 million standard cubic metre per day, or 883 billion cubic feet per year. Public sector companies presently dominate the oil and gas industry in the country. RIL's oil and gas strategy is aimed at further enhancing the level of vertical integration in its energy business, and capturing value across the entire energy chain. RIL holds 30% interest in an unincorporated Joint Venture with British Gas and ONGC, to develop the proven Panna Mukta. On the product distribution front, Reliance has a 10% stake in Petronet India Limited, the holding company set up for creation of pipeline infrastructure for distribution of petroleum products all over India. India is expected to become the world's third largest polymer market after the US and China by the end of this decade. Current polymer consumption of 3.4 million tonnes in the country is expected to treble during this decade, owing to the huge latent demand potential. Reliance is the world's second largest polyester manufacturer (fibre and yarn). Demand for polyester in the country crossed 1.3 million tonnes during the year 2002, reflecting growth of 5% despite the impact of the global slowdown. Reliance is the country's largest manufacturer of these products, with a market share of 54%. Reliance entered into a strategic alliance with Dupont for exclusive distribution of Lycra–the most widely used stretch fibre and a registered trademark of DuPont. RIL's refinery at Jamnagar, with capacity of 27 million tonnes per annum, is the world's largest grassroots refinery and fifth largest refinery in the world at any single location. RIL's refinery is the first and only refinery to be set up in the private sector in India, pursuant to oil sector reforms. RIL's refinery accounts for almost 25% of total production of petroleum products in the country. Public sector oil companies dominate the Indian refining and marketing industry, Reliance being the only private sector company. Within the country, RIL continues to be the largest manufacturer of polyester Intermediates, with market share of about 80%. RIL operates one of the largest grassroots multi-feed cracker at Hazira, with capacity of 750,000 tpa. It is the country's largest producer and exporter of linear alkyl benzene (LAB), a leading surfactant ingredient in the manufacture of detergents. Reliance accounts for 40% of the domestic Normal Paraffin production. It produces commercial grade butane from its cracker at Hazira. Packed LPG is marketed as 'Reliance Gas' in cylinders to domestic and commercial customers. Bulk product is being sold directly to industrial users for use as fuel, and to private bottlers. Reliance's textiles complex at Naroda, Gujarat, is one of India's largest and most modern textile complexes. Its flagship brand is one of India's largest selling brands of premium textiles.

Advantages of the Merger

The merger was aimed to help RIL create a great deal of synergies. RIL is a petrochemical company producing plastic raw materials (HDPE, PVC, LLDP, polypropylene, etc.), intermediates for polyester (MEG, polyester chips, paraxylene, etc.) and chemicals, like LAB. The feedstock for its cracker is gas and Naphtha, which is produced by RPL (along with other petroleum products like petrol, kerosene, diesel, etc.). In addition, RPL's Jamnagar refinery also supplies aromatic naphtha and propylene to RIL's Hazira cracker (both are in Gujarat). In all, nearly 25% of RPL's output is used for captive consumption, bringing in large savings in terms of sales tax, because these transactions are treated as inter-divisional transfers. Besides, as both RPL and RIL operate continuous process chemical plants, there is great deal of engineering synergy in terms of operation, maintenance and expansions. The merger was aimed to create India's only world scale fully integrated energy company with operations ranging from oil and gas exploration, production, refining and marketing of petrochemicals, power and textiles. The merger has to lead to strong financials. Under the terms of merger, shares of RPL held by RIL, representing 28% of RPL's equity shares capital, were cancelled. RIL's subsidiaries and associate companies will hold 12.2% of company shares in exchange of present holding in RPL. These shares are transferred to a trust and can be monetised up to Rs 5400 crore at an appropriate time in the future. This aggregate shareholding may also be leveraged to pursue significant acquisition and growth opportunities. The other big advantage is the huge depreciation cover from RPL. RIL's plants are relatively older and have used up its depreciation cover to a large extent, while RPL, whose refinery was set up in the last 10 years, enjoys a huge depreciation cover on its assets worth Rs 25000 crore. This will come handy in saving taxes. Besides, RPL's, products like petrol, diesel and kerosene, sell mostly on cash basis, as against RIL's products, which are sold on credit. The merger results in a balance in cash management by churning out cash. As the debt equity and interest coverage ratios will improve post merger, RIL will be in a position to leverage its strong balance sheet to raise fresh funds at ease. It has paid off expensive loans from financial institutions. Reliance Group needed outlets for selling its refinery products. In the petro sector, where RIL has been a major player for years, it had big retail plans under which over 5,800 retail outlets were to be set up across the country. But the disinvestments derailment of oil PSUs may prove to be a dampener, as acquiring an oil PSU with huge retail network in urban areas is critical (state owned firms own most of prime retail space in this areas). Stronger balance sheet will make the job easier in terms of funds availability.

The merger helped RIL to insulate the petrochem business against price volatility of naphtha, a feedstock for its cracker. In the global energy business, standalone refineries cannot be profitable in the long run. At the time of the merger, average profit margins on refining had fallen from \$4.69 per barrel to \$1.45 per barrel. It makes economic sense only when the entire chain of oil business is integrated from exploration to refining to marketing and distribution. The growth and profitability in petrochemicals have been increasingly governed by international price fluctuations of various end products. The diverse streams of earnings' would reduce earnings volatility.

RIL was the market leader in petrochemicals with market shares of 50 to 80% in polymers, polyesters and fibre intermediates.

Challenges

With the deregulation of oil sector and dismantling of Administered Price Mechanism (APM), the regime of assured return on investment came to an end. There is a strong possibility that, in future, competition among oil companies at the market place will be intense and margins will be under pressure. RIL, being one of the largest producers, will naturally face stiff challenges. It faces the challenge of competing with low cost producers from the Middle East and parts of Asia Pacific. Refining of petroleum products and manufacture of petrochemical products presently form the core of Reliance's business portfolio. Both these businesses being global in nature, the outlook for margins and profitability depends, in large measure, on the overall global economic outlook, the global demand-supply scenario and trends in feedstock and product prices. Any economic slowdown can adversely impact demand-supply dynamics and profitability of all industry players. But, it is stated that the company's operations have historically shown significant resilience to the fluctuations of economic and industry cycles. Reliance's operation has significant exposure to the domestic market, which accounts for nearly 80% of its revenues.

Table CS9.2 and CS9.3 gives a comparative picture of RIL's financial performance with respect to the largest Indian companies and the peer group in oil sector in the year of merger. Table CS9.4 compares RIL's performance with global peers in the same year.

Table CS9.2 *Comparison with Largest Indian Companies/Groups in the Year of the Merger (2002) (in Rs crore)*

Company	RIL	TATA	AVBIRLA	INFOSYS	WIPRO	HLL
Sales	57120.16	40000	17000	2603.59	3486.54	11056.04
Net Profit	3242.70	1100	1300	807.96	866.11	1825.86
Market Cap	49000	15000	10471	23879	38013	57,782

Source: Prowess Database.

Table CS9.3 *Indian Peer Group in Oil Sector (2002) (in Rs crore)*

	RIL	IOC	ONGC
Sales	57120.16	117106.93	23754.70
Cash Profit	5633.23	4487.70	9682.06
Net Profit	3242.70	2884.66	6197.87
Net Worth	25073.90	15166.30	29511.84
Assets	56776.27	56434.87	57548.76
Cash Flow from Operations	7987.16	14443.18	11631.81
Market Cap	49000	13500	34500

Source: Prowess Database

Table CS9.4 *Comparison with Global Peer Group in the Year of Merger (2002) (in $ billion)*

	RIL	BP	Exxon	Shell	DOW	Dupont
Sales	11.8	174.2	212.8	149.1	27.8	28.2
Net Profit	0.8	8	15.3	12.7	(0.4)	2.3
Net Worth	5.8	75	73.3	57.1	11.4	13.3
Assets	11.2	134	111.5	121	30.4	34.6

Source: Economy & Business, Deccan Herald, Monday, March 11, 2002.

Table CS9.5 *Consolidation of RIL*

Year	Event
July 1975	Reliance Textiles merged with Mynylon–Manufacturer of synthetic blend yarns & fabrics and polyester filament yarn
March 1992	RIL merges Reliance Petrochemicals into self
June 1995	RIL merges Reliance Polypropylene & Reliance Polyethylene into self
March 2002	RIL merges Reliance Petroleum into self.

RELIANCE'S ACQUISITION OF IPCL

As a result of the disinvestment process of the PSU Navratna, Indian Petrochemicals Ltd (IPCL) was acquired by Reliance Industries. Three parties, namely Reliance, IOC and Nirma, had submitted bids in closed envelopes to UBS Warburg, the investment banker who handling the process. Reliance's successful bid of Rs 1491 crore, at Rs 231 per share, was, by far, the highest compared to IOC's target of Rs 128 and Nirma's Rs 110 per share. The proceeds of Government of India's 26% share, valued at Rs 1491 crore, were the highest received by it from any single transaction of a similar nature in the past. Reliance had to make an open offer for the acquisition of 20% public stake in IPCL at the same price. After the acquisition, Reliance's petrochemical production increased by over 1.33 million tonnes, whereas Reliance sales (of over Rs 580 billion per annum) increased by over Rs 52 billion. IPCL was the second largest petrochemical company in terms of sales, assets, net worth and profits. Reliance and IPCL had naphtha fed crackers at Hazira and Baroda, while the crackers at Gandhar and Nagothane were gas fed, to provide a unique advantage in terms of feedstock and product-mix flexibility. Reliance production of naptha was a feedstock for IPCL. The acquisition of IPCL by RIL resulted in a large integrated petrochemical company which possessed a mix of competitive gas and naphtha based assets. This acquisition provided benefits of scale, integration, operation synergies, logistical advantages, higher global competitiveness, cost reduction and efficiencies.

INDIAN OIL CORPORATION'S ACQUISITION OF IBP

As part of the disinvestment process, IBP was the first national oil company (from among the four oil marketing PSUs) to be put on the block. IOC and Shell were the major bidders. IOC's offer at Rs 1,153.61 crore was, by far, the highest. Royal Dutch/Shell's bid was valued at Rs 595 crore. As a result of this acquisition, the government's stake in IBP came down to 26% from its 59.58%. IBP's valuation was at 48 P/E multiple over its last year's earnings before merger.

Synergies

Apart from incremental cash flows that would accrue to IOC after the acquisition, it could also avoid likely losses by pre-empting a bid by an aggressive competitor. In the north and the east, IBP had strong retail presence, whereas IOC had substantial refining capacity. The IBP acquisition, while conserving its gross earnings, gave IOC control over 1.2 Mt of petroleum products supplied by BPCL to IBP. With the acquisition, Indian Oil had over 9000 retail outlets which accounted for nearly 50% of the country's network of over 18500 outlets at the time of merger.

ONGC'S ACQUISITION OF MRPL[1]

Mangalore Refineries and Petrochemicals Ltd (MRPL), the first joint sector refinery, had been acquired by ONGC in 2003. MRPL was established as a joint venture under a tripartite MoU in 1987 with the Government of India, Hindustan Petroleum and Indian Rayon Industries Ltd. The refinery was commissioned in two phases –3.69 mtpa in March 1996, followed by 6 mtpa in February 1998. MRPL's refinery was conceived and configured when the Administered Price Mechanism (APM) was in place. MRPL contributes about 8% to the country's refining capacity. Due to dismantling of APM, the company had shorter time under APM as compared to other refineries in the country. In addition, the surplus product position in the country, low gross refining margins in Asia, deteriorating liquidity, and its leveraged position were hampering operations. The problems of MRPL can also be attributed to the capital structure adopted by the company in terms of high debt/equity ratio. The joint management by the AV Birla Group and HPCL was also an issue.

In June 2002, the Ministry of Petroleum asked ONGC to explore the possibility of acquiring MRPL for forward integration, as ONGC had expressed its intention to enter the refinery sector. In the last two decades, the trend, world over, had been to consolidate the operations of oil companies in exploration and production of oil, refinery and marketing, as well as downstream products. Obtaining approvals from the Cabinet, the Public Investment Board, the Petroleum ministry and the boards of MRPL, HPCL and ONGC was a time consuming process. The whole process was completed by March 2003. Had this bailout not been affected, it is said that MRPL would have been referred to the Board for Industrial and Financial Reconstruction, or the lenders could have invoked the provisions of the Securitization Act. This was the first acquisition in the country where the deal was structured to make equity infusion by the acquirer conditional to implementation of financial restructuring of the target in order to best protect the interests of the acquirer. ONGC acquired 37.4% from the AV Birla Group companies at Rs 2 per share, and subscribed to additional equity of Rs 600 crore to increase its holding to 51%. In all, it spent Rs 659.4 crore for acquiring 51% stake in MRPL. With the increased equity, shareholding of HPCL was reduced from 37.4% to about 17%.

With respect to debt restructuring, out of the total domestic term loans of Rs 3,185 crore, Rs 600 crore were repaid from the money received from equity participation by ONGC. The domestic lenders converted part of their loans into equity, and into zero interest/dividend carrying debentures /preference shares. The balance loans were converted into loans of two different tenures of 10 years and 12 years. The deal provided ONGC an option to increase its stakes further by buying back equity acquired by institutions and banks at 8% return within five years. After this period, ONGC had the right of first refusal on the shares. As a subsidiary of ONGC, MRPL had access to large cash flows to establish new retail outlets.

HPCL'S ACQUISITION OF KPRL

Hindustan Petroleum Corporation Ltd (HPCL) picked up controlling stake of 67% in Kenya Petroleum Refinery Ltd in a deal valued at around Rs 2200 crore ($500 million). HPCL also acquired 50% of the marketing rights of British Petroleum in the African Company. HPCL acquired the entire 50% stake of the Kenyan government and 17.11% stake of BP Africa in KPRL.

Megadeal

In a mega Rs 50,000 crore deal, the Anil Ambani group announced the merger of RNRL with another group firm Reliance Power, which would now become a direct beneficiary of the gas deal signed with Mukesh Ambani led Reliance Industries. As part of the all stock deal, Reliance Power will give one of its shares for every four held in RNRL.

[1]Hina Shah, 'From Private to Public', Business India, June 9-22, 2003, page 86-88.

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DISCUSSION QUESTIONS

1. What was the significance of the RIL–RPL merger?
2. Discuss the consolidation strategy of oil majors like IOC and ONGC.

Case Study 10

MASTER ACQUIRER—THE STORY OF CISCO

Working as network managers at Stanford University, the husband and wife team of Len Bosack and Sandy Lerner developed, with others, the basic ideas which later could be translated into a router—a combination of hardware and software capable of linking communications from one computer operating system to another, thus linking all computer users regardless of the operating system. Outside equipment vendors, such as Hewlett Packard and Xerox, became interested in Bosack and Lerner's work. Stanford University was neither ready to devote the needed resources nor did it permit them to give the technology to interested companies in exchange for equipment necessary to continue their work. In December 1984, Bosack and Lerner founded Cisco Systems. Don Valentine, who had invested $2.5 million in Cisco as a partner in the venture capital firm of Sequoia Capital, bought in John Morgridge as CEO. After the initial public offering in 1990, the founders cashed in their ownership in the company and sold their stock for about $150 million.

Cisco engineers have been prominent in advancing the development of IP–the basic language to communicate over the Internet and in private networks. Cisco enabled people to make powerful connections-whether in business, education, philanthropy, or creativity. Cisco hardware software and service offerings are used to create the Internet solutions that make networks possible-providing easy access to information anywhere, at any time. Cisco engineers have been leaders in development of Internet Protocol (IP)-based networking technologies. Today, with more than 65,225 employees worldwide, this tradition of innovation continues with industry-leading products and solutions in the company's core development areas of routing and switching, as well as in advanced technologies such as:

- Application Networking
- Data Centre
- Digital Media
- IPICS
- Mobility
- Security
- Storage Networking
- TelePresence
- Unified Communications
- Video
- Virtualization

The emergence of network as a platform is changing the entire value chain of technology and is placing the network squarely at the centre of innovation— as many as 14 billion devices will be connected to the Internet by 2010. The explosion of devices will be fuelled by more and more services and tasks being handled online, from phone calls to personalized searches to downloading videos, games and other forms of entertainment. The role of the network is evolving beyond that of infrastructure. It is emerging as a secure platform for delivering the customized and personalized experience that 21st century users expect–whether that means delivering new services as a carrier, boosting productivity for businesses of any size or consumers looking for real-time, personalised entertainment and services. As an increasingly intelligent network evolves into a platform, users will be able to communicate from any device, and in whatever mode they choose.

Cisco is leading the transition to network-centric technology environment. By combining its core strength (IP) with intelligence, the company is creating a powerful communications platform that will serve as the basis for the convergence of data, voice, video and mobile communications in a secure, integrated architecture. Cisco actively supplements internal development efforts with partnerships, minority investments and acquisitions, to offer customers a broad range of solutions in networking for the Internet.

Its long-term commitment to ongoing research and development is the basis for Cisco innovation. In the year 2007, the company invested more than $4.5 billion in R&D. The unified communications advanced technology, formerly enterprise IP communications, has positioned Cisco as the market leader in enterprise voice marketplace.

In addition to hardware and software products, Cisco provides a broad range of service offerings to its clients, including award-winning technical support and advanced services. Cisco sells its products and services–directly through its own sales force and indirectly through a network of channel partners–to large enterprises, small and medium-sized businesses, service providers and consumers.

Cisco has long been recognised as a pioneer in using the Internet and its own network to improve its business practices. The Cisco@ Internet Business Solution Group (IBSG), the global strategic consulting arm of Cisco, helps Global Fortune 500 companies and leading public organisations improve their customer experience and increase revenue growth by transforming the way they do business. IBSG designs innovative business processes and then integrates advanced technologies into visionary roadmaps that optimise business results and increase efficiency. Drawing on a unique combination of industry experience, business acumen, and technical knowledge, IBSG consultants work as trusted advisers to many of the world's leading organisations.

Network technology is rapidly changing and creating new demands are being created by businesses and organizations of all types. In response, Cisco Systems has developed its industry-leading channel partner programme to help the company's important sales force, its channel partners, develop the skills and expertise they need to thrive. Cisco’s channel partners, a global force of over 200,000 people in 35,000 independent value-added resellers, systems integrators and network consultancies account for more than 90% of Cisco's commercial and enterprise revenue worldwide.

STRATEGIC PURSUITS

During the Morgridge era, the strategy was to improve the network with suppliers and customers alike, particularly in providing customer service, development of sales capability, followed by creation of a distribution network and conversion of all of Cisco’s information systems to common platform architecture, with uniform application packages to be utilised by Cisco’s employees worldwide. By 1991, customer service was converted to online application. By 1999, through a series of initiatives, Cisco became a recognised leader in information technology, organisation and implementation.

Morgridge’s successor, John Chambers, focused on customer satisfaction. It is often said that the company focused on A&D (Acquisitions and Development) rather than R&D. New product ideas were acquired through venturing (with often accompanied by minority investments by Cisco), as well as acquisition of other innovative companies as opposed to total reliance on in-house research. In the late 1990s, Cisco was often cited as one of the important models for management of organisations in the rapidly changing environment.

Cisco's strategy was centred on leadership position in product technology that delivered superior solutions to selected markets, customer-driven products and solutions' effort. The Internet ecosystem enabled Cisco to cope with the exploding growth and demands of organisations using and providing internet services.

By the early 1990s, Cisco was focusing on providing internal network capability for large corporations. The primary product that contributed to the growth of the company was the router – a combination of hardware and software providing data routing capability, superior to the network switching capability that it replaced. By 1999, its routers represented 80% of those directing data to destinations on the internet.

Later, primarily through acquisitions, the company developed new technologies that provided faster alternatives to routers. The management decided that the first most logical opportunity for continued development was the market for voice communication switching capabilities. With the need for increased speed and network capacity for voice communication, Cisco had to alter its products to carry voice as well as data. Hence, Cisco purchased several small start-ups that had developed new telephone technologies. The acquisition of Cerent Corporation in 1999 provided Cisco the capability for merging voice and data traffic for transmission over optical fibres more efficiently than other technologies. Cisco's competitors, like Nortel and Lucent, responded by acquiring internet based data routing companies. Nortel merged with Bay Networks, one of Cisco's competitors, in 1998. Lucent purchased companies like Ascend Communications and Nexabit Networks in 1999.

Cisco implemented ERP system running on Oracle software to replace all existing order entry, manufacturing and financial systems in just nine months.

In the 1990s, the Information System platform architecture was standardised throughout Cisco. Virtually all business functions utilised similar applications packages worldwide. Upon an acquisition, the employees of the target company were trained for its IS platform and applications. Employee services were among the first to make extensive use of the internet at Cisco. Internet made it possible to process the 20,000 resumes per month the company was receiving in 1999, because 70% arrived in digital form.

Cisco was one of the first companies to present all employees with stock options on their first day at work. In appraising possible acquisitions, Cisco gave heavy weightage to the cost per professional in the organization being acquired. This action underlined the company's efforts to acquire talent teams and ideas, and not just technology and market share.

Cisco's line of products was made-to-order for e-commerce. Its interactive website, Cisco Connection Online (CCO) included features like ordering, product configuration, technical assistance, software downloads, support contacts, order status, partner referrals and self-service diagnosis in 14 languages, 24 hours a day. On the Cisco Marketplace site, customers were led through the task of configuring, pricing and ordering their products. By the late nineties, the company had become the largest practioner of business-to-business e-commerce.

Cisco owned only 2 of the 37 plants producing its line of products, relying on 5 contract manufacturers for nearly 60% of final assembly and testing, and 100% of basic production. The partnerships were supported by a net-based supply chain management system, linking customers with other members of the supply chain. The contract manufacturing enabled Cisco to take advantage of excess manufacturing capacity in its partners' plants, shifting manufacturing, as necessary, from one location to another. Under Cisco's supply chain management process, manufacturing partners were responsible for various aspects of production and assembly of the company's products, working to product specifications, production methods and testing standards. These activities are carried under round-the-clock internet facilitated quality control supervision provided by Cisco. In 1999, $4 billion in products was shipped to customers directly from manufacturing partners without any intervention by Cisco's employees. It was estimated that, in late nineties, Cisco's supply chain management was saving the company over $440 million per year.

Cisco linked its employees to an Intranet site called Field E Learning Connection that enabled them to engage in anytime, anywhere, self-paced sales and technical training as well as testing. In 1997, Cisco launched a network of 64 high school academies in seven states in the United States. At Cisco Academies, students not only acquired internet skills, they also designed, maintained and provided troubleshooting for school networks as part of their training.

Internet based applications enabled Cisco to implement a set of financial accounting and control systems that enabled the company's management to report performance daily and maintain an ongoing knowledge of the state of the company through the EIS (Executive Information System). The most important benefit of Cisco's internet based control system was the management's ability to track important indicators–orders, shipments, gross margins and billings on a daily basis.

The Cisco competitive model centered around a concept called Internet ecosystem. This system was based on partnerships with providers of various aspects of total communication solution. Cisco maintained the ownership of what was regarded as the product (master code, product and manufacturing specifications, etc.) It partnered in most other activities. Its partners included IBM, Hewlett Packard and others, in network and system management; Microsoft, SAP in applications; and Telcordia, EDS in integration services. Competitors like Lucent, Nortel, Ericsson and Siemens use vertically integrated organization of product development and manufacture, software control and services as an alternative strategy to Cisco's Internet Ecosystem.

ACQUISITION GUIDELINES

Cisco believes in five acquisition guidelines.

1. Shared vision between the acquiring and the target firm
2. Focus on creation of short-term gains for employees in the acquired firm
3. Strategic fit of the acquired company with Cisco. This guideline implies that when the target firm is integrated with Cisco's operations, it should create value for all stakeholders
4. Cultural similarity and compatibility
5. Target firms must be geographically proximate to parts of Cisco's current operations. Cisco believes that geographic dispersion between units prevents development of operational efficiencies.

The integration team facilitates compliance with the five guidelines. It is interesting to note that only two and half hours of negotiations, spread over three days, were required for Cisco to finalise its \$7.2 billion acquisition of Cerent Corp.

THE ACQUISITION STRATEGY

The ability of Cisco to consistently earn above average returns and gain strategic competiveness is often attributed to the company's acquisition strategy. The strategic vision is to achieve corporate growth by acquiring firms with products and technologies that the firm cannot or does not want to develop internally. In the period, 1993 to June 2008, Cisco acquired 127 companies, with 79 of these during the period 2000 to June 2008. The peak period of acquisitions was in the year 2000 when 22 companies were acquired.

The analysis of Cisco's acquisition strategy suggests that Cisco has repeatedly succeeded in using acquisitions to reshape itself and remove the lacunae in its product lines. Some survey results suggest that Cisco is the most successful company using merger and acquisition strategy. Yahoo! Inc and US West Inc study Cisco's acquisition strategy, while competitors Lucent Technologies Inc and Nortel Networks attempt to mimic it.

Cisco's emergence to a position of dominance in the industry can be attributed to its strategy of partnering with other companies that has led to its rapid rise as a manufacturer of routers-devices capable of switching data and voice messages at ultra speed. Cisco partnered with many other organisations, including INS, in the provision of network solutions requiring extensive consulting, integration services, software applications, network and system management services and software control.

The year 2003 was a significant milestone in Cisco's acquisition history. Cisco extended its networking technology expertise, in the enterprise and service provider markets, into the high growth consumer networking market with the addition of Linsksys Division in June 2003. Linksys has the most extensive product line in home networking, with more than 70 products, including wireless routers and access points for simultaneous sharing of broadband Internet connections, wireless network adapters and wireless print servers, as well as traditional wired products, such as Ethernet routers and cable modems, unmanaged switches and hubs, print servers and network attached storage for easy sharing of digital music, photo and video media files. With Cisco's networking expertise and Linksys' user-friendly features, consumer and small medium business (SMB) users will be able to build high quality networks designed for home or small office environment. A home network enables families to better utilise their broadband Internet connections by offering the ability to share Internet access using either wired or wireless connections.

In February 2006, Cisco completed the acquisition of Scientific Atlanta of Lawrenceville, Georgia, a leading global provider of cable and IPTV set-tops, data and voice cable modems, end-to-end video distribution networks and video systems integration services. The acquisition enables Cisco to offer a world-class, end-to-end data, voice, video and mobility solution for cable and telecom operators that deliver expanded entertainment, information and communications experiences to consumers. The addition of Scientific Atlanta products, systems, services and video delivery expertise complements the Cisco IP Next Generation Network architecture, which offers service providers an open platform for service differentiation. This allows them to move beyond digital video and IPTV to develop and deliver a variety of integrated media services to the connected home.

The acquisition of WebEx was completed in May 2007. WebEx is a market leader in on-demand collaboration applications, and its network-based solution for delivering business-to-business collaboration extends Cisco's vision for unified communications, particularly within the small to medium business (SMB) segment. WebEx's service portfolio includes technologies and services that allow companies to engage in real-time and asynchronous data conferences over the Internet, as well as share web based documents and workspaces that help improve productivity, performance and efficiency of workers in any size organisation. WebEx's subscription based services strategy has been the key to its success, and Cisco plans to preserve this business model.

By 2004, the networking giant had acquired and successfully absorbed 36 firms. Cisco entered into more than 100 alliances in the same period and managed them well. Largely owing to Cisco's dual growth strategy, between 1993 and 2003, the company's sales and market capitalisation grew by an average of 36% and 44%, respectively. A key factor for its M&A success can be attributed to the policy of having one senior vice president in charge of corporate development who is responsible for M&A, strategic alliances and technology incubation. By placing all three functions under the same person, Cisco is able to look internally first, and then if there are no viable options for meeting its objectives, consider either an alliance or an acquisition. The VPs head teams that have honed the ability to execute acquisitions and alliances. Usually Cisco first assesses whether the target company has technology critical to Cisco's core products. The target company's technology, when combined with Cisco's technologies, must provide solutions to meet customers' demand immediately and in the future. If that seems likely, Cisco will acquire the business right away. Cisco avoids deals that require employees to relocate, because they usually leave the company instead of moving. Thus, Cisco rarely buys companies that are not located in its general neighbourhood. When there is high degree of uncertainty around technologies, Cisco uses alliances as stepping stones to acquisitions. Approximately, 25% of Cisco's acquisitions start as small equity investments. This helps Cisco to get partners to accelerate development of products, take options on competing technologies and evaluate firms to determine if acquisitions will work. According to the company, it takes between 12 to 18 months to build trust amongst partners and decide if the companies can work together. The equity relationships also help Cisco to move quickly to pre-empt rivals and acquire firms when the time is right. Cisco has been able to use both acquisitions and alliances successfully because it has developed processes that help it to determine when to use which strategy.[1]

Table CS10.1 *Cisco's Fact Sheet*

Year	Head Count	Revenues in $	Networking Academic locations	Number of Patents	
				Filed	Issued
1984	2	NA	NA	NA	NA
1985	2	NA	NA	NA	NA
1986	4	NA	NA	NA	NA
1987	9	NA	NA	NA	NA
1988	29	NA	NA	NA	NA
1989	111	27 million	NA	NA	NA
1990	251	69 million	NA	NA	NA
1991	503	183 million	NA	NA	NA
1992	875	381 million	NA	NA	NA
1993	1,459	714 million	NA	NA	NA
1994	2,269	1.3 billion	NA	6	NA
1995	3,827	2.2 billion	NA	13	11
1996	8,259	4.1 billion	NA	43	67
1997	10,728	6.5 billion	64	105	34
1998	14,623	8.5 billion	580	260	60
1999	20,657	12.2 billion	2532	530	88
2000	34,613	18.9 billion	4901	751	150
2001	38,402	22.3 billion	8000	688	185
2002	35,670	18.9 billion	10175	695	240
2003	34,466	18.9 billion	10497	747	327
2004	34,371	22 billion	10275	825	447
2005	38,413	24.8 billion	10,000+	1218	469
2006	51,840	28.5 billion	10,000+	1127	688
2007	63,050	34.9 billion	10,000+	968	647

Source: http://newsroom.cisco.com/dlls/corporate_timeline.pdf

[1]Jeffrey H Dyer, Prashant Kale and Harbir Singh, 'When to Ally & When to Acquire', Harvard Business Review, July–August 2004, Page 115.

In the company's growth history spanning two decades, the number of employees have grown from a mere 2 in 1984 to 63050 in 2007. In 1989, the revenue was $27 million. By the year 2007, the revenue grew to $34.9 billion. The number to patents issued increased by about 58 times during the period 1995-2007.

SUMMARY OF CISCO'S ACQUISITIONS

Details

1993

1. Cisco Systems Inc. acquired Crescendo Communications, whereby Cisco got Crescendo, a privately held, high-performance networking company that provides workgroup solutions to the desktop.

1994

1. Cisco Systems, Inc. acquired LightStream Corp., a jointly held company formed in 1993 by Bolt Beranek and Newman and UB Networks. LightStream products offer enterprise ATM switching, workgroup ATM switching, LAN switching and routing.
2. Cisco Systems, Inc. acquired Kalpana, Inc., a privately held manufacturer of LAN switching products. Kalpana's product line consists of modular and stackable platforms which extend the usability and data capacity of existing Ethernet LANs.
3. Cisco Systems, Inc. purchased Newport Systems Solutions, Inc., a privately held company, providing software-based routers for remote network sites. Newport was a leading supplier of access products in small-to-medium size networks.

1995

1. Cisco Systems, Inc. purchased privately held Network Translation, Inc. (NTI), a networking manufacturer of cost-effective, low maintenance network address translation and Internet firewall hardware and software. The investment has helped broaden Cisco's offerings for security conscious network administrators, who want to dynamically map between reusable private network addresses and globally unique, registered Internet addresses.
2. The Company purchased Grand Junction Networks, Inc., the inventor and leading supplier of Fast Ethernet (100Base-T) and Ethernet desktop switching products. Cisco's Grand Junction acquisition gives users a range of LAN switching and Fast Ethernet products. This purchase provided comprehensive desktop solutions for CiscoPro, a line of switching and remote access products targeted at small/medium businesses and individual professionals.
3. Cisco acquired Internet Junction Inc., a developer of Internet gateway software connecting desktop users with the Internet. Internet Junction products provide users with Internet gateway software for central and remote office Internet access. Cisco continued to expand its expertise in software-based Internet gateway tools for popular computing platforms leveraging Internet Junction's technology and alliances.
4. Cisco purchased Combinet, Inc., a leading maker of ISDN (Integrated Services Digital Network) remote-access networking products. Cisco's integration of Combinet broadens the solutions Cisco offers for telecommuting, and strengthens its expertise in ISDN technology.

1996

1. Metaplex Inc., Specialist in network product development in the IBM enterprise marketplace, was acquired by Cisco, and this gave enterprise customers the ability to easily migrate from SNA to IP.

2. Cisco Systems, Inc. signed a definitive agreement to acquire privately held Netsys Technologies through stock purchase. Netsys is a pioneer in network infrastructure management and performance analysis software. Cisco's intent in acquiring Palo Alto, Calif. based Netsys Technologies was to give customers the ability to simulate their network design in order to optimize capacity and performance. Netsys provides standards-based software capable of leveraging the graphical World Wide Web and Internet technology for managing today's hybrid internetworks.
3. Cisco Systems, Inc., announced an agreement to acquire Granite Systems, Inc. for its standards-based multilayer Gigabit Ethernet switching technologies. Cisco's intent in acquiring Palo Alto, California based Granite Systems is to give customers a wider choice of backbone network technologies, best suited for their individual network environments.
4. Cisco Systems, Inc. announced an agreement to acquire privately held Nashoba Networks, Inc. and its Token Ring switching technologies. Cisco's intent in acquiring Nashoba Networks is to give users a wide choice of Token Ring LAN switching products, targeted at the workgroup and backbone environments. By joining forces, Cisco and Nashoba can help customers employ high-performance switched workgroup and backbone Token Ring LAN connectivity.
5. Cisco Systems, Inc. acquired Telebit Corp. and its Modem ISDN Channel Aggregation (MICA) technologies. Cisco integrated the advanced features of MICA's high-density digital modem technology development into current and future Cisco products, including the Cisco 2509-2511 access servers and the AS5200 Universal Access Server. Under the terms of the agreement, Telebit will sell its analog modem business, NetBlazer and MicaBlazer products and other assets and liabilities to a new entity formed via a Telebit management buyout.
6. Cisco Systems, Inc. acquired StrataCom, Inc., a leading supplier of Asyncronous Transfer Mode (ATM) and Frame Relay high-speed wide area network (WAN) switching equipment that integrates and transports a wide variety of information, including voice, data and video. The combination of Cisco with StrataCom enabled Cisco to provide end-to-end solutions across public, private or hybrid networks.
7. Cisco acquired TGV Software, Inc., a leading supplier of Internet software products for connecting disparate computer systems over local area, enterprise-wide and global computing networks. The acquisition extended Cisco's software product line to include network applications and services which are used to build corporate intranets and support the growing global Internet and World Wide Web.

1997

1. The acquisition of LightSpeed International Inc enabled Cisco to provide solutions in both the enterprise and service provider markets, as voice traffic transitions from purely circuit switched networks to integrated circuit and packet/cell switched networks. LightSpeed has developed leading-edge voice protocol conversion and intelligent call control software which enables signaling to be transmitted among diverse sets of voice protocols and applications. This technology allows different phone and communications systems to work together in a seamless fashion, lowering communication costs for both businesses and consumers.
2. Cisco Systems, Inc. signed a definitive agreement to purchase the Dagaz xDSL business of Integrated Network Corporation. INC, based in Bridgewater, New Jersey, is a broadband networking company providing a suite of products for high speed information transmission over existing copper phone lines. Cisco will acquire INC's Dagaz xDSL products and intellectual property, personnel, and other xDSL-related assets. The purchase of the Dagaz business, combined with Cisco's xDSL internal development, gave users a new carrier compliant fast lane on their networks.

3. Cisco Systems, Inc. acquired privately held Ardent Communications Corp. The San Jose-based Ardent is a pioneer in designing combined communications support for compressed voice, LAN, data and video traffic across public and private Frame Relay and ATM networks. The acquisition of Ardent complemented Cisco's 3800 series within carrier service offerings for branch offices and remote sites by extending leadership in integration of voice, video and data.
4. Cisco Systems, Inc. acquired Global Internet Software Group, a wholly owned subsidiary of Global Internet.Com Inc. based in Palo Alto, California. Global Internet Software is a pioneer in the Windows NT network security marketplace. To complement Cisco's enterprise-class PIX firewall, Global Internet Software and its Centri Security Manager Windows NT firewall was designed to meet the turnkey needs of small and medium businesses, who are often without security engineers, to design, build and support their networks offerings.
5. Cisco Systems, Inc. signed a definitive agreement to acquire privately held Skystone Systems Corp. of Ottawa, Ontario, Canada. Skystone is an innovator of high-speed Synchronous Optical Networking/ Synchronous Digital Hierarchy (SONET/SDH) technology. SONET/SDH is the emerging transport technology used for carrying information in very-high-capacity backbone networks, such as those operated by telecommunications carriers and large Internet Service Providers. Cisco intends to leverage Skystone development efforts on new SONET/SDH transport technologies for integration within next-generation Cisco products.
6. Cisco Systems, Inc. acquired Telesend, a privately-held company specialising in wide area network access products, in a stock swap in which shares of Cisco stock were exchanged for all outstanding shares and options of Telesend. Through the acquisition, Cisco announced a new channel unit for D4 DSL Frame Muxes, the Cisco 90i. The Cisco 90i provides telecommunications carriers with a more cost-effective way to deliver high-speed data services for Internet and intranet access applications. The resulting service is ideal for small business users, telecommuters and residential Internet access.

1998

1. Cisco acquired PipeLinks, a pioneer in SONET/SDH routers capable of simultaneously transporting circuit-based traffic and routing IP (Internet Protocol) traffic. This acquisition was intended to enable Cisco's service provider customers to transition to the New World while utilising their existing SONET/SDH (synchronous optical network/synchronous digital hierarchy) infrastructure. Using Cisco's IOS® software as foundation, this technology is expected to allow service, providers to offer new services, such as managed Internet access and native LAN services over existing TDM infrastructure.
2. Cisco acquired Selsius, a leading supplier of network PBX systems for high-quality telephony over IP networks. Selsius' technology will enable Cisco to accelerate the transition from conventional, proprietary circuit-switched PBXs to multi-service, open LAN systems capable of enabling the next step in data/voice integration.
3. Cisco acquired Clarity, a leading developer of wireless communication technology for computer networking and Internet service markets. This acquisition provides Cisco with fixed wireless technology, which complements Cisco's current last mile solutions, including dial, xDSL, and cable.
4. American Internet Corporation (AIC) is a leading provider of software solutions for IP address management and Internet access. Building upon an existing original equipment manufacturer (OEM) agreement with Cisco, the acquisition enabled Cisco to extend American Internet's technology into other areas, including the service provider line of business.
5. Summa Four is a leading provider of programmable switches. Summa Four's open standards-based programmable switches will enable Cisco to offer value-added telephony applications to new and

existing service providers, as well as extending these services to a voice-over-IP (Internet Protocol) infrastructure.

6. CLASS Data's products give network managers the ability to allocate network resources according to company policies and priorities. Such control capabilities mean that business-critical applications are assured timely, high-quality network transport.
7. Cisco Systems, Inc. signed a definitive agreement to acquire privately-held Precept Software, Inc. of Palo Alto, California. Precept is a leading multimedia networking software company. The acquisition complements Cisco's strategy of developing networking solutions that integrate voice, data and video traffic. Precept's IP/TV product is a client/server application that sends live or pre-recorded digital video and audio to a large number of users over any IP-based local- or wide-area network.
8. NetSpeed's product suite adds customer premise equipment, central office products and broadband remote access to Cisco's DSL product portfolio. Its DSL products are deployed in production carrier networks, including Cincinnati Bell, Telus and US WEST. NetSpeeds DSL product line for North America complements Cisco's 1997 acquisition of DSL solutions from the Dagaz Business of Integrated Network Corporation, targeted at international markets.
9. WheelGroup's software technology will extend Cisco's leadership in end-to-end network security solutions and help create a more secure environment for Cisco customers to do business on the Internet. Wheel Group is a leader in intrusion detection and security scanning software products. Its technology delivers a 'radar-like' intrusion detection system that operates with network routers and switches as real-time 'sensors' to identify and respond to unauthorized intrusions and hackers. WheelGroup's scanning technology identifies network security gaps throughout the enterprise and offers solutions for closing them. Cisco will refer to this new class of detection and scanning technology as 'active audit'.

1999

1. POS is a leading developer of Dense Wave Division Multiplexing (DWDM) equipment. A pioneer in the DWDM market, the company has leading-edge technology and the world's largest installed base of open 10 GBPS (gigabits per second) optical transport systems in operational networks. POS products will accelerate the deployment of more cost-effective transitional and New World networks. Customers benefit from a complete infrastructure solution, transport product leadership and lower network costs.
2. IEng is a leading developer of high-performance software. This acquisition strengthens Cisco's optical internetworking strategy to enable service providers to build next-generation high-speed networks.
3. Worldwide Data Systems is a leader in consulting and engineering services for converged data and voice networks. This acquisition underscores Cisco's strategy to accelerate deployment of New World data, voice and video networks for its enterprise and service provider customers.
4. V-Bits is a leading provider of standards-based digital video processing systems for cable television service providers. Underscoring Cisco's New World strategy, this acquisition enhances Cisco's solutions for streamlined broadband networks, supporting data, voice and video services.
5. Aironet is a leading developer of standards-based, high speed wireless LAN (local area network) products. Wireless LANs are used in enterprise, small/medium businesses and home environments. They enable PC users to establish and maintain a wireless network connection anywhere throughout a building, providing benefits in mobility, simplicity, flexibility, scalability and reduced cost of ownership.
6. Tasmania is the leading developer of network caching software technology. This acquisition underscores Cisco's commitment to offer its service providers and enterprise customers leading edge con-

tent networking services, including content-aware network caching. Network caching technology accelerates content delivery and overall network performance by localising traffic patterns. It uses the intelligence of the network to move frequently accessed content closer to the user, increasing the cost effectiveness and performance of data networks.

7. WebLine is the leading provider of customer interaction management software for Internet customer service and e-commerce. This acquisition underscores Cisco's commitment to the New World communications network of integrated data, voice and video, and strengthens its strategy to create an open software platform for enterprise and service provider customers.
8. Cocom A/S is a European developer of standards-based access solutions over cable TV networks. The company's DVB (Digital Video Broadcasting) and DAVIC (Digital Audio and Video Council) based headend and cable modem solutions connect homes and businesses to the Internet and interactive services at high speeds, upto 1,000 times the speed offered by traditional telephone modem technology. Cocom's DVB/DAVIC technology will complement and enhance Cisco's existing cable solutions, enabling Cisco's market leading cable solution to address the needs of cable providers all over the world.
9. With the acquisition of Cerent and Montery Networks, Cisco entered the optical transport market with next-generation products in order to provide service provider customers a complete infrastructure solution for transitional and New World networks. Cerent provides next generation SONET ADM (Synchronous Optical Network Add-Drop Multiplexer) equipment that is a fundamental building block in voice and data networks, and is used to add and remove lower speed traffic from higher speed optical rings. Service providers will use Cerent's product in the access portion of networks (i.e., between the Central Office and businesses), in the Inter-Office portion of networks, and in the core of the network (i.e., between IXC points-of-presence) in SONET ring configurations.
10. Monterey Networks technology allows Cisco to enter the optical transport business with a best-in-class product that focuses on the core of next-generation optical transport networks. Its infrastructure-class optical cross-connect products enable service providers to handle the rapid growth of Internet traffic, thus facilitating the migration to New World networks. Monterey Networks cost-effective solution is primarily targeted to carriers with high-bandwidth (e.g., OC-48, OC-192) requirements.
11. The MaxComm technology enables delivery of additional voice lines and high speed data over broadband to the home. The unique benefit to the customer is that it utilizes existing wiring (no new holes in the walls). Service Providers benefit from not having to roll a truck to install the technology (customer installable) and increased utilization of existing wiring (more phone lines per pair). This opportunity delivers increased features to the home with minimal deployment costs. The MaxComm technology also enables Service Providers to optimize the value of their existing investments in Old World technology while positioning them to introduce New World features. The technology is comprised of two basic components; a Voice LAN hub with a Telephone Module for each phone for the home and a GR303 Gateway integrated with a Cisco ATM switch to interwork with a Service Provider's Class 5 voice switch. The technology will first appear in Cisco DSL solutions and will complement Cisco broadband applications by increasing service offerings.
12. Calista provides technology that allows legacy digital phones to interoperate with New World voice-enabled switches and routers (IP-PBXs) in a feature transparent fashion. Calista products open up what has traditionally been a closed proprietary market and enables products from different manufacturers to interoperate. Customers preserve their investments in existing digital phones and wiring infrastructure, while migrating their old telephony networks to new IP-based solutions.

13. StratumOne provides highly integrated semiconductor products for very high speed wide area (OC48, OC192 and beyond) data based interfaces. StratumOne's leadership and strategic silicon expertise will enable Cisco to provide its customers with the best price/performance data products available in the market. As the insatiable demand for IP bandwidth continues, the use of highly integrated, high performance data optimised devices becomes a key differentiator for Cisco.
14. TransMedia provides Media Gateway technology that seamlessly unites the multiple networks (ATM, IP, PSTN) of public voice communications, providing a successful transition to New World networks. TransMedia's Media Gateway technology focuses on circuit switching and packet voice in a single, cost-optimised platform. A Media Gateway device takes incoming TDM circuits and either converts them to packets and sends them to a data network, or connects them to other TDM circuits (i.e., it switches the call). This strengthens offerings for packet voice (long distance tandem) and wholesale dial (managed modem) services.
15. Amteva provides IP-based Unified Communications middleware that consolidates voicemail, e-mail and fax on a single IP network, accessible independent of location, time or device. Unified Communications as a set of key value-added applications that showcase the advantages of a converged data/voice/video network infrastructure and is important all across customer base, Service Providers, enterprises, and small and medium businesses.
16. The GeoTel software solution integrates enterprise data applications with voice infrastructure devices, such as PBXs, to deliver integrated data and voice to call centres over an Internet infrastructure and the PSTN. This acquisition furthers Cisco's strategy to create an open data and voice software infrastructure. GeoTel allows Cisco to accelerate the development of applications on the Cisco packet voice architecture by providing a call centre infrastructure on which companies like Oracle, SAP, Siebel, Vantive, etc, can build enterprise and service provider applications.
17. Sentient Networks has developed the industry's highest density ATM Circuit Emulation Services (CES) Gateway, which is capable of transporting circuit-based private line services across packet-based ATM networks. By delivering technology that allows service providers to combine their circuit-based equipment with Internet-based data, voice and video gear, this acquisition will help them migrate to cell and packet-based networks.
18. Fibex Systems is a pioneer in Integrated Access Digital Loop Carrier (IADLC) products-devices that combine traditional voice services with data services using ATM as underlying architecture. The acquisition helps service providers transition voice/data traffic to cell/packet networks while maintaining traditional phone business using existing circuit infrastructure.

2000

1. Exio Communications Inc. is a leading developer of in-building, wireless technologies for corporate networks, based on standard Code Division Multiple Access (CDMA) technologies. ExiO's wireless telephony solution builds on Cisco's existing wireless technology that enables enterprise customers to add the convenience of mobility to voice-over-IP (Internet Protocol) services. This acquisition further strengthens Cisco's commitment to development of fully converged network which supports multiple wireless standards, including GSM and CDMA, for integrated mobile voice and data services.
2. Radiata is a leading supplier of chipsets for high-speed wireless networks. This acquisition strengthens Cisco's New World strategy by expanding its ability to deliver next generation wireless networks using the IEEE 802.11, a standard for faster data rates. Radiata provides Cisco with leading semiconductor technology and extensive radio and modem systems expertise for developing next-generation

wireless networks, which will operate in the unlicensed 5 GHz frequency range and will enable wireless communications between devices at speeds up to 54 Mbps, which has previously been possible only with wired connections.

3. Active Voice Corp. is a leading provider of IP-based Unified Messaging solutions for the enterprise and small/medium business customer. Unified Messaging consolidates voicemail, e-mail and fax messages on a single IP network, accessible independent of location, time or device. Unified Messaging (UM), a key component of Unified Communications (UC), is an important initiative for Cisco that paints a very compelling picture for the future of communications applications and supports its direction with the Architecture for Voice, Video, and Integrated Data (AVVID) for the corporate enterprise. Cisco also delivers UC solutions for the service provider market through its own software platform/technology.
4. CAISsoft offers software applications that enable service providers to provide and manage high-speed, broadband Internet services in the multi-unit building market (MxU). CAISsoft's suite of server-based software applications complements Cisco's existing in-building DSL, Ethernet, cable, wireless and VPN network solutions. It enables broadband service providers to deploy, market and operate services for the multi-family, multi-tenant and hospitality markets. CAISsoft's application, the IPORT Broadband Provisioning System, provides security, authorization, accounting, billing, reporting, policy and management functionality.
5. IPCell provides software for broadband access networks combining IP and telephony services. IPCell has developed an interface between the call control and service layers for voice over packet applications. It has also developed Opticall, a call agent for legacy-free ‘greenfield’ broadband access packet-based telephony networks.
6. PixStream Corporation is a provider of hardware and software solutions that enable network service providers and enterprises to reliably distribute and manage digital video and streaming media across broadband networks. PixStream's carrier class products will allow Cisco to provide a single end-to-end solution for the delivery and management of video and streaming media across broadband networks. Their products are complementary with Cisco's V-Bits technology and fits well into Cisco's Architecture for Voice, Video and Integrated Data (AVVID). PixStream provides Cisco a strong foundation of video networking expertise, including senior management and engineering. The acquisition of PixStream signals Cisco's commitment to enable IP-based entertainment services over broadband (e.g., broadcast video, VOD, multi-player games, etc.).
7. IPmobile is a leading provider of software systems that enable service providers to build the next generation IP-based wireless infrastructure, known as third generation or '3G' networks. 3G networks will allow the creation of the Mobile Wireless Internet, which refers to the convergence of Internet-related data services and mobile wireless services. 3G networks will be based on the Internet Protocol (IP) and will seamlessly merge with the Internet that exists today. IPmobile is a leading developer of IP Radio Access Networks (IP-RAN) that will connect wireless base stations to the Internet in 3G networks. RANs control and manage the radio networks between the user devices and the base stations, while providing access to data and voice services.
8. NuSpeed Internet Systems' technology connects storage area networks and Internet Protocol networks. NuSpeed Internet Systems technology will be implemented in Cisco solutions to interconnect storage area networks with metropolitan area networks (MANs), wide area networks (WANs) and local area networks (LANs). NuSpeed Internet Systems is a leading company in implementing the iSCSI protocol that provides a way for the two disparate networks to communicate. Customers benefit by managing a single, common network infrastructure as opposed to two separate and distinct environments.

9. Komodo Technology is a leading developer of Voice-over-IP (VoIP) devices that allow analog telephones to place calls over IP-based networks. This acquisition strengthens Cisco's service provider solutions by offering a smooth transition path from traditional circuit-switched networks to new packet-based networks. Komodo's VoIP devices are cost-effective solutions that will help service providers meet the growing demand for IP telephone services by supporting customers with analog telephones. An analog phone can be connected directly to Komodo's product, which connects via an internal modem to a standard telephone line, or via an Ethernet jack to a broadband (DSL, cable or wireless) access device.
10. Netiverse is a leading provider of content acceleration technology that enhances the performance and functionality of networking devices. This acquisition strengthens Cisco's content networking solutions by offering its customers added performance capabilities for meeting the growing demands of distributing web content and managing large amounts of Internet traffic. Netiverse's technology was developed specifically for use across multiple product lines and will be integrated into Cisco's existing content networking solutions.
11. HyNEX, a subsidiary of Elbit Ltd (Nasdaq: ELBTF), is a leading developer of intelligent access devices for ATM network providers. HyNEX's products strengthen Cisco's solution for service providers in international markets by accelerating the deployment of IP+ATM networks. This enables service providers to deliver an expanded range of data, voice and video services as well as provide large enterprises with managed network services and service level agreements. HyNEX's products complement the Cisco 3800 family of access routers as a higher end network convergence product for customer premises.
12. Qeyton is the developer of Metropolitan Dense Wave Division Multiplexing (MDWDM) technology. The acquisition of Qeyton Systems expands Cisco's optical networking capabilities and enables it to provide a comprehensive end-to end optical networking solution for service providers' metropolitan networks. Qeyton's Metro DWDM technology links carriers points of presence (POPs) and customer sites with an optical ring and enables Cisco to offer service providers increased capacity without needing to add or lease new fibre in the metropolitan areas. Qeyton Systems optical technology will be seamlessly integrated with optical products and technology in Cisco's Optical Networking Solutions (ONS) 15000 family of products.
13. ArrowPoint Communications is a leading provider of content switches that optimise the delivery of web content. ArrowPoint's products will provide a new level of intelligence that will enable ISPs, Web hosting companies and other customers to create a faster, more reliable Web experience, and its services can direct traffic based on information, such as the content being requested and the frequency of the content request.
14. Seagull is a leading developer of silicon technology. The subsidiary of Seagull which Cisco acquired is comprised of Seagull's core technology development team. Seagull's development team has high-speed silicon expertise which will allow Cisco to accelerate the development of terabit performance routers, and also strengthen Cisco's New World strategy by enhancing its ability to provide next generation IP networking infrastructures to service providers.
15. Pentacom is a leading provider of products implementing Spatial Reuse Protocol (SRP) which allows IP based metropolitan networks to offer the same protection and restoration benefits as SONET-based networks while doubling bandwidth efficiency. Pentacom's technology provides fibre management and hubbing for IP transport networks. This acquisition underscores Cisco's New World strategy to deliver end-to-end IP based solutions for service providers to deploy advanced data, voice and video services.

16. SightPath is a leading provider of appliances for creating intelligent Content Delivery Networks (CDN's). Cisco is acquiring SightPath to give its customers the ability to create CDNs using existing Internet and Intranet infrastructure.
17. InfoGear is a leading provider of Internet appliances and software used to manage information appliances for Internet access. This acquisition increased Cisco's ability to provide the service providers, consumer-based businesses and vertical markets with a complete end-to-end solution for the deployment of advanced data, voice and video services.
18. JetCell is a leading developer of standards-based, in-building wireless telephony solutions for corporate networks. JetCell's open, standards-based wireless technology will extend Cisco's AVVID architecture into the wireless domain, integrating New World IP telephony solutions with traditional PBX systems.
19. Atlantech is a leading provider of network element management software, which is designed to help configure and monitor network hardware. It provides service providers and ecosystem partners with a single integrated platform for enabling network management functionality across multiple diverse networks.
20. Growth Networks is a market leader in Internet switching fabrics, a new category of networking silicon. Growth Network's technology will allow service providers to deploy advanced systems with switching capacities that scale from 10s of gigabits per second (Gbps) to 10s of terabits per second (Tbps), meeting customers' critical requirements for scalability, flexibility, multi-service support and quality of service.
21. Altiga is a market leader in integrated VPN solutions for remote access applications. Its product suite will complement Cisco's existing family of VPN routers and security appliances. Altiga's integrated VPN client, remote access gateway and management solutions will extend Cisco's broad VPN portfolio, providing enhanced VPN scalability, manageability and performance for enterprise edge applications, including service provider-managed remote access.
22. Compatible is a leading developer of standards-based, reliable and scalable VPN solutions for service provider networks. Its industry-leading platform enables service providers to deploy robust, IPSec architectures for VPN services.

2001

1. Allegro Systems is a leading developer of Virtual Private Network (VPN) acceleration technologies designed to enhance the performance and functionality of secure networking platforms. Allegro Systems VPN acceleration technologies and expertise will advance the integration of highly scalable security within existing networks and complement Cisco's existing portfolio of security products, which include VPN gateways and concentrators, firewalls, intrusion detection systems and device and policy-based security management systems. Allegro Systems VPN acceleration technologies are designed for high-bandwidth networks. The technologies also enable large number of simultaneous VPN connections required for today's e-commerce and remote access applications.
2. AuroraNetics, Inc. is a leading developer of 10Gbps silicon technology for metropolitan fibre networks. AuroraNetics' silicon technology is used in data-optimised fibre rings, known as Resilient Packet Rings (RPR). RPR offers service providers the ability to create high-speed metropolitan networks that efficiently transport significant amounts of IP and other data, including Ethernet. Additionally, RPR provides Cisco customers with the intelligence of an IP network combined with the redundancy benefits of traditional SONET networks. Cisco plans to license AuroraNetics' silicon design to companies interested in producing and participating in the development of 10Gbps SRP RPR-based

solutions. Licensing AuroraNetics' design augments Cisco's existing licensing of 2.5Gbps SRP silicon and will help accelerate industry availability of 10Gbps RPR products.

2002

1. Psionic Software, Inc. develops network security software that increases the efficiency of intrusion detection systems (IDS) by reducing false alarms by upto 95%. Psionic's software will allow Cisco's security customers to increase productivity and lower the costs associated with network-based intrusion detection systems (NIDS) by enabling businesses to focus manpower and attention on legitimate attacks against their networks.
2. Andiamo Systems, Inc. has developed the storage industry's first family of multilayer intelligent storage switches, and is Cisco's entry into the large, high-growth Fibre Channel Storage Area Networking (SAN) market. With Andiamo's technology, Cisco will be able to offer enterprise customers the same levels of network scalability, performance and manageability to storage networking that Cisco pioneered in LAN and IP networking.
3. AYR Networks is a provider of high-performance network technologies that will enhance and accelerate time-to-market delivery of Cisco's network operating system and routing software (i.e., Cisco IOS) for routing and switching markets. AYR's technology and talent, in distributed architectures and integration techniques, will help augment and solidify Cisco's technology leadership in these areas.
4. Navarro Networks is a leading developer of high-performance, cost-effective ASIC components for the Ethernet market. Navarro Networks' technology will enhance Cisco's internal development of new, high-end ASICs and increase ASIC manufacturing flexibility on next-generation Ethernet switching platforms.
5. Hammerhead Networks is a leading developer of next-generation software solutions that integrate with and accelerate time to market delivery of Cisco hardware solutions for IP aggregation–namely the broadband aggregation, leased line and cable (uBR 10K) markets. Hammerhead's software utilizes advances in parallel processing technology that allow for enhanced services, such as billing, security and Quality of Service (QoS) to be offered without degradation in performance.

2003

1. Latitude Communications is a leading provider of enterprise conferencing products with its MeetingPlace audio and web conferencing solution. Latitude MeetingPlace currently integrates with leading enterprise desktop scheduling applications, such as IBM/Lotus Notes and Microsoft Outlook, as well as with data collaboration and instant messaging solutions, such as IBM/Lotus Same time. Latitude MeetingPlace also offers significant integration with Cisco CallManager, enabling users to schedule, attend and manage meetings using the display on Cisco IP phones. Cisco and Latitude also intend to integrate MeetingPlace with Cisco IP/VC for video conferencing capability.
2. Linksys Group, Inc. is the market and product leader in the Consumer/SOHO networking market. Linksys' products include wireless/wired home routers and access points, wireless adapters for laptops and desktops and unmanaged switches.
3. SignalWorks, Inc. is a developer of advanced software that delivers high-performance audio capabilities for IP telephony systems. SignalWorks' Acoustic Echo Canceller (AEC) software, which provides unparalleled voice clarity, is a digital full-duplex, voice processing algorithm that will drive continued product innovation and differentiation across Cisco's complete line of IP phones and IP softphones. SignalWorks' AEC software delivers advanced audio features, such as multiple microphone capabilities, stereo sound and PC-based softphones, providing the basis for future expansion of Cisco's IP phone product line into new high-end markets. The technology's advanced audio and speakerphone

capabilities will allow Cisco to further penetrate the enterprise, small- and medium-sized businesses and service provider managed services markets.

4. Okena, Inc. is a developer of software providing threat protection for desktop and server computing systems. Okena's technology is a complement to Cisco's own current family of network security offerings, which include Firewall, VPN, IDS, and SSL solutions. With the addition of Okena's endpoint security software, Cisco offers the most comprehensive threat protection portfolio in the information security market. In addition, Okena's technology will provide enhanced protection for Cisco server-based solutions, such as IP Telephony Call Manager and Network Management applications.

2004

1. Protego's technology will enhance the management, monitoring and mitigation capabilities of Cisco's portfolio of security products. Protego provides traditional security information management (SIM) functions, including security event/log capture, consolidation, centralisation, correlation, prioritisation, visualisation, investigation, escalation and compliance reporting. It extends this functionality by obtaining detailed information about network infrastructure through a variety of device logs and alerts, Netflow communications, and other means, allowing their appliances to interoperate with both Cisco core infrastructure and network security products lines.
2. BCN Systems, Inc. has developed a flexible networking software architecture for routing applications. This technology will further improve the reliability, modularity, feature enhancement and innovation of Cisco's portfolio of routing products. In the future, this architecture will allow additional hardware acceleration for advanced features, such as QoS, security and other services. BCN Systems, Inc.'s architecture will have application across all CPU-intensive routing platforms.
3. Jahi is a provider of network management appliances aimed at simplifying interfaces for device management, deployment and configuration of a network of heterogeneous Cisco devices. Jahi's technology includes an external Programmatic Interface (PI) and other interface enhancements which complement Cisco's existing CLI and PI strategy and will enable Cisco to provide an enhanced network management solution to customers.
4. Perfigo is a leading developer of access control solutions that provide endpoint policy analysis, compliance and access enforcement capabilities. Perfigo's technology extends the offerings in Cisco's Network Admission Control (NAC) programme, an industry-leading effort designed to enforce endpoint policy compliance and help customers implement self-defending networks. Perfigo enables organisations to intelligently provide trusted access to 'clean' endpoints, thereby increasing the availability and integrity of customer networks and critical business applications.
5. Dynamicsoft is the leader in Session Initiation Protocol (SIP) technology. Dynamicsoft's portfolio of carrier-class infrastructure technology, combined with Cisco's Softswitch-based solutions, enables wireless and wireline service providers to quickly develop and deploy 'subscriber-aware' IP communications services using voice, video, messaging, presence awareness and other real-time capabilities.
6. NetSolve is a leading provider of remote network and IT infrastructure management services for the enterprise and service providers. NetSolve remotely monitors, pro-actively diagnoses and solves a range of network and IT infrastructure issues related to LAN/WAN, as well as advanced technologies, such as IP Communications and Security.
7. P-Cube is a leader in programmable IP Service Control platforms for wireline network operators. P-Cube's Service Control solutions overlay intelligence and application-level control on existing IP transport networks-enabling service providers to analyse, control and meter application and content-based services.

8. Parc develops traffic engineering (TE) solutions and software for routing optimisation. Parc's Route Server algorithms apply innovative technology to break-up network routing problems involving complex Quality of Service constraints. These algorithms integrate specialised solvers, and the solutions they generate can help service providers deliver high quality services while improving network utilisation and reducing capital expenditure.
9. Actona is a developer of wide-area file services software that facilitates data management across geographically distributed offices. Cisco currently offers a Full Service Branch solution that combines enhanced wide area network (WAN) connectivity with advanced network security, IP voice communications and business application and video acceleration services on a common platform. Actona's technology will augment that offering by expanding the functionality of Cisco's branch office access router portfolio with intelligent network services that enable WAN-optimised file transfer and access.
10. Procket Networks is a developer of concurrent services routers, and has expertise in silicon and software development. This purchase will add a rich intellectual property portfolio and a team of proven silicon and software architects to Cisco's industry leading routing technology and products.
11. Riverhead Networks is a leading developer of security technology that protects against Distributed Denial of Service (DDoS) attacks and other security threats in enterprise and service provider networks. DDoS attacks represent a severe threat to the availability of network and data centre resources, and can severely impact enterprises and service providers. Riverhead delivers an innovative solution that protects online operations from sophisticated attacks by detecting and blocking malicious traffic without impacting legitimate business transactions. Quick detection and mitigation of these attacks enables businesses to stay online and reliably service their customers without interruption.
12. Twingo Systems is a leading provider of desktop security solutions for Secure Socket Layer (SSL) Virtual Private Networks (VPNs). This acquisition advances Cisco's leadership in providing secure connectivity solutions and reinforces Cisco's Self Defending Network strategy, which dramatically improves the network's ability to identify, prevent and respond to a range of security threats. Cisco plans to incorporate Twingo's Virtual Secure Desktop into its existing WebVPN solution, beginning with the Cisco VPN 3000 Concentrator series.

2005

1. Intellishield Alert Manager is a web-based security intelligence service, providing daily information to customers about information security threats and IT product vulnerabilities that affect the entire corporate information technology domain. The service is delivered through a continually updated web portal, XML feeds and email subscriptions. The ability to research, understand and advise customers on all types of threats and vulnerabilities is core to Cisco's Self-Defending Network strategy. Intellishield Alert Manager became part of the Cisco MySDN security intelligence Website.
2. Scientific-Atlanta is a leading global provider of set-top boxes, end-to-end video distribution networks and video system integration. The combined entity creates a world class, end-to-end triple play solution for carrier networks and the digital home. In addition, upon closure, the market opportunities represented by this acquisition will become part of Cisco's Advanced Technology portfolio.
3. Nemo Systems has developed leading-edge technology in the network memory space that will offer enhanced performance on Cisco's core switching platforms and service modules. Once incorporated into Cisco's products, the technology will allow customers to scale network systems and line card bandwidth, while reducing the overall cost of high-performance networking systems.

4. Sheer Networks is a pioneer in the development of intelligent network and service management products for service providers and large enterprises. Sheer's technology can adapt to network changes easily, scale to large networks, and help extend new technologies and services to simplify the difficult task of monitoring and maintaining complex networks.
5. KiSS is a leading technology provider for networked entertainment devices, and has a product portfolio that includes home video products, such as networked DVD players and networked DVD recorders. KiSS's technology platform also has the capability to extend to other consumer electronics products and will help Linksys develop a unique, networked entertainment product suite.
6. The NetSift acquisition will help Cisco to accelerate the integration of additional packet processing capabilities into future core Cisco platforms, such as modular switching. NetSift provides Cisco with a unique solution to deep packet processing challenges, valuable intellectual property, and a core team with a long history of algorithmic innovations supporting high-speed packet processing.
7. M.I. Secure is focused on the development of advanced features and functionality for security and VPN solutions. M.I. Secure brings unique security technology expertise and a team of talented and proven security architects to Cisco. Security is one of Cisco's key advanced technologies and an integral part of its overall product strategy.
8. FineGround is a leading provider of network appliances that accelerate, secure and monitor application delivery while minimising bandwidth usage and maximising infrastructure capacity in the data centre. By integrating FineGround's technology with its products, Cisco will provide customers with advanced application-acceleration across networks for secure and optimised delivery of web-based applications.
9. Vihana is focused on the development of efficient semiconductor solutions for the computer and communications industry. In terms of vision, Cisco and Vihana both recognise the importance of custom ASIC technology in providing leading technology solutions to customers. In the short-term, Vihana will provide needed high speed, custom silicon design expertise, and will accelerate Cisco's innovation in more flexible, programmable ASICs, and in the long term, Vihana's technology will be integrated across multiple platforms, across technology groups.
10. This represents Cisco's first acquisition for its Linksys division—Sipura is a leader in consumer voice over internet protocol (VoIP) technology, and is a key technology provider for Linksys' current line of VoIP networking devices. In addition to Sipura's valuable technology and customer relationships, their experienced team with extensive VoIP expertise will help build a foundation for Linksys' internal research and development capabilities in voice, video and other markets.
11. Topspin is the leading provider of intelligent server fabric switches. Server fabric switching provides low latency, high performance fabric for server virtualisation, clustered enterprise applications and grid/utility computing. Topspin delivers a compelling return on investment by promoting resource flexibility, and dramatically reducing equipment and management costs. This acquisition strengthens Cisco's ability to provide customers with specialized networking technology and services to allow them to build their data centres in a flexible, grid-like fashion.
12. Airespace is a provider of wireless local area networking (WLAN) systems, which provide a secure, flexible and cost-effective solution for enterprise and commercial customers. Airespace's product portfolio will expand Cisco's WLAN solution portfolio, accelerating delivery of key WLAN features and capabilities for Cisco's entire customer base. Airespace's product portfolio includes WLAN controllers, Access Points, WLAN Management and Location Software, and Security capabilities, including IDS. The acquisition will allow Cisco to address a broader set of market segments, and integrate advanced capabilities into current Cisco products.

2006

1. Tivella is a leading provider of digital signage software and systems. Digital signage is an emerging technology that has the potential to transform customer experience, and to promote richer communications. Digital signage is quickly gaining attraction as companies face a variety of challenges. These include revenue and growth, building and maintaining brand identity and customer loyalty, and effectively reaching target audiences with advertising and marketing. Companies conducting deployment of digital signage solutions have clearly demonstrated higher brand awareness and sales uplift by targeting relevant information to an audience near the point of purchase.
2. Greenfield Networks provides integrated circuits, hardware and software optimised for Ethernet packet processing that enables next-generation Metro Ethernet services. This technology is highly complementary to Cisco's existing line of Metro Ethernet products, and will enable Cisco to improve time to market of carrier-class features for service provider customers.
3. Orative develops mobile software solutions that extend the communications and collaboration capabilities of the Cisco Unified Communications system to business mobile phone users. With Orative Enterprise Software, mobile phone users can coordinate conversations, collaborate with colleagues, view information on Unity voicemail messages, screen unwanted telephone calls and interruptions, and securely access personal and corporate phone books. Together, Cisco and Orative aim to transform the mobile phone into a true business device, using Cisco Unified CallManager for call control, Cisco Meeting Place for collaboration and Cisco Unity as voicemail platform.
4. The Arroyo solution is designed to deliver exceptional scalability, service availability and operational simplicity—offering a highly extensible platform for video-on-demand today and emerging time-shifted services in the future. The integration of the Arroyo platform into the Cisco IP-NGN (Next Generation Network) architectural framework will help enable carriers to accelerate the creation and distribution of network delivered entertainment, interactive media and advertising services across the growing portfolio of televisions, personal computers, mobile handsets and emerging media capable devices in increasingly connected lives.
5. Meetinghouse provides a client-side 802.1X supplicant security software that allows enterprise customers to restrict network access to only authorized users and/or host devices attempting to gain access to networked resources through both wired and wireless media. When integrated with Cisco's existing security portfolio, Meetinghouse's AEGIS SecureConnect products will enable Cisco to provide a single unified wired and wireless client to enterprise customers that will help them to reduce operational costs by simplifying security management of a broad array of host devices and operating systems.
6. Metreos is a leading provider of IP communication application development and management environments. The acquisition will help Cisco's ecosystem of third party technology partners, systems integrators, value-added resellers and customers, build and deliver applications on Cisco's Unified Communications System. Metreos' technology has proven itself in enterprise environments as a platform for integrating Cisco's Unified Communications System with enterprise business applications.
7. Audium is a leading provider of VoiceXML speech self-service application development and management environments. The acquisition will enable enterprises to easily build automated voice response applications that are integrated with not only their converged IP network but also work well within their Services Oriented Architecture (SOA), enabling the use of common services across the network. Leveraging the intelligence of the network, Audium's technology further strengthens Cisco's SONA and provides a platform for enterprises to integrate their business process workflow with their speech self-service applications.

8. SyPixx Networks offers network-centric video surveillance software and hardware that enable existing analog video surveillance systems to operate as part of an open IP network. This acquisition will enable Cisco to deliver video surveillance as part of an Intelligent Converged Environment.

2007

1. Securent, Inc. is a leading provider of policy management software for enterprises. Securent's scalable, distributed policy platform allows enterprises to administer, enforce and audit access to data, communications and applications in heterogeneous IT application environments. Securent's software will enable Cisco customers to protect and secure valuable application data regardless of vendor, platform or operating system, while still allowing ubiquitous access to the content workers and their collaborative communities' need to be productive. By delivering policy from the network, Cisco will simplify entitlement decisions for all communications, collaboration and other third party applications.
2. Navini Networks is a leader in the Mobile WiMAX 802.16e-2005 broadband wireless industry. Navini is a pioneer in the integration of 'Smart Beamforming' technologies with Multi-Input Multi-Output (MIMO) antennas, a combination that improves the performance and range for WiMAX services and lowers the overall deployment and operational costs for service providers. Navini's WiMAX products will extend Cisco's market-leading WiFi and WiFi-Mesh portfolios, allowing Cisco to uniquely address the rapidly growing markets for broadband wireless services.
3. Latigent is a leading provider of web-based business intelligence and analytics reporting solutions, focused on contact centres. Latigent's products are built from the ground up, to take advantage of Web 2.0 principles that help enable customers to create flexible, scalable, easily customizable, and intuitive historical and real-time reports for their contact centres.
4. Cognio is the market leader in wireless spectrum analysis and management for wireless networks. Cognio's industry-leading spectrum technology enhances performance, reliability and security of wireless networks by detecting, classifying, locating and mitigating sources of radio frequency (RF) interference. The acquisition will provide Cisco with complementary and differentiating technology, intellectual property, and a core team to expand Cisco's leadership in unified wireless networking.
5. BroadWare Technologies is a leading provider of IP-based video surveillance software. BroadWare's software enables web-based monitoring, management, recording and storage of audio and video that can be accessed anywhere by authorised users. With this acquisition, Cisco will be able to help customers easily gain access to live and recorded surveillance video for faster investigation response and event resolution. The BroadWare acquisition complements Cisco's existing video surveillance product offering, which provides a smooth migration path from analog surveillance video to a digital network solution.
6. SpansLogic is a leading provider of processors that dramatically improve packet processing speeds across the network. SpansLogic offers a breakthrough approach for resolving packet processing bottlenecks at extremely high speeds. The SpansLogic acquisition will provide Cisco with valuable technology, IP, and a core team to productize innovations that support Cisco's SONA architecture.
7. WebEx is a market leader in on-demand collaboration applications, and its network-based solution for delivering business-to-business collaboration extends Cisco's vision for Unified Communications, particularly within the Small to Medium Business (SMB) segment. WebEx's service portfolio includes technologies and services that allow companies to engage in real-time and asynchronous data conferences over the Internet, as well as share web-based documents and workspaces that help improve productivity, performance and efficiency of workers in any size organisation. WebEx's subscription-

based services strategy has been key to its success, and, going forward, Cisco plans to preserve this business model.

8. NeoPath Networks is the leading provider of high-performance and highly scalable file storage management solutions. Cisco and NeoPath share a common vision of providing unique and flexible file storage management services to enterprise customers. In line with its Service-Oriented Network Architecture (SONA) strategy and vision, Cisco plans to integrate the NeoPath technology in future products with the goal of providing additional value-added file services. This will benefit both its current file based solutions, such as Wide Area Application Services (WAAS), and its business partners' file based solutions.
9. Reactivity is a leading XML (eXtensible Markup Language) gateway provider for organizations ranging from commercial enterprises to the Global 500. The acquisition demonstrates Cisco's commitment to the expanding Application Networking Services (ANS) Advanced Technology segment, which is an important part of Cisco's Service-Oriented Network Architecture (SONA) strategy and vision. Cisco ANS provides customers with shared application-aware services to improve the availability, performance, and security of applications delivered from the network platform. Reactivity complements and extends the capability of Cisco's ANS portfolio for these emerging application architectures.
10. Five Across is a leading vendor in the social networking marketplace. The Five Across platform, Connect Community Builder, empowers companies to easily augment their websites with full-featured communities and user-generated content, such as audio/video/photo sharing, blogs, podcasts and profiles. These user-interaction functions help companies improve the interaction with their customers and overall customer experience on their websites. Social networking functions are of unique interest to media companies, sports leagues, affinity groups and any organisation wishing to increase its interaction with its online constituency.
11. IronPort is a leading provider of messaging security appliances, focusing on enterprise spam and spyware protection. Securing email, messaging and other sorts of content is of primary concern to enterprises and other organisations. As email and messaging are leading applications for use over the Internet, the acquisition of IronPort's industry-leading messaging and Web security solutions is a natural extension to Cisco's security portfolio. The security products and technology from IronPort add a rich and complementary suite of messaging solutions to Cisco's industry-leading threat mitigation, confidential communications, policy control and management solutions.

June 2008

1. DiviTech is a leader in the digital-service management (DSM) market. DiviTech's DSM solution offers media broadcasters, cable and Internet Protocol Television (IPTV) service providers an intuitive interface for creating, modifying and managing video networks. Cisco plans to integrate DiviTech's DSM product with the industry-leading Cisco ROSA network- and element-management solution to create an end-to-end platform that offers all layers of digital video management (element, network and service) a single modular product.
2. Cisco is acquiring Fast Data's technology to provide differentiated, real-time, content scanning and filtering functionality to Cisco IronPort's industry leading SenderBase Network and Web Reputation systems. Fast Data has the only truly 'real-time' scanning engine which uses artificial intelligence to immediately and accurately categorise web content. Because internet-based threats continue to morph much more quickly, and are often only hosted in one location for hours or minutes, static URL lists and databases often do not provide adequate protection against such threats.

3. Nuova Systems is a start-up focused on the development of next-generation products for the data centre market. Cisco introduced the Cisco Nexus 5000 Series, the first product developed by Nuova. The Cisco Nexus 5000 is a 10 Gigabit Ethernet 'top-of-rack' switch that offers unified fabric capabilities through the support for multiple data centre networking protocols and software intelligence. Prior to the acquisition, Nuova operated as a majority-owned subsidiary of Cisco, which had invested $70 million, and owned 80% of the company.

Adapted from: http://www.cisco.com/web/about/ac49/ac0/about_cisco_acquisitions.html 2008

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DISCUSSION QUESTIONS

1. Discuss the strategy for growth adopted by Cisco.
2. Explain the salient features of Cisco's acquisitions.

Case Study 11

CONSOLIDATION IN THE METAL INDUSTRY

CONSOLIDATION BY HINDALCO

Established in 1958, Hindalco commissioned its aluminium facility at Renukoot in Eastern Uttar Pradesh, in 1962. It has today grown to become the country's largest integrated producer of aluminium, and ranks among the top low cost producers in the world.

In the fiscal year 2000, Hindalco acquired majority stake in Indian Aluminium Company Ltd (Indal), an Alcan Canada Group company with major presence in aluminium products and a leader in specialty alumina chemicals.

In fiscal year 2002, Hindalco acquired the copper business of Indo Gulf Corporation Ltd, with strategic intent to achieve integration.

Acquisition of Indal

In the year 1999, the A V Birla Group examined the possibility of buying out the stake held by Alcan Aluminium of Canada in Indian Aluminium (Indal). But the deal fell through. On March 10, 2000, Birla's Hindalco again received an offer to buy out Alcan's 54.62% stake. Hindalco acquired Indal for Rs 738 crore. Both companies decided on a share swap ratio of one share of Hindalco for every seven shares of Indal. After the merger, Hindalco owns nearly 97% equity stake in Indal. Around 12,000 shareholders hold the remaining 3% stake in Indal. The Birla Group wanted to exploit the synergies between the two companies. While Hindalco buys part of its alumina needs, sells metal ingots and has minimal presence in downstream business, Indal buys primary aluminium, exports alumina, and manufactures downstream products. In 1998-1999, Indal purchased 29,000 tonnes of aluminium, while Hindalco sold 11,2367 tonnes of ingots.

The problems with Indal are manifold. It has always depended on external sources for its metal requirements. Indal's power cost was Rs 1.68 per unit as compared to 55 paise for Hindalco. Indal has been hit by volatile metal prices on the London Metal Exchange. It also had to face hostile attitude of its employees.

Post merger, Hindalco became a strong player, with the capacity to manufacture over 8 lakh tonnes per annum (tpa) of alumina, smelt over 3 lakh tpa of aluminium and produce 15,000 tpa of foil. In addition, the takeover helped Hindalco to get 20% stake in the proposed Rs 4300 crore Utkal Alumina. After the merger, Hindalco's priority was to rationalise Indal's product portfolio, production planning and new product development. Hindalco will need to tackle the negative financial impact of the takeover in the short run. At Rs 190 per share, the price was lower than what Alcan paid (Rs 200 per share) to ward of Sterlite's threat and the replacement cost (over Rs 300 per share). The combination of Indal's weak balance sheet and Hindalco's cash outgo may act against merger in the short term.

Merger of Indo Gulf Corporation

The merger of Indo Gulf Corporation was aimed at building the non-ferrous metal powerhouse in the global economy with a wide scope for growth. Under the restructuring scheme of Hindalco and Indo Gulf Corporation, the ratio was of one share of Hindalco for 12 shares of Indo Gulf Corporation.

The mergers of Indal and Indo Gulf helped Hindalco double the production of metal within three years. The production of copper increased from 5,00,000 tpa in a span of seven years. The A V Birla group had earlier acquired the cement operation of L&T Cement.

Three-way Merger of Group Companies

In 2005, Birla merged its group companies, Indo Gulf and Birla Global Finance, with Indian Rayon. The merged entity was renamed Aditya Birla Nuvo. The restructuring was a major step in shareholder value creation. The merger was aimed at creating a company that captured opportunities in the evolving Indian economy through focused value businesses, such as carbon black, VFY, textiles and fertilizers, and driving high growth businesses, namely garments, IT/ITES, financial services and telecom. The restructuring took place under two separate schemes. Under the first scheme, Indian Rayon issued one equity share to Indo Gulf shareholders for every three equity shares of Indo Gulf. Under the second scheme, Indian Rayon issued one equity share to Birla Global Finance shareholders for every three equity shares of Birla Global Finance. The swap ratio was expected to translate into a reasonable premium for both Indo Gulf and Birla Global Finance Shareholders, based on the Indian Rayon share price at the time of merger. The share exchange ratios were based on calculations by the firms—Bansi S Mehta & Co and Deloitte Haskins & Sells. The merger was effective from 01 September 2005. The new shareholding pattern saw promoter's shareholding at 38%, financial institutions at 15% and banks at 22%. The remaining 25% was with the public. Prior to reorganisation, the promoters held 28.6% in Indian Rayon, 58% in Indo Gulf and 75% in Birla Global. The aim of the union was to make Indian Rayon, or Aditya Birla Nuvo, a diversified high growth company. The combined entity had nine businesses—textiles, insulators, carbon black and VFY from brick and motar segment, and life insurance, telecom, mutual fund, garments and IT from the new age businesses. For the fiscal year 2005, the combined entity's sales were Rs 3209 crore. Of this, insurance contributed 30%, garments, 15%, carbon black 15%, textiles 14%, VFY 11 %, IT/ITES 6% and telecom 3%. Some businesses of Birla Global Finance have been hived off. The rationale behind merging Birla Global into Indian Rayon was to bring all the financial services businesses under a single entity. Birla Global, the original flagship of the financial services arm of the AVB group was registered as a non-banking finance company. It was involved in capital, corporate finance and general insurance advisory. The acquisition of Alliance's mutual fund business increased the company's assets to Rs 16,000 crore. Birla Global had joint ventures in the financial business (BSL) and mutual fund sector with Sun Life Financials. In fact, BSL was the largest new business generator for Sun Life in Asia. The second joint venture was with Sun Life in mutual funds business. Birla Sun Life is the sixth largest mutual funds in the country. Birla Sun Life Distribution, a third JV with the Canadian company, sells products of third party companies, such as mutual funds, bonds and fixed deposits.

Indo Gulf's Shaktiman branded urea was a strong brand name. Functioning in an over regulated industry structure and a controlled pricing regime, Indo Gulf could not achieve fast growth. The demerger of copper business from Indo Gulf in 2001 was intended to make it a fertilizer major. The merger with Indian Rayon was expected to help Indo Gulf shareholders to shift focus to high growth business. The Birla Global shareholders extended their participation in financial services beyond mutual funds into life insurance, as the financial services business was consolidated under Indian Rayon.

According to analysts, the merger will help the new entity use Indo Gulf's strong cash reserves for future growth plans. Idea Cellular also became a part of Indian Rayon.

The Novelis Acquisition

In May 2007, Novelis became a Hindalco subsidiary with the completion of the acquisition process. The transaction made Hindalco world's largest aluminum rolling company and one of the biggest producers of primary aluminium in Asia, besides being India's leading copper producer.

Novelis was incorporated in 2005 as a result of forced spin from its parent, the $23.6 billion Canada based aluminum giant, Alcan. Alcan had acquired the French aluminum company, Pechiney, through a hostile offer. Alcan and Pechiney had bauxite mines, facilities to produce primary aluminum and rolling mills to turn the raw metal into products, such as stock for Pepsi and Coke cans, and automotive parts. The US and European anti-trust regulatory authorities ruled that the rolled products business of either Alcan or Pechiney had to be divested from the merged entity. Alcan spun off its rolled products business to form Novelis. Novelis became the world's leading producer of aluminum rolled products, with 19% global market share. In the process of spin off, Novelis ended up inheriting a huge debt of $2.9 billion on capital base of less than $500 million. On net worth of $322 million, Novelis has a debt of $2.33 billion, which translated into a debt equity ratio of 7.23:1.

Novelis's Problems Novelis buys primary aluminum, processes it into rolled products, like stock for soft drink cans, and automotive parts, and sells it to customers–such as Coke and Ford. In order to increase business from soft drink manufacturers, it promised its four customers no increase in product prices even if raw material (aluminium) prices went up beyond a point. Few months after Novelis signed these contracts, aluminium prices shot up by 39%. Novelis was forced to sell its products at prices that were lower than the raw material costs. This led to losses of $350 million in 2006. The board replaced its CFO and CEO, Brian W Sturgell, in August 2006. During the period 2005-06, the company laid off employees and closed plants in Switzerland, Germany, Italy, France, etc. This resulted in charges of $46 million.

The Deal Kumar Mangalam Birla paid an enterprise value of almost $6 billion for Novelis. The stock market was not impressed with the decision. On Monday, the day after the acquisition announcement, investors dumped almost 7.3 million shares of Hindalco (the highest in nine months) on the BSE. The stock lost Rs 2759 crore in market capitalisation. Analysts had warned that the acquisition could bring down Hindalco's consolidated EPS by at least 25%. The valuation for Novelis was double Hindalco's current enterprise value/earnings before interest, taxes, depreciation and amortisation (EV/EBITDA) multiple. Rating agency, Crisil replaced its long-term rating of AAA/Stable with Hindalco with "rating watch with negative implications". Fitch, which rated both Hindalco and Novelis, placed both companies on ratings watch with negative implications. Analysts felt that the price paid for Novelis was too high. Concerns were raised regarding the funding process. There were two parts to the deal. Hindalco bought 100% of Novelis equity at $ 44.93 per share, which amounted to almost $3.6 billion. With a high debt equity ratio of 7.23:1, the Birla group would not be able to have a leveraged buyout. Hindalco borrowed $2.85 billion and 300 million was raised. The debt from group companies and $450 million have been mobilised from its cash reserves. The interest cost on this amount of $2.85 will be between Rs 700 crore-Rs 800 crore. The second part of the deal was the $2.4 billion debt on Novelis's balance sheet. Hindalco would have to refinance these borrowings though they would be paid with Novelis cash flows. Analysts believe that the Birlas have paid too high a price for a company that incurred a loss of $170 million for the nine months ended September 2006. The price Hindalco paid translates to a market capitalisation net profit before tax (PBT) multiple of 36 on Novelis's 2007 forecast.

The Hindalco management believes that Novelis will help the Aditya Birla Group to double its turnover to over $20 billion. Novelis will also give Hindalco entry into the downstream business of rolled aluminium products. At present the Hindalco business is limited to the upstream business of mining bauxite and converting it into alumina, and then smelting it into aluminium. Globally, about 35 million tonnes of aluminum is consumed every year. Hindalco does not have a presence in about 40% of this rolled products market. Novelis has a 19% world share. Similarly, in India, the rolled products market is expected to grow from 220,000 tonnes to a million tonnes in a few years. Novelis also has advantage with respect to technology. It has built a new fusion technology that increases the formability of aluminium, making it more suitable for products like sheet metal that help build cars with more curves. The low weight of aluminium in relation to its strength will find many new applications in the auto industry. It would take ten years for Hindalco to develop such technologies on its own. It would also cost $12 billion to build assets that match Novelis's 29 plants in four continents, with current production of 3.3 million tonnes. Hindalco's finished product, aluminium, is the raw material that Novelis uses to make stock for cans, auto parts, etc. Novelis will form a natural hedge for Hindalco. After Novelis' contracts expire in 2010 its business model and profitability will be LME independent. Though Novelis has a leading share in global rolled aluminium, it has limited pricing power. The rolled business is quite competitive. The spreads between primary aluminium and the selling price of rolled aluminium are sharply squeezed in periods of rising aluminium prices. After 2011, with more aluminium capacity at its disposal, Hindalco may find more synergies with Novelis. Analysts believe that aluminium prices could come down to $2400 a tonne. That could pull down Hindalco's profit margin, though Novelis' profits may not be affected.

STERLITE'S ACQUISITION OF HINDUSTAN ZINC LTD

Sterlite Industries (India) Ltd is the leading producer of copper in India. Sterlite is part of Vedanta Resources, a London listed metal and mining major with aluminium, copper and zinc operations in India and Australia. It was the first company in India to set up a Copper Smelter and Refinery in private sector. Sterlite India's main products include copper cathodes and copper rods. Through a couple of strategic consolidation moves, Sterlite embarked on the road to realizing its stated objective of becoming a significant player across almost the entire non-ferrous metals chain. The first move was its successful bid for the 51% equity stake in Bharat Aluminium Company (Balco) disinvested by the Union Government for Rs 551 crore.

Hindustan Zinc Ltd (HZL) was created from the erstwhile Metal Corporation of India (MCI) on 10 January 1966 as a Public Sector Undertaking. HZL produces zinc, lead and by products, sulphuric acid and silver. Hindustan Zinc Ltd (HZL) was India's leading zinc producer. HZL had six leading zinc mines with a combined annual capacity of 3.49 million tonnes. HZL was the only integrated primary producer of zinc and lead in the country and accounted for 80% of the total zinc production.

In 2002, the Sterlite Group bought controlling stake of 26% in Hindustan Zinc by paying a bid price of Rs 445 crore to the Union government. With an open offer, the total consideration for this acquisition was Rs 787.30 crore.

This acquisition helped Sterlite to emerge as a dominant player. As domestic supplies fell short of demand, the acquisition helped Sterlite to expand the production capacities of Hindustan Zinc to capitalise on the demand-supply gap in the domestic market.

Zinc consumption in industrialised countries was virtually stagnant due to replacement by alternatives, such as aluminium and plastics. Its consumption in emerging countries has risen despite the substitution effect and improvement in technology. This was expected to increase with rapid industrialisation in end user industries, such as transport, infrastructure and building activities.

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DISCUSSION QUESTIONS

1. Discuss the major consolidation activities undertaken by the Hindalco Group.
2. Explain the synergies involved in the Novelis acquisition?

Case Study 12

THE MITTAL ARCELOR MERGER

The steel industry had long fragmented capacity. Consolidation would increase the pricing power for both suppliers and buyers. The top ten auto companies, major buyers of steel, control about 95% of the market while the top three ore companies control 75% of supply. Consolidation would allow steel companies to adjust demand-supply issues. Commodity cycles have eroded steel companies' profitability. The companies have responded to downturns with price cuts and, in the process, destroyed shareholder value. The top five steel companies control barely 20% of the business. The top 20 global steel companies account for 30% of the one billion capacity.

Table CS12.1 *World's Biggest Steel Makers*

Steel Company	Production (in million tonnes)
Arcelor Mittal	110
Nippon	32
POSCO	31
JFE	30
BAO Steel	24
US Steel	20
Nucor	18
Riva	18
Thyssen Krupp	17
Tangshan	16

Source: India Today, July 10, 2006, page 42.

The Mittal-Arcelor combine created a 100 million tonne giant, controlling 10% plus of the global steel industry.

HISTORY OF MITTAL STEEL

Mittal, an India based company, was the fourth largest producer of steel before its merger with Arcelor. This group was formed when the two sister companies in the Mittal family, LNM Holdings and ISPAT International, were merged into Mittal Steels in 2004. The evolution of Mittal as a big entity came through the merger of many steel making companies–like Trinidad & Tobago based Iron & Steel Co. Sibalsa, Dosco, Ispat International, Island Steel Company, Unimetal, Alfasid, Iscar, Novahut, etc. and, as a result, the company made it to the list of Fortune 500 companies.

The focus of Mittal's growth strategy has been multiple acquisitions. In 2005, with the acquisition of ISG, the 20 million tonne American Steel Company, Mittal Steel emerged as the largest steel company in the world. In the last decade, Mittal Steel's capacity has grown more than 10 times.

Table CS12.2 *History of Mittal's Acquisitions*

Year	Company	Country	Value (in $ million)
1989	Iron & Steel Co	Trinidad &Tobago	
1992	Sibalsa Steel	Mexico	213
1994	Sidbec Dosco	Canada	455
1995	Karmet Hamburger Stahlwerke Ispat International Ltd	Kazakhistan	950
1997	Stahlwerk Ruhort & Walzdraht	Germany	16.4
1998	Inland Steel Co	US	1430
1999	Unimetal	France	120
2001	Alfasid Sidex	Algeria, Romania	NA
2003	Nova Hut	Czechoslovakia	905
2004	Polskie Huty Stali	Poland	1050
2004	Balkan Steel	Bosnia	NA
2004	Tepro Lasi	Romania	NA
2004	Siderurgica	Romania	126
2004	B H Steel	Bosnia	280
2004	Iscor Steel	South Africa	NA
2005	Hunan Valin	China	37.7
2005	International Steel, Kryvorizhstal	US Ukraine	4.5 billion 4.8 billion

Source: arcelormittal.com

In 2002, Mittal Steel signed an agreement with Iscor. In 2005, Mittal announced an investment of $9 billion in Jharkhand, India. In 2006, an investment plan for 12 billion tonnes capacity steel plant was announced in Orissa.

Arcelor Mittal and the Government of Liberia concluded the review of the mining development agreement. With this agreement giving access to iron ore mining, with capacity of 15 million tonnes a year, the Liberian government and Arcelor Mittal will be partners in jumpstarting economic recovery and development for Liberia. The $1 billion investment will bring around 3500 direct jobs and 15,000 to 20,000 indirect jobs.

MITTAL STEEL'S PRODUCT RANGE

Semi-finished Steel: In the form of slabs, semi-finished steel is used to roll into flat products. In the form of blooms or billets, it is used to make long products.
Flat Products: Mittal Steel makes a complete range of flat products. Hot rolled products are used in petrochemicals, construction, shipbuilding and general engineering industries; cold rolled products are used in automotive and white goods sectors. Finished products include aluminised, hot dip galvanised, electro galvanised and pre-phospated products.

Long Products This is a diverse range of finished products–spanning everything from automotive forgings to bright dawn free machining bars for precision engineering.

Wirerod Mittal Steel produces everything from 0.4 mm wire to high tensile steel rounds. At one extreme, they can be further processed into paper clips, while at the other, into suspension bridge cables.

Coated Steels Durable surface protection coatings have been developed for white goods, computer and hi-fi chassis, heating and ventilation.

Tubes and Pipes They are used in everything from oil and gas pipelines to general construction and manufacturing. Tubes and pipes are manufactured to survive the most hostile environments on the planet.

ARCELOR STEEL

Arcelor was formed in February 2002, when France's Usinor, Spain's Aceralia and Luxembourg's Arbed merged. The Luxembourg government owns 5.6% of Arcelor.

Arcelor was major player in all its main markets, which included automotive, construction, metal processing, primary transformation, household appliances and packaging. The company employed 94,000 employees in over 60 countries. With total sales of over Euro 30 billion, Arcelor was the world's largest steel manufacturer in terms of turnover. It produced long steel products, flat steel products and inox steel. In 2006, Arcelor acquired Dofasco, Canada's largest steel producer with an annual output of 4.4 million tonnes. Arcelor had to pay Can $5.6 billion after an intense bidding war against the German ThyssenKrupp.

THE GEOPOLITICAL IMPACT OF THE DEAL

In January 2006, Laksmi Mittal made a hostile bid for Arcelor. The world's largest steel company was ready to acquire the second largest steel company in the world. The Arcelor merger with Mittal Steel created the worldwide leader in steel industry.

The merger of Mittal Steel and Arcelor could barely control 10% of the global steel business. Mittal successfully took over the world's second largest steel maker in a $38.3 billion agreement.

Arcelor's directors, including Chief Executive Guy Dolle, had opposed the takeover. The French, Luxembourg and the Spanish governments strongly opposed the takeover. The Belgian government, on the other hand, declared its stance as neutral, and expressed interest in associating with both companies for future investments in research in Belgian steel plants. Indian Commerce Minister, Kamal Nath, warned that any attempt by France to block the deal would lead to trade war. Thus, Mittal's bid had stirred up passions in Europe, with politicians, ministers and ordinary citizens joining in. Other steel makers, like Japan's Nippon Steel, have adopted poison pills to thwart hostile takeovers in the future. When President Chirac visited India, Prime Minister Manmohan Singh intervened with a subtle hint, 'There should be no discrimination'. Commerce Minister Kamal Nath warned the Luxembourg government that Indian government would have to relook at the double tax avoidance treaty if the concept of national treatment under mode II was being re-written. Mittal succeeded in settling the geopolitics of the deal. The Mittal Steel team consisted of 100 people while the total number of people working on the deal was over 300, including investment bankers, lawyers, accountants, advisers and support staff. Goldman Sachs, CrediSuisse and Citigroup were the advisors for Mittal Steel. The advisors for Arcelor included Merrill Lynch, Morgan Stanley, Deutsche Bank, AG, BNP Paribas SA and UBS AG. JP Morgan was advising the government of Luxembourg. Lazard was the counsellor for the Belgian government. The investment banks reportedly earned $200 million in fees.

Attempts to Thwart the Deal

The first attempt to stymie the deal was transferring of subsidiary, Dofasco, into a trust. The poison pill was meant to keep away Mittal from buying Arcelor. After Mittal's hostile bid in January, Arcelor decided to put Dafasco into Netherland Trust as part of the bid. Arcelor's key plan was to keep Dafasco away from clutches of Mittal and to make acquisition difficult. Mittal rejected Arcelor's bid criticism and said that their company was paying Euro 21 billion and he was not after size for size's sake. He met European governments and convinced them that the takeover would not result in any loss of jobs, and the financial markets would remain positive after the deal. The French Prime Minister, Dominique de Villipin, described the bid as a 'hostile offer' and promised a hostile reaction. (This was because Mittal had once bid for it had divulged his intention to sell it to Thyssen krupp in his plans.) Arcelor CEO brought in a white knight. Mr Dolle, the CEO of Arcelor, chose Alexei Mordashov, a billionaire considered close to Russian President Vladmir Putin who ran the Russian Severstal, as its white knight. On May 26, 2006, Arcelor announced a deal with Severstal that would give it a controlling stake in Russia's largest steelmaker, and $1.59 billion in cash in exchange for 32% stake in Arcelor. But shareholders were apprehensive. Severstal belongs to the country which is not exactly known for corporate governance. The CEO of Arcelor also erred by making a unique case where over 50% shareholders were required to vote against the deal for it to fail instead of a simple majority. Investment banks advising Mittal Steel activated shareholders across regions to unleash shareholder rebellion. Mordashov of Severstal Steel offered to hold only 25 % of the Arcelor stock but that didn't work. Romain Zaleski, who owned 7.8% of the Arcelor stock, triggered the opposition to the deal with Severstal. Mittal had the support of Jose Aristrain who held 3.6% of shares of Arcelor. The unions too swung behind the deal as Mittal promised no job cuts. Breaking away from customary majority control in order to satisfy corporate governance concerns of shareholders, Mittal capped his stake under 45% and offered 12 of 18 seats on the board to independent directors, including those from the unions, and also agreed to a lock in on his shares for five years. By mid-June, the board of Arcelor was under pressure to consider the deal. Mittal raised his bid once again and took it to 40% over the original offer price, and a premium of 80% on the pre-offer price of Arcelor shares.

Severstal increased its valuation of Arcelor. The combined markets of France, Belgium, Luxembourg and Spain chided the Arcelor management, as it had undervalued its company and suspended trading of its stock. Arcelor presented a strategic plan to investors in a bid to persuade them that the company could generate more value as a standalone, than as part of Mittal Steel, and raised its dividend of Euro 5 billion. This has provoked the institutional shareholders not to re-elect the Arcelor Chairman and Vice Chairman in order to protest against not being consulted over the anti takeover tactic.

But on 25 June 2006, the Arcelor board decided to go ahead with the merger with Mittal Steel and scrapped plans for Severstal Steel. The new company was called Arcelor Mittal. Arcelor also paid Severstal Euro 140 million as fine for the fall-out of their talks. Lakshmi Mittal (owner of Mittal Steel) became the president and Joseph Kinsch (formerly, Arcelor chairman) was appointed a chairman of the new company till his retirement. Roland Junck, Arcelor's senior executive vice president became the CEO of the company. Aditya Mittal became the CFO of the merged entity.

Arcelor Mittal sold Thuringen long carbon steel plant to Grupo for Euro 591 million and Italian long carbon steel production, Travi e Profilati di Pallanzeno, to Dufero for Euro 117 million as a part of Mittal Steel's commitment to the European Commission. Arcelor Mittal acquired Sicarsta, the leading Mexican long steel producer, to create the largest plant in Mexico with an annual capacity of 6.7 million tonnes.

MAJOR TERMS OF THE DEAL

- Ownership of 50.5% for Arcelor investors and 49.5% for Mittal Steel investors
- Arcelor shareholders got 13 Mittal Steel shares plus Euro 150.60 in cash for 12 Arcelor shares
- After the $33.7 billion (Rs 1,52,000 crore, approx.) deal, 43% of the shares were with the Mittal family, thus creating the largest steel company
- One share one vote agreement
- Lakshmi Mittal succeeded Kinsch who was chairman till 2007
- The board had 18 members–six from Arcelor, six from Mittal Steel, three from among Arcelor shareholders, and three employees' representatives
- Management board comprised of seven members–four from Arcelor and three from Mittal Steel
- CEO to be proposed by the Chairman
- Mittal family agreed to a standstill at 45% of share capital and a five year lock-in.

Salient Features of the Merged Entity

- The new company, with production of 110 million tonnes, would be three times larger than its nearest rival.
- It would occupy the number one slot in North America, South America, Europe and Africa.
- Its 61 plants, located in 27 countries, would enhance revenues being earned at the time of the merger, to $77.4 billion and profits to $14.4 billion.

EXPECTED SYNERGISTIC BENEFITS OF THE MERGER

Ever since Mittal Steel has announced its bid for Arcelor, share prices of both companies have risen. Between the two of them, Mittal Steel has created Euro 10 billion in value.

The merger will give Arcelor entry into emerging markets and access to raw materials through low cost operations of Mittal Steel. It will also create leadership position for Arecelor in North America, and strong R&D capabilities. For Mittal Steel, the merger is expected to give leadership position in high-end steel segment in Western Europe, and access to low cost manufacturing in Brazil. Increased free float and liquidity for shareholders is another benefit accruing from the merger. Mittal was not making the kind of high value steel-like flat products, cold rolled and stainless steel—that Arcelor was producing. Arcelor's presence was mostly in West Europe and South America where Mittal did not have presence. Arcelor's geographical presence synchronised with Mittal's in America, and in the high growth areas of East Europe and Asia. Mittal's access to raw materials and plenty of commodity steel would be value-additions at Arcelor's plant, resulting in cost savings of one billion dollars. As a result of the merger, Arcelor Mittal accounted for 10% of world's steel production.

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DISCUSSION QUESTIONS

1. In macro environmental perspective, what is the significance of the Arcelor Mittal merger?
2. Does the Arcelor Mittal merger make sense with respect to value creation?

Case Study 13

THE TATA CORUS DEAL

Consolidation is good economics in a fragmented market. The top five global steel players now account for more than 20% of global production. In the steel sector, the suppliers and buyers of steel makers are well consolidated. In iron ore supplies, the three major players–CVRD, Rio Tinto and BHP Billiton-have three-fourth market share and average margins of over 40%. Auto makers, who buy finished steel, are also well integrated with major global players (6–7). Steel industry grew by 6-7% annually during the period 1945-75. This was due to the economic growth witnessed in Europe and USA. During the period 1975-2000, the industry grew, on an average, by just 1%. In the 1990s, the growth was even lower at 0.4%.

Table CS13.1 *Top Acquisitions in Steel*

Target	Acquirer	Rank Value ($ million)
Arcelor	Mittal Steel	43,632
NKK Corp	Kawasaki Steel	11,895
Dofasco Inc	Arcelor	5,269

Tata Steel, with its 100 year history and ranking 58 by production in 2005, bid for UK based Corus, which was four times its size, in the face of fierce competition from resource rich Brazilian company, Companhia Siderurgica Nacional (CSN), and finally bought it by offering 608 pence a share for acquiring 1.01 billion outstanding shares.

Tata outshoned its Brazilian rival,[1] CSN, for the $12.1 billion Corus. The combined entity became the fifth largest producer in the world, and second in Europe.

Corus makes nearly four times more steel than Tata Steel. Tata Steel, in August 2004, acquired Singapore based Natsteel for $486.4 million, thus gaining access to South East Asia, Australia and China. During the period December 2005-March 2006, it bought 67% stake in Thailand based Millennium Steel, and also entered into a joint venture agreement with Australia based Blue Scope Steel. The Tata Group's international business, which stood barely at $2.5 billion in FY 2003, went up to $6.7 million in FY 2006. About 30% of the group's aggregate revenues of $22 billion come from international markets.

THE HISTORY OF CORUS

In the year 1999, British Steel and the Dutch Koninklige Hoogovens merged to form Corus, the largest steel maker in Europe. But the merged entity could not integrate well. Sale of its aluminium business was proposed

[1]Piya Singh, 'Making Corus Work', Business World, 19 February 2007, Page 33.

and then aborted. The merged entity saw an operating loss of $1.152 billion. The company had been operating under the shadow of a merger for the past few years. Phillipe Varin took over as CEO of the company in 2003. Varin launched the 'Restoring Success' programme, targeting cost savings of about £680 million, over the three and half year period. By the end of 2005, Corus had effected savings worth, 555 million and the gap between its earnings before interest, tax depreciation and amortisation (EBITDA) margin of 10%, and that of its competitors had dropped to 4.5%.[2] During the period 2003-2005, the number of suppliers was reduced from 16,000 to 9000, and employee productivity was raised by 5%. Its ratio of on-time deliveries increased to 85% from 75%. The sale of aluminum business in 2006 for $570 million to Aleris, a US based aluminium company, helped Corus reduce its debt considerably. Varin and his team consolidated the flat products business in Port Tablot. Corus had also entered into a long-term offtake agreement for 10 years with a consortium of four steel makers, including Dongkuk from South Korea and Duferco from Sweden. These companies had access to 80% of the slabs produced on cost basis.

It is primarily engaged in manufacture of semi-finished and finished carbon steel products. Corus is UK's largest steel company, with a workforce of 47,000 people spread across 40 countries. Its production facilities are spread across various locations in the UK (14 million tonnes) and Netherlands (6.8 million tonnes). It enjoys exclusive presence in Western Europe and UK, serving the automobile, construction, engineering and package sectors. Outside UK and other regions of Europe, it has less than 20% market share. The main divisions consist of long product, strip product, distribution and building systems, and aluminium divisions. The long product division makes plates, sections, engineering billets, railway products and custom designed steel. The division has 11,500 employees. The strip product division makes coated steel, tubes, hollows pre-finished steel, HR and CR steel. The distribution systems consist of services centres, consultancy and service solution for trade. The aluminium division consists of smelters. Corus gets iron-ore and coke mainly from Australia, Canada, South Africa and the US. Since the year 2003, Corus was facing the challenge of restoring the competitiveness of the company. On the financing side also, the company was facing problems. The company had huge debts and went into a rights issue in 2003.

Corus imports around 25 million tonnes of iron ore a year, principally from Brazil, South Africa, Australia, Canada and Venezuela. It controls 14% of the European auto market. Automobiles is a major thrust area for the Tatas. Corus has plants in UK, Netherlands, Germany, France, Norway and Belgium, and is listed on the London, Amsterdam and New York exchanges. Corus reaches out to markets that Tata Steel does not have access to, including Europe, which accounts for 53% of the Corus turnover.

THE HISTORY OF TATA STEEL

Established in 1907, Tata Steel is Asia's first, and India's largest private sector steel company. Tata Steel is among the lowest cost producers of steel in the world, and one of the select steel companies in the world that are EVA+. Its captive raw material resources and state of art 5 MTPA (million tonne per annum) plant at Jamshedpur in Jharkhand State, India, gave it a competitive edge. Tata Steel had included in its fold, Nat Steel Asia (92 MTPA) and Millennium Steel (now Tata Steel Thailand), creating a manufacturing network in eight markets in South Asia and Pacific-rim countries. It is a vertically integrated manufacturer, and is one of the world's most profitable and value creating steel companies. The company has rich iron, dolomite, chromium and manganese mining and related assets. It currently produces over 9 million tonnes of iron ore. Though it is well represented in South East Asia with Nat Steel and Millennium Steel, it has no presence in Europe. For Tata Steel, almost all of its turnover comes from Asia, mainly India, South East Asia and China.

[2]Pallavi Roy and Mobis Philopose, Cover story, 'This is Corus', Business World, 19 February 2007, Page 38-39.

THE BIDDING WAR

Tatas had great interest in Corus. Tatas initially started with a 455 pence all cash bid per share on October 20, 2006. Thus, Corus was valued at £4.3 billion. CSN made its first bid on 17 November 2006, offering 475 pence per share. Tata upped the offer on 11 December, valuing the enterprise at £4.7 billion, followed by the CSN offer of 515 pence and thereafter on 31 January, 2007. Tatas were willing to bid higher than the 608 pence that sealed the deal. The first counter bid by CSN was the turning point in the whole episode, when a friendly negotiated deal turned into a fierce battle. Ratan Tata's team members included B Muthuraman (MD, Tata Steel), Arun Gandhi (Chief strategist and Head of M&A division), Koushik Chaterjee (Vice President, Finance), and Ishaat Hussain (Director of Steel). The Tatas' external advisory group consisted of representatives of ABN Amro Bank, Duetsche Bank, Credit Suisse and Rothschild.

Tatas maintained a low profile compared to CSN'aggressive stance which was part of the overall tactical plan. It was stated that when bidding began, Arun Gandhi, the M&A whiz of the group was stationed at the office of the group's lawyer on Primrose Street, London EC2A2HS, all night–with a motorcycle stationed kerbside, revved up and ready to go in case networks failed and email bids could not be sent. Each bidder had to email his bid during each round from his own solicitor's office. The bidding was to go on for nine rounds, during which a minimum of 5 pence enhancement per share was allowed over the offer made by each party. In the ninth round, the parties had to put in their final bids, besides indicating the maximum amount they were willing to pay in case theirs was the lower bid. When Tata Steel bid 608 pence per share, their bid was higher than the last bid put in by CSN by 5 pence.

Market Reaction during the Acquisition Process

Research has shown that the acquirer tends to lose value in a merger announcement. Tata Steel had lost billion dollars in market capitalization since it first announced its intention to buy Corus in October 2006. The BSE sensex rose 18% during the same period. On the day the deal was stuck, opening lower at a gap of nearly 2% over its previous day's close of Rs 519 on the BSE, the share was pounded to Rs 461 within minutes of the opening session. The 12% drop was amongst the steepest witnessed in the scrip since the takeover announcement was made. The deal had implied a high enterprise value/earnings before interest, taxes, depreciation and amortization (EV/EBITDA) multiple of 9 for Corus versus 4.6 for Tata Steel. Interestingly, CSN's market value has risen by about $1.6 billion since it lost the Corus bid.

STRATEGIC REASONS

The steel industry is witnessing consolidation. The companies are moving efficient material which is steel based (deintegrated production) instead of moving large quantities of iron ore. The company aims to focus on adopting a philosophy of deintegrated production. The major strategic reason for the acquisition, as described by Tata Steel, is to adopt the deintegrated method of steel making, whereby the focus would be to break up the supply chain and produce parts of it that make most economic sense. Low cost steel producing countries like India, Brazil, Russia and China are building enough of slab capacity on account of their proximity to iron ore. In order to market these slabs, expansion at the global level is very important. Corus' product portfolio would be a perfect fit for Tata Steel's deintegrated production strategy—make the raw or semi-finished steel in India and value-add in Europe. In other words, Tata Steel's deintegrated strategy is two pronged: steel making close to raw materials (iron ore, coal, gas) and production of finished steel in markets with a high rate of GDP growth where demand for finished steel from construction sector is high. Volumes in the steel business come from the construction and engineering sectors which are the core areas of Corus. Corus' concentration on high-end, value-added products could fit in well with Tata Steel's stated strategy which is to get 'more from steel' via branding and value-added products.

Tata Group was convinced that long-term synergies in manufacturing, access to global customers, along with leverage in Research and Development would result due to the Corus acquisition. The acquisition was also expected to result in cost savings of $350 million per year. The deal was expected to increase Tata Steel's capacity exponentially and give it a wider customer and enhanced product portfolio. Significant cost savings were expected by exporting cheaper inputs (slabs) from India that would be processed in Corus' plants in UK. The export of low cost slabs from India would be the key to improve Corus' profitability. Tata Steel has to get its green field expansions in Orissa, Chattisgarh and Jharkhand to have spare slab facility. It will have to work soon to ensure its upstream activities outside of Corus are up in time to boost Corus' capability.

The combined entity would emerge as the second most geographically diversified steel company. It will have access to high value-added product mix and strong market positions in automotive, construction and packaging industries. The combined entity would also emerge as the second largest tin plate maker in the world. The value creation in terms of synergies will result from sharing of manufacturing practices, shared services and purchasing. Synergies will also result from sharing complementary strengths. Corus has strong R&D and product development capabilities for value-added products in the auto, construction and packaging markets, which will complement Tata Steel's products in the fast growing Asian markets. [3]

BENEFITS OF THE ACQUISITION

- The acquisition positions the combined group as the fifth largest steel company in the world, with meaningful presence in both Europe and Asia.
- The powerful combination of low cost stream production in India with the high-end downstream processing facilities of Corus improve the competitiveness of the Corus' European operations significantly.
- The combination also allows cross fertilisation of research and development capabilities in the automotive, packaging and construction sectors, and transfer of technology, best practices and expertise.
- Tata Steel retains access to low cost raw materials and slab for enlarged group, and exposure to high growth in emerging markets.
- Tata gets a very good international distribution network.
- Tata gets access to low cost slabs: Steel makers in India enjoy a 20% cost advantage in slab making over their European peers. The ability to export surplus slabs, either from Tata Steel facilities or through acquisitions in low cost regions, is one of the key drivers of the deal.
- It would cost between $1200 and $1300 per tonne to set up a greenfield capacity anywhere in the world, going downstream, as much as Corus has, in terms of tin plate capacity, galvanizing and construction solutions.
- The Corus acquisition will immediately add 19 million tonnes of capacity to Tata Steel, apart from giving it access to growth markets of Europe where quality of products and services are very important.

FUNDING FOR THE DEAL

Corus acquisition was routed through a special purpose vehicle (SPV), Tata Steel, UK. The funding was for 60:40 debt equity. The Group holding was expected to pump in $4.1 billion as equity into the SPV. The balance $8 billion was to be raised through junk bonds and senior term loans from banks, like ABN Amro

[3]Pallavi Roy, 'The man who bought Corus…and the one who made it worth the buy', Business World, 19 February, 2007, Page 36-37.

Bank, Deutsche Bank and CSFB. Of the \$4.1 billion equity component of the deal, Tata Steel have injected \$2.3-\$2.4 billion into the SPV. Tata Sons sold 0.84% stake, raising more than Rs 1000 crore in the process. Tata Steel has subscribed \$2.8 billion equity in the SPV. Equity contribution from Tata Steel was placed at \$3.88 billion with fully underwritten debt package of \$5.63 billion. The debt was to be raised on the assets of Corus and repaid through its future earnings. A \$2 billion bridge loan facility has been tied up with Standard Chartered Bank and ABN Amro India, repayable after a year, a part of which has been used to buy around 21% of Corus shares tendered. The booming conditions in the steel industry have also allowed Tata Steel to bring down its debt equity ratio from its peak of 2.78 in 2001-02 to 0.29 in 2005-06.

VALUATION PERSPECTIVE

As per statistics of the IISI, in 2005, Corus' annual production was 18 million tonnes (mt), while that of Tata Steel was at 5 mt. Corus turnover worked out to \$18 billion as compared to Tata Steel's \$4.64 billion in FY 2006. The enterprise value was placed at \$10 billion, including its outstanding debt. Brokerage house, First Global, estimates that a \$50 fall in global steel prices could lead to a \$414 million loss from the acquisition in the FY 2008.

People often argued that Tata had paid a higher price than what was paid for Arcelor. The price earnings ratio (the number of times the price is paid over the current years earnings), at 14.8 times was also high. In case of Arcelor Mittal deal, the acquisition price per tonne worked out to \$840 as against \$750 paid by Tatas for Corus assets, even though the EV/EBITDA in the case of Tata Corus is higher at 7.6, as against 5.4 in Mittal's case. According to Choksey's estimates, the realisation per tonne in case of Corus is higher than Tata Steel, at \$866 per tonne, as against the average realization of \$674 per tonne. The operating profit of Tata Steel was at \$270 per tonne which was four times that of Corus.

At 608 pence per share (which worked out to a price of £5.2 billion) the enterprise value is seven times Corus' EBIDTA (earnings before interest, depreciation, taxes and amortization) for December 2005. In terms of EBITDA, as against a 5.4 times payment of Mittal Steel for acquiring Arcelor, Tata Steel paid nearly 7.6 times. The premium was for consolidated capacities.

Logic for the Valuation

According to Muthuraman, Tata Steel MD, the strategic objective of the deal is that it brings to Tata Steel 19 million tonne capacity at once, at a cost which is roughly a little more than half the cost of greenfield sites. It also gives the company access to mature and developed markets of Europe. Moreover, Corus also has highly developed R&D capabilities. Corus, which has multi-locational plants, is not a fully integrated steel company. Unlike the Tatas, who have their own coal mines and captive source of iron ore, Corus has to source its raw materials from the global markets. The higher the value added, wider the specialty product range that Corus can add to the Tatas product range. The Tata Group, which had embarked upon a major expansion spree by setting up greenfield projects, is looking at exporting a part of the semi-finished products from these capacities to Corus, which would bring down costs considerably.

Riding the steel cycle boom, beginning in 2003, its cash flow from operations crossed Rs 6000 crore in both FY 2005 and FY 2006. With profits of over \$840 million, Tata Steel was the group's most profitable, company, even ahead of its high profile TCS, in FY 2005.

THE CHALLENGES AHEAD

Tata Steel's financials, to a great extent, hinge on the future behaviour of the steel prices. Labour is a contentious issue that the Tata Management has to deal with. Cultural issues are other important aspects of the deal. Tatas have been managing workers across continents.

The payoff may not be immediate, as the merger may take 5-7 years to realize its full potential.

Table CS13.2 *Global Steel Production (in million tonnes)*

Company	Million tonnes
Arcelor Mittal	109.7
Nippon Steel	32
POSCO	30.5
JPE	29.9
Tata Corus	23.5
Bao Steel	22.7

Source: Business India, November 05, 2006.

Table CS13.3 *Global Market Share*

Company	Global Market Share (%)
Mittal, Netherlands	5.56
Arcelor, Luxembourg	4.15
Nippon, Japan	2.82
Posco, South Korea	2.74
JFE, Japan	2.65
Bao Steel, China	2.12
US Steel, USA	1.77
Corus, UK	1.59
Riva, Italy	1.59
Nucor, USA	1.59
ThyssenKrupp, Germany	1.50
Tata Steel, India	0.4
Rest	72

Source: Business India, November 05, 2006.

Table CS13.4 *Corus Employees by Location at End January 2010*

UK	21,405
The Netherlands	10,861
Germany	1,256
Other countries	3,638
Total	37,160

Source: www.corusgroup.com, May 20, 2010.

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DISCUSSION QUESTIONS

1. What are the strategic reasons for the Tata Corus deal?
2. Discuss the valuation aspects involved in the deal.

Case Study 14

ACQUISITION OF HUTCH BY VODAFONE

The Indian telecom juggernaut continues to roll. The telecom sector has touched Indians in ways no other infrastructure has till date. In 1994, when it was launched it was a rich man's status symbol. As the licensing policy changed, competition led to decreased prices. It was widely adopted in most major cities by the middle class. In 2007, out of 250 million telecom subscribers, 200 million were mobile phone users. Mobile telephony is coming of age, and is changing the way India communicates. Mobile revenues already account for 57% of the $22.5 billion (Rs 101,250 crore) Indian telecom market. By 2010, it is expected to account for 76% of an estimated $43.6 billion (Rs 196,200 crore) market.

The multi-billion dollar acquisition of Hutch by Vodafone is an evidence of the robust telecom sector, with significant consumer, revenue and market capitalisation growth. Mumbai based Hutchison Essar, India's fourth largest mobile operator, is among India's most respected telecom companies. The decision of Hong Kong based Hutchison Whampoa's subsidiary, Hutchison Telecommunications International, to exit the venture was unexpected. After three months of minute media coverage, UK based Vodafone picked up the Hutch stake for $11.08 billion (Rs 48,752 crore). Among the losers was the Anil Ambani led Reliance Infocomm.

Table CS14.1 *Top Four Global Telecom Deals*

Date Effective	Target	Target nation	Acquirer	Acquirer nation	Value of deal ($ bn)
9 March 1999	Tele Comm Inc	US	AT&T Corp	US	69.90
19 June 2000	Mannesmann AG	Germany	Vodafone Air Touch PLC	UK	202.79
8 October 1999	Ameritech Corp	US	SBC Comm. Inc	US	70.39
30 June 2000	GTE Corp	US	Bell Atlantic Corp	US	71.32

Source: Business World, 15 January 2007, Page 38

VODAFONE

Vodafone is the world's leading international mobile communications group with operations in 25 countries across five continents, and over 200 million proportionate customers by the end of January 2007, along with 36 partner networks. The seven markets where Vodafone has more than 10 million proportionate customers are Germany, India, Italy, Spain, Turkey, United Kingdom and United States. Vodafone was the largest telecom operator globally in terms of revenues of around $58 billion in 2006. The revenues roses to $64.30 billion in the period ending March 2010. The net profit was $12.5 billion in March 2010 compared to

$4.45 billion in 2009. On 31 December 2009, based on the registered customers of mobile telecommunications ventures in which it had ownership interests at that date, the group had 333 million customers, excluding paging customers, calculated on a proportionate basis in accordance with the company's percentage in these ventures.

The company has presence in 27 countries – either directly as an operator, or as an investor in other telecom companies–and has a total customer base of close to 200 million, excluding Hutch-Essar. The company employs nearly 60,000 people worldwide. In January 1999, UK based Vodafone made its maiden entry into India when it merged with US based AirTouch. AirTouch had 49% stake in Madhya Pradesh's RPG Cellcom, and 20% in RPG Cellular in Chennai. By 2003, Vodafone had exited the Indian market. In October 2005, it picked up 10% stake in leading mobile operator, Bharti Televentures, for $1.5 billion (Rs 6,700 crore).

HUTCH ESSAR

Hutch Essar was the leading Indian telecommunications mobile operator with 23.3 million customers. With 16% share of the national telecom market, as in October 2006, Hutch is the fourth largest telecom player after Bharti Airtel, which leads with 22% market share, followed by BSNL (20%) and Reliance Infocomm (18%).

The origin of Hutch Essar

1994: C Sivasankaran sells 51% stake in Delhi's Sterling Cellular to Essar Group

1995: Hutchison Max mobile goes live in Mumbai; Essar Cellphone starts services in Delhi

1996: Swisscom sells 49% stake in Essar Cellphone to Hutchison

1998: Max's Analjith Singh sells 41% stake in Hutchison Max to Hutchison Hong Kong

2000: Hutchison acquires 49% stake in Sterling Cellular. Buys Kolkata's Usha Martin Telekom

2001: Hutchison buys 49% stake in Gujarat's Fascel. Gets licences for Karnataka, AP and Chennai

2003: Aircell Digilink becomes part of Hutch

2004: Essar picks up France Telecom's 9.9% stake in BPL Communications

2005: Essar picks up BPL Comm for Rs 4,400 crore. Essar Tele Holdings buys Max Telecom, Ventures 3.16% stake in Hutchison Essar for Rs 657 crore

2006: Kotak sells 8.33% stake to Analjith Singh for Rs 1,019 crore. In June 2006, Hutchison paid $450 million to buy Hinduja's 5.11% stake in Hutch Essar.

In 1994, when the Ruias made their first investment in telecom (a 49% stake in Delhi's Sterling Cellular), India was a piffling telecom market where mobile telephony had yet to happen. Over the years, they shored up their stake to 33%, spending barely $1.5 billion in all.

Towards the end of 2005, when Hutchison sold 19.3% stake in Hutchison Telecommunications International (HTIL), the holding company that owns its stake in the JV, to Egyptian operator Orascom, Essar protested against the sale as it effectively gave Orascom 10% stake in the Indian joint venture. Ruias existing 33% in the joint venture made it more than likely that any prospective foreign buyer will want to have Essar on it side. Moreover, since Indian regulations allow upto 74% equity in FDI in a telecom company operating in India, any global player, such as Vodafone, wound need an Indian partner by law.

Essar's interest in the telecom sector dates back to 1995-96 when the company had applied for licences for Delhi, Haryana, Rajasthan and UP circles. Hutchison and Essar came together in 1999 when Hutchison picked up 49% stake of Swisscom AG, Essar's then joint venture partner who was exiting India. Essar acquired Kolkata and Gujarat circles. When the fourth licence bids came up, the company jointly bid for four southern circles through Hutchison Essar South. Essar's UP East, Rajasthan and Haryana circles were sold to Hutch. The consolidation of all these circles took Essar's stake to 26.99%, with Hutchison Max Telecom being renamed Hutchison Essar in February 2005. The acquisition of Usha Martin Telematics Ltd's 3.43% stake in Hutchison Essar on 30 June 2005 for Rs 267 crore increased Essar Group's stake in Hutchison Essar to 30.42% . BPL Cellular's three circles were sold to Hutchison Essar. It paid Essar Teleholdings $345 million for BPL's Mumbai circle. Essar started by first acquiring 10% stake in BPL and then increasing it by acquiring one shareholder's stake at a time. Once Essar got 100% stake in BPL, the company was merged into Hutchison Essar. After BPL's acquisition in 2005, the south circles, Kerala and Tamil Nadu, as well as Maharashtra, increased the company's footprint.

In November 2006, Hutchison Whampoa announced its intention to sell its stake in Hutchison Essar. In March 2007, the $54.8 billion Vodafone bagged Hutchison Essar, India's fourth largest mobile operator, by paying $11.08 billion (Rs 49,860 crore) for 67% stake. In the process, it edged out Hutch's 33% partner, the Essar Group, Anil Ambani led Reliance Communications (RCom) and the London based Hinduja Group. Vodafone had offered to pick up Essar's 33% stake at the same valuation. Vodafone has a presence in 16 of India's 23 circles, plus licences for another six. Hutchison Telecommunications International (HTIL) obtained $8.48 billion by exiting the Indian operations.

The company got Foreign Investment Promotion Board's permission for name change after one month of the acquisition's announcement. This was probably one of the biggest brand changes in India. The brand change will impact 35 million customers, 400,000 retail outlets, business partners and suppliers and their employers.

Hutchison hasn't exactly stated why it wants to exit India, the least objectionable version for both partners being that Hutchison has lined up investments in 3G Technology in around 10 European markets, and needs money to bankroll it. Hutchison, which has invested over $25 billion in European 3G networks, has been known to cash out when the valuation is right. It sold its stake in Hutchison Telecommunications Paraguay in 2005 to Mexico's America Movil.

Sarin, the CEO of Vodafone, has been under pressure to increase the company's presence in emerging markets where growth is significantly higher. Vodafone is sitting on a pile of cash (free cash reserves of £3 billion in the first six months of 2006).

Bharti Televentures is valued at Rs 54018 million (Rs 540 crore). Bharti had 46.81 million subscribers, as in August 2007, giving it a market share of 31.70%. Hutch Essar (now Vodafone Essar) had 34.11 million subscribers with a share of 23.10%. This would value the Hutch brand at over $1 billion.

The Indian acquisition fits into Vodafone's focus on the EMAPA (Eastern Europe, Middle East, Africa, Asia Pacific and affiliates) markets. Vodafone sold assets worth $15.8 billion in Japan and Sweden and got out of minority stakes in Switzerland and Belgium. In the end of 2005, it acquired Turkey's Telsim for $4.5 billion.

STRATEGIC REASONS

Vodafone's acquisition of Hutchison's 67% stake in Hutch Essar may be due to its compulsion to enter the high growth Indian market. Hutch Essar was the fourth largest mobile operator in India, with 24.41 million subscribers. Vodafone was the least leveraged of all the bidders. It had $5 billion from the sale of its Japanese unit for $15 billion. It would also get $1.62 billion cash from its 5.6% stake sale in Bharti. Vodafone had free cash reserves in excess of $3 billion. It also sold its 25% stake in Swisscom Mobile and exited Belgium. Vodafone is targeting 100 million Indian subscribers in three years–Hutch had 24.41 million. Hutch have been adding around one million subscribers a month while market leader Bharti has been adding 1.75 million subscribers per month. Vodafone has earmarked an investment of $2 billion over the next couple of years to strength its presence. Vodafone has based its valuation on the growth trend of Indian mobile sector. No other country is adding over 6 million subscribers every month. The mobile penetration is expected to touch 40% by 2011-12. By then, Vodafone expects to control 20 to 25% of the market, against 16% now. Vodafone will have to bid for 3G spectrum.

The Hutch brand has premium positioning, and is one of the most recognisable brands in the industry. Hutch Essar is the third largest GSM mobile operator, and fourth largest overall operator in India with a premium customer base and average customer revenue, which are higher than industry average. India has been the most attractive telecom destination. The Indian telecommunication industry is among top 15 countries of the world.

VALUATION

The total valuation of $18.8 billion was considered a major issue with Vodafone investors. Vodafone paid $11.08 billion for the 67% stake. It would also assume Hutch-Essar's net debt of $2 billion, taking the enterprise value to $18.8 billion. The $18.8 billion valuation by Vodafone means that the company has offered $770.2 per subscriber, a 53.4% increase. The Vodafone's advantage is that at Rs 374, Hutch Essar has the highest average revenues per user (ARPU) in India.

Benefits from the Acquisitions

The acquisition has Accelerated Vodafone's move to the controlling position as a leading operator in the attractive and fast growing Indian mobile market.

As the fastest growing telecommunications industry in the world, it is projected that India will have 1.159 billion mobile subscribers by 2013. Vodafone has infrastructure sharing MOU with Bharti to substantially reduce network operating expenditures and capital expenditures.

Reliance Communications has no option but to build its own GSM network (as announced) as there are not many reasonably sized players in the mobile telecom space. After Hutch, the next big players are Idea Cellular and Aircel. Idea Cellular, owned by Aditya Birla Group, is currently in the process of raising funds through IPO for its expansion. The alliance between Bharti and Vodafone would add a completely new dimension to this battle for growth.

The acquisition is a major strategic move for Vodafone as it gives the company strong presence in a fast growing market. Though the Hutch brand has premium positioning and is one of the most recognisable brands in the industry, Vodafone has replaced it with its own brand.

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DISCUSSION QUESTIONS

1. Discuss the significance of the Vodafone Hutch deal and the expected synergies from the deal.

Case Study 15

THE GROWTH STRATEGY OF TATA GROUP THROUGH MERGERS AND ACQUISITIONS

Tata Group is one of India's largest and most respected business conglomerates. The group comprises 93 operating companies in seven business sectors, namely information systems and communications, engineering, materials, services, energy, consumer products and chemicals. Tata Group was focusing on the strategy of extending its presence in international markets. Its overall acquisitions during the seven years, 2000–2006, have crossed the $2.5 billion mark. Tata's strategy was to rationalise the group's business portfolio and deliver returns on investment that exceeded the cost of the capital. It aimed to have a symbolically unified brand and grab new opportunities.

Tata Steel's latest acquisition—the 18-million tonne Corus Steel, the second largest European steel maker with footprints in the US and Europe, and nearly four times Tata Steel's size, for $8.2 billion—is the biggest cross-border transaction by an Indian company. It also makes Tata Steel the fifth largest steel maker in the world. In the past six years, the Tata Group has made about 21 overseas acquisitions, investing around $12 billion (Rs 54,018 crore) till date. In fact, 30% of its Rs 96,723 crore revenue comes from overseas businesses. The company focuses on finding a 'strategic fit' for its acquisitions. Tata Tea, in the year 2000, paid $407 million for UK's Tetley Tea, a company that was nearly thrice its size. The deal catapulted Tata Tea to the no. 2 spot among the world's tea makers, and gave it an international beverage brand. With 15 acquisitions worth $13 billion in 2005, and 17 deals worth $12 billion, the Tata Group is gaining reputation in the international mergers and acquisitions circuit. Before the Corus acquisition, the 125 companies in the group had a consolidated net worth of $12.03 billion and borrowings of $6.18 billion.

The deal with Daewoo Motors heralded Tata Motors' big-ticket entry into the medium and heavy commercial markets of China and South East Asia, and also rejuvenated its own truck making division through production of bigger vehicles. During the period 2000 to 2006, a number of significant acquisitions were made by Tata Tea. Its 30% equity stake buyout of Energy Brands, a top US player in the enhanced water category, in 2006 transformed Tata Tea into a global beverages giant. The acquisition of Tyco Global Networks, one of the advanced and extensive submarine cable providers in the world, in November 2004, gave VSNL control over a 60,000-km cable network spread over three continents.

Another significant merger was between Tata Chemicals (TCL) and Hindustan Lever Chemicals Ltd (HLCL). As per the proposed scheme of the merger, HLCL shareholders were issued TCL shares in the ratio 2.5:1. The businesses of TCL and HLCL had natural synergies that contributed to a superior operating model. TCL's inorganic chemical business was a natural fit with HLCL's bulk chemicals business. TCL was the largest manufacturer of soda ash, the key raw material for the production of detergent, whereas HLCL was India's largest manufacturer of sodium tri-polyphosphate (STPP), used as builders in detergents. TCL's fertilizers were highly complementary to HLCL's operations. Post merger, the company was able to offer wide range of complementary products and support services to the current base of customers. This was the third time that the Tatas and HLL were coming together. Previously, the two groups came together during the HLL-Tomco deal in 1993 and Lakme-Lever deal in 1998. After the acquisition of Brunner Mond group, Tata Chemicals had become the world's largest producer of soda ash. Prior to the acquisition, Tata Chemicals had soda ash capacity of 0.9 million tonnes. Brunner Mond had a capacity of 2 million tonnes, spread over four plants, and was the second largest producer of soda ash in Europe, and the fifth largest globally.

Tata Power acquired 30% stake in major Indonesian thermal coal producers, PT Kaltim Prima Coal and PT Arutmin Indonesia.

THE NATSTEEL ACQUISITION

The National Iron and Steel Mills Ltd (NISM) was incorporated on 12 August 1961 to manufacture and produce iron and steel products. In 1990, the company changed its name to 'NatSteel'. The Singapore based company spun off its entire steel business into a wholly owned subsidiary, NatSteel Asia Pte Ltd (NatSteel Asia) in 2004. NatSteel enjoyed good brand recognition in Singapore and in the other South East Asian region. There was growing demand for long products, especially in the Asian region. Tata Steel would like to have equal presence in both long and flat products. NatSteel employed over 3000 employees across Singapore, China, Thailand, Vietnam, Malaysia, the Philippines and Australia. The company produced around 2 million tonnes of premium steel products for construction industry in the region.

In February 2005, NatSteel Asia was sold to Tata Steel in India. Tata Steel purchased Singapore NatSteel Ltd for Rs 1,313 crore ($286.12 million). A part of the deal included 26% stake owned by NatSteel in Southern Steel Berhad, the 1.3 million tonne steel maker in Malaysia. NatSteel thus became wholly owned subsidiary of Tata Steel. NatSteel is well placed to tap into Tata Steel's extensive resources to further expand in the region. This acquisition not only gave Tata Steel manufacturing footprint in seven new countries in Asia–Singapore, China, Malaysia, Thailand, Australia, Vietnam and Philippines, it also gave geographic access to the Asian region. Tata Steel's acquisition of Singapore-based NatSteel—a 1.7-million tonnes per annum steel business—in 2004 was a strategic initiative to enter the high growth geographies of China and South East Asia.

Advantages of the Acquisition

The main advantage of the acquisition was lowering of input steel costs. NatSteel Asia and Tata Steel would be able to offer a more comprehensive basket of products to their customers and provide more complete steel solutions. The opportunity for optimal configuration of facilities, based on the concepts of deintegrated manufacturing of steel and the resultant flexibility to maximize product mix and logistic levers, would offer tremendous advantages to the partners.

The two key acquisitions made by Tata Steel, namely the Singapore based NatSteel and Thailand based Millennium Steel in 2004, had given the company access to new markets–Thailand, China, Singapore, Australia, Malaysia and the Philippines. It also helped Tata Steel increase its production capacity by 3.7 million tonnes to its existing capacity of over 5 million tonnes.

OTHER ACQUISITIONS

In March 2004, Tata's VSNL acquired Chennai-based Dishnet DSL's internet service provider (ISP) division for Rs 270 crore in a slump-sale transaction. The deal included internet assets, employees and customers of Dishnet's ISP division. This acquisition consolidated VSNL's position in the dial-up space, giving it control over 600 owned and franchised Dishnet cyber cafes as well as broadband assets serving more than 50,000 customers in key cities. To strengthen its offerings for the insurance sector, Tata Consultancy Services (TCS) acquired Phoenix Global Solutions (PGS) in May 2004 for an undisclosed sum. PGS, an insurance company, is a subsidiary of US-based Phoenix Companies Inc.

Tata Coffee spent Rs 1,015 crore for acquiring Eight O' Clock Company. The acquisition bought strategic and operational gains for Tata Coffee as it gained entry into the world's largest coffee market, the US.

In 2004, Tata Motors completed its global acquisition of Daewoo Commercial Vehicles (DWCV) in South Korea for $103 million. The acquisition was meant to strengthen synergies, like expansion of the product line, R&D capabilities and new markets. This acquisition gave Tata Motors entry into markets of China, Western Europe, South Africa and Latin America. DWCV was the second largest heavy truck maker, with an annual production capacity of 20,000 medium and heavy vehicles. The major reason for the acquisitions was based on the company's global plans to reduce domestic exposure. The domestic Commercial Vehicle market was highly cyclical in nature, and prone to fluctuations. The company had plans to diversify into various markets across the world, in both MHCV and LCV segments.

Hispano Carrocera is one of the largest bus and coach bodybuilders in Europe and North Africa. It exports 50% of its production to countries worldwide. Tata Motors acquired 21% stake in Hispano Carrocera. After tying up with Tata Motors, the company was able to supply world class buses in Europe and outside, and gained access to new markets in North Africa and Middle East.

Another big ticket Tata acquisition was Tyco Global Network, which was bought by internet and telecommunications major, VSNL, in November 2004. VSNL was acquired by Tatas from the government during its divestment in 2002. VSNL purchased Tyco for Rs 585 crore in an all cash deal, pipping Reliance Industries Ltd, which had also bid for the submarine deal. This deal was one of the world's most advanced and extensive submarine cable systems purchased for $ 130 million. The acquisition gave VSNL control over a network that spans 60,000 km (37,208 miles) and three continents.

In January 2005, Tata Finance Ltd. (TFL) was merged into Tata Motors. The merger was effective from April 2005, and under the scheme of amalgamation, all equity shareholders of Tata Finance Ltd were entitled to receive eight ordinary shares of TML of Rs 10 each for every 100 equity shares of Tata Finance of Rs 10 each. The merger was expected to enable the vehicle financing business of TFL to grow stronger by leveraging its synergies of the direct business model with the dealer driven business of Bureau of Hire Purchase and Credits (BHPC), a division of the company. The merger allowed TFL shareholders to participate in the growth of Tata Motors. As a result of this restructuring exercise, TFL re-emphasised auto financing as its core business, and divested all non-core businesses.

In May 2005, Tata Rallis acquired 5% strategic equity stake in Advinus Therapeutics. In June 2005, Indian Hotels bagged its fourth international property deal by signing a $5 million contract with the Pierre, a Manhattan hotel, for 30 year lease.

In 2008, the Tata Group acquired U.K. based Land Rover and Jaguar units from Ford Company of US for $2.3 billion. Ford contributed approximately $600 million to the Jaguar Land Rover Pension Plans. Ford had to sell both the brands due to its ill-fated expansion strategy into premium auto brands. The company bought premium brands, such as Aston Martin, Jaguar, Land Rover and Volvo, based on the assumption that multiple luxury car brands could be served by a new kind of relationship. The strategy did not work. In addition, Ford was also facing financial crisis. Then the company decided that it had to return to its core business of cars and trucks.

As part of the transaction, Ford would continue to supply Jaguar Land Rover for differing periods, with powertrains, stampings and other vehicle components, in addition to a variety of technologies, such as environmental and platform technologies. Ford has also committed to provide engineering support, including research and development, plus information technology, accounting and other services. Tata wanted to acquire a world class brand, which could be a way to increase visibility for the company.

The major advantages of the deal were:

Land Rover's Benefits

- Upmarket SUV brand

- Access to latest technology in four wheel, readymade R&D
- Access to prestigious clientele

Land Rover's Disadvantages
High cost of existing infrastructure
Significant investments required

Jaguar's Benefits
- Upmarket brand
- Access to new technologies
- Premium customer profile competing with Mercedes, BMW and Audi
- Considered the best British brand

Jaguar's Disadvantages
- High Maintenance cost for existing infrastructure
- Expertise for Tatas is limited.

Table CS15.1 *Tata's Key Acquisitions*[1]

Period	Acquirer	Target	Value (in Rs crore)
February 2000	Tata Tea	Tetley UK	1870
November 2001	Tata Sons	CMC Ltd	157
February 2002	Tata Group	VSNL	1439
June 2002	Tata Teleservices	Hughes Telecom India	Undisclosed
September 2002	Indian Hotels	Regent Hotels	415
May 2003	TCS	Airline Financial Support Services	Undisclosed
July 2003	VSNL	Gemplex	Undisclosed
March 2004	Tata Motors	Daewoo Commerical Vehicle	459
March 2004	VSNL	Dishnet DSL's ISP Division	270
March 2004	TCS	Aviation Software Development Consultancy	4.02
May 2004	TCS	Phoenix Global Solutions	Undisclosed
August 2004	Tata Steel	NatSteel	1313
November 2004	VSNL	Tyco Global Network	13
February 2005	Tata Motors	Hispano Carrocera	70
July 2005	VSNL	Teleglobe	1076
October 2005	Tata Tea	Good Earth	144
December 2005	Tata Steel	Millennium Steel	1818
December 2005	Tata Chemicals	Brunner Mond	789
June 2006	Tata Coffee	Eight O' Clock	1015
April 2007	Tata Steel	Corus	1210

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DISCUSSION QUESTION

1. M&A has been a major strategic pursuit for Tata Group's growth strategy. Discuss.

Case Study 16

THE GROWTH STORY OF GE—ACQUISITION PERSPECTIVE

In 1876, Ohio born Thomas Alva Edison opened a new laboratory in Menlo Park, New Jersey. In the lab, the most famous invention–the incandescent electric lamp–was made. By 1890, Edison had organised his various businesses into the Edison General Electric Company. In 1879, Elihu Thomson and Edwin J Houston formed the rival Thomson Houston Electric Company. It merged with several companies. Mergers with competitors and access to position patent rights owned by each company made both of them dominant in the electrical industry. On account of expansion in business opportunities, it became difficult for the two companies to produce complete electrical installations, relying solely on their own technology. In 1892, the two major companies combined in a merger facilitated by J P Morgan to form the General Electrical Company, with its headquarters in Schenectady.

GE is a diversified technology, media and financial services company, with products and services ranging from aircraft engines, power generation, water processing and security technology to medical imaging, business and consumer financing, media content and advanced materials. GE serves customers in more than 100 countries and employs more than 300,000 people worldwide.

The company is composed of a number of primary business units. The list of the GE businesses varies over time as a result of acquisitions, divestitures and reorganisations. General Electric's tax return is the largest return filed in the United States (approximately 24,000 pages when printed).

In 1896, GE was one of the original 12 companies listed on the newly formed Dow Jones Industrial Average, and is still listed after 112 years. It is the only original company remaining on the Dow. In 1911, the National Electric Lamp (NELA) was absorbed into General Electric's existing lighting business.

General Electric was one of the eight major computer companies through most of the 1960s. GE had an extensive line of general purpose and special purpose computers. It is said that GE got into computer manufacturing because in the 1950s it was the largest user of computers outside of the US Federal Government. In 1970, GE sold its computer division to Honeywell.

The Radio Corporation of America (RCA) was founded by GE in 1919 to further the cause of international radio. In 1986, GE reacquired RCA, primarily for the NBC television network. The remainder was sold to various companies, including Bertelsmann and Thomson SA.

In 2002, Francisco Partners and Norwest Venture Partners acquired a division of GE, GE Information Systems (GEIS). The company, named GXS, is a leading provider of B2B e-Commerce solutions. GE maintains a minority ownership position in GXS.

GE Capital is itself the product of dozens of acquisitions that have been blended to form one of the world's largest financial services organisations. GE Capital was founded in 1933 as a subsidiary of the General Electric Company to provide consumers with credit to purchase GE appliances. Since then, the company has grown to become a major financial service conglomerate, with 27 separate businesses and more than 50,000 employees worldwide. The businesses that generate these returns range from private label credit card services, to commercial real estate financing, to railcar and aircraft leasing. More than half of these businesses became part of GE Capital through acquisitions. The acquisitions come in different shapes and sizes. Sometimes, the acquisition is a portfolio or asset purchase that adds volume to a particular business without adding people. Sometimes, it is a consolidating acquisition in which a company is purchased and then consolidated into an existing GE Capital business. That happened when GE Capital Vendor Financial Services bought Chase Manhattan Bank's leasing business. Sometimes, the acquisition moves into fresh territory, spawning an entirely new GE Capital business. GE Capital made such a platform or strategic acquisition when it bought Travelers Corporation's mortgage services business.

GE Commercial Finance is one of the General Electric's largest growth engines with lending products, growth capital, leasing, cash flow programmes, and asset financing. It plays a key role for client business in over 35 countries. In the mid-1980s, GE Capital acquired Dart & Kraft Leasing (D&K) and Kerr Leasing, intending to integrate Kerr into D&K. In the midst of the integration process, GE Capital acquired Gelco Corporation, a much larger leasing company that also included other financial services businesses.

ACQUISITION OF TRANSAMERICA BY GE CAPITAL

In 2003, GE acquired Transameria through a leveraged buyout by assuming $3.8 billion in debt, in addition to cash payment of around $1 billion. This acquisition helped GE to add about 4% to its existing asset base. This purchase added $8.5 billion in managed assets to a $200 billion portfolio at its commercial finance unit.

Transamerica Corporation is involved, largely through semi-independent subsidiaries, in life insurance, financial services and real estate services. Through its Transamerica Life insurance subsidiary, it is the eighth largest life insurer in North America.

The major motive of the acquisitions are:

1. They expand GE commercial finance distribution offerings to manufacturers and dealers of industrial and recreational products.
2. It enhances the company's leasing and commercial loan financing in equipment, real estate and industrial finance.

GE sold its Japanese Life and American Auto and Home Insurance businesses to AIG for $2.6 billion in 2003.

In 2004, GE bought Vivendi's television and movie assets, becoming the third largest media conglomerate in the world. The new company was named NBC Universal. In the same year, GE spun off most of its mortgage and life insurance assets into an independent company, Genworth Financial, based in Richmond, Virginia.

Genpact, a BPO company, was established by GE in the late 1990s. GE hived off 60% stake in Genpact to a consortium in the year 2004. GE is still a major client to Genpact availing of services in customer service, finance and analytics.

ACQUISITION OF IDX BY GE HEALTHCARE SYSTEMS

GE Healthcare provides transformational medical technologies to facilitate patient care. Its broad range of products and services enable healthcare providers to better diagnose and treat cancer, heart disease, neurological diseases and other conditions.

In 2005, GE Healthcare acquired IDX Systems Corporation, a provider of clinical and practice management systems for hospitals and physicians. Under the estimated $1.2 billion deal, IDX shareholders received $44 cash per share. The healthcare IT world has great potential for growth, as hospitals and healthcare providers are increasingly focusing on computerised information system for patient care, office administration and financial transactions. The compatibility of offerings has been cited as the reason for the deal. GE Healthcare provides a range of products from diagnostic equipment to drug research. The company also specialises in imaging systems, such as for the radiology and cardiology departments. The company is also leading provider of picture archiving and communication systems. IDX offers electronic medical records and revenue and specific workflow systems for the healthcare industry. Prior to the acquisition, IDX had four primary lines of business. Flowcast, the original application produced by IDX, is a revenue cycle management system for medium to large physician groups, hospitals and integrated delivery networks, and includes scheduling, billing and collection modules. Groupcast is a financial management system for smaller provider groups. Carecast is a system used primarily by large hospitals and medical centres as an integrated clinical and financial application. Image is a radiology information system which enables 'filmless' radiology image workflow. The acquisition was aimed to integrate IDX's workflow offerings for clinical specialities with GE's imaging market. The strategic advantage for GE was the addition of IDX's Carecast clinical IT system to its product line. GE lacked a core clinical data repository. IDX's revenue cycle systems for physician received a healthy boost from GE's resource and scale. The GE deal was also expected to improve IDX's position in the UK.

In 2007, General Electric sold its GE Plastics division to petrochemicals manufacturer, Saudi Basic Industries, for net proceeds of $11.6 billion.

GE AVIATION'S ACQUISITION OF SMITHS AEROSPACE

GE Aviation is one of the world's leading producers of large and small jet engines for commercial and military aircraft. It also supplies aircraft derived engines for marine applications and provides aviation services. GE Aviation's products include jet engines for civil and military aircraft as well as aeroderivative engines for marine applications. It also operates a worldwide network of engine services facilities.

In 2007, GE Aviation purchased Smiths Aerospace, a UK based supplier of integrated systems for aircraft manufacturers and components for engine builders, for $4.8 billion in an all cash deal. Smiths Aerospace is a leading transatlantic aerospace systems and equipment business. In 2006, it had more than 11,000 employees and $2.4 billion in revenues. The company had significant presence on most commercial aircrafts, including Boeing 737 and Airbus 320, as well as on many military aircrafts. Smiths also has major presence on new aircraft, such as the Boeing 787, Airbus A380 and the Joint Strike Fighter. Its products include flight management systems, airborne platform computing systems, power generation, conversion and distribution products, actuation products and systems for flight control, thrust reversers and landing gear applications, various engine components and a global customer service organisation. The business holds key positions in supply chains of all major military and civil aircraft and engine manufacturers, and is a world leader in digital, electrical power, mechanical systems, engine components and customer services. The acquisition will broaden GE's offerings for aviation customers by adding Smiths' innovative flight management systems, electrical power management systems, mechanical actuation systems and airborne platform computing systems to GE Aviation's commercial and military aircraft engines and related services. This acquisition is consistent with GE's strategy to invest in high technology infrastructure businesses that deliver strong growth, earning expansion and higher margins.

GE SECURITY'S JOINT VENTURE WITH SMITHS DETECTION

GE Security business is a wholly owned subsidiary of the General Electric Company, focussed on communication and information technologies for security and life safety solutions. GE Security is represented by some of the best known brand names for intrusion and fire detection, access and building control, video surveillance, explosives and drug detection, key management and structured wiring. Smiths Detection was part of the global technology business of Smiths Group. It offers advanced integrated security solutions for customers in civil and military markets worldwide, and is a leading technology developer and manufacturer of sensors that detect and identify explosives, chemical and biological agents, weapons and contraband. Its advanced technology security solutions also include Smiths Heimann x-ray imaging systems, millimeter wave technology and a specialist software supply business for the management of large sensor and video surveillance networks.

GE entered into a detection joint venture with Smiths Group for a part of its security business. The joint venture included GE Security's Homeland Protection business and Smiths Detection. GE has a high level of technical expertise and has experienced strong growth in its security platform.

In 2007, GE initiated plans to buy the British oil field services equipment manufacturer, Sondex, for $583.1 million in cash.

GE buys approximately 100 companies a year, mainly with a view to obtain operating synergy in its business.

MAJOR CORPORATE RESTRUCTURING BY GE IN THE PERIOD 2000-2007:

2001: GE and Honeywell agree to merge. The merger is blocked by European Union M&A chief, Mario Monti.
2001: NBC acquires Telemundo, one of the leading Spanish language television networks.
2003 : GE Healthcare acquires Instrumentarium.
2003: GE Capital acquires Transamerica Finance, which retained the rest of Transamerica Corporation.
2004: NBC acquires the entertainment assets of Vivendi Universal, excluding Universal Music, thus forming NBC Universal, of which GE owns 80%.
2004: GE Healthcare acquires Amersham Plc.
2004: GE Capital acquires Dillard's credit card unit for $1.25 billion.
2004: GE sells 60% stake in GE Capital International Services (GECIS) to private equity companies, Oak Hill Capital Partners and General Atlantic, for $500 million.
2004: Genworth Financial formed from GE's life and mortgage insurance assets.
2004: GE Security acquires InVision Technologies, a leading manufacturer of airport security equipment.
2005: GE Commercial Finance acquires financial assets of Bombardier, a Canadian aircraft manufacturer, for $1.4 billion.
2006: GE Healthcare acquires IDX Systems, a medical software firm for $1.2 billion.
2006: GE Advanced Materials division sold to Apollo Management for $3.8 billion.
2007: GE Aviation acquires Smiths Aerospace for £2.4 billion.
2007: GE Plastics sold to SABIC for $11.7 billion.

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DISCUSSION QUESTION

1. What are the major features of the consolidation activity of the GE group?

Case Study 17

BHARTI AIRTEL ACQUIRES ZAIN AFRICA

BHARTI AIRTEL

Bharti Enterprises is one of India's leading business groups with interests in telecom, agri business, financial services, retail and manufacturing. Out of its 15 group companies, Bharti Airtel is the flagship company, and is one of Asia's leading integrated providers of telecommunications services with operations in India and Sri Lanka, spanning mobile services, telemedia services and enterprise services. The company was established as a public limited company in July 1995. Bharti Airtel has always been at the forefront of the telecom revolution, transforming the sector with its world-class services built on cutting edge technologies.
The company is structured into four strategic business units.

- Mobile Services
  Bharti Airtel offers GSM mobile services in all the 23-telecom circles of India and is the largest mobile service provider in the country, based on the number of customers. The mobile business offers services in India, Sri Lanka and Bangladesh.
- Telemedia Services
  Airtel offers high speed broadband internet with a best in its class network. It provides world class entertainment with one of India's best direct to home (DTH) service digital TV in more than 150 cities.
- Enterprise Services
  Enterprise Services provides a broad portfolio of services to large enterprise and carrier customers. This division comprises the carrier and corporate business unit.
- Digital TV services
  Airtel also provides digital TV services.

Recent Milestones

- In April 2010, inorder to boost Trans-Pacific connectivity, Bharti Airtel launched the Unity cable system. The Unity consortium together with its suppliers, NEC Corporation and TE SubCom (formerly Tyco Telecommunications), have successfully completed comprehensive end-to-end testing, making the cable system ready for service. This cable link synergises with Bharti Airtel's existing multiple high speed connectivity options from India to Singapore on i2i and from Chikura, near Tokyo to the US west Coast. Unity is an international consortium that developed the 9,620 km undersea cable system connecting Japan and the United States.
- In March 2010 Bharti Airtel and Ericsson further strengthened their strategic partnership with a US$ 1.3 billion network expansion contract. Airtel users will enjoy an enhanced voice quality and faster data access. The agreement will enable Airtel to put in place a converged network and expanded coverage in rural India. Ericsson will expand and upgrade Airtel's network in 15 of India's 22 telecom circles.

- HTC Corporation, a global smartphone designer, and Bharti Airtel have an exclusive partnership to launch the HTC Smart in India in collaboration with Qualcomm Incorporated. The HTC Smart marks HTC's strategic focus on India, the fastest growing telecom market in the world. HTC Smart, an easy-to-use and affordable smartphone, aims to create a new category of smartphones by bringing the globally acclaimed HTC Smart to the masses.

The company also deploys, owns and manages passive infrastructure pertaining to telecom operations under its subsidiary Bharti Infratel Limited. Bharti bought 70 percent of Bangladesh's Warid Telecom for an initial investment of US$300 million.

Bharti Airtel is the largest wireless service provider in the country, based on the number of customers as of September 30, 2009. Bharti served an aggregate of 113,439,670 customers as of September 30, 2009; of whom 110,511,416 subscribe to the GSM services and 2,928,254 use the Telemedia Services, either for voice and/or broadband access delivered through DSL. The company provides telemedia services (fixed line) in 95 cities in India.

Partners' Profile

Network Equipment	Nokia, Siemens, Ericsson, Huawei
Telemedia and Long distance services	Nokia, Siemens, Wipro, Cisco, Alcatel, Lucent, ECI, Tellabs
Information Technology	IBM
Call Centre Operations	IBM Daksh, Hinduja TMT, Teleperformance
Equity Partner (Strategic)	SingTel

Source: www.airtel.in

Financial Highlights

As of April 01, 2010, Bharti Airtel was a Rs 1147 billion company with a share price of *Rs 302.15.*

Parameters	**2007**	**2008**	**2009**
Revenue (in millions of Rs)	185,195	270,249	369,615
Operating Expenses (in millions of Rs)	135,904	193793	265,518
Net Income (in millions of Rs)	42571	67,008	84699
EPS	22.50	35.36	44.67

Source: Company Reports, www.airtel.in

ZAIN

Zain is a leading telecommunications operator across the Middle East and Africa, providing mobile voice and data services to over 70 million active customers as at 30 September 2009 with a commercial presence in 23 countries. Zain is listed on the Kuwait Stock Exchange with a market capitalisation of over US$ 20 billion. Year-on-year customer growth in the two continents across which Zain operates was 14%, whereby the company serves 72.5 million managed active customers as of December 31, 2009. Zain Group added over 9 million new active customers in the year 2009.

Zain Africa spans 15 countries across Africa serving 42 million customers and in 2009 generated proportionate EBITDA[1] of US$ 958 million. Zain Africa has operations in Burkina Faso, Chad, the Republic

[1] Earnings before interest, tax, depreciation and amortization.

of the Congo, the Democratic Republic of the Congo, Gabon, Ghana, Kenya, Malawi, Madagascar, Niger, Nigeria, Sierra Leone, Tanzania, Uganda and Zambia. The total population of these 15 countries stands at over 450 million with telecom penetration of approximately 32%.

THE DEAL

Bharti Airtel Limited announced on 30th March 2010 that it had entered into a legally binding definitive agreement with Zain Group ("Zain") to acquire the sale of 100% of Zain Africa BV, its African business, excluding its operations in Morocco and Sudan, based on an enterprise valuation of US$10.7 billion. Under the agreement, Bharti will acquire Zain's African mobile services operations in 15 countries with a total customer base of over 42 million. Zain is the market leader in ten of these countries and ranks second in four countries. With this acquisition, Bharti Airtel will be the world's fifth largest wireless company with operations across 18 countries. Bharti group's global telecom footprint will expand to 21 countries along with the operations in Seychelles, Jersey, and Guernsey. The company's network will now cover over 1.8 billion people—the second largest population coverage among telecom companies globally. With this acquisition, Bharti's total customer base will increase to around 179 million in 18 countries. The acquisition has put Bharti in direct competition with South Africa's MTN Group Ltd., the regional market leader. The acquisition was the second biggest ever by an Indian company after the Tata Corus deal.

Standard Chartered was the Lead Advisor to Bharti on this transaction. Barclays Capital was the Joint Lead Advisor and SBI Group was the Lead Onshore Advisor. Global Investment House KSCC was the Regional Advisor to Bharti for this deal. The deal made Bharti Airtel the second largest cellular company in the African Continent. Zain's assets will give the Indian mobile market leader a footprint in 15 African countries.

Bharti, which is 32 percent owned by Singapore Telecommunications Ltd, selected Zain as its second choice for building a major presence in Africa after it twice failed to finalise tie-ups with South Africa's MTN Group Ltd, the continent's biggest operator.

Valuing the Deal

Bharti Airtel has paid 10 times enterprise value to EBITDA for the deal. According to analysts, the combined entity will have 163.5 million subscribers with Zain Africa constituting 41.9 million and Airtel 121.6 million. The combined EBITDA margins are 38.3%, with Zain Africa's EBITDA at 32% and Bharti's at 41%. The combined net margins are 15.4% with Zain Africa's at 4.1% and Airtel at 23.8%. Figures are based on data available for 2009. The transaction implies an equity value of US$ 9 billion and consideration will be fully satisfied in cash, of which US$ 8.3 billion will be paid upon closing and US$ 0.7 billion will be paid one year from closing

Financing the Deal

Bharti Airtel will assume US$ 1.7 billion of consolidated debt obligations. Bharti has secured debt of up to US $ 8.5 billion from lenders to fund the deal. The company's purchase was financed by a group of banks led by Standard Chartered Plc, Barclays Plc and State Bank of India. Other lenders include Australia & New Zealand Banking Group Ltd., Bank of America Merrill Lynch, BNP Paribas SA, Credit Agricole CIB, DBS Group Holdings Ltd., HSBC Holdings Plc, Bank of Tokyo-Mitsubishi UFJ Ltd. and Sumitomo Mitsui Banking Corp.

Challenges for the Deal

Regulatory Issues The small central African nation of Gabon has come out against the deal stating that Zain Gabon had not complied with regulations. Zain holds more than 60 percent of the mobile market in Gabon. The firm has been operational in the central African country of around 1.5 million people since 2000. Bharti will have to face stiff competitors in Africa. The company will also have to complete all regulatory clearances in 15 countries.

Ownership Issues Minority ownership of Zain's operations in Nigeria, the biggest market in the deal, is also in dispute. There are seven different lawsuits being heard in various courts across countries such as Nigeria, Britain and the Netherlands on the Nigeria issue. South Africa-based Econet Wireless Holdings, which owns 5% of Zain's Nigerian assets, is seeking to overturn a 2006 deal by Zain—then called Celltel—in which it bought a majority stake in Nigerian mobile operator Vee Networks Ltd, now called Zain Nigeria.

Strategic Issues Global telecom players are increasingly looking to Africa as one of the few regions in the world offering growth. Advances in mobile-phone technology are driving prices down to within reach of many African consumers.

Bharti Airtel is facing stiff competition in its home ground. South Asia's largest mobile phone company Bharti Airtel has been forced to drop some call rates for many of its 125 million customers to as little as half a US cent a minute because of competition from newcomers such as Japan's NTT DoCoMo Inc. and Norway's Telenor ASA. In the contest of heightened competition in India, Bharti Airtel is seeking new markets and opportunities.

Zain's African businesses account for 16 of the group's 23 markets and around 65 percent of the group's customers. However, Africa contributed only 10 per cent of group profit in the year 2009.

This sell off of Zain's African positions is significant in the context that it marks a strategic reversal that saw the local regional player rise to international status and then revert to that of a regional player. Zain has spent more than US $12 billion to expand in Africa alone since 2005.

Zain's underperforming assets in Nigeria and Kenya became an obstacle for growth in the African region. The group pulled back from an expansion spree in 2009 and rejected an offer from France's Vivendi for its African assets. A consortium of Asian investors tried to buy the 46% stake from Kuwaiti family conglomerate, Kharafi Group, for 2 dinars per share, or about US $13.7 billion. Africa represents about 62 per cent of Zain's 64.7 million customers but only 15 percent of the group's net profit. Zain Africa was not able to maintain its profitability due to less profitable business in its portfolio, costs related to integration and forex losses.

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DISCUSSION QUESTION

1. Discuss the strategic importance of Zain acquisition for Bharti Airtel.

Appendix 1

LARGEST INDIAN MERGERS AND ACQUISITIONS DEALS

Sl	Deal	Date	Value	Details
1	Tata Steel Corus	Jan 2007	$12.2 billion	Tata Steel purchased a 100% stake in the Corus Group at 608 pence per share in an all cash deal.
2	Vodafone–Hutchison Essar	Feb 2007	$11.1 billion	Vodafone bought the controlling stake of 67% held by Li Ka Shing Holdings in Hutch Essar.
3	Bharti–Zain	March 2010	$10.7 billion	Bharti entered into a legally binding definitive agreement with Zain Group ("Zain") to acquire the sale of 100% of Zain Africa BV, its African business excluding its operations in Morocco and Sudan, based on an enterprise valuation of USD 10.7 billion. Under the agreement, Bharti will acquire Zain's African mobile services operations in 15 countries with a total customer base of over 42 million.
4	Hindalco–Novelis	Feb 2007	$6 billion	Aluminium and copper major Hindalco Industries, the Kumar Mangalam Birla-led Aditya Birla Group flagship, acquired Canadian company Novelis Inc in a $6-billion, all-cash deal. The acquisition made Hindalco the global leader in aluminum rolled products and one of the largest aluminum producers in Asia.
5	Ranbaxy–Daiichi Sankyo	June 2008	$4.5 billion	The largest ever pharma deal in India. Japanese drug firm Daiichi acquired the majority stake of more than 50 per cent in Ranbaxy. The deal created the 15th biggest drug maker globally.
6	ONGC–Imperial Energy	Jan 2009	$2.8 billion	ONGC acquired 96.8 per cent of the London listed firm's shareholding.
7	NTT DoCoMo–Tata Tele	Nov 2008	$2.7 billion	Japanese Telecom giant NTT DoCoMo acquired 26 per cent stake in Tata Teleservices. With a subscriber base of 25 million in 20 circles, the company paid Rs 20107 per subscriber to acquire the stake.
8	HDFC Bank–Centurion Bank of Punjab	Feb 2008	$2.4 billion	HDFC bank have approved the acquisition of Centurion Bank of Punjab for Rs 9510 crore($2.4 billion) in one of the largest mergers in the financial sector in India. Centurion Bank of Punjab shareholders got one share of HDFC Bank for every 29 shares held by them. Post Acquistion, HDFC Bank became the second largest private sector bank in India.

(*Contd.*)

(*Contd.*)

9	Tata Motors–Jaguar deal	March 2008	$2.3 billion	Tata Motors acquired auto brands Jaguar and Land Rover from Ford Motor
10	Sterlite–Asarco	May 2008	$1.8 billion	Sterlite, the Indian subsidiary of London based Vedanta Resources Plc acquired Asarco
11	Suzlon–RePower	May 2007	$1.7 billion	Wind Power major Suzlon acquired the German Wind turbine manufacturer REpower. Suzlon is now the largest wind turbine maker in Asia and the fifth largest in the World.
12	RIL RPL Merger	March 2009	$1.68 billion	RIL approved a scheme of amalgamation of its subsidiary Reliance Petroleum with the parent company. The merger became effective from April 1 2008. The RIL RPL Merger swap ratio was at 16: 1

Source: Business.rediff.com (May 2009).

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