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Corporate Restructuring

Enhancing the Shareholder Value

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Preface

With liberalization and opening up of the Indian economy since the middle of 1991, Indian corporate sector felt the need to reposition itself quickly in order to effectively respond to emerging competition and also exploit the opportunities that were expected to unfold in the coming years. Repositioning became a critical necessity since most Indian companies flourished till that time, under a protectionist umbrella and got used to business models that were hopelessly out of tune with the requirements of an intensely competitive scenario. Some of the glaring inadequacies were in relation to—lack of customer focus, diversified portfolio, unprofitable product lines, outdated technologies, uneconomic capacities, poor productivity and efficiency in asset utilization, slow and unwieldy business processes, over manning, huge overheads, high gearing, etc. Fortunately, a consensus soon emerged among corporates, chambers of commerce, consultants and academicians that Indian companies will need to reposition themselves very quickly through a series of well-planned corporate restructuring initiatives that would help overcome not only the weaknesses, just mentioned, but also build new capabilities to exploit emerging opportunities. Seen from this angle, corporate restructuring really meant combining both defensive and offensive stances taken by Indian firms to reposition themselves in the new competitive space.

This book is an attempt to provide a broad overview on the subject of corporate restructuring. The book centers around how corporate restructuring helps in enhancing shareholder wealth and contains both concepts and cases related to this theme.

Part I of the book deals with concepts and frameworks relating to corporate restructuring. Chapter 1 starts with the concept of shareholders' wealth and argues that managers have the principal responsibility to enhance both corporate and shareholder value. Chapter 2 describes how corporate restructuring helps in enhancing the shareholders' value and why the process has to be a continuous one. Chapter 3 deals with the various forms of corporate restructuring and provides a brief overview of each. Chapter 4 outlines the key implementation issues and observes that if adequate care is not taken during the implementation phase, the benefits of restructuring will be hard to come by. Chapter 5 describes some of the recent experiences of corporate restructuring undertaken by Indian firms and draws key conclusions in a number of areas. Chapter 6 discusses a few select legal issues relating to corporate restructuring but avoids detailed deliberation on any specific issue. Chapter 7 briefly introduces the concept of "market for corporate control" and observes that presence of such a market is required to put pressures on management team to enhance shareholder wealth by undertaking corporate restructuring periodically.

Part II of the book contains a number of short but insightful illustrations, each of which describe certain corporate restructuring issues and decision context. These illustrations, which have been drawn from real life situations (though the names of companies and their industry identity have been disguised for administrative reasons), briefly describe some broad managerial issues in select instances of corporate restructuring. Needless to say, the areas covered through such illustrations are not exhaustive and the authors have no doubt that there will be quite a few other areas which, though important, are not exemplified in a similar manner in this book. It is hoped that the readers will find the illustrations useful to understand the concepts described in Part I of the book.

Part III of the book has only one chapter and deals with a rather unconventional subject—ethical issues relating to corporate restructuring. This chapter first describes a number of corporate restructuring decisions where ethical issues are more often than not violated and argues that it is possible to pursue corporate restructuring moves that are ethically correct and yet commercially viable, provided managers of the firm are competent enough to ensure highest possible productivity and efficiency in resource utilization. This chapter provides a different perspective on corporate restructuring and will be useful to readers who wish to pursue success in their managerial career through adopting means that are based on ethical foundations.

There are essentially three categories of readers who will find the book interesting. First, the practising managers who are responsible for either leading their companies' corporate restructuring moves or providing analytical and decision support to such moves. Both should find the concepts and cases useful in terms of coverage and practical thrust. The next category of readers are the strategy, financial and HR consultants who work closely with managers and provide objective and indepth insight in the subject area. The third category of readers are the faculty and MBA students of Indian business schools who will get a holistic view on corporate restructuring along with all related concepts in one place. The strategic and multifunctional perspectives, maintained through out the book while describing various concepts, should be interesting particularly to students specializing in strategic management. The cases included in the book will give the students a first hand experience of the various decision contexts related to corporate restructuring.

To write this book, we drew extensively from our collective experiences as teachers, researchers, consultants and practising managers in the field of strategic management and corporate restructuring. The contents and cases chosen and perspective provided reflect our professional specialization and thinking. While every attempt has been made to provide a comprehensive overview in a reader-friendly manner, any shortcoming that still remains will essentially be our inadequacies.

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UDAYAN K BASU

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PART I

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CHAPTER
1

Wealth Creation for Shareholders and Managerial Responsibility

1.1 The Changing World of Business

The poor performance of star companies in the 1980s and 90s, both MNCs and domestic, has amply demonstrated their susceptibility to under-perform in the face of rapid and marked changes in technology, competition and customer expectations. It is not that all these companies lacked resources, capabilities or competent managers to anticipate and assess the impending changes and initiate proactive action; what they lacked was concern on the part of their managers to enhance the shareholder value of their respective firms on a sustained basis. As a result, this value got diverted to the customers, employees, competitors and suppliers of the company. While it is well known that a firm needs to develop distinctive capabilities and also build a strong network with its key stakeholders to enhance its value creating potential and appropriation of value thus created, what really happened in case of most of these unsuccessful firms was that one or more of the stakeholders gained at the expense of the shareholders. The propensity of managers to take operating, investment and financial decisions without any concern as to how such decisions can affect their shareholders led them to pursue strategies and investments that were ill-conceived and poorly executed, thereby systematically destroying the capabilities and equity developed over the years. This chapter argues how the outcome of such a tendency can be detrimental to not only the firms but also to the job and career of the managers, particularly in the light of the various new developments—such as economic liberalisation and opening up of most economies to domestic and global competition, greater freedom to access and move capital, emergence of the market for corporate control, and rising shareholder activism—which have brought the issue of enhancing shareholders' wealth to the forefront.

In addition to these developments, there were other changes during the 1980s and 90s which made the task of managers across industries and firms very complex. One major change was the rapid progress in the area of information and communication technologies which is altering the way in which products and services are designed, distributed and consumed. To respond to this development, companies are compelled to revisit their strategies and reconstruct their age-old, time-tested value creation processes in order to retain their competitive advantage built over the years. Another change that is sweeping the world of business is the pace at which new products and services, with attractive prices, are being introduced across categories, forcing the incumbent firms of the industry to backtrack. The problems of managers got further complicated as consumers started looking at other options in relation to everything that is linked to the benefits expected by them. This resulted in proliferation of categories, products, services, brands, distribution channel, and the media. Companies that failed to understand the impact of such proliferation and gear themselves up to exploit the same started losing the confidence of the investors.

Another significant change is the growing desire of employees to add value to whatever they are doing and get commensurate incentives and recognition in return. Pressure is mounting on managers to design alternative organisation structures, systems and processes that facilitate intra and extra-organisational networking and also provide ample opportunities to leverage and exploit capabilities of individuals. Firms are experimenting and seeking new ways of organising their business to achieve the dual requirement of organisational effectiveness[1] and also recognising 'individuals' as key drivers for innovating and effecting far reaching changes[2]. The works of Drucker[3], Savage[4], Collins and Porras[5], Peters[6], and Stopford and Baden-Fuller[7] also pointed out this new trend. Unfortunately, while managers of forward looking organisations consider these changing expectations of individual employees as an opportunity to further enhance shareholders' wealth, their less competent counterparts working with a large number of inward looking companies do not see this development as a positive one.

It is clear that managers will need to take a fresh guard and revisit their strategies, business processes and organisation in order to face this complex set of challenges and retain their firm's ability to enhance wealth of their shareholders. Thanks to the contribution made by the academia and practising executives, managers now have access to various concepts based on experiences when it comes to facing such challenges. However, it must be stressed that the need of the hour is not another set of concepts and framework; rather what is required is a new "philosophy of business" that draws the attention of every employee of an organisation, starting with the CEO, to the importance of creating, enhancing and sustaining shareholder value in everything that the company does—be it strategic, tactical or even routine matters. Needless to say, the employees will also need guidelines on how to operationalise this new philosophy and what actions are needed to sustain the same. These issues are dealt with in the sections and chapters that follow.

1.2 Firm Value and National Wealth

Nobel laureate Herbert Simon once said that the wealth of a nation was the wealth of its organisations[8]. Mintzberg observed that ours is a society of organisations. When these two observations are combined, it becomes clear that the wealth-creation process of a nation cannot be seen separately from that taking place at the industry level. Hence, unless a nation is able to unleash the value creating potential of each organisation, its overall progress in this context will be significantly hampered. Incidentally for each firm to maximise its wealth creation potential, the need for private ownership of capital and well defined property rights in all sectors of an economy cannot be overemphasised[9]. Private sector business organisations will ensure that their managers are held accountable for the way they use the company assets, and the outcome thereof. When the firm level ownership is diffused (as in the cases of public or joint sector companies) and the majority ownership is predominantly with distant and impersonal state, there is no incentive for intra and inter-organisational cooperation for mutual benefit including wealth creation.

Since the wealth-creation process of a nation is synonymous with that of its organisations, macro policies of governments of nation states must facilitate evolution and development of organisations that are focussed, market driven, efficiency and change seeking, nimble-footed, and also capable of building and leveraging capabilities, all required to create wealth not only for their shareholders but also for other stakeholders, including the government. For such value creation to take root within an organisation, the external context must be right—market economy, healthy competition, transparent regulations, strong institutional frameworks in all public policy areas, clear intellectual and other property rights, freedom to access information and high ethical standards. If a nation state is not able to put in place the required public policies in these areas and also no effort is made to simultaneously enhance managerial capabilities to create value, its wealth creation effort will always remain sub-optimal.

1.3 The Concept and Meaning of Value and Value Drivers

Value or wealth of an organisation at any point of time is the present value of its future free cash flow, net of all operating expenses and all incremental fixed and working capital needed to sustain and make the business grow over the entire life span of the firm. The value so determined is called the enterprise value available to all classes of investors such as lenders, preference shareholders and equity shareholders. The value attributable to equity shareholders will be the enterprise value less the debt and preference shares outstanding on the date of valuation.

What drives the value? Putting it simply, drivers influence the value of a firm through their impact on: (i) the level of free cash flow generated from operations, (ii) the quantum of cash required to fund incremental, fixed and working capital necessary to sustain and make the business grow over its life span and (iii) the rate to be used to discount the net free cash flow available to the investors. The list of drivers that influence these three factors includes: (a) growth in revenue, (b) growth in operating margin as percentage of revenue, (c) rate of investment as percentage of net operating profit, (d) rate of marginal income tax applicable to the firm, and (e) the opportunity cost of capital (reflecting the investors' opportunity cost and the associated risks). Here, it needs to be highlighted that while growth in revenue and earnings are key drivers, these by themselves may not provide sustainability in shareholder value unless the quality of revenue and earnings is perceived by the capital market as robust. A proof of this particular aspect is to be found in the case of GE of USA, which after showing steady growth in revenue and earnings for nearly a decade, is suddenly facing a backlash from the capital market since the first quarter of 2002, and the nature of questions now being raised by the market analysts (such as significant dependence on pension income, emphasis on acquisition, cost cutting and low cost of funds to support earnings growth in the face of flat sales, reliance on a few business lines such as GE Power Systems and GE Capital Services and declining order book position in gas turbine) indicate that mere growth in revenue and earnings is not sufficient. The market also wants to be convinced that quality of sales and growth in earnings (in terms of mix and how organic is the said mix) are in line with the best that is possible given the environment of the organisation.

It is interesting to note that these value drivers themselves are the outcome of decisions taken by managers on a day-to-day basis in a variety of operating, investment and financing areas. Some examples of strategic and functional decisions that affect the net free cash flow and discount rate, both of which together determine the enterprise value are:

- Direction of future growth and vision thereof
- Stretch in performance standards set in all key result areas such as growth in revenue and investment, mix of revenue from existing and new generation products, operating efficiency, margins, resource productivity, etc.
- Customers and market segments being targeted and positioning aimed at in each such segment
- Competitors being targeted while deciding on strategies and functional policies
- Emphasis on innovation in order to come up with new product and services vis-à-vis current product/market posture
- Configuration of value chain including activities that are outsourced but networked in a seamless manner
- Quality of company infrastructure put in place and level of technology deployed for each activity
- Financing policies adopted to fund the current and future growth plans
- Organisation structure, systems and processes chosen to implement the strategy formulated to achieve the set direction
- Quality, number and mix of managers and employees
- Performance appraisal and rewards, and punishment system designed to direct attention of managers and employees to the task of value maximisation
- Numerous routine and tactical decisions taken by managers daily across the organisation, each of which directly or

indirectly influences the size, quality and timing of net free cash flow from business

Obviously, the above list is not exhaustive. But what is important to note is that concern for maximising the value of the firm (and that of the shareholders) must be the sole consideration of managers while taking strategic, functional and routine decisions. It is only when the concept of value becomes the common link across various strategic and operating decisions that a firm can expect to maximise not only its shareholder value but also the value for the society and nation at large.

1.4 Sources of Value

It is by now clear that the extent of value to be created by a firm essentially hinges upon its capability to design and implement an enterprise-wide infrastructure, systems and processes and also establish networks with outside service providers that will create, in a seamless form, the best possible value, for its target customer groups—at a cost and resource deployment which is less than that of its competitors. Such a concept of value creation was first developed by Schumpeter[10] and further developed by Penrose[11]. Recently, significant contribution has been made in this area by Ghosal and Barlett[12], Hamel and Prahalad[13] and D' Aveni[14].

Kay[15] observed that for sustaining and appropriating value, firms need to have three distinctive capabilities, viz. (a) a system of relationships within and between the firms and their customers and suppliers, (b) ability to innovate frequently across the entire value creating process, and (c) reputation that is built over the years. It takes enormous time, cost and persistence to acquire these three capabilities but if achieved and sustained, the same can go a long way in creating superior value for the enterprise. Kay also observed that certain 'strategic assets' such as market dominance, privileged access to critical inputs, regulatory protection, etc. are also key sources of value, albeit for a limited time period. Organisations possessing such strategic assets may, for some time, enjoy certain advantages, unlike their less lucky competitors, but these advantages are rarely sustainable.

1.5 Designing and Implementing Context for Value Creation

Who creates value? While technology and physical infrastructure do play a significant role, it is the managers and employees who individually and collectively come up with innovative ideas for value creation, including how such value can be sustained through a creative combination, tangible and intangible assets and processes. This being so, it is important that a firm is able to leverage the tacit knowledge available with its employees and facilitate knowledge creation across different levels of the organisation[16]. In the days to come, a firm's competitive advantage and value creation ability will increasingly depend on unique ideas and knowledge of its people with regard to everything that the firm does. Most of these ideas and knowledge are tacit and hence difficult to document and communicate. This being the case, organisations must put in place a 'social' context for tapping and transferring such ideas and knowledge. And when this is done, a firm will not only be able to leverage its existing capabilities better to enhance its value but will also create new capabilities that cannot be matched by its competitors easily.

Hence, there is a need to create the right context in which employees will be motivated to unleash their creativity and energy to identify not only new sources of value but also to deliver such value in a most productive and cost effective manner. In value creating organisations, there is a constant endeavour on two fronts simultaneously: one is identifying new opportunities for value creation through using existing capabilities and building or acquiring new capabilities; the other is delivering the value thus identified at the best price/cost ratio. When this twin combination is achieved, the firm automatically enhances and sustains its value, and in the process, that of its shareholders' wealth.

Design of right organisational contexts involves taking into consideration the following factors:

- Performance metrics should be used and benchmarks set against each metric for evaluating managerial and business performance
- Structure, systems and processes to be put in place so as to enable managers and employees to leverage physical infrastructure and capabilities of the firm to the maximum extent possible
- Employees should be given opportunities and encouraged to learn, experiment, create and share knowledge, cutting across hierarchy and functional boundaries
- Nature of managerial compensation (including rewards and punishment) system should be deployed to direct managerial attention to the task of value creation
- Commitment and leadership qualities should be displayed by the top and senior management to create and sustain a culture where concern for continuously enhancing the value of the firm and its shareholders becomes a way of life

The role of each of these factors in implementing a value based management system in an organisation cannot be overemphasised. Performance metrics and benchmarks are critical for communicating to everybody in the organisation that numbers count so far as value creation is concerned. The design of structure, systems and processes, particularly those connected with information capturing and processing, delegation of authority, strategic planning, budgeting, reporting and review, and follow up, should be such that every decision and activity of the firm—whether strategic, tactical or routine—is guided by the sole consideration of corporate and shareholder value. Facilitating the process of individual and group learning and providing opportunities to exploit the capabilities of the firm are critical for knowledge creation as well as its dissemination across the organisation. Without the development of such knowledge creating facilities, a company will never be able to sustain its value creating abilities in the long run. Right compensation and incentive system is a powerful tool to influence managerial behaviour and ensures that managers work towards achieving the targets set against each parameter of the performance metrics (thus contributing to the value creation tasks of the firm), and get rewarded for the same. Role of top and senior management and their explicit commitment to enhance the value of the firm and its shareholders will be the key to ensuring that no strategic, tactical or even routine decision is taken that could undermine the value of the firm. The importance of maximising the value of the firm needs to be stressed time and again in order to ensure that people remain focussed towards the same. It is only when all these conditions are satisfied, that the firm can hope to become a shareholder value company.

1.6 How to Guard Against Failure to Maximise Shareholder Value

Organisations are often not able to maximise corporate and shareholder value because of their failure to focus on value drivers and sources of value, discussed in Sections 3 and 4, respectively. The failure in this regard does not happen suddenly; rather it is a gradual process, its indicators being as follows:

- Loss of customer loyalty and market share (reflecting the organisation's inability to create value for customers)
- Declining competitiveness in all aspects of business—cost, quality, productivity, service, and asset management
- Inability to create new opportunities through using existing assets and capabilities, in present and/or new product-market segments
- Declining output-capital ratio and growing number of non-value creating activities
- Locking of capital in unremunerative/non-productive assets and activities

- Loss of individual and group competencies because of their inappropriate use
- Declining visibility in the eyes of all categories of investors including financial institutions and adverse business press
- Inadequate return to shareholders
- Becoming a takeover target

An alert shareholder, value driven management team will be able to sense the emergence of any such signals immediately and initiate corrective action at the very outset. For example, loss of customers or declining competitiveness in key result areas could trigger a series of remedial step to bring these two important value creating factors, e.g. customer satisfaction and competitiveness, back on track. Similarly steady decline in stock prices or attempted bid on the company by a hostile bidder should be a clear indicator that current strategies and value creation processes deployed by the firm are not perceived as the best in the capital market and that there exists a significant gap between the value being created by the incumbent management team as against the potential that is available. Rappaport[17] observed that unless the incumbent management team pursues new strategies and finds new ways of creating value that eliminates this 'value gap', the firm will continue to destroy value in the eyes of the shareholders, leading to initially a decline in stock prices and ultimately, a takeover by a new management group.

1.7 Experiences of National and International Companies

Some of the international companies that are known to have enhanced their shareholder and corporate value on a steady basis by adopting the principles outlined in this chapter are: Coca Cola, GE, Microsoft, Intel, Wrigley, Berkshire Hathaway and South West Airlines, among others. However, a large number of companies in the West are also known to be notorious in that they have destroyed their corporate and shareholder value on a consistent basis. While reasons for failure to enhance shareholder value vary from one company to another, successful companies, on the other hand, do show some common best practices viz. concern for value creation at all levels through using the 'value' yardstick as the sole guiding principle for taking strategic, tactical and even routine decisions. To such companies, every activity must justify its existence in terms of value it creates, directly or indirectly, for their shareholders.

The key observations of a recent study on how well the international companies are creating value in the new economy are as follows:

- Intangible assets are increasingly playing a major role in value creation
- Companies with more physical assets use capital less efficiently
- A fewer companies create disproportionate share of value in the new economy
- Certain industries, for example high technology, health care, IT and communication, certain FMCG companies and financial services are represented by highly valued companies
- Organisations with fewer physical assets show superior ratio of risk and return

The study also found that factors such as customer satisfaction, installed customer base, retention of key people, knowledge management, etc. that contribute to the bulk of value created by a firm, are rarely included in its financial reporting system. It suggested that firms should recognise the fact that to operate successfully in the new economy, they would require a new business model which would bring with it certain associated risks. To manage such a model, managers would require new processes, tools and information that will enable them to measure and manage the process of value creation better.

In India, the concern for value creation, till even recently, was only skin deep. Indian companies, given to operating under a regulated regime for over 40 years, and in the absence of any market worth its name for corporate control (see Chapter 7), never gave any importance to maximising corporate and shareholder value. Except for a few select companies, most never bothered to meet the changing value expectations of customers or to become cost competitive. No conscious effort was made to upgrade technologies, improve productivity and efficiency, avoid over-manning or unlock investments that had become infractuous or non-value adding. Companies either did not pay the dividend or paid at a level that was far lower than the opportunity cost of the investors. With no plan in place as to how to overcome the existing inefficiencies and exploit emerging opportunities, shareholders perceived that the value creation abilities of such firms were limited which in turn resulted in depressed prices of their shares. While government policies did influence the growth of various industries and structural and transaction costs of Indian firms in a major way, there is no denying the fact that managers of most of these firms never paid any attention to the important task of enhancing value of their firms.

However, beginning 1991, deregulation of Indian industrial sector ushered in a new era. There is definitely a clear indication that certain firms had already started thinking and acting in terms of their value enhancing capabilities. Some of the private sector companies which are now generally considered as shareholder value-driven firms are: HLL, Reliance Industries, Wipro, Infosys, ITC, HCL Technologies, Cipla, Ranbaxy, Hindalco, HDFC Bank, L&T, Nestle, Satyam Computer services, and ICICI (all these companies had market cap of over Rs 5000 crore as in October 2001). However, some of these companies, too, have not yet fully moved towards becoming true shareholder value-driven companies in the eyes of the capital market, as reflected in the low appreciation of their share prices vis-à-vis their competitors as well as their own book value per share. When one considers the case of TISCO or TELCO, this lack of concern for shareholders becomes even more prominent. These two companies, which occupied the top two positions in terms of market capitalisation in 1990, slipped to 29th and 45th position by October 2001. There is of course also the good news that there were more than 40 companies in the list of top 100 companies, in terms of market capitalisation as in 2001, which did not figure in the same list prepared in 1990.

Based on the performance of Indian companies in terms of market capitalisation during the period 1990-2000, the following broad observations can be made:

- Highly focused companies are better able to enhance value for their shareholders than less focussed companies
- Asset intensive companies are not doing as well as those with fewer assets
- Older, well known companies are finding it difficult to enhance their shareholder value
- Companies operating in information intensive or emerging industries are likely to fare better in the future because of their low asset intensity

Hence, Indian companies will sooner or later find that they cannot afford to destroy corporate and shareholder value any more if they want continued support of the investing community. Emergence of global competition in almost all sectors of the economy will force them to reassess their business portfolio in terms of what capabilities they should acquire in order to create value for their customers on a sustainable basis and at a cost that is competitive by international standards. With the progressive withdrawal of all sorts of protection that was available till even recently, Indian companies have a very small chance in terms of surviving and growing unless they undertake comprehensive restructuring of their business portfolio, capital structure and also organisation and management. The various concepts and framework relating to such corporate restructuring moves are discussed in the following chapters, which also indicate how different approaches to restructuring contribute to creation, enhancement and sustenance of corporate as well as shareholder value.

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CHAPTER

2

Enhancing Corporate and Shareholder Value through Corporate Restructuring

2.1 Introduction

In Chapter 1, we discussed how customer value and shareholder value are closely linked and why managers need to focus on maximising shareholder value as their principal objective. Examples have been given to show how decisions taken by managers can either create or destroy shareholder value. An important conclusion drawn at the end of the chapter was that every company must become a shareholder value company with all its decisions—strategic and operating—driven by the sole objective of maximising this value.

2.2 Corporate Restructuring: Its Meaning and Scope

Decision to undertake corporate restructuring of a firm may encompass a broad range of activities and include acquisition and divestiture of lines of business and assets, acquiring controlling shares in other companies, alteration in capital structure through a variety of financial engineering initiatives, and also effecting internal streamlining and business process re-engineering to improve efficiency and effectiveness of the firm. In other words, corporate restructuring can lead to changes along one or more of the three directions, viz. (i) assets and portfolio, (ii) capital structure and (iii) organisation and management[2]. Assets and portfolio structure can get significantly altered when a firm undertakes a series of acquisitions and divestitures to bring more focus to its lines of business or widen its activities to enter new fields. Capital structure can change due to corporate restructuring caused by infusion of large debt, change in equity due to either expansion of capital base or buyback of equity or composition of owners (e.g. participation of MNCs, FIs and FIIs in the equity of the firm). Organisational restructuring is also a part of the overall corporate restructuring and is designed to improve the overall efficiency and effectiveness of the organisation through changes in structure, systems and processes, people and culture.

Hence the scope of corporate restructuring includes:

(i) Portfolio and Asset Restructuring

- (a) Mergers & Acquisitions
    - Merger of two or more legal entities or companies
    - Purchase of assets/business of another firm as a going concern
    - Substantial acquisition of share of a legal entity leading to change of control in the same
- (b) Divestitures
    - Divestment of assets/business as a going concern
    - Divestment of controlling stake of a legal entity leading to change of control.
    - Spin-off of a division or a subsidiary into a separate legal entity
    - Split-off
    - Split-up
    - Equity carveout

(ii) Financial Engineering (leading to changes in existing capital structure)

- Alteration in debt-equity mix/debt-equity swaps
- Issue of different classes of shares (e.g. non-voting shares and preference shares)
- Issue of different types of debts to meet fixed and working capital needs
- Infusion of foreign debts and equity
- Buyback of shares

(iii) Internal Streamlining and Business Process Re-engineering (leading to changes in organisation and management structure of the firm)

- Downsizing of head count
- Cost reduction programmes
- Closure of uneconomic units
- Disposal of idle assets
- Business process re-engineering
- Changes in structure, systems (including HR systems) and processes, skills and culture to facilitate implementation of various change programmes

This book thus defines 'Corporate Restructuring' as a comprehensive route for changing the portfolio and assets structure, capital structure, and organisation and management structure of a firm. Its scope includes three major initiatives, viz. Portfolio and Asset Restructuring, Financial Engineering, and Internal Streamlining and Re-engineering. The definition and operational aspects of each of these three modes of corporate restructuring are discussed in Chapter 3. What is important to note is that managers need to understand this holistic definition of corporate restructuring to appreciate the entire range of activities that are required to be initiated for maximising shareholder value of their firms. In the next section, we will discuss how such corporate restructuring is crucial to enhancing shareholder value.

2.3 Corporate Restructuring and Shareholder Value

It is well known that with changes in business environment, most firms need to reposition themselves periodically in terms of products-market segments served, value offered to target customer groups, capabilities built to deliver the value propositions, value creating activities undertaken in-house or outsourced, and so on. The aim of such repositioning is to sustain relevance and remain profitable and growing over the long haul. Corporate restructuring, as defined in this book, is the principal route through which such repositioning is done. For example, mergers and asset buyouts can help enhance market power, achieve economies of scale, streamline core capabilities, pool resources, extract synergies and so on, all of which are vital for growth in existing line of businesses. Similarly, divestitures can help do away with non-core activities, provide focus to individual businesses (e.g. a division is converted into a separate legal entity through spin-off) and simplify the ownership structure (e.g. divestment of cross holding as happens in a family business). Financial engineering can help change the debt-equity mix and alter the ownership structure (e.g. infusion of foreign equity, buyback of share, issue of non-voting or preference shares, and so on), and this may lead to greater fund mobilisation, lowering of risk and also reduction in cost of capital. Internal streamlining and business process re-engineering, another mode of corporate restructuring, is normally an ongoing affair in a firm aimed at enhancing its cost competitiveness through downsizing of head count, reducing cost of operations, closing down uneconomic units/product lines and undertaking process simplification to improve speed, quality and services. A close look at the outcome of these three modes of corporate restructuring will reveal how vital is the need for periodic restructuring for any firm to sustain its continued profitability and growth.

The decisions taken as part of restructuring a company using one or more of these modes will change a company's operating and financial parameters in the post-restructuring phase. Some of the key parameters where performance should improve significantly are:

(i) Operating Margin and Volume Growth

- Portfolio and asset restructuring

  (a) M&A leading to greater economies of scale, growth in volume and market share, more bargaining power vis-à-vis customers and suppliers, efficiency in operations, etc. all contributing to creation of greater surplus

  (b) divestment of non-profitable business, leading to improvement in margin and releasing of scarce resources

- Internal streamlining and re-engineering leading to improvement in cost competitiveness, quality, delivery and services

(ii) Asset/Resource Productivity

- Both portfolio and asset restructuring, and internal streamlining and re-engineering will lead to improved usage of invested capital

(iii) Cost of Capital and Risk

- Financial engineering will help by changing debt-equity mix, debt composition and risk exposures

The above are just some examples of what corporate restructuring can do to improve the performance of an existing firm, thereby, enhancing its shareholder value which is the principal objective of any firm. The question is, how do these changes come about through such action. In Chapter 1, we have briefly defined shareholder value as corporate or enterprise value (which is equal to the present value of future free cash flow) less corporate debt obligations and preference shares, if any, existing on the date of valuation. Thus, for maximising shareholder value, a firm will need to maximise its corporate value. Corporate value can be maximised only if free cash flow from operations during each of the future years is maximised. It is well known that free cash flow of a firm is a function of three key drivers, viz. (a) growth in revenue and operating margin, (b) incremental fixed capital requirement and (c) incremental working capital requirement. If the present and projected performance of a firm, based on the strategy it is pursuing, along these three drivers is unsatisfactory, vis-à-vis the performance expected by the shareholders (based on their judgement using information available on competing firms in the same industry and prospects thereof, and also the opportunities available to invest their money), there will be a downward pressure on firm's stock prices. When a firm receives such adverse signals from the stock market over a considerable period of time, it is the duty of the management to initiate programmes for corporate restructuring in order to enhance the organisation's level of performance as well as to bring about a significant improvement in free cash flow.

To determine the corporate value, the relevant discount rate to be used for discounting the free cash flow from operations will be what the market expects it to be, given the risk involved and the opportunity costs to the investors. If the capital structure of the firm is not an optimum one from cost, liquidity and risk point of view (implying that the discount rate will be higher than what is applicable for an optimum capital structure), it is possible to alter the same through financial engineering (another mode of corporate restructuring). If the latter is done judiciously and stock market appreciates the same, the discount rate used by the market will automatically improve, leading to maximising the present value of the future free cash flow.

The above discussion establishes the close linkage between corporate restructuring and maximisation of shareholder value. If the restructuring is carried out appropriately, through adopting one or more of the three proposed modes and keeping in view the requirements of enhancing volume and operating margin, augmenting the productivity of fixed and working capital investments and lowering the discount rate, there is bound to be a favourable impact on the shareholder value of the firm. Taking a long-term perspective in this regard is crucial and short-term gains should not colour the view of the management in taking the restructuring decisions.

2.4 Need for Periodic Restructuring

How frequently should a company restructure? There is no hard and fast rule. There may not even be any need to restructure for a long period of time if the firm is operating in an environment where changes in competition, technology, product, customer mix and cost of financing are minimal and the firm is holding a steady or dominant position in the industry. However, with the onset of competition, rapid obsolescence in technology, skills and product-market and rising volatility in money and capital market, the steady state is virtually non-existent. Overnight, companies which were known to dominate their respective industries for decades have begun to under-perform and are showing signs of extinction. The reasons can be traced to the declining competitiveness of their product, technology and value creation processes vis-à-vis new generation players—both within the country and overseas—as well as to absence in growth segments of the market, lack of economies of scale, poor efficiency in operations, high cost structure, mismanagement of fixed and working capital, lack of funds to support brand and distribution network, high cost of capital, etc. Interestingly, the decline does not come about suddenly; rather, it is a gradual process coinciding with changes in the environment in areas such as technology, competition, regulations, etc. that begin to nullify the assumptions made by the firm based on strategies being pursued, and its failure to foresee the urgent need for a new set of strategies relevant to the changed environment. Hence repositioning becomes crucial whenever there is a major shift in the business environment, which is beyond the control of the firm. Besides, it is equally important to revisit the firm's choice of product-market, basis of competitive advantages and also the configuration of its value creation processes (consisting of tangible and intangible assets, technologies, brands and distribution network, people and skills, organisation and systems, financial and intellectual capital, and so on). Such repositioning of the firm is done through corporate restructuring, which, given the volatility of present-day business environment (including global competition), has to be a continuous process. The strategic planning of a firm must take cognisance of the dynamics of the environment with regard to both opportunities and threats, and also must facilitate review of its value creation processes vis-à-vis the new environment on a regular basis, for the decision to restructure, whenever needed, has to be absolute.

2.5 Benefits of Corporate Restructuring

The fundamental objective of corporate restructuring is to continually reposition the firm against the fast changing business environment for maximisation of its shareholder value. It is a key managerial task and failure to achieve this objective can be detrimental to not only the firm but also to the managers themselves.

For the managers to establish to the shareholders that they are taking all the necessary actions to enhance shareholder value, they should ensure: (a) that the firm is maintaining the highest level of productivity and efficiency of all its assets (both tangible and intangible), (b) that it has built (or in the process of building) a set of intangible assets and capabilities (such as brands, distribution network, installed customer base, new product development, project management capabilities, and so on) which are (or will be) difficult to imitate, (c) that it is already implementing a series of plans and programmes (e.g. capacity expansions, brand building, expansion of distribution network, installing e-commerce capabilities, etc.) which when completed will have favourable impact on its future cash flow, (d) that it is working on some ambitious projects (such as research in some advancing area) which, if successful, will give it significant, long-term competitive advantages and hence scope to earn superior profit in the future, and (e) that the firm possesses the required intellectual capital which will enable it to come up with new generation products and services that cannot be matched by the existing or new competitors. Hence, ensuring that best of strategies are being pursued by the management team in these five areas and making sure that the stock market is aware of this will have positive influence on the current and future stock prices of the firm. Needless to say, the stock market would also like to be kept informed about the actions being proposed to restructure the firm along one or more of the three dimensions as described.

The need to keep shareholders informed and updated on the firm's progress along the five directions discussed above cannot be overemphasised. Many a time, share prices do not improve even after taking the necessary steps to enhance the same; the reason being lack of communication between the shareholders and the firm. But what needs to be understood is that a firm cannot blow its trumpet on uncertain grounds. Shareholders are aware that with the changing business environment, there will be both increased opportunities and threats and that the firm must review all its value creation processes to assess their relevance in the changed context. If the market finds that the management is consciously working on improving current efficiency and productivity, investing in brands and future competencies, strengthening the distribution network, developing intellectual capital and also undertaking corporate restructuring to lay a strong foundation for gaining greater competitiveness in the future, the outcome would be a positive impact on share prices, reflecting the market's expectations in terms of the firm's future growth opportunities.

What happens if a firm fails to enhance its shareholder value? At the least, its share prices will fall leading to loss in investor confidence; its ability to access the capital market will be significantly reduced and more shares will need to be issued to raise the required capital. Besides banks and FIs will hesitate to lend money to such firms as share price is the ultimate indicator of how ably the firm is being managed and a reflector of its future prospects in the hands of the incumbent management.

A major risk in failing to enhance shareholder value is the possibility that these firms could become easy targets for takeover attempts by other firms, particularly with the steady emergence of market for corporate control (see Chapter 7) and relaxation of regulatory constraints on M&A activities. The aim of the bidder will be to acquire the target company or any of its divisions at a price which may be marginally higher than its prevailing value but which will still be below the level that the bidder hopes to attain either through employing a series of strategies and actions that better leverage the firm's existing capabilities and resources or through exploiting the firm's synergies with the bidder's existing activities or both. In other words, if the incumbent management fails to enhance the shareholder value to the maximum extent possible, it will always be open to takeover attempts, i.e. either the company will be sold by the existing majority shareholders at a negotiated price or it will be taken over through a hostile bid. In either case, the fate of the senior management team would be uncertain.

An alert management is always aware that the perception of the capital market vis-à-vis the performance of their company has a major impact on the shareholder value of their firm. Hence in order to enhance this value, the management takes all the necessary actions, which could be many and varied, but one key task, that is particularly relevant to the well being of a company, is periodic corporate restructuring. The series of tasks such as portfolio and asset restructuring (through M&A and divestiture), financial engineering and internal streamlining undertaken by the Indian industry during the last seven to eight years reflects the growing concern for maximising shareholder value and also the importance of corporate restructuring as one of the key routes to achieve this objective.

2.6 Things to Remember

Even though corporate restructuring as a means of enhancing shareholder value is gaining importance in the corporate world, it needs to be stressed that the same must not be undertaken for short-term gains or because it is considered trendy. There are instances of companies, both in India and abroad, acquiring and divesting companies merely for tax purposes or for entering into a new field for making quick money. What managers must understand is that any restructuring done without assessing the medium and long-term strategic implications on future business prospects and competitive advantages is bound to backfire sooner than later. There are many examples of corporate restructuring (particularly M&A and divestitures) which just did not produce the desired benefits and had to be reversed on a number of occasions. It is to be noted that favourable financial pay-off from any corporate restructuring move is always the outcome of a well thought out programme for strategic repositioning of the concerned firm. If there is no robust long-term strategic thinking behind the corporate restructuring, the short-term financial gain will only be illusory and may in fact divert attention of the management team from the real issues concerning the business.

Each of the three modes of corporate restructuring—portfolio and asset restructuring (e.g. M&A and divestitures), financial engineering and internal streamlining, and business process restructuring—has different strategic, legal, financial and organisational implications which are to be addressed correctly while formulating and implementing any corporate restructuring move. The next two chapters will focus on these implications.

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CHAPTER

3

Corporate Restructuring—Concepts and Framework

3.1 Introduction

In Chapter 2, we discussed the meaning and scope of Corporate Restructuring as defined in this book, and talked about the three following approaches to it:

1. Portfolio and Asset Restructuring
    - Mergers and Acquisition
    - Divestitures
2. Financial Engineering
3. Internal Streamlining and Business Process Re-engineering

In this chapter we shall discuss the concepts and frameworks underlying each of these factors so that the readers get a general overview of all that is involved in formulating and implementing corporate restructuring decisions. Here, our focus will be more on managerial issues rather than detailed technicalities and hence, it will be brief in nature.

3.2 Portfolio and Asset Restructuring

3.2.1 Mergers & Acquisitions

We have already stated that M&A can take place through three routes viz. merger of two or more legal entities, purchase of a firm's business/assets as a going concern and acquisition of a substantial share of another company leading to change of control. We will now give some specific details on M&As specially for the benefit of managers.

3.2.1.1 Purpose

This will differ from one firm to another:

- Procurement of input
  - Safeguard
  - Economies of scale
- Strengthen production facilities
  - Economies of scale in production
  - Standardisation of input and output
  - Incorporate best manufacturing practices
- Expand market
  - Reduce competition/safeguard present market
  - Access new product for diversification or expansion of product range
  - Strengthen distribution network
  - Get rights on patent
- Enhance financial strength
  - Improve liquidity
  - Opportunity to dispose surplus land/assets
  - Increase borrowing limit

- Take advantage of tax benefit
- Improve EPS

➲ Improve general image

- Improve image
- Attract managerial talents

3.2.1.2 Types of M&A

There are essentially three types of M&As:

Horizontal Mergers

Key characterstics:

➲ They result in forming a large firm which can give the benefits of economies of scale and increased competitive power.

➲ Such mergers may attract regulatory control because of their potential negative effect on competition.

➲ Timing is the key.

Vertical Mergers

Key characteristics:

➲ Reliability of input availability is ensured.

➲ Better management of production and inventory.

➲ Common ownership of different activities of the value chain helps in reconciliation of conflicting interests and motives.

➲ Opportunity to gain competitive power through controlling input prices (lower prices for own consumption and higher prices for competitors).

➲ Such mergers have the potential to increase entry barrier (in terms of capital and knowledge) and hence may be perceived as anti-competitive.

Conglomerate Mergers

Key characteristics:

(a) There can be three types of conglomerate mergers:
- Entry into a related business through product extension;
- Entry into a new geographic market;
- Entry into unrelated business activities.

(b) Such mergers require special competence and skill to manage different functions such as R&D, Operations, Marketing, etc. pertaining to each diversified business.

(c) Synergy helps gain competitiveness and cost advantage provided there are certain levels of relatedness, and assets and capabilities acquired are complementary to the existing ones, even though product-market scope of each business is different.

(d) Corporate office must be able to add value to individual operating units by way of its expertise in the field of general management functions across diverse businesses.

3.2.1.3 Industry Life Cycle and M&A

The nature and scale of M&A activity in an industry generally follow the following pattern:

(a) *Introduction Stage*—Established firms in mature industries may acquire medium or small sized firms in related or diversified businesses that are either averse to risk or lack management competence required to manage business during the growth stage. It is also possible that smaller firms may enter into horizontal mergers to acquire the critical mass required in areas such as management capabilities and financial resources.

(b) *Growth Stage*—Same approach as described above; the purpose being to exploit opportunities for growth and profit by mobilising or investing required resources.

(c) *Maturity Stage*—At this stage, the aim is to achieve economies of scale in R&D/Production/Marketing to match lower cost or prices of other competitors. Established firms may take over smaller firms during this stage to teach the latter management skills and provide financial support.

(d) *Decline Stage*—During this stage, horizontal M&As are pursued for survival. Vertical M&As, though rare, can take place to increase efficiency and profit. Some firms may diversify into new businesses through related mergers to exploit opportunities for synergy and for using existing capabilities. Steps are taken to divert cash from portfolios with declining prospects to acquire high growth businesses in other industries.

While the above patterns are general in nature and may not be applicable exactly to all industries, they do act as a guide to decide a firm's M&A strategy.

3.2.1.4 Advantages of M&A

Some major advantages of M&A are:

(a) Entry into new business/activities or expansion of capacity is faster through M&A than through internal development and joint ventures.

(b) M&A may enable a firm to acquire assets/competence in new activities at a comparatively lower cost than internal development or JV.

(c) It facilitates developing new capabilities while operations continue.

3.2.1.5 Financial Issues in M&A

There are certain financial issues that managers will need to understand as they formulate their M&A strategy and evaluate the options available. These issues are:

(a) Financial analysis of the target

(b) Valuation of target

(c) Basis of exchange

These three issues are applicable to the three types of M&As (viz. merger of two or more legal entities into one, asset buyout as a going concern and substantial acquisition of shares of another legal entity). There are also two other important financial issues viz. post-merger accounting and taxation which are specialized topics and are not discussed here as the same are beyond the scope of this book.

(a) *Financial Analysis of the Target*

In a friendly M&A, it is possible to obtain substantial financial and operating data that are needed to value the target. However, managers of the acquiring firm should be careful in assessing the target's financial figures, particularly with regard to the accounting policies that underline each figure, the assumptions made on revenue and capital expenditures, quality of assets indicated in the balance sheet vis-à-vis those physically available as well as disclosed/undisclosed legal encumbrances, provisions made/not made and finally level of performance against domestic and global benchmarks. It is only reasonable to assume that the seller will like to present a picture that is 'interesting' to the buyer. This being the case, managers of the acquiring firm will need to be extremely careful in order to ensure that they do not end up paying for assets and liabilities that will become less beneficial than made out by the seller.

Some of the areas that require careful attention while making financial assessment of the target are:

(i) Issues that are to be considered in relation to balance sheet items:

- Time element—difference between the date of valuation and date of actual transaction.
- Extent of liquidity including understated liabilities, if any.
- Low quality assets, if any.
- Overstated receivables.

- Inventory—physical condition and method of valuation.
- Intangible assets and whether there is any pending litigation.
- Real estate assets and encumbrances, if any.
- Valuation of SBUs/Divisions individually vis-à-vis the entire firm.

(ii) Issues to be considered in relation to income statement:

- Depreciation policy.
- Inventory valuation policy.
- Quality of earnings, particularly percentage of non-operating income.
- Key ratios—Liquidity ratios, Activity ratios, Financial leverage ratios, Profitability ratios, Market based ratios.

(iii) Cash flow issues:

- Cash flow from operations.

A detailed discussion on each of the above issues is avoided here as these are available elsewhere.

(b) *Valuation of Target*

Valuation is one of the most important aspects of M&A. One needs both functional and managerial skills as well as a holistic and long-term perspective on the business being acquired while doing the valuation exercise. Leaving this entire exercise to the finance and accounting professionals could be dangerous because high quality valuation goes beyond mere financial technicalities and requires considerable business acumen and judgement. The salient issues relating to financial aspects of valuation exercise, are given later, with due reminder to the readers that the figures that go into the valuation exercise will have to be generated or vetted by managers who are responsible for both planning and executing the M&A move.

Essentially there are six methods for valuing a target:

(i) Dividend based
(ii) Earnings based
(iii) Net asset value based
(iv) Market price based
(v) Free cash-flow based
(vi) Economic profit base

(i) *Dividend based valuation*

This method is not used when the acquirer is considering the M&A option for strategic reasons such as enhancing market power or expanding into a new field. The method essentially involves determining the price of share of the acquired firm, based on the following formula:

Price of share in year 0 = Present value of future dividend = $D1/(K - g)$ where $D1$ is the rate of dividend in year 1; K the rate of capitalisation and g the growth rate in dividend.

(ii) *Earnings based*

In this method, the first step is to calculate the last three years' average Profit After Tax (PAT), after adjusting for extraordinary items; the objective being to iron out the one off variations and arrive at a maintainable PAT. From the average PAT, thus arrived at, preference dividend is deducted to determine the PAT available to common shareholders. Next step is to determine the appropriate capitalisation rate (i.e. average cost of capital) based on yield on equity and cost of long-term borrowed funds. Once the capitalisation rate is decided, the average PAT (net of preference dividend) of the company is capitalised at the said rate to arrive at the value attributable to the common shareholders. This value is divided by the number of outstanding equity shares to determine value per equity share.

Detailed discussion on the above is avoided here as these are available elsewhere[1].

(iii) *Net asset value based*

In this method, adjustments are to be made in the valuation of assets, as reported in the balance sheet, in areas such as elimination of the value of intangible assets, deduction of bad and doubtful debts not provided for and also any arrears of depreciation; also to be removed is the impact of any revaluation made. Likewise liabilities, as reported in the balance sheet, will have to be adjusted (depending on what has been provided or not provided for) in areas such as preference capital, provisions for gratuities and taxes, arrears of preference dividend, contingent liabilities, etc. Adjusted liabilities, as determined above, are deducted from the adjusted asset value to arrive at the net asset value which is then divided by the number of outstanding equity shares to arrive at the break-up value per share.

(iv) *Market price based*

Under this method, the average market price of equity share—high and low—for the last three or five years is considered after making due adjustments for the impact resulting from such aspects as cum dividend, bonus or rights issue.

(v) *Free Cash-Flow method (also called Discounted Cash-Flow (DCF) method)*

The earnings and assets based methods of valuation, in spite of their simplicities, have two inherent shortcomings, viz. both use past data and both are influenced by accounting principles and policies. The Free Cash-Flow or DCF method, in contrast, emphasises valuation on cash basis and enables the valuer to factor in the impact of future strategies and initiatives on the projected financial performance of the firm being valued.

Copeland et al.[2] identify the key elements of the DCF method as follows:

- Value of equity is the value of company's operations (available to all investors) less the value of debt and other investor classes that are considered superior to common equity (such as preferred stock).

- Value of operations is equal to Free Cash Flow (FCF) from operations discounted at a rate that reflect the riskiness of these cash flows.
- Free cash flow is the sum of after tax operating earnings and non-cash charges less investment in fixed and working capital.
- FCF excludes any financing related cash flows such as interest expense or dividend.
- FCF is the right cash flow for valuation since it is available to all capital providers, both debt and equity.
- Discount rate is the Weighted Average Cost of Capital (WACC) which is the opportunity cost to all the capital providers weighted by their relative contribution.
- Present value of operations has two parts:
  - Present value (PV) of cash flow during 'explicit' forecast period.
  - PV of cash flow 'after' explicit forecast period (called continuing value).
- For valuing of debt, cash flows relating to the debt are to be discounted using proper rate reflecting the risk. Two points to remember:
  - Debt outstanding on the date of valuation is valued.
  - Future borrowings (i.e. over and above outstanding borrowings) are assumed to have zero present value.
- Equity value of a multi-business firm is the sum of:

  (a) Values of individual operating units;

  (b) Cash generating corporate assets less;

  (a) Cost of operating the corporate centre;

  (b) Value of company's debt and preferred stock.

- Factors driving cash flow and value:
  - Value drivers are those factors that drive the value (upwards and downwards). The same factors also drive the free cash flow (since value itself depends on FCF). The two key drivers are:

    (a) Rate of growth

    — Revenue

    — Profit/cash flow

    — Capital base

    (b) Return on invested capital (ROIC)
  - The three key definitions for understanding the value drivers are:

    (a) NOPLAT = Net Operating Profit Less Adjusted for Tax = EBIT(1–T)

    (b) Invested capital (IC) = Operating working capital + 'Net' fixed assets + other assets

    (c) ROIC = NOPLAT divided by IC
  - Annual growth in NOPLAT and return on incremental or new capital being invested determine the growth of FCF.
  - Value is created when ROIC exceeds WACC.
- To get a complete picture of valuation being done, one needs to do:
  - Comparison with the historical performance
  - Comparison with other comparable entities
- Also important will be to identify:
  - Underlying economics of the business
  - Factors that increase or decrease the value

(vi) *Economic profit method*

Economic profit is defined as follows:

$$\begin{aligned}\text{Economic profit} &= \text{IC} \times (\text{ROIC} - \text{WACC}) \\ &= \text{IC} \times \text{ROIC} - \text{IC} \times \text{WACC} \\ &= \text{NOPLAT} - \text{Capital charge}\end{aligned}$$

Hence as per the economic profit model, value of a company is equal to invested capital plus the present value of projected economic profit.

Of these six methods of valuation, the free cash-flow method is considered the most appropriate since in this approach, valuation is done on cash basis and the impact of future strategy proposed to be pursued, initiatives planned to improve operating efficiency and investments required to support the business are all factored in. The problem of what items to be expensed and what to be capitalized, a common issue whenever one uses accounting based information, are not confronted with in the free cash-flow method. In this method, it is also possible to develop a few scenarios on future cash-flows and attach probability to each. However, in spite of the apparent advantages of the free cash-flow method, it is useful to derive the value employing the other five approaches (depending on each method's applicability in specific cases) and then arrive at a judgement on the band of upper and lower value of the target company's share. If all the six methods are used with great care, there is a good chance that the right value will be arrived at, since the shortcomings and advantages of each will be taken care of in the overall term.

It would also be useful to compare the value arrived at with some benchmark value so as to get a correct perspective on the whole subject, including the expectation of the seller. The following are the three possible benchmarks that this value can be compared with:

- Book value per share (net worth divided by the number of shares).

- Liquidation values (i.e. what value the business will fetch if it is liquidated on the date of valuation).
- Replacement value.

These benchmarks can give clues to both the buyer and the seller as to the floor and ceiling value, and can be a useful basis to start negotiation, depending on relative strengths, weaknesses and keenness of both the parties.

Copeland et al. identified the following two aspects relating to valuation:

(a) Limitation of direct discounting of equity cash flows (i.e. discounting only the dividend and share repurchases) vis-à-vis free cash flow:

- Suitable for FIs primarily;
- Does not identify sources of value creation nor value creation opportunities;
- Choice of discount rate is difficult (if high dividend payment rate is contemplated, higher debt will be required, implying higher risk for equity holders);
- Difficult to use in multi-business entity since debt and equity need to be allocated to each individual business.

(b) Unsuitability of real cash flows and discount rate vis-à-vis nominal rate:

- Real cash flows mean cash flows using constant currency value (say rupee at 1990 prices), i.e. without any impact of inflation.
- Real discount rate, which is defined as nominal rate less expected inflation, is difficult to visualise or forecast in real terms since managers are inclined to think in nominal terms.
- Interests are also quoted in nominal terms rather than real terms. Since historical performance is always in

nominal terms, projecting future performance (whether NOPLAT or IC) in real terms is difficult.

(c) Basis of Exchange

There are three principal approaches to acquiring shares of another company, viz.

- Cash for stock, in which the acquiring company acquires the shares of the acquired company through payment of cash.
- Debenture for stock, in which the acquiring company acquires the shares of the acquired company through issuing debentures.
- Stock for stock, in which acquiring company issues its own shares to buy the shares of the acquired company.

In case of a legal merger, the stock for stock option is chosen. If the acquisition aims at acquiring control in another legal entity, all three options can be deployed.

In 'assets buyout' type of acquisition, the cash option is preferred by sellers, though use of debentures or even stock of acquiring company can be considered.

3.2.1.6 Acquisition Finance

Funds are required for the following M&A activities:

- Asset buyout (ABO) involving purchase of business/assets of another company as a going concern.
- Merger of two legal entities where part of the consideration is in cash.
- Purchase of controlling share of the target company.

There are a number of funding options which include:

- Internal generation
- Fresh debts (including highly leveraged ones)
- High risk bonds

- Issue of redeemable preference shares/non-voting shares
- Convertible securities
- Issue of fresh equity
- Mix of the above

Different types of financial instruments (over and above the conventional ones) are now available to finance any requirement, including acquisition (this is not an exhaustive list):

- Optionally convertible debentures
- Non-recourse financing
- Zero coupon/deep discount bonds
- Floating rate notes
- GDRs and ADRs
- Yankee bonds/Samurai bonds
- Euro-convertible bonds
- Bonds with step up/step down interest structure
- Interest rate collars

Managers must take into account the following key considerations before deciding which financing option to pursue:

- Leverage issue (how much debt and equity)
- Ownership issue (equity structure)
- Timing (when debt/equity should be raised)
- Pricing/cost of debt and equity
- Tax and dividend issue
- Relationship with providers of funds

Acquisition finance is a specialised subject and it is desirable that a firm seeks an expert's help before deciding on the course of action.

3.2.2 Divestitures and Sell-offs

These are part of corporate restructuring. Studies have focussed on divestitures as means of separating a product line, division or subsidiary, which are sold for cash, securities or some combination. Both acquisition and divestiture activities were pursued by post-war business firms (in Europe and the US) to tackle the changing economic environment in the 1960s and 70s.

3.2.2.1 Theories of Divestment

Resource-based Theory

The resource-based theory suggests that firms are actually a collection of assets, some of which may be disposable. Firms should be able to enter new markets and re-deploy their resources when returns decline. Acquisitions and divestitures should be viewed as the two aspects of corporate portfolio management, wherein each supports or complements the other. In a declining market, resources can be deployed through diversification or consolidation oriented measures. Divestments may take place as a result in either case. In consolidation oriented measures, divestments they take place to get rid of poorly performing businesses, and in diversification oriented measures they help to generate funds to acquire other non-related businesses. The former is characteristic of declining markets, while the latter of growing markets. Divestments are also known to take place, when the unit concerned is not as efficient as other alternatives in the market place, when the business is in decline or when the unit is not in sync with the group's business philosophy. It has also been contended that many of the divestments of the 1970s and 80s were the result of poorly performing businesses acquired during the 1960s. This means that in many cases the realisation of the motives for acquisition (such as financial synergy, lower costs, increase in volume, etc.) determine whether or not the unit will be divested.

Agency-based Theory

Shareholders prefer that senior managers pursue only those strategies which enhance value of their firm. Senior executives, however, may take strategy decisions based only on their personal gains and losses from such strategies. This is the well known "Agency problem". Among the various stakeholders of a firm, senior managers are the most likely targets for private and public political pressures, because other stakeholders (such as shareholders, customers, suppliers, and employees) are less involved in corporate strategy formulation and implementation. In some situations, senior managers may adopt strategies which are not value enhancing. One very common strategy is divestment which sometime may prove detrimental to shareholder value, particularly when managers are guided by non-economic factors such as political pressure, personal gain, etc. Institutional pressures and power mechanisms are also reasons for divestment, and support this theory.

Reasons for divestments

Some of the reasons for divestment are:

- To regain efficiency by getting rid of non-performing units and improving performance.
- To better manage internal operations.
- Achieve focus: excessive diversification may lead to dilution of a firm's assets by distributing them over a large area. This may result in a resource crunch and hence a poor return.
- When the assets, proposed to be divested, add more value to the buyer rather than to the divesting company's existing portfolio.
- Some past acquisitions may represent undervalued investments. After increasing the value of the segment acquired, divestitures may be used to realise gains achieved.
- Reverse the acquisitions that were wrongly made in the past.

- Release financial and managerial resources locked in non-remunerative businesses and use the same for creating new opportunities.
- Improve managerial efficiency: there exists a perception that managers in general are unable to manage complex organisations and hence the need for divestitures. This is reinforced by the trend that there have been more spin-offs in larger corporates and of unrelated subsidiaries .
- Respond to changing economic environment: with globalisation, and increasing convergence of demand for goods and services, it has become necessary to operate on a global scale for maximising returns; hence the rationale for spinning off units into compact and separate organisations which can be managed more efficiently. It is quite normal for companies to spin-off units which are more successful, are growing and require greater focus, rather than loss making units.
- Tax consideration: Tax advantages can be achieved through divestments, including spin-offs, depending on the tax laws.
- Facilitate valuation by stock market: the stock market prefers pure plays or single industry securities because security analysts tend to specialise in the field. For example, an oil industry analyst may undervalue an oil company's chemical and real estate business. Hence, this hypothesis which holds that the true value of a subsidiary's assets is obscured when these assets are embedded in a complex business structure.

3.2.2.2 Financial fall-outs of Divestment

If any divestment announcement is made as a result of agency conflicts, the concerned firm's stock prices react negatively, resulting in negative, abnormal returns.

Alternatively, if the divestment is motivated by value enhancement reasons, such as sale of non-performing divisions, the stock prices are expected to show an increase. Voluntary spin-offs provide abnormal returns to parent companies through abnormal increase in shareholder wealth. The size of the effect is directly proportional to the size of the spun-off division, relative to the parent's size. Spin-offs associated with tax considerations have been known to show an abnormal return.

In general, divestments are associated with financial synergy. In terms of money value, the overall company gains are almost equal to the size of the subsidiary spun-off. The parent's value remains the same, while the subsidiary has a new independent market value of its own.

3.2.2.3 Methods of Divestment

Spin-offs

Spin-offs are associated with controlled subsidiaries. In a spin-off, a company distributes, on a *pro rata* basis, all the shares that it owns in a subsidiary, to its shareholders. Post spin-off, two separate corporations with the same proportional equity exist vis-à-vis only one that existed before. No money changes hands and the subsidiary assets are not re-valued. The transaction is treated as a stock dividend and a tax free exchange.

Another approach, which is also sometimes called spin-off, will be to float a new entity, with the selling company participating in the equity of the latter, and sell the division or assets proposed to be spun-off to the new company. The consideration in this case will flow to the selling company (and not to its shareholders directly) and can be in the form of cash or stock of the new company or a combination depending on the capital structure proposed for the new company.

Split-off

This is a kind of sell-off where some, but not all, shareholders of the parent company receive a subsidiary's shares with the condition that they must return the shares they hold in the parent company. For example, Dow Petroleum acquired from the market an equity interest in Conoco, which they subsequently traded for ownership in Hudson Bay Oil and Gas fields, which was a

Conoco subsidiary. Family owned businesses, where there are complex cross holdings, can use this approach to separate the interest of different family streams.

Split-ups

A split-up is a case of sell-off where all of a company's subsidiaries are spun off and the parent company no longer exists. This can easily be implemented in case of a non-operating company that has a number of subsidiaries. In a split-up, all the shares held by the parent company in all the subsidiaries are distributed among its shareholders in the ratio in which they hold its shares. The parent company thereafter ceases to exist.

Equity Carveouts

An equity carveout can be defined as the first public offering by a parent company of a percentage of stock of its wholly owned subsidiary. It is one method of equity financing by which the assets of the parent and its subsidiary are separated. The shares which are offered are not reversible like the redeemable preference shares. They are voting stock in the subsidiary company.

Equity carveouts and spin-offs differ in the following ways:

- A carveout leads to creation of new shareholders. In a spin-off, the shares of the subsidiary are distributed among the existing shareholders of the parent company.
- There is no cash flow associated with spin-offs. Stocks issued through a carveout results in cash infusion for the company.
- Greater scrutiny and stricter regulations are involved in equity carveouts than in spin-offs. This is because for the first time a market for the subsidiary company's share gets created. Hence auditing, reporting and legal requirements have to be met.

Equity carveouts differ from seasoned equity offerings in the following ways:

- The assets of the subsidiary and the parent company get separated, i.e. a new company is created in an equity carveout.
- In a seasoned equity offering, public stocks already exist and hence public trading has already taken place. Equity carveouts result in initiation of public trading for the common stock of the subsidiary company.
- Many carveouts lead to changes in managers' responsibilities and incentives. Prior to the public offering, different divisions may be ungrouped or regrouped into a subsidiary, thus bringing about such changes. Also the subsidiary share prices and earnings are included in the incentive and remuneration structure.
- In most equity carveouts, parent companies do not give up the controlling stake in the subsidiary. Hence, minority shareholders are created when the public offering takes place. Overlapping of boards of directors and top management also may happen.

There can be several reasons for companies going for equity carveouts. For example, it could be that the parent company requires cash to fund its various growth projects, repay debt or to pay dividend. In case where a firm's assets are undervalued but those of the subsidiary are overvalued, the former can leverage this difference in value to generate cash either for itself or for the subsidiary. Equity carveouts often take place is such situations.

Equity carveouts can be used to obtain separate funding for the subsidiary's growth projects. If the parent company stock is offered for such purposes, then the securities offered would have a joint claim on both the subsidiary and the parent. By separating the two claims, a carveout facilitates greater information sharing with respect to the projects of the subsidiary.

Overvalued firms are more likely to go for equity carveouts. In contrast, since a spin-off implies continuity of management, firms which have undervalued assets would usually divest through a spin-off.

Equity carveouts can also signal the firm's quality. Firms with high debt or risky returns may find it hard to raise money through the capital markets. Also, the scrutiny requirements as stipulated by regulatory bodies are more stringent in the case of equity carveouts. Therefore low quality firms may not find the carveout route worth the cost. Well managed firms will want to separate themselves from these firms, by willing to bear the costs of equity carveouts as also the greater scrutiny. This is especially so if the management of such companies possess definite information about the value of their firms. Low quality firms would divest through spin-offs.

Main costs involved in equity carveouts:

- An equity carveout creates a new organisation from a previously wholly owned subsidiary. This new company is subject to all financial and reporting requirements of regulatory bodies, meeting which can be quite costly. There are costs of auditing, preparing statements and also, indirectly, of disclosing proprietary information to competitors.
- The creation of minority shareholders may lead to a conflict of interests and priorities. This is a strange situation where the very means of financing a subsidiary growth may lead to a situation where there are important people who may not agree with these growth plans. Resources consumed in tightening control over these minority shareholders constitute an additional cost for the newly created subsidiary firm.

It must be remembered that equity carveout is not a hassle-free solution. While many companies perform better after the carveouts, there are many that may not be as lucky. Equity carveouts are not a means to sell off businesses which are not profitable. Rather they are means to restructure the parent company to add more overall value to the shareholders. Carveouts are meant to facilitate entrepreneurship; they should be used to obtain synergies within the firm.

Leveraged Buyout (LBO)/Management Buyout (MBO)

It is a financing technique that uses large amount of debts to buy stock of a company. In most cases, it involves taking a public company private.

There are three categories of LBO candidates. These are:

A. Premier companies with the following characteristics:
   - High quality assets that can be used as collateral
   - Sizeable and stable cash flow
   - Experienced and successful management
   - High quality product, market share and brand equity
   - Superior performance
   - Premium over book value

B. Second tier companies and their characteristics:
   - Some positive and some negative aspects
   - High quality assets but erratic cash flow
   - Volatile industry
   - Buyer may want seller to participate in financing the buyout

C. Troubled companies and their characteristics:
   - Those that already have large debts and hence taking further loan is difficult
   - Buyer is in strong position
   - Premium is not available

There are two types of LBO players:

Sellers: (a) Owners of private companies wanting to cash out.

(b) Public companies seeking to divest a particular division.

Buyers: (a) Managers of the division being divested.
(b) Any large company willing to buy another company.

Management buyout (MBO)

It is a special case of LBO where management of the company decides to take their company private. Large borrowings are made by managers to buy the stocks held by shareholders. In general, managers (who become shareholders of the new entity formed through MBO), work harder to earn greater surplus to repay the debts.

The MBO Process

The key steps are:

- Decision is taken to divest a particular division.
- Management of the division decides to purchase the said division.
- Appointment of an investment banker (approved by the selling company and the management of the division).
- Financial evaluation and gauging credit worthiness to support the debt.
- Purchase price determination.
- Investments to be made by the management are determined (normally a small percentage of the purchase consideration).
- Assembly of the leading group by the investment banker to decide total debt requirement and proposed exposure of each (including security to be offered).
- Obtaining additional equity from outsiders if debt equity ratio is very high.
- Cash flow analysis and determination of debt servicing capacity.
- Final agreement on financing based on cash flow analysis.

Financing of LBO

Following options are used:

(a) Secured debts (called asset-based lending using both fixed and current assets):

- Senior debts
- Intermediate term debts

Note: There are certain differences between the above two options in terms of duration, interest and type of asset back-up.

(b) Unsecured debts (also called subordinated debts)

- No asset back and hence take high risks
- Higher returns
- Secondary claims on assets

Desirable characterstics of a secured LBO

Following are some of the key characteristics of a secured LBO:

- Stable and experienced management
- Scope for significant cost reduction
- Stability of cash flow
- Sizeable equity investment by the new owners

Key Characterstics of an unsecured LBO

These are:

- Stable cash flow
- Ability to reduce cost
- Managerial experience
- Limited debt on the division's balance sheet
- Separable, non-core business

Level of risks in LBO

There are essentially two key risks:

- Business risk of not generating sufficient earnings
- Interest rate risk—the higher the rise in interest rate, the higher the obligations

Sources of LBO Finance

- LBO funds (such as KKR of USA who invests in LBOs and provides a certain percentage of return)
- Other sources are: venture capital funds, loans from commercial banks, etc.

3.2.2.5 Steps for Implementing a Divestment Move

Rationale for Sale

Divestment requires as much planning and action on the part of the company as does any major acquisition planning. One of the agonising problems for managers is to decide when and how to dispose off part of the company. The decision-making process involves study of the division in question, including investment requirements, possibilities in that division vis-a-vis other divisions, and consultation with independent professional advisors. Alternate schemes should be worked out and all possible avenues explored. During this period, it is advisable to see that the division does not make any long-term commitment.

Steps in planning

Following are the key steps at the planning stage:

- Estimate the after tax free cash flow (as defined) from the business and find out the present value (NPV).
- Deduct the interest bearing liabilities from the NPV and arrive at liabilities to the shareholder(s).
- If price offered is P, the division rule will be:
  - If P>S: decision to SELL

- If P<S: decision to KEEP THE DIVISION.
- If P=S: then there is no financial reason to sell the division. In such cases, other concepts like core competence, growth plans of other divisions etc. will prevail while deciding.

Process of selling

(i) Identify the prospect

A good buyer means a better price. Companies usually avoid buyers who are competitors, are antitrust, or have insufficient resources. Information on buyers should include the following:

- Labour relations: How does the buyer treat its employees, i.e. how will the selling company's employees be treated after the business is sold off?
- Are there any product, market or reputation related problems so far as the buyer is concerned?
- Is the buyer credit worthy i.e. will he be able to pay up? It is no use selling to a buyer who will not be able to pay.
- What kind of an organisation structure does the buyer have? For example, do divisions have autonomy or are they under strict central control? Existence of multi-divisional structure helps in integrating the acquired business.

The buyer should satisfy the following criteria:

- He should be very clear as to what he wants to do with the acquired business. Ideally the latter should fit in with his existing strategy.
- The buyer should find synergy in the business.
- He should be able to pay.
- The merged entity should be credible in the eyes of the financial community. Otherwise the buyer may not be able to raise money either from the capital market or from financial institutions.

- It is desirable that the buyer has prior experience in acquisition. Such a buyer would be able to better appreciate not only the value of the business being acquired but also the related regulatory issues.

Some of the sources from where information regarding the buyer can be obtained are:

- Business reference services, like publications of various Chambers of Industry, Industry Associations (FICCI, CII, etc.).
- Investment bankers, brokers and business consultants.
- Certified Public Accountants (such as CAs) and lawyers.
- Management officials and members of board of directors.
- Suppliers and customers of the division being sold.

(ii) Specify the objectives for selling

These may differ from case to case. If the proceeds from divestment are proposed to be used to finance some other acquisition, then maximising the cash payment will be the objective. In such a case, the buyer who meets this condition gets selected. If the management, on the other hand, is interested in seeing that the employees get a good deal even after selling off, then they should look for a buyer whose HRD policies are similar to theirs. The objectives for selling would determine, to some extent, the conditions for sale.

(iii) Calculate the floor level financial value

The seller should be very clear about the minimum price he is willing to accept for the division or company being sold. This could be arrived at by using such techniques as liquidation value of assets or the book value or assets.

(iv) Tax Considerations

The deal has to be structured carefully to sell the division, duly taking into account the possible tax benefits that can accrue to both buyer and the seller under the existing Income Tax Act.

Very often, there can be conflict of objectives. The subject being very specialised, assistance of professional tax consultants must be sought.

(v) Disclosing of relevant information

Companies often do not disclose sensitive information in a competitive environment. However, in order to ensure that the buyer appreciates the true value of the business being sold, it is important that all the relevant information is conveyed to him. The information about the company should conform to the format of disclosure of other companies in the industry. This includes current and past-operating and financial performance data and also projected cash flows[13]. The seller should also give information about the accounting methods, number of plants, locations, markets, products, future plans, relative contributions of various products to sales and earnings, extraordinary earnings, bad debts and finally, an objective account of the firm's competitive position.

(vi) Make the company attractive to the buyer

All said and done, finding the right buyer at the right price is actually an exercise in marketing. This is becoming increasingly the case, as financial markets mature and mergers and acquisitions become common in India. Hence the management must make an effort to make the company more attractive, as doing so places them in a stronger negotiating position. The desired result can be achieved if all concerned are made aware, even before the negotiation starts, about the quality of the firm's manpower and product and also the strength of its competitive position to impress upon the prospective buyer.

(vii) Secrecy and speed are important

The best of plans can be wrecked by faulty execution. If time is wasted in prolonged discussions with the would be buyers, rumours may begin to spread, employee turnover may take place, competitors may become aggressive and customers may become nervous. Once a plan has been made, it must be pursued at the required speed and with a certain amount of secrecy. Important announcements should not be made earlier than when deemed absolutely necessary

(viii) Formation of a specialist team

A team has to be formed to handle the entire exercise. This would include specialists, consultants, bankers, legal and tax advisors, etc. The task of this team would be to identify the best potential buyer, negotiate a fair price, resolve legal, financial, tax and accounting problems, and close the sale.

3.3 Financial Engineering

The principal objectives of financial engineering are:

- To enhance liquidity
- To lower cost of capital
- To reduce risk
- To avoid loss of control
- To improve shareholder value/EPS

To achieve these objectives, some of the key considerations are:

- Level of leverage (how much debt and equity should be there in the capital structure)
- Pattern of ownership (enhancement/dilution of holding of present promoter group/controlling group)
- Choice of instrument (existing or new instruments to achieve the objectives stated above)
- Correct timing (taking into account the buoyancy of capital market and firm's track-record/position as perceived by the prospective investors/lenders)
- Decision on pricing (to keep the overall cost of capital under control)

- Nature of contract with the providers of funds (objective is to ensure maximum flexibility)
- Ability to pay dividend—as per market expectations—in the future.

Some of the preferred financial engineering tools (to achieve the objectives stated above):

- Enhancement of foreign equity (taking advantage of government's foreign direct investment policy)
- Use of GDRs/ADRs to raise equity from overseas market
- External commercial borrowings (ECB)
- Various instruments for raising debts (other than ECBs)
- Various actions to alter share capital (other than GDR/ADR and FDI):
  - Buyback of shares
  - Use of non-voting shares/preference shares
  - Employee stock option plan/equity reduction
  - New approaches to working capital financing

A detailed discussion on the above is not given here as it is beyond the scope of this book.

Firms normally need an expert's help to undertake financial engineering because innovation is the key to achieving its objectives. Outside experts are generally up-to-date on new and innovative instruments being developed and hence should be of great help to firms desirous of engineering their capital structure.

3.4 Internal Streamlining and Business Process Re-engineering

3.4.1 Internal Streamlining

An organisation tends to develop inefficiencies over a period of time, making it incompetitive. General tendency is to explain away under-performance rather than initiate corrective action. As a result, the firm may face one or more of the following difficulties:

- Competitors become aggressive
- Customers get increasingly dissatisfied
- Signs of weakness in various activities of the firm become apparent
- Decline in profits as well as market share is experienced
- Takeover threats become increasingly a reality

To avoid such difficulties, internal streamlining measures are taken by the firm, either on proactive or reactive basis. Key action areas are:

A. Cost reduction
    - Reduction of headcount
    - Improvement of productivity/operating efficiency
    - Overhead reduction

B. Rationalisation of product lines

C. Closure of uneconomic units

D. Quality improvement—product/process

E. Improved working capital management
    - Inventory
    - Debtors

F. Disposal of idle assets
    - Land
    - Plant and Machinery
    - Utilities

G. Making the organisation lean

Internal streamlining measures may need balancing investments to increase efficiency and productivity.

Some of the key success factors are:

- Right benchmarking
- System for measurement, evaluation and feedback
- Concept of "first person responsible" to drive the change programme
- Continuous communication to create a sense of urgency
- Constant reminder and follow-up to retain the gains achieved over a period of time
- Top management and CEO's visible involvement in internal streamlining efforts
- Single mindedness and detemination to achieve the targets within the time scale agreed upon - no compromises, no matter what the obstacles are.

3.4.2 Business Process Re-engineering (BPR)

Modern organisations are characterised by division of work on functional, product, or area basis. This approach design of organisations has a number of shortcomings, such as:

- Inflexibility
- Lack of responsiveness to customers and related issues.
- Absence of customer focus
- Focus on activity rather than results
- Bureaucratic paralysis
- Absence of innovation

With enhanced competition and growing customer expectations, a need is now felt to re-unify miscellaneous tasks into coherent business processes. The technique used for this purpose is called Business Process Re-engineering (BPR). Business process here is defined as a collection of activities which, when performed, produce value to the customers (an example of such a process will be "receipt of order to delivery").

BPR starts from a scratch. The task of BPR involves unifying a group of activities that need to be performed, both individually and collectively, to create output that is valuable to both customers and the firm. As defined by its protagonists, the task of unification requires fundamental re-thinking and radical re-designing of business processes to achieve dramatic improvements in four critical areas:

- Cost
- Quality
- Service
- Speed

Most managers are task, job, role and structure oriented, and not process oriented. This orientation of managers is a major bottleneck to driving change initiatives in this regard and a firm must overcome the same if it wishes to become successful in its re-engineering efforts.

Knowledge of information technology and ability to think differently are critical to the success of BPR. Without a threshold level of knowledge about various IT options available to speed up and simplify business processes, and without the creative ability to think how a task can be performed with less human involvement vis-à-vis the current practice, success in BPR will be hard to come by, since one of the key emphasis areas is BPR is the elimination of as many hands as possible.

In BPR, process teams, complete in all respects, take all process related decisions. After re-engineering, work becomes satisfying since people see the job in its totality and thus feel empowered. In the re-engineered organisation, managers become coaches and not bosses; structure becomes flat and numbers come down.

Experience has shown that in many cases BPR efforts do not produce the desired results. Some of the best practices, as suggested in an article published in Harvard Business Review, are:

(i) Do not undertake re-engineering of all the processes simultaneously. Select only those which meet the following criteria:
   - Processes that require immediate attention.
   - Processes that will have significant impact on customers.
   - Processes which are most amenable to re-design.

(ii) Communicate intensely to persuade people to accept and not resist the proposed changes.

(iii) CEO must be seen to commit, at the minimum, 50 per cent of his time.

(iv) Set aggressive re-engineering performance targets; incremental improvement targets will not create either urgency or excitement.

(v) Monitor progress and initiate corrective action.

3.4.3 Changing the Culture

For BPR and Internal streamlining measures to be successful, culture and mindset of the company is to be drastically changed. The biggest bottleneck in this regard is the mindset of the managers, who tend to blame everybody outside instead of looking at their own inadequacies. Also, they are not always open to learning from new facts. Instead they tend to support all that has been done in the past as being correct.

What is needed is to initiate debates at all levels of a firm to develop a shared understanding on critical issues being faced and also on steps to be taken to resolve these issues. There has to be a concerted effort to convince managers and employees that change is needed to respond to new realities. Until managers and other people begin to question the existing business approaches, no fundamental change can even begin to take place in an organisation. Top management must make it clear to everybody that good practices of the past have outlived their lives. Care must be taken not to blame anybody for the decline in performance. Specifically, sensitivity displayed by top management in dealing with people facing hard choices will be important. This will determine whether the re-engineering effort will be obstructed or supported.

Organisations must encourage learning and continuous improvement for change to take roots. For this to happen, managers are to be pushed to face reality and challenged to make decisions and accept responsibility for the same. Also critical will be to provide employees with hard data and logic behind every decision taken, and to make the company's goals and methods transparent. This will help those down the line feel empowered and take calculated risks—the two essential requirements for BPR efforts to deliver results.

3.5 Conclusion

In this chapter, we have discussed the main concepts and framework relating to corporate restructuring. Our objective was to give a broad overview and not to go into the nitty-gritty of the subject. The readers will get further insights into the concepts and framework discussed here chapter in Chapter 5, which covers the Indian experiences in corporate restructuring.

Acknowledgments

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CHAPTER 4

Corporate Restructuring—Key Implementation Issues

4.1 Introduction

In Chapter 2, we defined the scope of corporate restructuring and explained why a holistic view is needed to develop a blueprint for restructuring a firm. In Chapter 3, we discussed the key concepts under the three main modes of corporate restructuring as defined in Chapter 2, namely

(i) Portfolio and Asset Restructuring (including mergers and acquisition, and divestitures)

(ii) Financial Engineering

(iii) Internal Streamlining and Business Process Re-engineering (BPR)

Each of these modes and their sub-categories have different strategic, organisational, financial and legal implications, and successful restructuring efforts will require paying careful attention to such implications. Complying with the legal requirements is a major task and managers should at least have a working knowledge of various legal issues that are to be addressed under different modes of restructuring. The idea here is not to ask the managers undertaking corporate restructuring to become experts in legal matters; what is needed is a good understanding of the subject and the ability to participate intelligently in discussions with legal experts.

Other than legal aspects, the strategic and financial aspects of restructuring also need to be understood. Strategic issues must be the principal consideration behind every corporate restructuring move. Any restructuring move that is planned only to make financial gain in the short run is likely to fail. Strategic advantages are key to success of any restructuring move. For example, if an acquisition proposal is being considered, one must know whether the proposed acquisition will help the firm in achieving one or more of its objectives, namely, enhancement of market power, increasing the size of the firm, reduction of cost, achieving greater synergy in operations, acquiring new skills and capabilities, accessing additional sources of funds, and so on. Similarly, a divestiture proposal should be based on strategic considerations such as attaining focus in business portfolio and getting rid of uneconomical product line or business or unit. If the strategy itself is wrong, no move in corporate restructuring is brilliant enough to help the firm enhance its value.

Financial issues come into play under each mode of corporate restructuring. In case of M&A, a key issue is the source of acquisition finance. Absence of appropriate sources will come in the way of successful implementation. In Chapter 3, a few issues relating to acquisition finance have been discussed. Similarly, for internal streamlining that involves large scale downsizing of head count, a key problem is how to finance the voluntary separation or retirement scheme. In divestiture, the financial issue is where to invest the proceeds from divestments made so as to improve the shareholder value. Needless to say, unless these financial issues are addressed, the process of implementation will suffer.

That leaves us with organisational issues. Of all the roadblocks to successful implementation of corporate restructuring, the most critical is organisational factors. Empirical evidence is available on how brilliant M&A moves have failed to produce the desired results just because these were poorly planned and badly implemented. Similarly, divestiture and internal streamlining efforts often fail to deliver the desired results just because organisational aspects were not carefully handled. This chapter will look at the various organisational issues that are to be addressed during the pre and post-restructuring phase in order to ensure greater effectiveness.

4.2 Implementation of M&A

4.2.1 Mergers

There are many examples of how a large number of M&A moves (such as merger of two or more legal entities or asset buyout involving one company purchasing some business/assets of another as a going concern involving transfer of people) failed to create value, even though these appeared most logical at the planning stage. Academicians and consultants have done a lot of research on why many M&A activities failed to deliver the expected results, and one thing that came out loud and clear was the lack of full appreciation on the part of managers vis-à-vis the complexities that are involved in achieving integration during the post-merger stage. Many of the organisational problems, encountered after the legal merger of businesses or transfer of assets, can be avoided if the right questions are asked at the planning stage. Failure to identify post-merger issues beforehand may lead to acquiring a company (or a division of another company as a going concern) that may appear strategic and primarily sound on paper but, in reality, is impossible to integrate without incurring a very high cost. A variety of organisational differences that exist between the acquiring and the acquired firms may undermine the hidden potential of the latter and hamper the realisation of the same if such differences are not reconciled effectively.

4.2.1.1 Pre-Acquisition Planning

The first step to ensure smooth integration during the post-acquisition phase is to undertake an appropriate pre-acquisition planning. In an article published in Harvard Business Review, following steps are suggested for effective pre-acquisition planning[1].

(a) Pre-acquisition Tasks

- Due diligence
- Assessing strategic and financial implications
- Negotiation and announcement
- Closing the deal

(b) Organisational Tasks (that have implications on post-merger integration)

- Undertake assessment of culture of the target firm
- Assess impediments (business and culture) to future integration
- Assess competencies of key managers of the target firm
- Develop communication strategies (which will be required as soon as the deal is closed)
- Select an integration manager (who will be responsible for integrating the newly acquired firm)

It must be noted that the first three of the five organisational tasks must be completed with due diligence so that by the time the negotiation is completed and the deal is announced, the acquiring firm has a fairly clear idea about the kind of organisational culture and people they are going to integrate with their own firm and possible problems that will have to be addressed. It is important to get this information in advance so that in case it is felt that post-integration problems are going to be insurmountable and may in fact even destroy the value of the acquiring firm, the negotiation on the deal can be aborted.

It needs to be mentioned that of the three types of M&A, viz. merger of two or more legal entities, purchase of business or assets as a going concern and substantial acquisition of shares of another firm leading to change of control, pre-acquisition planning on the above lines is more critical in case of the first two. This is because in these two cases, people, structure and systems as well as culture and values of the acquired firm will become an integral part of the acquiring firm during the post-merger phase. The problems of integration in the post-acquisition phase will be of much lower order in case of the third type of M&A, viz. acquisition of substantial control of another legal entity but not leading to merger or amalgamation, because in this case transfer of people, structure and system as well as culture and values from one firm to another will not be of extensive nature. But, even here, the organisational tasks mentioned above must be carried out since the new management team, comprising of some of the key managers of the acquiring firm, will have to work closely with managers and people of the acquired firm and effect a number of business and organisational changes that will require active cooperation and support of people from the acquired firm. This is an important issue as even in this case, the acquiring firm may need to undertake extensive overhauling of the organisation and culture of the acquired firm to fully realise its value potential.

Another aspect that must be highlighted is that the acquiring firm may not be able to carry out many of the organisation related pre-acquisition tasks if the acquisition is a hostile one. Even in case of friendly M&A, the top management of the target firm may not agree to give the organisational details required by the acquiring firm during the pre-acquisition phase. If this be the case, the acquiring firm must take steps to discreetly find out as much as possible from other indirect sources such as trade, suppliers, bankers, chambers of commerce, etc. Taking into account the fact that failure to integrate during the post-merger phase can be very costly and may even lead to reversal of the M&A decision at a later stage, it is important that special care is taken to understand the organisational issues during the pre-acquisition stage itself.

4.2.1.2 Post-Acquisition: First 100 Days

Immediately after the legal acquisition is completed (be it a merger or asset buyout), the momentum of activities of the acquired unit must be maintained. But that is not all; also to be spelt out are a number of other actions that are crucial to ensure that the acquisition starts delivering value from day one itself. These are[2]:

- Spell out the new organisation structure and clarify reporting relationships.
- Review financial power and accounting policies and practices.
- Design and install management information and reporting systems and identify key performance indicators for each responsibility centre.
- Review personnel policies including compensation, succession, career planning and retirement benefits (this is one of the most difficult aspects of integration).
- Start communicating to both insiders and outsiders the purpose of the merger and the future prospects of the combined organisation (based on plan already formulated during the pre-acquisition stage).

If information collected during the pre-acquisition stage on the acquired unit in respect of organisational and system related issues is reasonably satisfactory, it should not take too long to complete the above tasks following the completion of the legal process. What is important to note is that failure to complete these organisation specific tasks within the shortest possible time will not only keep everything hazy during the post-acquisition phase but will also give opportunity to people to spread unfounded rumours, thereby affecting the performance of the combined organisation. It is to be stressed here that resolving the organisational issues at a fast pace should not mean resorting to quick-fix solutions that can be more damaging in the long run and can lead to further problems at a later date. Efforts must be made by the managers of the acquiring firm not to gloss over operating details and complexities. It must also be ensured that key executives of the acquired firm are involved at every stage of the process to facilitate joint development of various organisational policies and action plans, an extremely vital requirement for successful integration.

Asakenas et al.[3] identified the following additional tasks to be carried out at this stage:

- Formally introduce the integration manager
- Expose the managers of the acquired company or unit to the business processes, philosophies and values of the acquiring company
- Involve the top management of both the companies
- Make sure that sufficient resources and accountability have been assigned to complete the task of integration

The first 100 days following the completion of legal acquisition are critical for the success of any M&A activity. Make a mistake or gloss over any item in any of the areas stated above, and the value creation potential of the combined organisation will be severely affected. And when it happens, all the projections made during the pre-acquisition phase with respect to the benefits envisaged will seem like a mirage, while the costs incurred for acquisition will start adversely affecting the bottomline of the acquiring company.

The rigorous analysis done and decisions taken during the pre and post-acquisition phases in respect of the merger of two or more legal entities or purchase of business/assets of another company as a growing concern will obviously be more than that experienced in case of takeovers where control changes as a result of substantial acquisition of shares. But even in cases of takeovers, a first 100-day plan for integration needs to be developed since the need may arise to replace the key executives of the acquired unit and also to effect changes in the working of the acquired firm's organisation structure and systems for extracting higher value.

4.2.1.3 Stepping up the Pace of Integration

If the objective of the first 100 days is to retain the momentum that existed before the M&A took place and provide a comforting and welcome environment to incoming people, the aim of the next phase is to speed up the integration and achieve the key objectives (such as cost reduction, better service to customers, gaining market power, supporting brands, strengthening distribution network, etc.) set out at the planning stage i.e. before undertaking the M&A activity. Specific programmes that were broadly identified at the planning stage now need to be worked out in greater detail and executed speedily. The list of such programmes includes[4,5].

(a) Initiating programmes for cost reduction/downsizing of head count, improvement of operating efficiency at all levels, enhancement of productivity, reduction of overheads, removal of unnecessary top management frills, etc.

(b) Identifying capital projects to be taken up for the improvement of quality, de-bottlenecking of capacity, reduction in cycle time, waste control, supply chain management (from suppliers to end customers), information processing, etc.

(c) Undertaking extensive process audit to check the scope for improvement in such areas as speed, accuracy, productivity, etc. as well as elimination of all redundancies and non-value adding activities.

(d) Identification of scope for integration of various activities such as field offices (sales and warehouse), purchase, information system, accounts, legal and secretarial, HR, etc. the objective being to eliminate duplication, speed up throughput, reduce head count, etc.

Among the tasks that starts right from the first day following the finalisation of the legal merger, the actions proposed for cultural integration of both the firms are the most critical. It must be appreciated that post-merger anxieties are experienced by both existing and incoming employees, with everyone trying to assess how the company's revised policies (business as well as personnel) during the post-merger phase are going to affect his/her own personal interest. Ignoring these anxieties could adversely impact the prospect of realising the full potential of the merger as envisaged at the planning stage. Hence, the development and execution of a clearly laid down integration programme aimed at bridging the gap in perception of employees of the two erstwhile legal entities is a must. The integration manager, appointed at the pre-acquisition stage itself, must be given responsibility and full authority to prepare and drive the integration programme. In addition to ensuring that post-merger HR policies and systems are based on objective principles and executed in a totally transparent and unbiased manner, there will be the need for extensive communication on an ongoing basis for at least the first two to three years, using all possible formal and informal fora, in order to familiarise everybody with the basic aims of the merger programme and what role each employee is expected to play to achieve the same. Such extensive communication is also needed to ensure acceptance of the new vision, new values and new managerial behaviour, which is crucial to success in the post-merger phase, by all concerned.

4.2.1.4 Achieving Total Integration with the Acquiring Company/Group

At this stage the thrust is on consolidation of gains made at the previous two stages and also on effecting changes in strategy, structures, systems, processes and people—in the light of experience gained in these areas—to further improve the performance of the combined organisation or the group. Efforts must continue to fine-tune the various systems, practices, policies and processes with a view to exploiting the emerging opportunities in the market place and also leverage of the resources and capabilities—tangible and intangible—to gain competitive advantage. Maintaining the momentum of such efforts, even two to three years after the legal merger, is extremely critical to achieving total integration. Unfortunately, many organisations that take all the correct steps during the first 100 days or even beyond that, overlook the need to continue doing so over a longer period, thereby reducing the possibility of superior performance by the organisation in the long run.

In cases where the takeover of another legal entity has been effected through substantial acquisition of shares, the need to continue the integration efforts over a longer period is no less. There will be a continuing need to improve various operating parameters through benchmarking group companies and also to restructure and rationalise the entire value chain for greater efficiency. For inculcating the corporate or group values and culture into the employees and managers of the acquired company, there may be a need for exchange of management and staff between the merged companies. Similar efforts will also be needed to integrate the acquired company's policies with those of the group. Failure to complete these tasks will only sub-optimise the gains made from acquisition.

4.2.1.5 Key Success Factors for Effective Post-Merger Integration

By now, it is clear that effective post-merger integration is as crucial as conducting the M&A negotiation or structuring the deal. Experiences of various successful, not so successful and unsuccessful cases reveal the need to learn certain key lessons, which are as follows (6–11):

A. Merger of two legal entities/cases of asset buyouts:

(i) Focussing on the issues and tasks involved in integration must start during the pre-acquisition phase itself and not after the deal has been structured and the agreement signed.

(ii) The integration manager should also be appointed at the pre-acquisition stage, on full-time basis. He should be given full authority and resources so as to effectively carry out the task of integration. In addition, he must have the support of the CEO and the top management team.

(iii) The first few days following the merger are extremely critical. It is important that all decisions regarding the structure, systems, allocation of responsibility and authority and staffing of key positions are announced at the earliest. Similarly, decisions on lay-offs, downsizing, closing of uneconomic units, rationalisation of manufacturing units, sales outlets and warehouses must be announced as soon as possible. Any heel dragging or delay due to indecisiveness will be counter-productive. Failure to introduce the desired changes rapidly could damage the reputation of the firm thereby diverting the attention and energy of both acquiring and acquired company's employees from the task of enhancing the value of the combined organisation.

(iv) Besides effective communication to provide relevant information on all aspects of changes (strategy, structure, systems, processes, people and policies) there is also the need to involve employees of both companies in resolving the strategic and operating problems encountered by the combined group. A better understanding of the new directions and possibilities, as well as policies and culture of the acquiring company or group is best achieved when people get engaged in resolving critical business tasks. Formation of task forces to address such problems could lead to substantial benefits in terms of achieving the goal of integration.

(v) Careful pre-acquisition planning is critical, as any mistakes made at this stage may make life after the legal merger quite complex. The most common mistakes that can hamper post-merger integration are:

   (a) The involvement of specialists, which often leads to blurring the principal objectives behind the M&A being undertaken. There is always the possibility of developing a fragmented view resulting from specialisation and perspectives of each specialist involved in executing the deal.

   (b) The desire and over-enthusiasm of the negotiators often leads to closing the deal hurriedly, thereby ignoring the critical integration issues that must be considered before signing the deal.

   (c) Many a time, even after best of efforts, both the buyer and the seller fail to resolve a number of ambiguities, particularly in organisation related areas. When such a thing happens, the merger process should not be carried on (unfortunately, companies, in their desire to go ahead with the merger, ignore these ambiguities which results in under-performance during the post-merger phase).

(vi) In addition to considering the business and financial synergy, special emphasis on understanding the compatibility of the two organisations is a must, particularly in areas such as style of management and delegation of authority, strategic predisposition (such as aggressiveness in building market share and pricing, attitude towards R&D and risk), time-return philosophy, corporate vision and culture, specific functional bias, employee orientation, ethics and values, etc. Without a certain degree of operating synergy, even the best of efforts in the post-merger phase will not result in the desired integration.

B. Takeover through acquisition of shares:

- Clearly spell out the objectives of the takeover
- Identify gains to shareholders of both the companies
- Convince yourself that the competence of the management team of the acquired company can be enhanced
- Develop a plan to dovetail resources of both the companies

In conclusion, it must be stressed that it is important to remember the following commandments for successfully managing a merger:

- Do not to rush to complete the merger process; don't bypass any homework
- Be absolutely clear as to what is being acquired; examine the total business and not just the financials

- Put emphasis on adopting the best practices and traits of both the acquiring and acquired company.
- Ensure that no manager (or managers) gains financially and/or career-wise as a result of the merger; rewards resulting from the merger must be equitably distributed.
- Free, frank and honest communication of the ground realities is a must.
- Ensure that the managers, whom the acquiring company wishes to retain, do not leave the company.
- Incorporate realism at every stage to avoid frustration and costly surprises at a later stage.
- Take extreme care in defining the job of the integration manager and also the profile needed.

4.2.2 Divestitures

In executing a divestiture decision (whether sale of a division as a going concern or spin-off of a division into a separate legal entity), the three key issues to be addressed are:

(a) Development of a negotiation strategy by the divesting firm to get the best possible consideration;

(b) Formulation of a plan to deploy funds received from divestment (applicable in cases where there is a consideration involved);

(c) Identification of steps needed, other than legal formalities, to make the transition period—during which assets and people of the divested division/business move to the acquiring firm—smooth as well as fear and tear less.

4.2.2.1 Getting the Highest Possible Consideration

The first thing to appreciate is that divestment of a business is as strategic as acquiring a business or another firm and hence requires as much planning, thought and expertise as in the case of buying. Failure to appreciate this critical issue will lead to selling the business or its subsidiary company for the wrong reason to the wrong buyer, thereby ignoring not only the strategic considerations that may adversely affect the remaining businesses later but also selling the divisions at a consideration far lower than its intrinsic value, thereby destroying the value of the divesting firm and giving ample scope to the acquiring firm to enhance its own shareholder value (as it happened with some consumer electronics companies in the USA, who thought there was no future in the said business and sold their interest in the same; as a result of such unthoughtful divestment moves, these consumer electronics companies lost key competencies in micro-electronics that were critical to make major breakthroughs in the next generation technologies in consumer electronics). Unfortunately, many firms planning to divest one or more of their businesses or controlled subsidiaries tend to ignore these factors when it comes to taking such strategic decisions.

4.2.2.2 Development of a Comprehensive Divestment Document

In order to ensure that the selling firm gets the best consideration needed to maximise its own shareholder value, it is important to keep in mind the related but equally important objective: the requirement that the acquisition by the buyer will also be maximising the latter's shareholder value. Only when a divestment takes place under a win-win situation does it produce best of benefits for both the selling and the buying firm. To achieve this twin requirement, the first step will be to develop a comprehensive document on the business or the controlled subsidiary proposed to be divested. Such a comprehensive document should include, among other things, the following:

- Objective or purpose behind selling (e.g. achieve focus, get rid of under-performing businesses or assets, pay off long-term loans, reverse diversification decision taken in the past, etc.)
- Strengths and weaknesses of the management team of the business proposed to be divested (e.g. how are they geared up to take initiatives, given the right support)

- Strengths and weaknesses of the division or the business vis-à-vis competition and future opportunities (particularly with regard to resources and capabilities available with marketing, production, R&D, etc.)
- Current and anticipated funding needs
- Financial value of the business as it exists and also its potential if given the right management and resource support
- Relative attractiveness to the prospective buyer

The comprehensive document should clearly indicate whether it is a case for selling the business or controlling the share (in case of subsidiary or an associate company) and how does the prospective buyer stand to gain through acquiring the business being divested. Broad indications as to what kind of buyer is likely to consider the proposal favorably should also be available through such a document.

4.2.2.3 Identification of the Buyer

An ideal buyer in case of a divestment should have:

- Clarity on objectives and goals that can be achieved through acquiring the business.
- Ability to achieve synergy with existing activities.
- Ability to pay (i.e. fund raising ability from capital and debt market as well as internal resources) and also in the manner the seller wants (for example, the mode of payment).
- Financial and capital market should perceive the acquisition as strategic and important.
- Organisation structure and culture of the buyer's organisation should be flexible enough to integrate effectively the structure and culture of the business or division to be acquired.

- Preferably, the buyer should have prior experience in acquisition (this will enable him to understand the process as well as the underlying issues).

4.2.2.4 Need for Expert Help

Divestment being a specialised subject, it is useful to form a team of specialists (consisting of both internal and external experts) to deal with various aspects of divestiture—starting from preparing the comprehensive document referred to above, to closing the deal. There will be a need for management consultants (to provide information on prospective buyers, their strategy and philosophy), investment bankers (to advise on financial strength, share market perception and financial credibility of the buyer) and investment advisers (to give advice, from a portfolio perspective, on how the acquisition/divestment enhances overall value of buyer's/seller's firm. There will also be the need for legal, accounting and tax consultants in addition to senior managers of the company divesting the business. The presence of specialists from diverse fields will provide the multiple perspectives that are critical to achieving divestment objectives in totality.

4.2.2.5 Need for Communication

As soon as the basic decision to divest is taken and the buyers have been short-listed and ranked, it is important to take into confidence the senior managers of the division being divested. Unless this is done, rumours will spread and managers, who are otherwise competent, may leave the company out of sheer anxiety. This may force the prospective buyer(s) to revisit his decision to buy (since in the absence of key managers, the acquirer will find it difficult to run the business and extract the value he desires from it). To avoid such a turn of events, communication that put things in their correct perspective is critical for successful implementation of the divestiture proposal. Correct perspective here means the rationale—strategic and operational—behind the divestiture, particularly how the managers and employees of the division or business being divested will stand to gain under the new management because of synergy of the acquiring company and the divested business. Making known the plans of the acquiring company in the post-acquisition phase (with the buyer's approval) in such areas as investment, growth, managerial remuneration, career planning, etc. will be helpful in convincing the employees and managers that the acquiring company will provide them with a better opportunity in terms of both career and future security. Failure to establish these may lead to resignation of key managers, widespread frustrations and even dragging the divesting company to protracted legal battles. Managing the communication process with the required finesse is the key to ensuring that the transfer of business or assets takes place without any hitch (from legal and administrative perspectives) and without any disappointment and anxiety among the managers and employees of the business or controlled subsidiary being divested.

4.2.2.6 Continuity of Terms and Conditions of Services of the Employees under the New Management

In order to ensure that the divestment process is successfully managed, it is absolutely necessary that the management of the selling company makes the management of the buying company agree to maintain or improve the terms and conditions of services of the employees of the division or business being divested. Without such a guarantee, the concerned employees will feel threatened and may take actions that could jeopardise the divestment proposal. However, it must be recognised that a variety of employee-related matters (such as excess manning, productivity, restrictive practices, immobility, leave rules, etc.) often are the key reasons for under-performance of the unit being sold and the new owners will find it extremely difficult to make the acquisition viable unless some drastic actions are taken to address the adverse factors pertaining to employee-related matters. This is where a difference of opinion may crop up at the negotiation stage and the buying organisation may insist on acquiring the business or division only if the divesting company takes some concrete steps (such as reduction of manning or changes in service rules) before the divestment actually takes place.

The above five steps are critical for ensuring successful implementation of the divestment proposal—whether selling a business as a going concern or spinning off a division into a separate company or dilution of controlling shareholding in a subsidiary company. Effective implementation requires deft handling of all the aspects stated above, coupled with the ability to sensitise the employees and managers well in time as to why the divestment is going to be beneficial for them in the long run.

4.3 Internal Streamlining and Business Process Re-engineering

4.3.1 Internal Streamlining

Some of the issues discussed under M&A and divestiture, particularly those relating to employee aspects (such as number reduction, productivity and efficiency improvement, overhead reduction, etc.) as well as other subjects like elimination of unproductive assets, rationalisation of product lines, etc. and approaches suggested thereof also apply equally in case of restructuring through internal streamlining. As a matter of fact, efforts to streamline internal operations to improve competitiveness and shareholder value will have to be on an ongoing basis. This cannot be seen as a separate activity from day to day management of business. Constant surveillance of performance in respect of key marketing, financial and operating parameters vis-à-vis the best achieved in the industry as well as global benchmarks must be on the agenda of the managers. Only when the managers lose single minded focus on key performance metrics and the organisation is allowed to slip to mediocrity, does the need for a major initiative to streamline the internal value creating activities become a necessity for bringing the company back on the track.

Some of the requirements for achieving success in internal streamlining are:

- Right benchmarking.
- Availability of MIS for measurement, evaluation and feedback.
- Identification of a specific manager with clearly defined responsibility, authority and accountability for each major programme proposed to be pursued.
- Continuous communication to create urgency among employees and managers to accept various change programmes identified.
- Constant reminder and meticulous follow-up to retain the gains made over a period of time.
- Visible involvement of CEO and his top management team in driving the internal streamlining programmes.
- Single mindedness and determination to achieve the results desired.

4.3.2 Business Process Re-engineering

This topic has been discussed in Chapter 3. The key success factors for its effective implementation are:

- Avoid re-engineering of all the processes together since the tasks involved are complex; focus should be on processes that are of importance to customers and that have scope for redesign.
- Targets set for improvement through re-engineering should be ambitious.
- Close monitoring of progress made vis-a-vis targets set, and timely initiation of corrective actions in case of any deviation.
- Employees must be persuaded to accept the change through use of logic and appropriate incentives.

- CEO must commit a significant portion of his time for driving the change programme related to the re-engineering exercise.

4.4 Financial Engineering

The basic approach to financial engineering has been discussed in Chapter 3. The following are the most important requirements of successful implementation of various approaches discussed therein:

(a) Quality of networking and relationships built with external specialist agencies providing professional support in such areas as financial services, merchant banking, legal matters, etc.

(b) Ability to comply with requirements stipulated by different agencies such as government departments (like Foreign Investment Promotion Board (FIPB) or RBI or Ministry of Finance), regulatory bodies, stock exchanges, etc.

(c) Development and maintenance of relationships with potential fund providers such as Foreign Institutional Investors, Financial Institutions, superannuation funds, international banks, etc.

(d) Keeping track of advancement taking place in academic and professional fields in areas such as development of new instruments to raise funds, risk management, valuation techniques, etc. Networking with business schools, professional bodies, merchant bankers and consultants will be necessary to achieve this objective.

As is well known, numerous options are available to effect financial engineering, depending on the specific objectives the firm is aiming to achieve in such areas as liquidity, leverage, cost of capital, risk, level of taxes, and ownership. Innovations are taking place continuously in the financial services industry, enabling firms to access low cost, low risk funds matching their respective cash-flow patterns. However, for a firm to access latest innovations, it will need to seek services of agencies that have special expertise in such areas; hence the proposal on networking with such specialist organisations. Similarly, the firm will need to be fully conversant with all regulatory requirements that will need to be complied with under various options to re-engineer the capital structure. For example, for enhancing foreign equity holding, approval of FIPB and RBI will be required if the increased ownership exceeds the stipulated limit. Likewise, if preferential allotment to promoter group is proposed to be made, steps as per SEBI guidelines will have to be followed. It is quite possible that a firm may not have all the expertise needed to deal with all these stipulations. What is important in such a case is to identify in advance all the areas where legal and regulatory clearances are necessary and seek the expertise of external organisations wherever necessary. Performing organisations are able to do everything correctly—from legal and regulatory perspectives—just because they can anticipate well in advance what all is needed and then access expertise, both internal and external, to address the same.

Successful financial engineering many a time requires tapping different sources of funds either to change the mix of current sources of loan capital (with a view to lowering the cost of capital as well as hedging the underlying risks) or to meet additional requirements of funds. While a healthy balance sheet and strong fundamentals are critical to access new and additional sources of funds, one key requirement is also effective networking with potential fund providers. No doubt there are intermediaries to do this job but well managed companies also keep in touch with such potential fund providers to ensure success in this area.

4.5 Conclusion

As stated at the beginning of this chapter, many corporate restructuring decisions fail to achieve the objectives set initially just because processes relating to implementation are badly managed. The problems start at the pre-restructuring phase itself, when detailed planning is discarded for reasons such as the need to move fast or non-availability of information. As a result, operational complexities in areas such as organisational, legal and financial matters are rarely captured at the planning stage, thereby either leaving everything to the last moment or making simplistic assumptions that in no way relate to the ground realities. The net result is that the potential roadblocks are not anticipated in advance and no proper corrective actions are initiated in time. No wonder, in such a situation, the value that is supposed to be created as a result of corporate restructuring is rarely realised. This being so, a greater concern for understanding and identifying the key implementation issues right at the pre-restructuring stage is a must for success in this area.

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CHAPTER

5

Corporate Restructuring—The Indian Experience

5.1 Introduction

Corporate restructuring, consisting of portfolio and asset restructuring (including M&A and divestitures), financial engineering and internal streamlining (including business process re-engineering) became a strategic activity at the firm level beginning early 1980s when the Indian industry first felt the need to redesign its businesses with a view to better manage its portfolio. However, the initial pace was slow and definitely not focussed on improving competitiveness or enhancing shareholder value. Corporate restructuring became a key priority starting 1992 when extensive economic reforms, undertaken by the Government of India, led to greater competition (including competition from MNCs) with simultaneous opening up of more opportunities. During this period, the Indian industry also felt the pressure from various stakeholders to pay greater attention to such areas as enhancement of shareholder value, ensuring focus in business portfolio, acquiring greater market power and size in every product category, building brands and distribution capability, professionalisation of family business and privatisation of public sector enterprises. All these signalled the need for extensive restructuring of the Indian corporate sector. The scale and size of corporate efforts that we have seen in India, particularly during the last five to seven years, have far exceeded the level that was experienced during the pre-1991 phase. However, a lot more needs to be done if India Inc. wishes to become globally competitive and shareholders are to be rewarded handsomely.

In this chapter, our endeavour will be to briefly highlight the corporate restructuring efforts undertaken by Indian companies in the late 1990s and the outcome thereof. We will first describe the events that took place during the pre-1992 phase and then take up the post-1992 developments.

5.2 Corporate Restructuring—Pre-1992

As mentioned, the pre-1992 restructuring efforts were modest. Also, the focus was mainly on M&A and divestitures and not so much on financial engineering and internal streamlining. During the period 1988-92, there were about 120 takeovers and mergers, and in about 37 cases, unsuccessful takeover bids were made. Horizontal mergers were clearly the preferred option, which accounted for 65 percent of all mergers in 1988, 50 percent in 1991 and 65 percent in 1992. A principal objective behind these mergers was seeking section 72A benefits which were to do with carry forward of losses and these were mostly "friendly" in nature.

There were a number of hindrances that came in the way of accelerating the pace of corporate restructuring during the pre-1992 phase. Some of these were: (a) difficulty in obtaining license for the product category for which opportunities for takeover existed, (b) Section 23 and 25 of MRTP Act, 1969 that discouraged mergers, amalgamations and takeovers, (c) Section 372 of the Companies' Act putting a limit on equity investment by one company in another, (d) Section 108 of the same Act allowing the board of directors of a company to refuse transfer of shares in favour of the acquiring company, making a hostile bid, in the (so called) interest of the company and finally (e) preference for Financial Institutions that normally held upto 40 percent of equity of many Indian companies (in addition to providing term loan), to support the incumbent management team whenever a takeover bid was made. All these hindrances prevented fast-paced corporate restructuring during pre-1992 phase.

Despite these hindrances, corporate India experienced a large number of M&A activities—both friendly and hostile—in the pre-1992 phase. The famous failed takeover bid by Mr. Swaraj Paul on Escorts Ltd. and DCM Ltd. is well-known. And so also are the successful takeovers by Hindujas (Ashok Leyland and Ennore Foundries), Chhabrias (Shaw Wallace, Mather & Platt, Hindusthan Dorr Oliver, Genelec, Herdillia Chemicals, and Ploychem) and Mahindras (automotive pressing unit of GKW and Alwyn Nissan). Other notable takeovers were: Universal Luggage by Blow Plast and Shalimar Paints by Jindals. Tata Tea was the first company to make a public offer in 1988 to take over Consolidated Coffee and acquired 50 percent of the company's equity from Indian shareholders by end 1989 through a combination of cash and Tata Tea Stock.

During the pre-1992 period, companies registered under the MRTP Act 1969, required permission under Section 23 of the Act for merger, amalgamation and takeover (this section of MRTP Act was subsequently omitted as part of economic reforms undertaken by the Government of India). During the nine year period, January 1980 to June 1989, 32 amalgamations and 52 takeovers of companies were approved by GOI under the MRTP Act[2]. The list of these companies included Brooke Bond India, Indian Explosives, Grasim Industries, L&T, TISCO, Mafatlal Industries, Sriram Fibres, etc.

A number of mergers within the same group were also initiated during the pre-1992 phase. For example, Furmanite Nicco merged with NICCO Ltd., both belonging to Rajiv Kaul Group. Likewise, loss making Tata Fertilizers merged with profit making Tata Chemicals. On the same basis, HCL Group restructured itself by merging four companies, viz. Hindusthan Reprographics, Hindusthan Computers, Hindusthan Telecommunication and Indian Computer Software Company Ltd[3].

A number of corporate restructuring ventures were initiated by the Board of Industrial Finance and Reconstruction (BIFR). Most of these restructurings were institutionally driven and the terms and conditions were designed to suit the creditors and lending institutions. Some well-known BIFR cases during the early 1990s, in which a healthy company took over a sick company were: VAM Organic Chemical taking over Ramganga Fertilizer, Straw Products taking over Orissa Synthetic, and Voltas Ltd. taking over Miami Pharma Ltd. In all these cases, BIFR sanction helped the transferee companies enjoy the benefits of carry forward losses of the transferor companies, even though these restructurings were not reverse mergers. As at 1994, BIFR could arrange a merger of only 4.3 percent of total cases referred to it. The list of approval of BIFR as at 1991 also included merger of two sick public sector companies viz. Bharat Refractories Ltd. and Indian Fire Bricks & Insulation Co. Ltd. The reconstruction proposals included, among others things, writing off of about Rs 50 crore of interest[4].

A number of reverse mergers took place during the pre-1992 phase whereby a healthy unit was merged with a sick company, as a result of which the former lost its identity. However, following a lapse of a few days or months, the name of the sick unit was usually changed to that of the healthy unit, thereby restoring the original position of the healthy company. As a result of such reverse mergers, under Section 72A of the Indian Income Tax Act, the healthy company could take advantage of sick company's carry forward of losses—including unabsorbed depreciation and investment allowance—and use the same as a tax shield. Companies under the same management were also eligible to use such benefits as available under Section 72A. Some of the well-known examples were: Ahmedabad Laxmi Mills and Arvind Mills, Kirloskar Pneumatics Ltd. and Kirloskar Tractors, Gujarat Automatic Company Ltd. and Atul Products Ltd. and Wiltech Ltd. and Asian Cables Ltd.

The above, in a nutshell, is the extent of corporate restructuring that took place during the pre-economic reforms period. That not much was done is not surprising given the fact that competitive pressures were not significant during this period and also there were definite hindrances where corporate restructuring was concerned. But, with the onset of liberalisation, many of these were removed and, more importantly, competitive pressures from both domestic and international companies became intensified, leaving the under-performing Indian companies with no option but to restructure. In the following section, we deal with this development.

5.3 Corporate Restructuring—Post-1992

5.3.1 Mergers

In the post-1992 phase, corporate India saw a sharp increase in the number of mergers (in which the transferor company got amalgamated with the transferee company and in the process got liquidated). This spurt in acquiring other companies through mergers was primarily due to one or more of the following reasons:

(a) To enhance market share

(b) Achieve economies of scale

(c) Remove gaps in brand/product range and increase market presence

(d) Achieve synergy in operations and distribution

Certain patterns are visible in the way M&A activities (including amalgamations and takeovers) took place in India during this period. Some preliminary findings are presented in Section 3.4 following the discussions on pure takeover cases (i.e. one company acquiring substantial control in another but both continuing to exist) and asset buyouts.

5.3.2 Takeover of Companies through Substantial Acquisition of Shares and/or Changes in Management Control

Based on a sample study[5] of 58 takeover cases during the period 1992–97, following pattes have been observed:

(a) Highest number of takeovers took place in pharmaceutical industries, followed by diversified groups and electrical and electronics.

(b) More than 25 percent of these acquisitions were by MNCs and rest by domestic companies. This is a clear shift from the trend prevailing in the pre-1992 phase.

(c) Two most important objectives sought to be achieved through acquisition of controlling interests were:

   (i) Greater market power (e.g. Glaxo India acquiring Burroughs Wellcome)

   (ii) Expansion into new fields (Ranbaxy acquiring Crossland to enter into dermatology)

(c) Majority of the acquisitions were non-BIFR cases.

(d) Size of acquisitions was not at all large. Only a few were around Rs 300 crore (one example was Mcleod Russel's acquisition of Eveready Industries Ltd.).

5.3.3 Asset Buyout (ABO) on a Going Conern Basis

Based on a sample study of 43 cases[6] of asset buyout during the period 1992-97, the following patterns were to be found:

(a) Twenty two percent of the sellers were MNCs while 78 percent were Indian firms.

(b) Sixty-five percent of the buyers were either existing MNCs operating in India or firms entering India for the first time.

(c) Average number of years of operations in case of the buyers was less than the average of the selling companies.

(d) Majority of the sellers did not sell the business because they were making losses. Many of such sales were based on strategic and long-term considerations (e.g. Lakme was a highly profitable company but it still sold the cosmetic business to HLL).

(e) There were a number of reasons why ABO was preferred by the Indian industry. These were:

(i) ABOs do not come under the Takeover Code and hence are perceived as hassle free.

(ii) ABOs can be transacted fast.

(iii) Asset valuation is easier as compared to valuation of companies.

(iv) ABOs are useful for entering into a business and also for growing quickly.

(v) Banks and NBFCs were willing, at least in principle, to finance ABOs but not takeovers.

(f) Amount involved in ABOs in a number of cases was considerably higher than that involved in takeover of companies either through negotiation or the hostile route. Some notable examples were: Exide Industries buying the battery business of Standard Batteries (Rs 130 crore), JVG Group buying polycondensation and spinning business of Orkay Industries (Rs 228 crore), and Tata Power buying the captive power plant of TISCO (Rs 300 crore). However, amount involved in bulk of the ABOs were less than Rs 50 crore.

(g) Most ABOs took place after 1996. For example, as many as 200 ABOs were reported in the press during the first eight months of 1997[8].

(h) MNCs have preferred the ABO route to make entry into India (e.g. Heinz, USA bought Glaxo's food business and Sara Lee bought the biscuit business of Nutrine).

(i) In ABOs, manufacturing plant was the most frequently acquired assets, followed by brands and distribution network. While purchase of brand and distribution network had more strategic importance (e.g. Coca Cola buying soft drinks brands and distribution network from Parle, and HLL buying Kwality brand of ice creams and Lakme's cosmetic business), their valuation is comparatively more complex than that of tangible assets such as manufacturing plants.

5.3.4 Patterns of M&As in India during 1992–98

A certain pattern can be observed in mergers, takeovers and ABOs, in so far as the Indian industry is concerned. Based on a study of about 90 firms, the following broad trends have come to light[9]:

(a) Number of M&As (mergers, takeovers and ABOs) that took place during 1997–1998 was far higher than those that took place during 1992–95.

(b) Eighty per cent of the M&As were between Indian companies.

(c) Fifty-eight percent of the M&As were horizontal, followed by 26 percent vertical and 16 percent conglomerate.

(d) In 66 percent of the cases, both the bidder and target companies had a turnover of less than Rs 250 crore; in only 22 percent of the cases either the bidder or the target had a turnover of over Rs 500 crore.

(e) The top five industries where most M&As took place were financial engineering, textiles, pharmaceuticals, electrical equipment and food and beverages.

(f) Among the reasons cited for M&As, the most common were:

- Group consolidation
- Operational synergies
- Financial synergies
- Save loss making company
- Expansion programme of the acquiring company
- Marketing synergies

5.3.5 Takeover Funding

During the initial years following the indroduction of the Takeover Code in August 1994, very few takeovers could be effected smoothly, mainly due to problems relating to its legal interpretation. There were also problems due to the lack of suitable funding options to finance takeovers. However, the situation has improved during the last few years so far as acquisition financing is concerned and banks and financial institutions are now definitely interested in taking a look at this promising opportunity. Several foreign banks and FIs have announced their intention to set up an M&A fund, subject to the RBI issuing guidelines on M&A funding. For example, Citibank and Hong Kong & Shanghai Banking Corporation have plans to set up US$1 billion funds each to finance M&A activity. And some private equity funds are also expected to play a role.

Market players are expecting takeover funding to gather momentum. In fact, for some larger financial players, it would be an extension of their existing activity of structuring takeover deals—for example, the takeover of a sick cement company, Modi Cement, by Gujarat Ambuja. The erstwhile ANZ Grindlays stepped in and structured the Rs 166 crore deal with Gujarat Ambuja. Under this, Rs 100 crore was raised through three-year redeemable preference shares and the balance Rs 66 crore came through Gujarat Ambuja's internal accruals.

Takeover funding options are required by even the cash-rich companies. For example in the takeover of Raasi Cement by India Cement in which the deal size was Rs 445 crore, the latter needed to borrow Rs 180 crore after other options such as sale of assets, issue of shares and internal accruals could generate only Rs 265 crore. Unfortunately, no positive support is yet to come from RBI in so far as large scale M&A funding is concerned. Even its circular on bank finance against shares and debentures is ambiguous when it comes to takeover funding. Under Clause 8, RBI has permitted banks to extend loans against shares to meet promoters' contribution to the equity of new companies but is silent on the issue of the existing companies.

Bankers point out with surprise that RBI appears to have more confidence in new projects where things have to start from scratch but not in existing companies where their worth can be assessed easily.

It is not clear to what extent nationalised banks will be comfortable in financing takeovers since they are traditionally used to lending against assets and not against projected cash flows. Neither are they innovative like foreign banks in arranging funds by structuring instruments matching the needs of the acquirer. Banks are also at a disadvantage vis-à-vis the FIs when it comes to funding takeovers. Because of their large equity holding in companies, FIs can influence the decisions on takeovers in several ways. For example since FIs control a substantial part of the equity in most companies, no M&A activity can take place without their approval. In general, institutions have access to three strong routes to veto a deal: the loan document, the nominee director, and through the AGM by virtue of it being a shareholder. And at least two of these routes are generally not available to the banks.

Given this perspective, it appears that if banks wish to participate in M&A funding, it will involve lending money to predators to finance takeovers. This option can be considered by banks only if the new management group will agree to restructure the target company, the objective being to salvage some of its NPAs in the essentially sick target company. Traditionally, banks have attempted to reduce NPAs by re-scheduling loans. That often amounts to throwing good money after bad. What they did not tackle was the business and its weaknesses. Many of the problems of sick units stem from poor management, mismanagement and siphoning off of funds.

5.3.6 Divestiture and Spin-off

Divestitute and Spin-offs were used by Indian companies to achieve greater focus in their business. According to a study undertaken at IIM Calcutta, following patterns are visible in this context[11]:

(a) Technology intensive companies have gone in for more hiving off. In most cases, divestment was part of a wider restructuring strategy rather than a single instance. Restructuring moves of companies in such industries as chemicals, electrical, financial services, petrochemicals and pharmaceuticals exhibit this pattern.

(b) A majority of the companies where divestment took were professionally managed (about 48 percent). A few public sector companies also divested (about 10 percent). Owner managed companies are also now taking interest in divestment.

(c) Thirty-six percent of the sample companies studied were diversified; 53 percent of that were not extensively diversified also divested some parts of their businesses.

(d) In case of Indian companies, more than 50 percent of the divestments were in unrelated fields.

(e) Majority of divestments and spin-offs during 1992–98 took place during 1997–98.

(f) Two preferred options for divestment were subsidiarisation (23 percent) and spin-off (25 percent); sell-offs and demergers accounted for 29 percent of the divestments. Other options such as using joint venture route (with equal or minority participation) or hive off to another group company accounted for 23 percent of the divestments.

(g) In 70 percent of the cases, the share market responded positively to divestment announcements; spin-offs and sell-offs as divestment routes were appreciated favourably by the market vis-a-vis the subsidiarisation route.

(h) Forty percent of the sample companies divested with a view to getting more focus. Many MNCs and Indian companies also divested with a similar objective.

(i) Market did not respond well when a division was divested for entering into a joint venture.

(j) Whenever the market perceived the divestment to be for increasing the level of competitiveness, its reaction was favourable.

5.3.7 Restructuring By Indian Industrial Houses

Restructuring among companies within the same industrial houses and groups has been a regular phenomenon in the recent years (for example, A.V. Birla Group hived off the cement business of its group company Indian Rayon to another group company, Grasim Industries. Similar steps were taken by NICCO Ltd. to merge its various group companies). The main reasons for restructuring within the group were: achieving focus in business portfolio of each individual group company and reducing administrative costs. A bulk of M&A by Indian companies took place as a part of restructuring within the same management.

5.3.8 Restructuring through BIFR[12]

The Board for Industrial and Financial Reconstruction was set up in 1982 as a quasi-legal body responsible for restructuring and revival of sick industrial undertakings. Companies are usually referred to BIFR when:

- Their net worth is wiped out
- Losses have been incurred for three consecutive years

The BIFR Performance Review (extract from BIFR Performance Review and Other Publications)

The accumulated losses of sick units with the Board for Industrial and Financial Reconstruction (BIFR) as on 31 December 1996 amounted to Rs 23793 crore. The total net worth of the companies registered with the board during the year, excluding those dismissed as non-maintainable, stood at Rs 8981 crore according to the BIFR performance review, 1996.

The review revealed that the more than 11.8 lakh workers were involved in the sick industrial companies registered with the board. The textile sector accounted for the maximum number of workers affected at 3.61 lakh. The board had sanctioned

593 schemes, including 27 by the Appellate Authority for Industrial and Financial Reconstruction (AAIFR). As many as 162 companies were declared no longer sick and discharged from the purview of the board.

The review stated that numerically, the maximum number of sick companies (304) were from the metallurgical sector. However, the maximum impact of industrial sickness was felt in the textile sector with 301 cases, followed by paper and pulp sector at 138 and chemicals at 118 cases. These accounted for about 46 percent of the sick companies registered.

Further, the BIFR performance review stated that 1,853 companies were registered under the Sick Industrial Companies (Special Provisions) Act. The maximum number of sick companies registered were from the western region with 583 cases, followed by the southern region at 558, northern region at 447 and 285 from the eastern region. Among the states, Maharashtra accounted for 290 cases. The Supreme Court held that in the larger interest of the industrial health of the nation, Section 22 of the Sick Industrial Companies (Special Provisions) Act 1985 required all creditors seeking to recover their dues from a sick industrial company, in respect of which an inquiry under Section 16 was pending or a scheme was under preparation or consideration or had been sanctioned, to obtain the consent of the BIFR for such recovery.

The number of cases referred to the BIFR in 1996 witnessed a decline as against the previous year. According to BIFR's Performance Review 1996, as against 296 references received in 1994 and 208 in 1995, the number declined to 193 in 1996. Correspondingly, against 193 registrations in 1994 and 117 in 1995, the number stood at 97 in 1996.

A total of 190 references from Public Sector Undertakings (PSUs) were received up to 31 December 1996, including 72 central PSUs and 118 State PSUs. However, only 145 (61 central and 84 State PSUs) were registered with the Board. The review revealed that out of 61 central PSUs registered since 1992, only 31 could finally be disposed of upto 31 December 1996. Even though 15 reached the penultimate stages such as draft scheme and winding-up notice, final decisions in eight cases were withheld as the Centre's stand was not finalised in these cases. As many as 451 hearings were held to decide the cases of the central PSUs. Consultation among the various government agencies and disagreements regarding concessions and reliefs sought to be granted for the revival of PSUs were the major reasons for delay in finalisation of these cases. The average time taken for disposal of 31 central PSUs was 31 months. According to the review, the total net worth of companies registered with the BIFR stood at Rs 8981 crore and the number of workers involved in these units was 1,183,432.

The board sanctioned 593 schemes, including 27 by the AAIFR. As many as 162 cases have gone out of the purview of Sick Industrial Companies (Special Provisions) Act, 1985 on successful completion of their schemes. The report also said that out of the total 145 Central and PSUs registered with the Board, 40 revival schemes were sanctioned and 24 companies were suggested for winding up.

Based on a sample study of 38 companies drawn at random, an IIM Calcutta study revealed the solving pattern so far as restructuring through BIFR was concerned:

Sectoral Break Up

Industry	%
Textile	25
Chemicals	11
Steel	11
Paper	8
Mining	5
Electronics	9
Others	36

Promoter

Promoter	*Number*	*%*
Central Government	3	8
State Government	3	8
Government Bodies & Fs	3	8
Private	29	76

Problems Identified

Cause	*%*
Bad Management	26
Financial	13
Operational	11
Others	50

Restructuring Done

Action Taken	*%*
Winding Up	32
Takeover	29
Financial Re-engineering	14
JVs	7
Operational changes	7
Plan Failed	11

Given below is a brief case study on Titagarh Paper Mills, which was restructured based on the BIFR Scheme of Rehabilitation.

TPM, incorporated in 1882, was one of the oldest paper mills in the country. The management was initially with the Bird Helliger Group of Companies, U.K. Later a West Bengal Government undertaking acquired a part of the shareholding. Remaining shares were held by financial institutions (45.54 percent), and the public (36.56 percent)

TPM had three paper mills with an aggregate capacity of 77820 tpa. Mill No. 1, situated at Titagarh in West Bengal, manufactured specialty, security, and cheque papers. Mill Nos. 2 and 3, located at Kakinara (West Bengal) and Chaudwar (Orissa) respectively, produced low or non-value added papers, such as writing paper, printing paper and boards.

The major raw materials for TPM were bamboo, wood, paper cuttings and talc. In addition, an adequate supply of water was required. All of TPM's mills were located near rivers, from where water was drawn directly. For wood supply, TPM depended in part upon its own eucalyptus plantation of 7000 hectares, held by a separate company called the West Bengal PulpWood Development Corporation. This company was a joint venture between TPM and West Bengal Government, with management control in TPM's hands.

TPM's performance was satisfactory till 1979–80, after which it started registering a decline. The main problems were:

- Government regulations hindering profitability and growth
- Price control
- Shortage of raw materials

As a result, beginning 1981–82, TPM started showing cash losses in spite of having undertaken various modernisation-cum-expansion programmes from 1971 onwards. By 1985, the company's net worth had been wiped out. In 1987, it became the first company in India to be referred to BIFR.

The following problems were identified by BIFR as the root cause of TPM's decline:

- Scarcity of raw materials and rising cost
- Obsolescence of equipment/machinery requiring frequent repairs
- Labour unrest
- Management inadequacies

As on 31 March 1990, TPM's accumulated losses stood at Rs 66.94 crore as against an equity of Rs 6.35 crore.

The BIFR, vide an order dated 21 December. 1990, sanctioned a scheme for revival of TPM, and identified IDBI as the Operating Agency. The main points of the scheme were as follows:

- Mill No. 1: to be brought back into operation after repair/augmentation. The labour force to be rationalised too.
- Mill No. 2: to be closed down and all employees to be retrenched.
- Mill No. 3: to be sold off to Orissa Government.
- Employees at corporate and branch offices to be rationalised.

The cost of the scheme was estimated at Rs 23.25 crore, of which Rs 18.60 crore would be provided by FIs as term loans and the rest as interest-free unsecured loan from the West Bengal Government. Once the above steps were completed, a suitable entrepreneur would be identified to take over the company as a co-promoter on terms approved by BIFR.

Accordingly, Mill No. 3 was sold to Orissa Government for a sum of Rs 6 crore. The West Bengal Government contributed Rs 5.77 crore and the entire amount of Rs 11.77 crore was utilised for retrenchment of labour and meeting working capital requirements.

However, even after this phase of implementation was over, the Operating Agency could not find a suitable co-promoter, and Mill No. 1 could not be put back into operation. Proposals were received from the following companies:

- Milton Medes Ltd.
- Memorial Finance and Investment (I) Ltd.
- Pudumjee Pulp and Paper Mills Ltd. (PPPL)
- Soma Papers and Industries Ltd.

After the evaluation of the proposals, Soma was asked to submit a detailed proposal. This proposal on the lines of the BIFR scheme envisaged retrenchment of the entire workforce at a cost of Rs 6 crore to be financed by National Renewal Fund of the Government of India. However, no confirmation could be obtained from the Central Government, and BIFR directed that TPM be wound up.

Following the winding up order, Soma indicated their willingness to contribute the retrenchment costs themselves. At this point a number of companies, viz. Himani Ltd., Global Boards Ltd., PPPL, and Titagarh Steel Ltd. evinced interest in reviving TPM. However, only PPPL and TSL could deposit the earnest money of Rs 3 crore, as required by IDBI. They were asked to submit detailed proposals, and TSL's proposal was accepted by BIFR and the Operating Agency.

TSL proposed a merger of TPM with TSL as the core of their revival scheme. A Scheme of Amalgamation (SoA) was submitted to the BIFR. The major points of the SoA, as extracted from company and BIFR documents, were:

- The merger would be effective from 1 April 1994, known as the Transfer Date.
- Assets and Liabilities of TPM would be:
    - All assets, including licenses, permits, quotas, recoverable claims, trademarks, patents, other industrial properties, and benefits of all agreements would be transferred to TSL.
    - All rights under the scheme of Sales Tax concessions to new industrial units, and entitlements under the scheme of subsidies for industrial units would be transferred to TSL.
    - All debts, liabilities, and obligations of TPM would be transferred to TSL, along with any concession extended by BIFR. However, the liabilities would not include interest payment on unsecured loans. Further, no additional security would be provided against any loan or deposit other than what has already been provided by TPM.

- Conditions imposed by FIs/Banks on TPM:
  - Any clause agreed to between TPM and FIs regarding appointment and remuneration of directors, declaration of dividends, raising loans, and appointment of agents and distributors would be considered deleted, or modified to TSL's and FI's mutual satisfaction.
- Consideration for the Transfer:
  - As consideration for the transfer of assets and liabilities, TSL would issue shares to TPM shareholders in exchange for their shares. The exchange ratio would be determined after valuation of both companies by the Operating Agency/BIFR.
- Discharge of Liabilities:
  - The liabilities would be discharged as agreed upon in the individual context and spelt out in BIFR's final order.
- Statutory/Legal Requirements:
  - TSL would pass a Special Resolution for the offer of share to TPM shareholders as per Section 81 (1-A) of the Companies Act.
  - The investment allowance to TPM would be transferred to the Investment Allowance Reserve of TSL.
  - The other reserves of TPM as on 31 March 1994 would be transferred to the General Reserve of TSL.
  - An object clause shall be deemed to have been incorporated in TSL's Memorandum of Association effective the Transfer Date, permitting TSL to carry on TPM's line of business.
  - From the Transfer Date (1 April 1994) to the Effective Date (date on which the last of the sanctions are received) TPM would be deemed to have carried on all businesses and activities of TSL.

- The BIFR would give sanction to TSL to set off TPM's carried forward losses and unabsorbed depreciation under Section 72A of the Income Tax Act (i.e. in public interest). The tax benefit to TSL would, however, be released only in proportion to the capital expenditure incurred in relation to the revival scheme.
- TPM would be exempt from provisions of Section 41(1) of the Income Tax Act (regarding income received with respect to deductions made in a previous year).

➲ Personnel:

- All employees of TPM would be retrenched and compensation paid as per provisions of the law.

➲ Other Sanctions Required:

- Approval of the scheme by TSL shareholders through a Special Resolution.
- Approval of government for amending the Letter of Intent/Industrial Licenses if required.
- Only the provisions of FERA, ULCRA and SICA will be operative during the rehabilitation period.

➲ General:

- The expenses incurred by TPM in connection with the negotiations leading up to the scheme and subsequent implementation will be borne by TSL.

Subsequent to the implementation of the revival scheme, TPM finally turned around and showed a net profit in 1995–96. In the fiscal 1995–96, it had a 19.2 percent contribution to the net profit of TSL.

It is widely believed and probably rightly so that that BIFR had largely failed to live up to the role it was supposed to play. Its poor track record in effecting fast disposal of cases proves this point. With growing grievances against BIFR from all quarters, including industry and labour unions, government of India finally got convinced that BIFR had outlived its utility, particularly in the context of the economic reforms that were initiated in mid-1991. An in-principle decision appears to have been taken to wind up BIFR.

5.3.9 Internal Streamlining—Indian Experiences

Internal streamlining is one of the three main modes of corporate restructuring. As a matter of fact, while the other two modes, viz. portfolio and asset restructuring (including M&A and divestitures) and financial engineering are effected only periodically, efforts to streamline internal operations is a continuous process. This is because there is never an end to any improvement process in an organisation—be it with regard to asset productivity or downsizing of head count or improving conversion efficiency. It is to be noted that corporate restructuring through internal streamlining can be effected, irrespective of whether or not one or more of the other two modes of restructuring is (are) also being implemented. However, experience has shown that in case of older companies that had not restructured their businesses at all in the last 5 to 10 years, the trend is one of undertaking one or more of the other two modes of restructuring along with initiatives for internal streamlining.

Based on a sample study of 60 companies and select case studies[13], the following patterns and effect of internal streamlining and business process re-engineering could be observed:

(a) *Triggers*

There are various triggers to the internal streamlining process that is undertaken in organisations. These triggers can broadly be classified into internal and external triggers. Internal triggers are those parameters that are within the control of the management or are internal to the company. External triggers, on the other hand, are those that are beyond the control of the management and thus are external to the organisation. Using this classification, the following patterns can be seen:

- Firms such as Ambalal Sarabhai and Piramal initiated their re-engineering process as a result of changes in management.

- Many firms initiated similar exercise but triggered by an external event:
  - Ballarpur Industries initiated internal restructuring when it faced cost competition from imported products.
  - Bank of Baroda and the like undertook re-engineering of their processes due to changes in the regulatory norms.

(b) *Trends*

The following trends were noted based on the study of 60 sample companies referred to above:

Trend 1:

Not all companies involved in the internal streamlining process show an immediate increase in the sales to asset turnover ratio. Of the 60 companies studied, 34.8 percent showed an increase in the ratio.

Trend 2:

For companies undertaking an internal streamlining exercise, one of the key purposes normally is to improve working capital management. In the sample studied, about 65 percent of the firms actually witnessed enhanced efficiency on account of gross working capital.

Trend 3:

Majority of the companies that streamline their business processes experience an immediate increase in their operating margins. For example, around 59 percent of the sample firms that went in for internal streamlining and business process re-engineering have benefited from an increased operational efficiency and margins.

Trend 4:

No clear relationship can be established between increase in shareholder value and efforts made towards internal streamlining and business process re-engineering. The study on 60 firms reformed here, tried to explore whether any such relationship existed between shareholder value and internal streamlining and re-engineering exercise. The date of initiation of the re-engineering was taken as a reference. The share price of each firm of the sample was tracked for a period of six months prior to this reference date to a period of one year after the completion of the re-engineering exercise. The movement of the share price was tracked against the movement in the index, namely BSE 200, for the corresponding period. Success was defined as outperforming the index and the extent of success was captured as the percentage by which a firm outperformed the index. Using this approach, the patterns that emerged did not show any clear linkage between enhancement of shareholder value and results achieved through internal streamlining efforts. This is not unexpected since the share price of a firm depends on various factors which were not isolated in the study under reference. However, there is no denying the fact that internal streamlining efforts do lead to significant enhancement of asset productivity and efficiency, which are one of the key drivers for enhancing shareholder value. It also needs to be remembered that most firms that undertake internal streamlining initiatives do not achieve dramatic improvement in performance even after a few years mainly because very often such moves involve fresh investments in new assets and capabilities and it takes time to manage the process of change that invariably has to be initiated to build the new culture required to fully leverage such investments.

5.3.10 Financial Engineering

Capital structure of a firm consisting of debt (secured and unsecured) and equity (common stock and preference shares) including reserves and surplus may need to be periodically reviewed not just when there is need for funds but also on a regular basis to achieve the following basic objectives, viz.

- Enhance liquidity
- Lower cost

- Lower risk
- Ensure flexibility to shift to different debt-equity mix
- Ensure no loss of control
- Improve shareholder value and earnings per share

Need for reviewing the capital structure of a firm and re-engineering the same periodically to ensure achievement of the above six objectives in the context of adverse performance of the firm in areas such as post-tax, pre-interest profits, mismatch of cash flows (i.e. inflows not matching with payment liabilities), high cost of capital, etc. or for responding to changes in monetary policy of the government and opportunities available to tap international financial markets cannot be overemphasised. Such re-engineering of the capital structure may need to be carried out irrespective of whether or not one or more of the other two modes of restructuring, viz. portfolio and asset restructuring (including M&A and divestitures) and internal streamlining is (are) being carried out. But it is only normal to expect that when any mode of corporate restructuring is being undertaken, there will also be the need to pay particular attention to the firm's capital structure, the aim being to ensure that the above stated six objectives are always achieved.

As a firm embarks upon financial engineering of its existing capital structure to ensure achievement of the six key objectives of liquidity, cost, risk, flexibility, control and shareholder value, it must keep in mind the following important considerations[14].

- Leverage issue: how much change in debt and equity will be acceptable.
- Ownership issue: extent of enhancement/distribution of present holding of promoter/controlling group.
- Instruments: whether the existing or new instrument (debt/equity) should be deployed to effect the desired changes and to achieve the six objectives stated earlier.

- Timing: if additional debts and/or equity is to be raised, what should be the right time (duly taking into account the state of capital and debt market and firm's positioning in the minds of the prospective investors)?
- Pricing: to raise debt and/or equity for meeting the additional funds requirement for restructuring or to change debt-equity mix or for financing an organic expansion, at what level should the firm price its issue?
- Terms of control: what kind of control should the firm enter into with its suppliers of fund so as to ensure maximum flexibility (implying that restrictive clauses are to be kept to the minimum)?

A related issue, along with the above considerations, that can have impact on the firm's re-engineered capital structure is the future dividend policy (how much to retain and how much to distribute). The decision and rationale in this regard, and also the way it is communicated to the shareholders can give important clues to the latter about the returns that can be expected in the future.

The approaches available to alter capital structure, considerations thereof and tools and techniques available to evaluate various options are not dealt with here primarily because they are beyond the scope of this book and also because they are available in any good post-graduate level book on financial management. What we intend to cover in the remaining part of this section are some of the trends seen in the late 1990s so far as financial re-engineering by the Indian corporate sector is concerned. These are:

(a) Enhancement of foreign equity in Indian companies

(b) Use of GDRs to raise equity; also FIIs as a source of fund

(c) Use of external commercial borrowings (ECBs) to raise funds

(d) Use of new generation debt instruments

(e) New developments in equity issues (other than GDRs and investments by FIIs)
   — Buyback of shares
   — Scope for increased control in other companies
   — Use of non-voting and preference shares
   — New moves in the field of equity capital

(f) New approaches to financing of working capital

(a) Enhancement of foreign equity

With the onset of liberalisation of Indian economy, many MNCs which already had a minority foreign equity holding in their Indian affiliates prior to 1991, decided to enhance the same to 51 percent and above. The decision to increase their control resulted from a variety of factors such as changed perception regarding prospect of Indian economy, relaxation of Foreign Exchange Regulation Act, 1973, opportunity to leverage Indian unit's ability to access low cost inputs (men and material) to meet pressures of global competition, and so on. Indian affiliates, which received additional funds as a result of such decisions taken by their respective parents to raise foreign equity holding, used the same to part finance the cost of restructuring as well as to make fresh investment in new capacities or support development of brands and distribution network. Since in many of the cases, enhancement of foreign equity was done through preferential allotment following SEBI guidelines, inflows to the Indian companies were quite substantial. A few cases where re-engineering of capital structure was done through enhancement of foreign equity were: BOC India, Glaxo India, Philips India, Coats of India, Indian Aluminum, etc. It is reported that more than 100 odd companies enhanced their foreign equity holding during the first four years of reform itself.

In many cases where MNCs increased their stake in the Indian affiliate, they insisted that certain restructuring be carried out prior to actual enhancement of foreign equity holding. For example, in case of BOC India Ltd. (formerly Indian Oxygen

Ltd.) foreign equity was brought down below 40 percent in 1979 to meet FERA requirements, but was later enhanced to more than 51 percent after the Indian company undertook massive internal streamlining (about 4000 out of 5300 people left through voluntary retirement scheme and closure of uneconomic units) during the period 1989 to 94 and also sold off its unrelated welding business as a going concern in 1991. Being satisfied with the action taken, The BOC Group Plc. UK, increased its equity to above 51 percent by 1995. A similar situation had arisen in the case of Philips India.

MNCs increased their equity holding in their Indian affiliate more due to compulsion than any premeditated strategy. A case in point is Alcan, the erstwhile Canadian parent of Indian Alluminium Co. Ltd. (Indal). Alcan was forced to make a public offer to increase its holding from 34 percent to 51 percent when Indal faced a hostile bid from Sterlite Industries, in early 1998. There is also the case of BAT, the UK parent of ITC Ltd., who in spite of repeated attempts to enhance their holding in the latter, could not do so as the then incumbent management as well as the FIs blocked their move. From all these experiences, one can conclude that while enhancing foreign equity holding is now an option available to existing Indian firms where MNCs already have a minority participation, not in every case will it be an easy route unless it is mutually agreed upon on a planned basis.

(b) Use of GDRs and FII investment

Indian companies, in order to fund potential acquisitions (under the overall plan to restructure) or organic expansions, have increasingly resorted to using Global Depository Receipts (GDRs) to raise money from overseas capital market. register. There were a number of companies that used the GDR route, which resulted in alteration in the respective company's capital structure. Some of the well-known companies which used this option were Arvind Mills, CESC, Hindalco, ICICI, TELCO, VSNL, Videocon, and L&T. As of June 1999, there were 64 outstanding GDRs issued by Indian companies.

GDRs were perceived by Indian companies as a suitable option for raising funds in the mid-90s when the capital market was depressed. The size of the GDR issue made by VSNL was US$527 million followed by $370 million by SBI, $359 million by MTNL and $230 million by ICICI. Arvind Mills, Ashok Leyland, BSES, TELCO, Reliance and a number of A.V. Birla Group of Companies used this route to raise $100 million or above from the overseas market. While not all of these companies used the GDR proceeds for acquisition or internal streamlining of operations, the same definitely helped in re-engineering their respective capital structures, leading to more liquidity, lower cost, lower risk and greater flexibility—all contributing to enhancement of shareholder value

Like GDRs, many Indian companies are also increasingly using foreign equity funds through widening the participation of Foreign Institutional Investors (FIIs) in their equity (upto 49 percent). For example, it was reported in the business press that as far back as in 1997, Infosys Technologies decided to hike their FII holding to 30 percent of their equity capital (maximum allowed at that time).

(c) Use of External Communal Borrowings (ECB)

As in the case of GDRs, Indian companies increasingly re-engineered their capital structure by accessing the ECBs. In mid-90s (i.e. during 1993–96), ECBs were easily available at a lower effective cost than domestic funds available from FIs. The stipulations, which Government of India put on tenure of the loans and end uses, did not deter Indian companies from borrowing extensively from overseas. Many Indian companies used this route to repay their expensive term loans from Indian FIs and commercial banks. Some that used this option during the initial years of reforms to change the mix of their debt funds were Reliance ($140 million), Sterlite ($100 million), ICICI ($200 million), TISCO ($100 million) Ispat Industries ($125 million) and Mahindra & Mahindra ($100 million). As at June 1999[15] there were about 10 companies which had outstanding bonds in overseas market, with the minimum size being $35 million.

A particularly interesting case was that of Reliance Industries' $614 million Yankee Bond Issue which offered maturities ranging from 20 to 100 years and coupon rates ranging between 8.25 percent and 10.50 percent.

(d) Use of new generation debt instruments

Beginning third quarter of 1990s, Indian companies, assisted by merchant bankers, also started exploring new debt instruments that met the key criteria in areas such as cost, cash flow, risks and flexibility relating to the need (either a project or working capital) for which the debt fund was being mobilised. Some such new generation debt instruments that were considered (in addition to conventional term loan, debentures, etc.)[16]:

- Non-recourse finance
- Zero coupon/deep discount bonds
- Step up/step down structures
- Variable rate bonds
- Eurobonds/Yankee bonds/Samurai bonds

Similarly, there were new kinds of convertible debt instruments[17]:

- Redeemable cumulative convertible preference shares
- Secured premier convertible bonds
- Optionally convertible discounted debentures
- Euro convertible bonds

Different kinds of leases were also deployed to act as new sources of fund for financing future requirements[18]:

- Financial leases
- Operating leases
- Vendor leases
- Big ticket leases
- Leveraged leases

A detailed discussion on any of the above topics is beyond the scope of this book. However, the reader is advised to appreciate the implications of each of these approaches and understand how to use them to re-engineer the capital structure of a company.

(e) New Developments in Equity Issues

GDRs, investments by FIIs and various debt instruments have already been used by many Indian companies not only to enhance their liquidity and lower the cost of funds but also in the process re-engineer their capital structure. In the following paragraphs, three other developments under the equity option are described:

—Buyback of shares:

Faced with the twin problems of low Earnings Per Share (EPS) and possibility of takeover by hostile bidders, an increasing number of Indian firms started contemplating on reducing the number of their outstanding shares through buyback. Government of India had already decided in principle to allow companies to buy back shares, subject to their meeting certain conditions and other provisions of the Companies' Act.

As is generally believed, after buyback, the EPS should improve significantly and the share prices should go upward. A probable buyback candidate must meet the requirements stipulated by the government, besides meeting the following criteria[19]:

- Book value is significantly higher than market value
- The company has sufficient cash and buyback will be financed through the same
- No plan for fresh equity issue
- Buyback amount: upto 25 percent of net worth
- Debt-Equity ratio will not exceed 2:1 after buyback
- The company is cash rich and has no avenues to deploy the cash elsewhere to improve existing RONW

- Buyback has to be completed within 12 months of passing the special resolution
- Main promoters are keen to increase their control on the company

An Economic Times Report[20] gave the names of 200 corporates who had passed enabling resolutions that would allow the Boards of these companies to buy back shares under the amended Companies' Act. The list included the top 100 companies. The market price of shares of many of these companies was less than the book value. One such example was Reliance Industries Ltd., the highest net worth company as of 31 March 1998 with Rs 11795 crore of net worth, whose book value as at 31 October 1998 was Rs 126.57 per share vis-à-vis the market price of Rs 110. Similarly, Tata Steel's book value in end October 1998 was Rs 110 per share whereas the share price was Rs 83. Other examples included IPCL, Essar Steel, Tata Power Co., ACC, Escorts, Videocon, Bombay Dyeing, BPL, etc.

However, this does not mean that only those companies whose market price is less than the book value will be interested in the buyback of shares. Even companies like P&G and Smithkhine Beecham, whose market prices were higher than the book value in end 1998, were reported to have shown interest in buyback of their shares since they believed that their shares deserved better valuation.

The ordinance issued by the government in October 1998 debarred companies from buying back shares through subsidiaries and other group companies[21].

—Scope for increased control in other companies:

Indian promoters traditionally retained control on various group companies through cross holding, so much so that even with a paltry holding of, say, 8-10 percent, the promoter group could maintain its control on such companies. With slow but steady development of market for corporate control, many such promoters feared takeover by a hostile bidder. They therefore became interested in increasing their holding in these group companies. Till recently, there was one bottleneck to enhancing holding in other companies, viz. the provisions relating to Section 372 of the Companies' Act. However, this problem got solved when Section 370 and 372 of the Act was replaced with a new section which did not specify any limit on investment size for either the investor or the investee company. As a result, a company can now buy 100 percent of the equity of another company without government clearance, subject to satisfying two norms[22]:

- Approval of the Board will be necessary for investment up to 60 percent of the equity or 100 percent of the free reserves of the company, whichever is more.
- A special resolution is necessary for investment or loan exceeding this limit

—Use of Non-Voting and Preference Shares:

Preference shares, though not a new concept, are likely to become a preferred option with the corporate sector in the near future. One of the reasons is that it enables raising of long-term funds without fear of dilution of control. The fixed return and non-tax deductibility on dividends paid are incentives to certain categories of investors. With the exclusion of preference shares and corporate debentures from the limit put on a bank's exposure to corporate securities (equal to 5 percent of incremental deposits) effective first half of 1997–98, banks are likely to put part of their surplus funds in preference shares. All these developments may lead to the Indian corporate sector raising funds for restructuring or for meeting ongoing project requirements through preference shares. Preference shares also provide an option for commercial banks to augment their Tier II capital.

Like preference shares, non-voting shares are expected to become an option to re-engineer the capital structure of a company. Under this option, funds can be raised without fear of dilution of control. Non-voting shares will have a market of its own and will be tradable. Prices of non-voting shares will be lower than those that have voting power, while the dividends will be higher. A number of conditions are to be satisfied prior to issuing non-voting shares and there is also a maximum limit (as percentage of the equity capital with normal voting rights) on amount to be raised through this route. Indian companies are actively considering this option, which, over a period of time, may become popular with certain types of companies and certain categories of investors.

—New moves in the field of Equity Capital:

- Employee Stock Option Plan (ESOP):

ESOP allows listed companies to issue shares to employees (both own as well as those of subsidiaries and holding companies) at any price[22]. Price here implies the price at which the concerned employee, who has been granted option under the plan, will be exercising the option to convert it into shares. Regulatory guidelines spell out how the ESOP will work and generally include, among others things, (a) identification of the classes of beneficiaries entitled to participate (e.g. whole time directors are not allowed to participate); (b) vesting period of the option; (c) lock-in-period (if any); (d) period and process of exercise; (e) non-transferability of the option (nor can they be pledged or hypothecated); (f) pricing basis; (g) process of determining the eligibility of the employee; (h) requirement of special resolution to issue stock options; (i) clear statement on accounting policies, etc.

ESOP will be an innovative step, and how it can be used to create more value for both shareholders and employees should be examined by every organisation.

- Equity Reduction Plan

Indian companies, as mentioned above, are actively thinking about the buyback of shares, particularly in cases where book value of shares is higher than the market price and also where the promoter group's control is perceived to be less than the minimum needed.

An alternative to buyback of shares can be an equity reduction[23]. Under the equity reduction scheme, a company can propose to reduce its equity capital by a certain percentage in order to enhance shareholder value and offer an equal number of preference shares (which earn a tax free dividend) in lieu of the same. Since in this process, EPS and ROE will be enhanced, the PE multiple, which generally moves in tandem with ROE will also be moving upward, which in turn will have a very favourable impact on the share prices of the concerned company. The preference shares, so issued, can be redeemed at par at the end of a certain number of years. According to some experts, this approach to equity reduction was always allowed under the Companies' Act while the buyback route was allowed only in late October 1998.

The difficulty with equity reduction plan is that it will reduce liquidity in the shares drastically. But the same problems will be there even in case of buyback of shares. However, companies with large equity stock should not face the problem of liquidity, as investors and speculators generally have an interest in such companies' stocks.

There is another approach to equity reduction[24]. Under this route, the main promoter group of a company can plan to extinguish a certain percentage of its equity by making every shareholder agree to give up the same percentage of equity in the company. In return, the shareholders can be given (free of cost) equity of any other group company which is also controlled by the same promoter group. To implement this proposal, the company will require approvals of FIs and also of concerned High Courts. Post-restructuring, the promoters, public and FIs/MFs would continue the same holding that existed before the equity reduction took place.

(f) New Approaches to Financing of Working Capital

The need to re-engineer the capital structure of a company is not felt just because there is requirement of additional and cheaper funds for corporate restructuring (such as M&A or internal streamlining) or undertaking a major expansion or diversification move on an organic basis. Such re-engineering may need to be done even for meeting the growing working capital requirement. The Indian corporate sector traditionally depended on certain options to finance their working capital needs such as "maximum permissible" bank finance (now abolished), trade credit, bill discounting, inter-corporate deposits, public deposits, commercial papers, and non-convertible debentures. It is now actively considering other options such as loans with variable prime lending rate, short-term foreign currency loans, euro-commercial paper, factoring, floating rate notes, revolving underwriting facilities, dutch auction notes (a debt instrument where the coupon rate is refixed periodically based on an auction), etc. As already mentioned, a detailed discussion on technicalities of each of these modes of financing is beyond the scope of this book. But what needs to be appreciated here is that even in case of financing of working capital, there exist a large number innovative options which, if implemented, will not only lead to re-engineering the capital structure of a company but also enhance shareholder value through lowering of cost of debt capital, minimising the underlying risks and augmenting flexibility.

5.3.11 De-mergers, Divisions and Splits in Indian Family Business

In addition to examples and trends given in Section 3.7 with regard to restructuring of large industrial houses (mostly controlled by Indian family groups), there are many instances of Indian family groups splitting up not just due to the needs of the business but also due to shift of power from one generation to the next. Take for example the Birla Group. What was once a monolith is now split into a six distinct family groups viz. B.K. Birla Group, A.V. Birla Group, S.K. Birla Group, K.K. Birla Group, M.P. Birla Group and C.K. Birla Group. Similarly, the DCM Group was split into a number of parts, viz. DCM Shriram Industries, DCM Shriram Consolidated, DCM Ltd. and Shriram Industries Ltd., each managed by different descendants of Lala Shriram. A similar split also took place in case of J.K. Group of Kanpur and Modi Group of Modinagar. Raurag Group and Ranbaxy Group too split up their businesses following differences among family factions.

Two recent cases of restructuring of Indian family businesses are the Jindal Group and S.P. Goenka Group. In case of the former, all four brothers will have independent control of the companies[25]; Jindal Steel and Power will be controlled by Mr. Naveen Jindal, Jindal Strips by Mr. Ratan Jindal, Jindal Iron & Steel Company by Mr. Sajjan Jindal and Saw Pipes by Mr. P. R. Jindal. In the case of the Rs 550 crore Calcutta based S.P. Goenka Group, the proposal was for a two-way split: Vinay K. Goenka, the second son, would take control of the tea, travel and engineering business, while the plywood, vegetable oils, chemicals and sugar business would be under the control of the eldest and youngest sons—Mr. P.K. Goenka and Mr. R.K. Goenka. Following the scheme of arrangement, Mr. Vinay K. Goenka resigned from the Boards of the companies looking after the business of plywood (viz. Kitply), sugar and vegetable oils. Similarly, Mr. P.K. Goneka resigned from the Warren Tea Board.

While it is difficult to generalise whether the de-merger or split of family businesses creates or destroys value, as against value created during the pre-restructuring phase, in quite a few cases the results have been encouraging. For example, businesses coming under the A.B. Birla Group performed well during the post-restructuring phase; similar improvement was seen in the case of Ranbaxy. Even in case of the DCM Group, pre-split performance during the year 1989–90 was extremely poor vis-à-vis the performance of the newly formed companies during 1993–94. In general, it has been seen that during the post-split phase, performance improved due to greater focus, faster decision-making and upgradation of management structure, systems and processes. Individual family members also become happier following the split, as their wealth multiplies as a result of improved performance.

5.3.12 Restructuring of the Public Sector

Most public sector units in India failed to live up to the expectation with which they were set up. Over the years, many of them not only failed to achieve the set objectives but also became inefficient, over-staffed and a drag on the national exchequer.

Of the 240 PSUs surveyed and reported by the Department of Public Enterprises for the year 1997–98, 100 were sick[26]; 75 percent of the total profit of all PSUs was earned by a handful of companies.

Government is definitely concerned and a move has been initiated, over the last few years, to restructure the PSUs. Some of the key actions that are currently under implementation, though not at the pace that is desirable, are:

(a) Granting of more freedom to the nine top PSUs to manage their own strategic and operating matters: These PSUs are: the four oil companies, BHEL, NTPC, SAIL, ONGC and VSNL. This list will be extended to other PSUs which are profitable and do not need any further support from government. The Board of Directors of these companies are being professionalised to facilitate implementation of this decision.

(b) Disinvestment of government's equity in PSUs: A Disinvestment Commission, set up for this purpose a few years ago, released the first list of 33 PSUs which were recommended for divestment[27]. Several modalities such as trade sale (six PSUs) strategic sale (18 PSUs), offer of shares (five PSUs), and closure/sale of assets (four PSUs) have been proposed. There have been major protests from various interest groups against government's disinvestment decision and it was felt that such disinvestments were being proposed to make up for the budgetary deficit (very little progress was made in respect of disinvestment till the end of 1998; a lot of protests took place after the government went ahead with BALCO disinvestment).

(c) The government has also been actively considering various approaches to downsize manpower strength in the PSUs. Though the progress is still very slow in this regard, as many as 62 PSUs have shed close to 1,20,000 employees under Voluntary Retirement Scheme (VRS) during the period 1993–94[29]. Some of the companies where extensive manpower reduction took place are: National Textile Corporation, Bharat Coking Coal, Central Coalfields, Eastern Coalfields, HMT, ITI, Mazagaon Dock, Hindustan Steel Works, etc. Because of this downsizing and general restriction on fresh recruitment, overall employment in PSUs stood still at Rs 194.45 lacs over the period 1994–96. Downsizing through VRS in public sector seems to be catching up and SAIL as well as many public sector banks planned to pursue it rigorously. In the 1999–2000 budget, the Government of India even provided the money for payment to workers in 10 PSUs which have been identified for closure.

In cases of large profit making PSUs, such as Indian Oil, some dilution in government equity has taken place but since the latter's holding in such companies continues to be over 51 percent, there are still no basic changes in the way these PSUs are supervised and managed by the administrative ministry. During the year 1998–99, faced with depressed market conditions, Government of India came up with a plan to disinvest its holding in select PSUs (like IOC and ONGC) that involved purchase of equity of one PSU, to be sold by the government at a predetermined price, to another PSU. For example, ONGC purchased the IOCL's equity disinvested by GOI and vice versa. In the process, the government got funds through disinvestment but the concerned PSUs became cash starved.

Another plan that the Government of India announced in end 1998 was to privatise the PSUs, using the concept of "Special Purpose Vehicle" (SPV). A SPV was supposed to be a company in which government would have 49 percent equity, and FIs (not controlled by the government) will have the balance. The plan was to transfer the government's equity in excess of 49 percent in six PSUs (viz. MTNL, IDBI, IPCL, IBP, HPCL and BPCL where the government's holding has already fallen below 70 percent) At a later stage, these PSUs, which were identified for privatisation, would take stake in the SPV[28]. From the way the SPV was conceptualised, it was clear that it would be a non-starter. No wonder, nothing has happened since its announcement.

The above developments have taken place in the last few years so far as PSU restructuring is concerned. Even though it is well accepted that PSU restructuring and reforms are a must for revival of the Indian industry and also for stopping drain on government's meagre resources, nothing significant is happening because of lack of political will and also because a part of the bureaucracy is not committed to such restructuring. While individual PSUs like the oil companies, ONGC, VSNL, MTNL, etc. have introduced a number of important organisational changes to speed up their business processes and are fast becoming market focussed, many a time their efforts are getting hampered due to lack of appreciation by both the concerned ministry and employees that the change is indeed needed. It is unfortunate that even though a number of PSUs have the opportunity and ability to become powerhouses in the liberalised world, they are still bogged down as controls are not released by the political leaders and bureaucrats who are not accountable for the outcome of their actions. Most PSUs have accumulated inefficiency over the years by way of excess assets, surplus people, possession of non-core activities and outdated infrastructure, and it is high time they undertake drastic corporate restructuring to become competitive. However, it appears that India is destined to carry with it a large number of outdated, unfocussed PSUs as she enters the next millennium.

5.4 Enhancement of Shareholder Value and Role of Corporate Restructuring—The Indian Experience

In Chapter 1, we took the position that maximisation of shareholder value should and must be the principal objective of any management, and made some observations on how the Indian corporate sector is performing in this regard. In this section, we intend to provide further insights into the subject and also illustrate how more and more Indian companies are resorting to periodic corporate restructruring to improve shareholder wealth on a continuous basis.

Performance of a company's stock in the capital market is the ultimate indicator of how it is performing. Even though most analysts and corporate executives tend to term Indian stock market as 'nefficient' and feel that it does not respect fundamentals and instead gets swayed by whims and sentiment, resulting in failure to isolate performing from non-performing companies, the truth is that in spite of all these inadequacies of the market, there is no denying the fact that many Indian companies have systematically destroyed their value over the last so many years. Fortunately, despite the overall sluggishness, companies such as HLL, ITC, Bajaj of VSNL were always concerned about enhancing shareholder value and the market has always rewarded them, for to what extent the Indian corporate sector is creating or destroying value can be assessed by looking at its performance against two key parameters, viz. (a) Economic Value Added (EVA—defined as the surplus or residual income net of opportunity cost of capital provided by lenders and shareholders) developed by Stern, Stewart and Company and (b) Return On Net Worth (RONW—defined as profit after tax divided by equity plus free resources). In a study[30], it was found that as at March 1998, top 130 companies of India, that were listed as group A companies in BSE and that accounted of 50 percent of India's total market capitalisation and 35 percent of total sales of 4985 companies listed in the BSE, lost Rs 36219 crore in EVA (assuming a 20 percent cost of capital) between 1994–95 and 1997–98. Similarly, at a 20 percent RONW benchmark, a total of Rs 12490 crore shareholder value was lost during the same period. The worst performance in respect of both EVA and RONW was during 1997–98.

Despite the under-performance of most companies in India, there were star performers as well, though their number was small. Notable examples—in addition to ITC, HLL, Bajaj and VSNL—are Castrol, Punjab Tractors, TVS Suzuki, BHEL and Colgate Palmolive. The report, referred to in the previous paragraph, also identified a few industries like auto ancillaries, two-wheelers, FMCGs, pharmaceuticals, electrical machinery, machine tools, hotels and paints that created more value during the period under reference, than at other times.

Another exploratory study[31] that examined market capitalisation data of top 100 Indian companies for the seven year period 1991–92 to 1997–98 made the following observations that provide important clues as to why and how Indian companies should undertake corporate restructuring:

(a) Firms that undertook corporate restructuring activities added more to shareholder value than those that did not.

(b) MNCs provide greater addition to shareholder value than companies with Indian ownership.

(c) Companies in the 'Sunrise' industries tended to provide better than average returns to shareholders.

(d) Companies in the 'mature' industry sector have under-performed the market on shareholder returns.

(e) Companies that were among the bottom 20s of the sample companies chosen have out-performed the top 20s of the sample, with regard to enhancement of shareholder value.

(f) Companies that were focussed in their line of business have performed better than the market.

The above observations, based on study of a limited sample of companies duly categorized into viz. MNCs, Sunrise, mature, etc. are noteworthy. The importance of periodic corporate restructuring to improve shareholder value is also brought out loud and clear. Managers must accept that their principal responsibility has to be to improve shareholders' wealth and that their business portfolio as well as the policies pursued by them to create value must be revisited all the time to ensure their continued commitment to such a responsibility.

One of the major weaknesses of the Indian corporate sector is its inability to extract the possible return from capital already invested through formulating and implementing appropriate strategy and functional policies—be it in marketing, finance, operations or personnel. A look at the financial and operating ratios of leading companies will reveal how such companies under-performed not only against their nimble-footed competitors, both domestic and international, but also against their own best performance achieved in the past. There is also a tendency, primarily a fall-out of license raj, to get into new projects—both related and unrelated—without appreciating how the company's EVA will get adversely affected if the returns from the same turn out to be inadequate, either because of lack of robustness in the project concept or due to incompetence of the incumbent management team. The diversity of product portfolio of a large number of Indian firms, in many of which these firms did not have core capabilities, was one of the reasons why many of them could not fully leverage the assets in which they invested in the past. It was very typical in India, even in the recent past, that companies which were already under-performing moved more frequently into diversified activities, as compared to firms that were highly focussed. The former did not seem to appreciate that their incompetence in managing their business and assets in existing areas would also be carried to the new fields to which they intended to move through diversification.

As mentioned earlier, the Indian corporate sector, barring a few companies, has systematically destroyed its shareholder value in the past. It will need to reposition itself by taking a fresh look at its strategy, organisation, legal structure and various functional policies, and effect changes in all of these as needed. It will also need to undertake corporate restructuring to reposition itself to face new competitive realities and enhance shareholder value.

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CHAPTER

6

Indian Legal Issues in Corporate Restructuring

6.1 Introduction

In Chapter 3, we described the various approaches to restructuring a company, as well as the different strategic, organisational, financial and legal implications of each one of them.

In this chapter, a brief overview on select regulatory dimensions relating to restructuring decisions is being given. At the time of making decisions, managers will no doubt seek specialist services from professionals working in relevant areas (readers are requested to take a look at the note provided in the reference section in this regard). Nevertheless, being aware of the broad legal issues will make them more effective. Hence this chapter.

In the following sections, we have listed the key legal and regulatory issues relating to certain specific corporate restructuring options; which are as follows:

(a) Merger/amalgamation of two or more companies (within the same group or across groups) through exchange of shares.

(b) Acquisition/divestment of a business as a going concern

(c) Substantial acquisition of shares or change in control in another body corporate.

(d) Spin-off of a business/division as a separate company (either as a joint venture with the selling company as one of the promoters or as a wholly owned subsidiary).

(e) Sale of controlling shares in a subsidiary/associate company.

(f) Merger of a healthy company (transferor) with a sick company (transferee).

(g) Restructuring within family business.

(h) Restructuring under BIFR.

(i) Financial Engineering:

- Enhancing promoters' quota
- Changing debt: equity mix
- Introduction or enhancement of foreign equity
- Issue of GDRs/ADRs.
- Change in secured/unsecured loan and use of external commercial borrowings/foreign loans
- Use of innovative debt instruments
- Buyback of shares
- Issue of non-voting shares and preference shares

(j) Internal streamlining of operations (without any change in ownership or portfolio structure)

- Downsizing of head count
- Closure of factory/uneconomic units
- Sale of idle assets

6.2 Mergers and Amalgamations (Through Exchange of Shares)

The important legal provisions that need to be kept in view while taking decisions regarding mergers/amalgamations are:

(i) Provisions under the Companies' Act 1956

(ii) Provisions under the Income Tax Act 1961

(iii) Miscellaneous regulations such as stamp duty, gift tax, excise duty, sales tax, etc.

Provisions under the Companies' Act 1956

- Section 391 to 394 of the Companies' Act 1956 provide a legal process for mergers/amalgamations. The act requires that approval of shareholders and creditors of both the companies to the scheme of amalgamation, followed by an order of the high court (of the State(s) where the registered office(s) of the merging/amalgamating companies are situated), sanctioning the scheme be obtained.
- Object clause of Memorandum of Association of both the companies must have the power to amalgamate.
- Court is not going to interfere with valuation and exchange ratio, if done by experts and approved by shareholders.
- The laid down procedures for making application to High Court to be followed (Rule 67 and 68 of Companies' (Court) Rules 1956).
- Convening of meeting of shareholders and creditors for obtaining approval of the Scheme of Amalgamation must be as per Rule 69, 73 and 74 of Companies' (Court) Rules 1956.
- Submission of petition to the court, as per Rule 79, for obtaining confirmation of the arrangement.
- A certified copy of the scheme, after confirmation by the court, should be submitted to Registrar of Companies within 14 days.

- Issue of shares to shareholders of transferor company as per Section 113 and rules passed thereunder.

Note: Specimen draft for scheme of amalgamation, notice conveying meetings, report of meetings of members/creditors, petition to court, and order of court are given in Verma, J.C., *Corporate Mergers, Amalgamation and Takeover*, Bharat Publishers House, November 1995.

Provisions under the Income Tax Act 1961

- For stock-for-stock exchange, the shareholders of transferor company will not be subjected to any tax; only when they dispose of the shares and there are capital gains as per the Income Tax Act 1961, will the tax be payable (Section 47(vii) and 49(2) Act).
- Transferee company must acquire all assets and liabilities of transferor company and 90 per cent shareholders of the latter (in value term) should become shareholders of the former (Section 2(1B)).
- Value of assets at which the transferred assets are to be placed by the transferee company will be the WDV value, prior to the merger, as recorded in the books of the transferor company (Explanation 7 to Section 43(1)). Similarly, for tax purposes, cost of stock-in-trade to the transferee company will be the cost to the transferor company (Section 43 (I)).
- Carry forward of unabsorbed depreciation and setting off of accumulated losses may not be allowed. However, if a merger with a sick company is proposed, Section 72A benefits can be availed if the Central Government makes a declaration to that effect.
- The transferee company will be entitled to the balance of the investment allowance, if any due to the transferor company, if the former fulfills the conditions which the latter was required to fulfill (Section 32A(vi)). Similarly benefits of development rebate and development allowance will be

available to the amalgamated company under certain conditions (Section 33(3) and 33A(5)). Also allowed are the deduction of expenditure on scientific research as allowed previously to the transferor company (Section 35(5)) as well as expenditure on acquisition of patents or copyright (Section 35A(6)).

Miscellaneous regulations

- *Stamp Duty*

  Some key aspects that need careful attention are:

  - Duty chargeable (as per Section 3 of the Indian Stamp Act)
  - Conveyance
  - Amendments made by the concerned state government covering court order within the meaning of 'conveyance'
  - Valuation for the purpose of levy of stamp duty

- *Gift Tax*

  Does not apply to Indian Companies in a scheme of amalgamation (Section 45(b)).

- *Excise Duty/Sales Tax*

  Excise licenses and sales tax registration issued in the name of transferor company will have to be changed to that of transferee company for the latter to continue operations in the post-merger phase.

- *RBI Approval*

  Before applying for approval under Section 391 to 394 of the Companies' Act, compliance with relevant RBI guidelines is needed if share transfer involves foreign nationals or non-resident Indians.

6.3 Acquisition/Divestment of a Business as a Going Concern

The Companies' Act

- Object clause of acquiring company must include the line of business being acquired.
- Shareholders approval under Section 293 1(a) of Companies Act (in case of both acquiring and divesting companies). Consent/approval of secured creditors and investing institutions will be needed before divesting the assets.
- If the consideration of sale of assets is neither cash nor stock nor a combination thereof, the share capital of the divesting company must be reduced.

The Income Tax Act

- For the acquiring company, the items mentioned in item 6.2 above under Income Tax Act will apply.
- For divesting company, capital gains tax becomes payable when the consideration is paid in cash. Two situations may arise.
  - (a) Sale of the capital assets in itemised form, each for a separate price.
  - (b) The transaction is done on 'slump sale' basis, meaning that the entire business is sold for a total and indivisible price.

Total capital gains in item-wise sales is easily worked out and taxes on profit made are paid accordingly. But in case of slump sale, where item-wise break ups are not available, it is difficult to estimate the actual capital gains since depreciable and non-depreciable assets are not identified (a must for item-wise capital gains calculation) and as a result a view is gaining ground that the entire asset may probably be treated as a non-depreciable asset and, when this is assumed, the indexed cost of acquisition is deducted from the slump sale consideration. The capital gains tax @ 20 per cent on the difference will be payable and experience shows that the tax paid can be lower than item-wise sale. A point of caution is that while structuring the sale of assets on 'slump' basis, care should be taken that such sale is not seen to be summation of individual considerations.

Miscellaneous Regulations

Stamp duty

Same as what mentioned in item 6.2 above.

Sales Tax

Payable on sale of assets to the acquiring company

Sales Tax Registration/ Excise Licenses

Same as what mentioned in item 6.2 above.

6.4 Acquisition of a Company through Purchase of Shares Leading to Change in Control

Securities & Exchange Board of India (SEBI) Takeover Code

SEBI Takeover Code provides a regulatory process for acquisition of another body corporate. The Takeover Code was first introduced in 1994 and was subsequently amended a number of times based on experiences gained by the regulator from specific cases. The code, among others things provides for conditions under which a public announcement for acquisition of shares will need to be made by the bidder, procedures to be followed by the bidder and the target company from date of trigger to actual completion of the transfer of shares, mode of financing the acquisition, definitions of change of control, competitive offer, creeping acquisition and conditional offers, roles of board of directors and merchant bankers and situations when SEBI's approval will not be needed. The details of the latest code are not being produced here as the same is easily available from SEBI office.

The Companies' Act, 1956

- Clearance needed under Companies Act, which gives the right to a public company to purchase shares in another company, subject to two conditions viz. (a) obtain approval of the board to invest upto 60 per cent of equity or 100 per cent of free reserve, whichever is higher and (b) pass special resolutions for investment exceeding that limit.
- Transfer of target company shares to acquiring company's name as per Section 108 to 115, including the amendments made. To take into account in this regard the provision of Securities Regulation (control) Act, 1956 (Section 2A). In this Act, clear guidelines have been given as to when the management can refuse transfer.
- Approval of Public Financial Institutions (that have outstanding loans with the acquiring company) is needed prior to making inter-corporate investment.

The Income Tax Act, 1961

- No special provisions even after change of control triggered by substantial acquisition; the target company remains a separate legal entity and both the acquiring and target company remain liable to pay their respective taxes as would be the case if there was no takeover.
- Indian shareholders of the target company who exchanged their stock for cash will be subject to capital gains tax as applicable.

Miscellaneous Regulations

- No implications so far as excise license and sales tax registration are concerned
- Normal stamp duty, as applicable, for sale of shares to the acquiring company.
- If an MNC wishes to acquire the shares of an Indian company, RBI/FIPB clearance will be needed in advance i.e. before the actual purchase of share begins (in most cases, such approvals are automatic).

6.5 Spin-off of a Division into a Separate Company (as Joint Venture/Wholly Owned Subsidiary/Subsidiary/Associate Company)

The Companies' Act, 1956

- Provisions for formation of a new company, issue of shares and related matters to be followed.
- Reduction of share capital of the divesting company (Section 100-105) if no consideration is received by the company (e.g. in cases where shareholders of the divesting company receive shares of the spun-off company).
- Approval under 293(1)(a) of the Companies' Act enabling the company to spin-off a business/assets.
- The procedure laid down under the Companies' Act (Chapter 5) for compromises, reconstruction, etc.
- Special resolution for spin-off, subject to confirmation by High Court.
- Memorandum and Article of Association must have provision for de-merger and spin-off as well as reduction of capital.

The Income Tax Act, 1961

- No special provision for the spun-off company.
- For the divesting company, there may be capital gains tax implications if a consideration is received by it (please see the issues involved in item 6.3 (income tax) above).
- If shareholders of divesting company receive shares of the spun-off company, there is no immediate tax liability.

Miscellaneous Regulations

- Stamp duty payable on transfer of assets to the spun-off company.
- Gift tax: Position not clear.

6.6 Sale of Controlling Shares in Subsidiaries/ Associate Company

The Companies' Act

Approval of the Board to dispose of the holding.

The Income Tax Act

Company to pay capital gains tax if there is gain on sale of shares.

6.7 Amalgamation of a Healthy Company (Transferor) with a Sick Company (Transferee)

The Companies' Act 1956

Same provisions as mentioned under item 6.2 above.

The Income Tax Act 1961

- Section 72A benefits of carry forward of losses and unabsorbed depreciation of a sick company can be obtained by a healthy company by merging itself with the sick company and in the process, losing its identity. The surviving sick company retains its name and becomes a healthy one as a result of the merger. However, the healthy company after taking advantage of tax shield (resulting from using the carry forward of losses of the sick company) normally changes the name of the combined company to the original name of the healthy company (as happened in the case of a few of the mergers effected by the NICCO Group).
- However, the benefits of carry forward and set-off of losses under section 72A are not available in all cases of all such mergers unless three conditions are satisfied (section 72A(1)).

  (a) The amalgamating company, just before the amalgamation, was financially non-viable due to such reasons as liabilities, losses, etc.

(b) The amalgamation is in public interest.

(c) Such other conditions as the Central Government may, by notification in the official gazette, specify to ensure that the benefit under Section 72A is confined to the proposed amalgamation.

- The Act provides a specific description of what is meant by financial non-viability and public interest and, for getting Section 72A approval, the amalgamation proposal must satisfy these conditions (see Verma, J.C. *Corporate Mergers, Amalgamations and Takeover,* Bharat Publishing, 1994, pp. 170–171).
- Even after the central government has cleared the benefits under Section 72A, the accumulated losses and unabsorbed depreciation shall not be allowed for tax purposes while assessing the amalgamated company, unless the following two conditions are satisfied:

(a) The business of the amalgamating company is carried on by the amalgamated company without any modification or reorganisation or with such changes as approved by the central government.

(b) The amalgamated company shall give a certificate, along with its return for the assessment year, to be issued by the specified authority indicating that adequate steps have been taken to rehabilitate the business of the amalgamating company.

- 'Specified Authority' is a committee as notified by a Government of India order. Issued first in October 1977 and amended from time to time thereafter, this committee consists of Secretaries of Department of Industrial Development, Department of Company Affairs, Ministry of Labour and Department of Economic Affairs. It also includes Member (Revenue Audit), Central Board of Direct Taxes and representative of Board of Industrial and Financial Reconstruction (set up under Section 4 of Sick Industrial Companies (Special Provisions) Act, 1985).

- If a foreign company is willing to get merged with a sick company, the provisions of relevant Foreign Exchange Regulation Act will be applicable.
- Under Section 72A(3), the proposal to amalgamate a healthy company with a sick company can be provided with an "advance ruling" by the specified authority on the eligibility of getting the benefits and its decision to recommend to the central government for sanctioning the benefits under Section 72A.
- After the proposed amalgamation takes place, certificate from the specified authority will be required for all the assessment years during which the revival proposal is being implemented and amalgamated company is availaing of the benefits under Section 72A.
- Section 72A benefits can be obtained even in cases where the sick company (i.e. the transferee) is a subsidiary of a healthy parent (the transferor).

Note: If a sick company (the transferor) gets merged with a healthy company (the transferee), the benefits under Section 72A will not be available. The regulatory provisions in such a case will be as per what mentioned in item 6.2 above.

6.8 Restructuring within Family Business

Restructuring within the family business normally takes place when individual companies and/or divisions coming under the same group need to be distributed among the family members (such as sons, daughters, daughters-in-laws, sons-in-law, brothers, sisters, and so on.). The split-up of the group becomes necessary mainly when family properties and wealth (mostly in terms of shares held in various companies) are required to be transferred to legal heirs as the older generation hands over the baton to the younger ones. In situations where the owner of the group has only one legal heir, such restructuring within the group is normally not required.

The key regulations that have a bearing on restructuring of family business are:

SEBI Takeover Code

- If one legal heir takes control (exceeding SEBI's trigger point of 15 per cent) of another group company, as a result of the restructuring agreed within the family, the Takeover Code may not be triggered. SEBI, however, will take the final view in this regard
- However, if SEBI does not agree, then all the provisions discussed in item 6.4 above will be applicable

The Companies' Act

- If any division of an existing company of the group is spun off to a separate company in order to bring it exclusively under one or more of the legal heirs, the provisions of the Companies Act as covered in item 5 above will be applicable
- If there is merger of one or more companies within the group or purchase/divestment of assets as a going concern, the provisions of the Companies Act, as spelt out in items 6.2 and 6.3, will be applicable

The Income Tax Act

- If any family member exchanges his/her share (controlling or not) in one group company with shares of another group company (in order to clearly separate the ownership of both the companies), no income tax is payable at the time of exchange of such shares
- If any family member gives up his/her stake in a company in lieu of financial considerations, tax on capital gains will be payable, using the approach proposed in the Act
- If, on account of family decision, any merger between two or more group companies takes place or any division is purchased or divested by a group company as a going concern, the provisions under the Income Tax Act, as spelt out in items 6.2 and 6.3, shall be applicable

Miscellaneous Regulations

Stamp Duty

Payable on all transactions; rates differ from state to state

Gift Tax

Possibility of taxing the recipient of assets (and not the donor) that were obtained without consideration.

Sales Tax

Payable if a division is sold as a going concern

6.9 Restructuring under Board for Industrial Finance and Reconstruction (BIFR)

Reference to BIFR, under Sick Industrial Companies (special provision) Act, 1985, is made when the company being referred loses its entire net worth and also incurs losses for three consecutive years.

Depending on the mode of reconstruction of the sick company, as proposed by BIFR after taking into account the representations made by all concerned—promoters, employees, state government, financial institutions and banks, creditors, etc.—the exact requirement of legal compliance will be determined. For example, legal requirements under the following modes of reconstruction will be as given against each mode (actual proposal may contain a combination of two or more of these options):

(a) Merger of the sick company with a healthy company: All the provisions, as referred in item 6.7 above, will be applicable if BIFR recommends, even if it is not a reverse merger.

(b) Change of promoter (i.e. the promoter sells off his controlling holding to a new promoter): All the provisions of item 6.4 will be applicable (except SEBI Takeover Code).

(c) Disposal of Idle Assets: As per item 6.11 (iii) below.

(d) Downsizing of Workforce: As per item 6.11 (i) below.

(e) Financial Engineering of Capital Structure: If owners cannot be changed and legal entity remains the same, the provisions mentioned in item 6.10 will be applicable.

6.10 Financial Engineering

Important regulatory provisions, under select financial engineering approaches, are given below:

Change in Debt-equity Structure and Related Matters

- Additional long-term borrowing under Section 293(1)(d) of the Companies' Act.
- Change in authorised and paid-up capital as per the Companies' Act.
- Bonus and Rights issue: as per Companies' Act.
- Preferential allotment to promoters or joint venture partners as per SEBI guidelines.
- Issue of preference and non-voting share: as per the Companies' Act.
- Buyback of shares as per the Companies' Act and SEBI guidelines.

Introduction / increase in foreign equity.

- FIPB/RBI clearance as required
- Preferential allotment as per SEBI guidelines

Issue of GDRs

- Clearance of RBI

External/Commercial Borrowings

- Clearance of Ministry of Finance
- Clearance under the Company's Act

6.11 Internal Streamlining and Business Process Re-engineering

One of the approaches to corporate restructuring is internal streamlining. In this method, no legal restructuring is involved but substantial changes are introduced in a number of operating areas within the company, leading to enhancement of both corporate and shareholder value.

Internal Streamlining, covers, among other things the following:

- Downsizing of head count
- Closure of uneconomic units
- Disposal of idle assets
- Business Process Re-engineering

The important legal aspects that managers will need to take care of in respect of each of the above are as follows:

(i) Downsizing through Voluntary Retirement/Separation Scheme (VRS/VSS)

- A VRS can be designed as per the prevailing Income Tax Act, giving benefit to both the initiating company (VRS payments under approved scheme are tax deductible) and also the departing employees (no tax is payable by the employee).
- Retirement of workforce, if required, can be effected through giving compensation as per the Individual Dispute Act.

(ii) Closure of Uneconomic Units

Notice under section 9A of the Factory's Act can be given to close uneconomic units; the concerned state government's approval will be needed for officially closing the factory.

Note: If all the employees accept VRS/VSS and leave the company, the unit's operations will automatically discontinue and hence whether the state government gives permission or not, will hardly matter. However, if there is any proposal to dispose of the land and other immovable properties, then official closure, duly approved by competent authority, will be needed.

(iii) Disposal of Idle Assets

- For selling surplus industrial land on stand-alone basis, clearance of state government, under the Urban Land Ceiling Regulation Act (ULCRA), will be needed. It is one of the most complex regulations and approval is very difficult to come by (If the entire factory where there is surplus land is sold as a going concern, then, of course provisions under the ULCRA will not be applicable).
- For selling various moveable assets, which are lying idle, normal contractual law will apply (due approval of the Board will be required).

(iv) Business Process Re-engineering (BPR)

As a result of BPR, many activities will either get discontinued, outsourced or may be merged with other activities to get such benefits as cost reduction, cycle-time minimisation, and quality enhancement. To implement BPR, it may be necessary to change the Standing Order and enter into negotiation with the employees and their representatives regarding method changes, alteration in manning norms, skill re-gradation, etc. The possibility of industrial disputes cannot be ruled out while negotiating and implementing various recommendations of BPR and the managers should be fully aware of various provisions of the Industrial Disputes Act, as well as managerial rights under various existing legislation.

Note: Beginning 1991–92, many changes were introduced by the Government of India in various legislation and Acts to facilitate reforms in capital and financial markets as well as in industrial activities. The reader is advised to check the latest position in respect of each of the legal and regulatory aspects referred in item 2 to 11, and the reader is also advised to note that the list of legal and regulatory provisions mentioned therein is not exhaustive and it is quite possible that there will be additional legal aspects that will need to be considered.

6.12 Conclusion

The above, in a nutshell, is a broad overview of key regulations and Acts that need to be kept in view while undertaking any corporate restructuring initiative. Needless to say, what has been covered here is not exhaustive; there are other regulatory matters, which though not included in this book, have to be addressed. Our objective here has been to make the reader, particularly the managers, aware of the broad legal issues to enable them to become aware of the legal aspects underlying each specific corporate restructuring route they plan to take. In addition, it is important that they seek the help of legal experts when it comes to actually initiating actions, as these must be error free and legally robust.

References

1. The readers are advised to check the latest positions in respect of all the Acts and Rules referred in the text. This is a must since such Acts and Rules are continuously evolving and changing to respond to new requirements. Also, since the legal aspect is a specialized subject, it is advisable that a full length discussion with concerned experts are undertaken before finalizing any corporate restructuring decision.

CHAPTER

7

Market for Corporate Control

7.1 Introduction

In this book, corporate restructuring has been defined to include three distinct types of restructuring, viz. portfolio and asset restructuring (including M&A and divestitures), financial engineering and internal streamlining and BPR. Chapter 3 discussed each of these three modes in detail while Chapter 4 described the key implementation issues. In Chapter 5, we provided a brief perspective on the experiences of Indian companies in respect of the three basic modes of corporate restructuring and their various sub-categories. One of the approaches discussed was portfolio restructuring through substantial acquisition of shares of another company, leading to change of control, either through friendly or hostile takeover. To facilitate such a takeover of another company as well as to protect the interests of minority shareholders, many countries have regulatory bodies that develop takeover codes and ensure their compliance. In India too, Securities and Exchange Board of India (SEBI) has been formed and the SEBI Takeover Code, amended from time to time, is already in force.

The objective of this chapter is to provide a general understanding of what is meant by corporate control, what constitutes a market for corporate control and the need for such a market, how to make such a market efficient and transparent so as to facilitate wealth creation at the firm level and finally, what precautions or defenses are available to the incumbent management to protect the company from takeover. As all these subjects have been researched extensively by economists as well as financial and legal experts and their findings are available in most books on M&A, the following sections carry only a brief discussion on these areas.

7.2 Concept of Corporate Control

Modern day large public limited corporations are characterised by separation of ownership from control. Gone are the days when shareholders participated directly in the management of the company in which they invested. Separation of ownership from control in present day organisations implies almost complete separation of decision management and residual risk bearing[1]. There is, of course, the agency problem arising due to divergence in interest between shareholders and the management team. The character of the management team can vary from company to company; for example, in some cases an entrepreneur or a promoter may have gone to the capital market to raise funds through the equity route leading to dilution of his holding but not erosion of control and ownership. There are also companies where the management team is hired simply to run the business, with the delegated power of the equity owners. Since the management is not the sole owner of the firm, there is always the possibility of the management team looking after their own interests or rewarding themselves with compensation and perquisites which may increase their personal wealth but not necessarily enhance the value of the firm. The firm can also suffer when the management team does not make the necessary effort towards arriving at strategic decisions, which leads to making investments that are not the most appropriate ones. Similarly, value can be destroyed if the management team fails to ensure that resources that are already in place are put to productive use in the best possible ways. This conflict of interest between the agents (i.e. the management team) and the owners (i.e. the shareholders, some of whom may also be part of the management team), if not mitigated (complete elimination is just not possible), can adversely affect both corporate and shareholder value.

Hence, it is clear that control of the company by the incumbent management does not necessarily enhance the wealth of the shareholders. The ability to control the management implies the "right" to decide on matters such as composition of the team, choice of key executives, quantum of compensation and incentives (including perquisites) to be paid, hiring and firing of people, and distributing favours to a select group of beneficiaries. It also implies influencing policies for procurement of inputs and disposal of outputs in a manner that may not be the best from the techno-economic point of view but that would still be pursued for personal benefits of this select group. Many a time, such benefits continue to accrue to these top executives inspite of it being known that they are incompetent, the reason being that they have the "corporate control" i.e., the "right" as defined above.

Does this definition of corporate control imply that shareholders who are not part of the management team will continue to suffer? Is there a mechanism by which the inefficient and incompetent incumbent management can be dislodged? The following section provides the answers.

7.3 Market for Corporate Control

If the incompetence of the incumbent management is widely acknowledged and there is a general belief among the shareholders, based on information available, that the firm's assets are not being managed judiciously and that many opportunities are allowed to pass by, it can lead to two kinds of reactions, viz.

(a) Declining share prices that will signal erosion of confidence in the management team.

(b) Possibility of a takeover through which an outsider group can dislodge the incumbent management team by acquiring shares directly from shareholders who are not part of the management team.

Decline in share prices can, of course, take place for a variety of controllable and uncontrollable factors, even in case of a firm where the incumbent management is known to be competent and is concerned about enhancing shareholder value. Such a company considers the decline in share prices as an indication of the lack of optimality in various short, medium and long-term initiatives being taken by managers. This concern pushes the managers to review decisions already taken, to initiate corrective actions, keep the shareholders constantly informed about the existing and new initiatives being taken and to continually learn from past mistakes. For such companies, share prices move up again when the market recognises that genuine initiatives and corrective actions have been taken, and that the future looks much brighter as a result.

However, companies that are run by self-centred, incompetent management teams (with or without major ownership interest) will be faced with the problem of continuously declining share prices if information on their operations is widely available and the capital market is well developed. The "market for corporate control" will ensure that takeover bids on such underperforming companies are made whenever it is perceived that their assets (both tangible and intangible), though good in quality, are being badly managed and that there is scope for unlocking the value of the same if the management teams are changed. The market for corporate control can thus act as a mechanism to discipline such erring teams.

What, then, is meant by "market for corporate control"? As Jensen & Purback[2] have observed, in market for corporate control, different management teams compete for the right to manage the target company's resources such as technology, assets (tangible and intangible), funds, human resources, etc. As commonly understood, such a market for transfer of control operates outside the firm. Even within a firm, transfer of management is possible through guidelines and systems introduced and overseen by the Board of Directors. External mechanisms, which is the focus of this chapter, includes proxy contests and hostile takeover.

An efficient market for corporate control helps keep up the pressure on firms and management teams that fail to maximise their corporate and shareholder value. For shifting the power from one team (with or without ownership in the firm) to another through using external mechanisms, there is always the need to pay a premium and the objective of the new team would be to maximise value of the firm in spite of having paid this premium. Failure to achieve this objective will lead to another hostile takeover bid, this time involving the new management. Viewed from this angle, the existence of an efficient market for corporate control is extremely crucial for wealth creation at the firm level.

The market for corporate control assumes a high positive linkage between the share price of a firm and efficiency of its management team[3]. When a firm continues to under-perform over a period of time, its stock prices decline vis-à-vis the industry average, thereby signalling an opportunity for takeover bids. This is particularly true in cases where it is known that the concerned industry has the growth potential and its assets are by and large of good quality; it is the failure of the incumbent management to exploit these opportunities and leverage the assets at its disposal that is resulting in lower stock prices. The existence of an effective takeover market provides the necessary assurance and protection to non-controlling and minority shareholders by keeping the incumbent management constantly under pressure to deliver competitive efficiency, lest they get thrown out.

To get an idea as to what is "market for corporate control" and how it works, it is important to understand the following:

(a) Different types of corporate control mechanisms

(b) Implications for management team that has equity ownership

(c) Value of voting rights and control

(d) Role of proxy contests

(a) *Types of Corporate Control Mechanisms*

Objectives of both internal and external control mechanisms are one and the same, viz. monitor performance of the management team, provide incentives to them for good results and replace them in case of continuing under-performance. Internal control mechanisms include, among other things, the following:

- Monitoring and evaluation by large shareholders such as FIs and mutual funds.
- Control by Board of Directors.
- Competition for career among managers.

If internal control mechanisms fail to maximise the value of the firm on a long-term basis, as reflected by continuing depressed stock prices, external control mechanisms such as the following come into play:

- Tender offer, the aim being to take over the management of the firm through hostile bid.
- Proxy contests.

Internal control mechanisms, particularly those exercised by the Board, are useful when the company under-performs in an otherwise healthy industry, in which case it is easier for the Board to pinpoint the sources of problems and identify what needs to be done by the top management. But the same task becomes difficult if the entire industry under-performs as it is not easy to judge whether or not the management team is making mistakes[4], in which case, the external mechanisms can pressurise both the management and the Board to pursue the path of shareholder value maximisation. In poorly performing industries, where the Board fails to take action against the management team, takeover opportunities open up.

(b) *Equity Ownership by Management Team*

Equity ownership by the management team can have various implications on share value, viz.

(i) Lower level of ownership may encourage managers to pursue self-interest rather than work towards maximising the value of the firm.

(ii) A higher level of ownership helps align managerial interests with the objective of maximising the value of the firm; however, the downside of higher ownership and control of voting rights is that it guarantees continued employment of the management team and provides it with greater opportunity to pursue personal interests at the expense of shareholders.

(iii) Higher equity stake of the management team normally discourages hostile takeover but increases the prospect of friendly acquisition[5].

A related and important issue in understanding the market for corporate control is the role of majority shareholders. In companies where the majority group controls more than 50 percent equity, there is the likelihood that most decisions taken by management team may lead to wealth maximisation for the said management group and not for all classes of shareholders. No amount of supervision and monitoring by the Board or threats through external mechanisms is likely to change this pattern. However, on many occasions, it was also found that in spite of this possible abuse of power by the majority shareholder group, the stock prices of companies controlled by them continued to rise. There is also a difference in performance of firms that are controlled by individual majority shareholder group and those controlled by corporate majority shareholder group.

(c) *Voting Rights and Control*

The extent of voting rights and control is valued by the capital market. It gets reflected by way of price premium received in times of takeover—both friendly and hostile. For the management team that has voting rights through ownership interest, there are advantages such as protection against possible take-over by other management teams and retrenchment; enhancement of salary and perquisites and the right to hire and fire people. Voting rights also enable the management team to invest in high risk, long-term projects, despite the fact that they can adversely impact the company's performance in the short term. While all these advantages may give the impression that the management only stands to gain by acquiring control through possession of voting rights, this is not entirely correct as there are other mechanisms such as rise in cost of capital and refusal of banks and financial institutions to lend further to firms which are consistently showing poor performance.

Many family business groups, who also participate in the management, retain control on the companies set up by them across generations through creating different classes of shares with inferior voting rights (such as preference shares or non-voting shares). This way, such family groups are able to raise the required resources to fund their growth plans and yet retain the critical control on their companies (Ford Motor Company is one good example).

(d) *Proxy Contests*

Proxy contests are endeavours by dissatisfied shareholder group(s) to seek membership of the Board, the objective being to influence the management decision-making process of the firm in order to protect the interest of the concerned group(s). Even if the dissident group obtains a minority position on the Board, it can have a positive effect on share prices by virtue of pressures they can exert on various corporate and functional policies. Even if the challenge posed by the dissident group does not fructify, it may still have a positive impact on the share value since the management team, when faced with such challenges, normally initiates policy changes that lead to improvement in the firm's performance.

Many a time proxy contests are initiated by former employees or other insiders who left the company because of differences on policy matters, suggesting a linkage between proxy contests and competition in the managerial labour market[6].

One of the possible reasons why share prices tend to move up when proxy contests take place is the increase in demand for voting shares by both the dissident group and the incumbent management. The improvement in share prices, however, may stop or even become negative if the endeavour made by the dissidents fails. As a matter of fact, even before the actual contest takes place, if it is found that either the incumbent management is well secured or they have taken steps in this direction, the expected premium in share prices declines considerably.

Opinions differ on whether there is any linkage between proxy contests and subsequent takeover activity. DeAngelo and DeAngelo[7] observed that a considerable part of the gains from proxy contest activities are related to M&A activity. The logic is based on their findings that 20 per cent of the gains are due to the increased possibility that the firm will ultimately be sold at a premium at a later date. However, the profile of the dissident group is an important factor in determining whether the proxy contest will ultimately lead to takeover. DeAngelo and DcAngelo's research findings show that many a time, the dissident groups are individuals or small companies that have severe resource constraints and very often this comes in the way of their making a full-fledged takeover effort. Unless the group is powerful, with adequate resources as well as prior experience in takeover, it is unlikely that a proxy contest will lead to M&A activity. There can, of course, be other hindrances such as regulatory barriers or anti-takeover defenses.

It is, therefore, clear that existence of a market for corporate control has a beneficial effect on share prices, particularly in cases where under-performance of firms is an industry-wide problem and internal control mechanisms such as supervision by the Board is not able to effect improvement. Needless to say, the capital market values positively the level of corporate control.

7.4 Making the Market for Corporate Control Efficient and Transparent

As mentioned earlier, a market for corporate control can enable the competing management teams to bid for the right to manage the resources and assets of the target firms. The process, which involves making an offer to the shareholders of the target firm, must comply with the following conditions in order to be effective:

(a) For every target firm, there must be a number of bidders; this is required for realising the best possible price.

(b) Adequate and correct information about assets and liabilities as well as capabilities of the target firm must be available to all concerned.

(c) The gains from the takeover bid must be uniformly available to all the shareholders of the target firm.

(d) The rules and procedures should be so framed that those who are not serious are not allowed to participate without incurring significant cost.

(e) No secret negotiation between the bidder and the incumbent management team (with or without ownership stake) or principal equity holder.

(f) Existence of a well functioning and efficient capital market capable of valuing firms correctly.

If one considers the rationale for allowing the market for control to develop, the need for the above six conditions cannot be over-emphasised. These conditions will give a chance to that management team which is most capable of maximising wealth of the shareholders at that point of time. Transparency in the execution of the entire process is critical to ensure premium over market price.

The Takeover Code introduced by Securities & Exchange Board of India (SEBI), as described in Chapter 6, will go a long way in developing the market for capital control in India. The code has been changed a number of times since it was introduced in August 1994. Some of the hostile takeover bids that India has seen are Torrent Group's takeover bid of Ahmedabad Electricity Company, NEPC's bid of Modiluft and Sterlite's bid to acquire Indian Aluminium. But it must be said that while SEBI has taken a number of steps that are helping the market for corporate control to develop in India, alleged insider trading, inefficient capital market, poor disclosure norms and lack of adequate finance for acquisition are still some of the major problems that need to be overcome to speed up its development.

7.5 Defense Against Takeover

Many a time, takeover defenses can be used to ward off raiders who are only interested in short-term gains such as buying companies for selling them off at a later date or purely to gain publicity or else, just to destabilise the incumbent management. From the point of view of non-controlling shareholders, such defenses matter only if they feel that the incumbent management is doing its best and making honest attempts to enhance shareholder value and no other management team can do better under the circumstances. The non-controlling shareholders, however, will welcome the takeover bids if they find that the management team is not able to deliver the desired improvement in shareholder value. In such a situation, such shareholders will hope that all kinds of takeover defenses put up by the management team should fail to perform as per the latter's game plan.

Under such circumstances, one or more of the following defenses can be adopted by the incumbent management team, the objective being to make the bid for acquisition unattractive. A detailed description of the following approaches is available in J.F. Weston, et al.[8]:

(i) *Adjustment of Assets and Ownership Pattern*

Some of the examples are:

(a) Acquisition and divestiture of assets such as counter-offer for purchasing the bidder, cash purchase or sale of assets unrelated to the bidder's line of business, sale (to a third party) of assets that are critical to the bidder's line of business, etc.

(b) Issue and repurchase of voting shares such as buyback of shares, private placement, issue of shares to diverse groups, etc.

(ii) *Increasing the Leverage*

To meet its funds requirement, the target firm goes for extensive borrowings, as a result of which its leverage rises to a very high level, thereby making the takeover move unattractive to the bidder.

(iii) *Golden Parachutes*

These are separate provisions of an employment contract, usually involving huge sums of money that will be payable to managers in case of loss of their jobs resulting from change of control. Though it is believed that this approach can make the takeover bid unattractive, since huge cash outflow may take place during the post-takeover phase, experience has shown that this is not a fool-proof method and provision for excessive post-separation payment can create a public outcry.

(iv) *Poison Puts*

These are investor protection devices that are built in while structuring the terms and conditions of a corporate bond, by which the bond-holder can apply his right "to put" in case there is change of control in the issuing company as a result of a hostile takeover. The right "to put" is considered as an anti-takeover mechanism in the sense that it can make the takeover very expensive for the bidder. It is possible to design the "put" condition to cover a variety of circumstances, including friendly mergers and hostile takeovers, thereby giving more protection to the bond-holders while, at the same time increasing their utility in acting as effective anti-takeover mechanisms.

(v) *Regulatory Protection*

Regulatory provisions such as use of non-voting share or issue of preference share for meeting additional funds requirement can act as takeover defense. Similarly, provision for buyback of shares is another mechanism against any future takeover bid. SEBI's Takeover Code, which allows the existing promoters to increase their holding @ 5 per cent for per every 12-month period through creeping acquisition, is another regulatory protection against hostile takeover. It needs to be mentioned here that regulations, besides providing transparent and legally valid opportunities to the existing management to consolidate its position, must also ensure that in the process, non-controlling shareholders' interests are not hampered. Nor should the firm suffer on account of its failure to exploit its assets and capabilities to their full potential just because the existing management team or the promoter group, who are not competent enough to run the firm, are given unnecessary protection.

(vi) *Poison Pills*

These are specially created securities (such as preferred stock dividend which is convertible to common stocks) that give their holders special rights that can be exercised even after a tender offer has been made and the number of shares that are required for change of control have been obtained. They are called poison pills since the acquirer will find the acquisition extremely expensive when the special rights are exercised.

Poison pills are generally introduced by the Board of Directors without the approval of the shareholders. The Board retains the right to redeem the securities in case the takeover threat disappears. These twin characteristics of using the securities to "poison" the acquisition efforts and the right that the Board retains to redeem the same compels the acquirer to come to the negotiation table and discuss the proposal with the Board. Because of this, poison pills are considered as a takeover defense mechanism. While these are not yet in use in India, it is expected that with hostile takeovers becoming a way of life, they will become popular here as well. Interested readers should go through the discussion on this subject by Weston et al.[9].

(vii) *Greenmail and Standstill Agreement*

Under greenmail, the target firm repurchases, through private negotiation, all the shares acquired by the hostile bidder at a premium. Because of the threat posed by the bidder initially and subsequent huge cash outflow that takes place to repurchase the share, normally there are changes in top management team and also in policies so that in the period that follows, both the firm performance and shareholder value improve. Often, as a part of the repurchase programme, a standstill agreement is entered into with the bidder by which the target firm ensures that the former does not make further purchase of its shares over a specified period of time in future. Such an arrangement provides protection to the management team in the market for corporate control.

It must be stated that while takeover defenses provide protection to the incumbent management team and increase their bargaining power, they also make the takeover more expensive, which may result in inefficiency in operation of the market for corporate control. Empirical evidence is available on both favourable and unfavourable aspects of takeover defense and what can be concluded from all these studies is that there is absolutely no clear advantage or disadvantage in favour of or against takeover defenses.

7.6 Conclusion

In this chapter, we discussed the concept and meaning of corporate control and explored why a country needs such a market to discipline incumbent management teams (with or without ownership interest) and ensure creation of highest possible value of the firm, through using its assets (tangible and intangible) and capabilities. Such a market will create wealth for the non-controlling shareholder groups—a requirement that is very often ignored by the principal promoter or the management team. It has been argued that a number of steps, as listed in section 7.4, can be taken to make the market for corporate control efficient and transparent. Failing to take these steps will not only hamper value enhancement at the firm level but will also destroy wealth for the country as a whole.

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PART II

CORPORATE RESTRUCTURING: MANAGERIAL CONTEXT AND ISSUES

Corporate Restructuring: Some Illustrations of Select Managerial Context and Issues

In Part I of this book, a brief overview has been provided on various aspects of corporate restructuring, including its rationale and the various approaches available to restructure a firm. The message that came out loud and clear was that companies need to undertake corporate restructuring periodically in order to reposition themselves as the complexities of business environment change and new competitive realities emerge. The arguments provided favoured adopting a correct managerial approach to corporate restructuring that takes into account a balanced view of the strategic, financial, legal and organisational aspects in order to unlock and enhance long-term shareholder value. Any partial view or overtone of one or the other of the four areas just stated will only undermine a firm's effort in this regard.

In Part II of the book, our efforts will be to expose the readers to some illustrations of select managerial decision contexts and issues, the aim being to give them a certain flavour of the real life problems generally confronted when a firm undertakes corporate restructuring. Knowing well that each firm's strategy and functional policies with regard to corporate restructuring are always unique, we have made an attempt to present to the readers some of the commonly faced decision contexts and issues. Needless to say, the list of illustrations included in this part cannot, and hence is not exhaustive and the reader is reminded that there are many other complex situations in real life which we have discussed in the Part I but have not provided illustrations for in Part II.

Given the above perspective, each illustration included here can form a basis for discussion in the subject area it focusses on and helps highlight the issues that should be explored as part of managerial decision making. These illustrations are not like cases that are used in management teaching and training and which are fairly rich in terms of data. They are rather conceptual, supposed to give the reader an overview of issues involved and help him appreciate the real life issues. Incidentally, all the illustrations included in this part are based on real life problems even though the names and identity of the concerned companies have been disguised and some parameters changed for administrative reasons.

As mentioned, the list of illustrations included here does not include all the topics discussed in Part I of this book. We have included mainly those situations which are more frequently encountered and where conceptual clarity is needed prior to decision-making. It is hoped that the readers will find the illustrations intellectually stimulating and helpful in applying some of the concepts discussed in Part I of the book.

NUGGET 1

COSMOS AND FALCON LTD.

Disinvestment and Strategic Acquisition

Cosmos and Falcon Ltd. was a joint venture company formed four years ago for producing and marketing certain high tech items in India. Cosmos Ltd. was a reputed industrial company of long standing from northern India and Falcon Limited, an international giant, had come to India to access the country's large domestic market. The joint venture company's equity shares were not listed and the stake was held equally, i.e. in the ratio of 50:50, with both the partners making an initial contribution of Rs 50 crore each towards the venture.

Following the liberalisation of Indian economy, many international giants had their eyes set on India because of its large domestic market. Falcon Ltd. too had studied this market and realised its vast potential before embarking on the joint venture. It set up the manufacturing facilities of this venture under the supervision of its skilled engineers. The employees of the joint venture company were given on-the-job training by experienced personnel during the initial period, until the manufacturing process stabilised. The foreign partner also played a crucial role in working out the product range and selecting the most appropriate machinery and equipment.

Falcon had estimated that the project would go on stream after a gestation period of eight to nine months. The joint venture company was expected to incur a loss during the first incomplete year of operations. During the second year, it was expected to barely break-even and from the third year onwards, it was projected to earn a reasonable return on investments.

In reality, however, the demand for its products did not pick up and hence the joint venture was forced to operate at a level much below the installed capacity. The price realisation, too, was poor in the Indian market. The prevailing situation did not allow the *company to earn as much as was required for breaking even. Consequently, it started incurring continuous losses, so much so that its net worth was on the verge of complete erosion, which would force it to be classified as a sick industrial undertaking. Given the future market scenario, the prospects in the immediate term too did not look bright.*

Cosmos Ltd. was in no mood to pump in more equity into the joint venture. However, unless infusion of additional equity took place, the company would become sick and be referred to BIFR. This prospect was not acceptable to Falcon Ltd. as it feared that this would tarnish its global image. So, the two partners came to an understanding whereby Falcon Ltd. would take over the full stake of the company and alter its name to Falcon (India) Ltd.

The Falcon management took note of the following for proceeding as per their agreement with Cosmos:

1. *For increasing the existing stake in the joint venture company, Falcon Ltd. would have to obtain prior approval of the Foreign Investment Promotion Board (FIPB).*
2. *With the increased stake in the erstwhile joint venture company, Falcon would be able to avail of tax benefits in the books of its parent company in the USA for the loss of the Indian entity. Moreover, it would be able to import raw materials freely from its subsidiaries to retain requisite margins on such transactions. So, it would be possible for Falcon to take the losses in its book for some more time and infuse additional equity into the Indian entity with the hope that further liberalisation of the Indian markets would finally tilt the scale in its favour. The wholly owned Indian subsidiary might also help Falcon to diversify into other areas of activity at the appropriate time (i.e. with effect from 1 April 2002).*

A key issue that remained unresolved was the price at which the transfer of shares would take place between Cosmos and Falcon. A number of methods listed below were available for valuing the shares of the joint venture company and a decision needed to be arrived at urgently in this regard:

a. *Discounted Cash-Flow Method (DCF)*

b. *Adjusted Net Asset Value Method*

c. *Market Multiples Method*

If you are a consultant, what will be your advice regarding the valuation method to be adopted and the considerations to be taken into account to arrive at the transfer price? How would you structure the deal? While responding to these questions, you will also need to take note of the following issues:

a. *In this particular case, will the choice of valuation method be influenced by the projected losses in the foreseeable future?*

b. *How important will be the issue of replacement cost or strategic price for Falcon in this case?*

c. *Cosmos will not be able to book any investment loss on account of certain overriding factors.*

■■

NUGGET 2

INDIAN INDUSTRIES GROUP

Merger for Restructuring

Indian Industries Group (IIG) was a NBFC, engaged primarily in lease and hire purchase business. It was the flagship financial sector outfit of a well-known business group in the private sector. Its balance sheet was adequately leveraged and it had a steadily growing strong asset base.

In the hay-days of the financial sector, the group had set up a venture capital finance company and also a securities trading company. However, with the unprecedented and unforeseeable slump in the stock market, these companies were in poor shape and the group was considering different restructuring options, including merger of the companies in the financial sector.

The additional information available on the company is as follows:

1. *In order to sustain the growth of its asset base, IIG must be able to augment its capital base suitably because further leveraging of the existing paid-up capital might not be feasible. Moreover, in view of the increasing competition and regulatory demands, only those companies that have a strong capital base and optimal asset size would be able to survive.*
2. *SEBI and RBI had, in mid-1998, finalised an arrangement whereby merchant bankers would not be allowed to engage in fund-based activities including leasing, hire-purchase, bill discounting, etc. Nor would they be allowed to raise any public deposit. NBFCs, on the other hand, would not be permitted to deal in securities related activities. In other words, fund-based and fee-based activities would be completely segregated, with NBFCs engaging in only fund-based activities, coming under the purview of RBI, and merchant bankers engaging in only fee-based activities under the supervision of SEBI. Accordingly, IIG—with a strong presence in the leasing, hire purchase and bill*

discounting markets—would be required to allow its merchant banking license to lapse.

3. *Although IIG had requirements for urgent augmentation of its equity base, it could not access the primary capital market as the latter was in a state of prolonged dormancy. Preferential allotment of shares to a group, say FIs or FIIs, was also ruled out as the floor price for such an allotment was dictated by SEBI guidelines, and in a falling market price scenario, the SEBI governed prices would invariably be higher than the prevailing market price of IIG shares.*
4. *No merchant banking outfit was permitted to broke shares/ securities. Accordingly, it was not possible to merge the activities of this company with those of any other group company. The venture capital financing outfit had become virtually defunct. Most of its stake had been used up for investment in shares of various companies, which were quoted at abysmally low prices. The scope for leveraging in the venture capital financing company was extremely limited.*
5. *The group might consider getting out of the business of securities broking by either selling its shares or the Stock Exchange cards in its name. The funds so received might be used to increase the share capital of IIG. Besides, the venture capital financing company could also be merged with the Indian Industries Group. IIG, being a leasing and hire purchase company, could leverage the consequential addition to its capital base quite effectively to fund its projected growth in asset base. Existence of such disparity, in so far as the scope for leveraging by IIG and the venture capital financing company was concerned, could pave the way for value enhancement as a result of the possibility such a merger. Moreover the much needed addition to the equity base of Indian Industries Group would not only help in sustaining its pace of asset growth but would also endow it with the required financial muscle to withstand intense market competition in the wake of financial sector liberalisation.*
6. *The shares swap ratio could be worked out based on the share values of the two merging companies. For working out the*

value of business of the Indian Industries Group, the venture capital financing company as well as the merged company, one may employ the following methods or a suitable combination thereof:

(a) Market Value (in case of listed companies).

(b) Book value with suitable revaluation or Adjusted Net Worth Value.

(c) Price Earning Capacity Value (PECV), worked out by discounting the expected future cash flows.

7. No market value is available as of now for the merged equity.

As a merchant banker, how would you advise the group and go about this assignment?

NUGGET 3

STERLING INDUSTRIES (INDIA) LTD. (SIL)

Hostile Takeover and Competitive Bidding

On 21 March 2001, Sterling Industries (India) Ltd. (SIL) and Eagle Pvt. Ltd. (EGPL) came up with a public announcement for the attention of equity shareholders of Non-Ferrous Metal Industries Ltd. whereby they made an offer, as per SEBI's Substantial Acquisition of Shares and Takeovers Regulation—1997, for acquisition of 20 per cent of the paid-up equity share capital of Non-Ferrous Metal Industries Ltd. (the target company), i.e. about 1.5 crore fully paid-up equity shares of Rs 10/- each at a price of Rs 100/- per share (offer price) payable in cash. The offer was conditional subject to a minimum level of acceptance of 10 per cent of the equity capital of the target company and the offer price of Rs 100/- was expected to be approximately 30 per cent higher than the closing price of the shares of Non-Ferrous Metal Industries Ltd. on BSE on 14 March 2001, i.e. seven days before the public announcement. The offer was also open to the GDR holders of Non-Ferrous Metal Industries Ltd. The declared objective of the acquirers was to acquire a stake in Non-Ferrous Metal Industries Ltd. and their plan was to establish a long-term relationship of mutual benefit.

Press reports indicated that the share price of Non-Ferrous Metal Industries Ltd. went up to Rs 105 by 28 March 2001, thereby exceeding the price offered by the bidders. Sterling's offer was reported to have propelled northwards its stock price from Rs 150, prior to the announcement, to Rs 180 by 28 March 2001.

Subsequently, on 10 April 2001, Major Aluminium Ltd. (MALCO), a company incorporated in North America and already holding 36 per cent of the total issued and outstanding equity shares of Non-Ferrous Metal Industries Ltd. made a counter offer to the shareholders of the latter to buy up to 20 per cent of its voting capital at a price of Rs 115 per equity share, payable in cash. The MALCO group of companies was one of the largest producers of metals in *the world and its offer was subject to all statutory and regulatory approvals and clearances as applicable, including those required by the group to acquire shares tendered following the open offer in question from the Secretariat of Industrial Approvals of the Ministry of Industry, the Reserve Bank of India, etc. However, unlike the Sterling Industries' offer, MALCO's offer was unconditional. One of the reasons stated by it for the public offer was: enhancement of the existing synergy and relationship between MALCO and Non-Ferrous Metal Industries Ltd.*

On 23 April 2001 SIL and EGPL made a revised offer to the shareholders of Non-Ferrous Metal Industries Ltd. for acquisition of 20 per cent of its shares at Rs 120 per equity share, payable in cash. This time the public offer of SIL and EGPL was also made unconditional.

On 6 May 2001, MALCO too came up with a revised offer for the existing shareholders of Non-Ferrous Metal Industries Ltd. whereby the offer price was raised from Rs 115 to Rs 130 per equity share of the latter, payable in cash.

On 25 May 2001, SIL and EGPL further revised their public offer. The size of the offer was increased to 50 per cent i.e. for acquiring nearly 3.7 crore equity shares of Non-Ferrous Metal Industries Ltd., and the offer price was hiked to Rs 200 per equity share of the target company. However, the entire price was no longer payable in cash. While 50 per cent was payable in cash, the balance Rs 100 was payable by way of allotment of 9.75 per cent Optionally Convertible Redeemable Preference Shares (OCPS) of SIL that had a face value of Rs 10 each, and to be issued at par in the ratio of 10 OCPS for every equity share of Non-Ferrous Metal Industries Ltd. accepted under the offer. The option to convert OCPS into equity shares of SIL was exercisable by the OCPS holders at the end of 18 months from the date of allotment at a discount of 5 per cent to the average of the weekly high and low of the closing market price of SIL equity shares on the Mumbai stock exchange during the 12 weeks preceding the conversion. However, the conversion price would have a floor of Rs 250 per equity share of face value of Rs 10 each of SIL. OCPS not converted as above were to be redeemed in *cash and at par in a single instalment at the end of 36 months from the date of their allotment.*

On the same date, i.e. 25 May 2001, MALCO too made a revised offer, whereby it offered to pay Rs 160 per equity share of Non-Ferrous Metal Industries Ltd., payable entirely in cash.

On 3 June 2001, MALCO made further disclosure that it had received approval from the SIA, Ministry of Industry for increasing its stake in Non-Ferrous Metal Industries Ltd. from 20 per cent to about 55 per cent and that it proposed to apply later to the central bank for obtaining their approval for acquisition of the additional shares. Meanwhile MALCO reportedly purchased some shares of Non-Ferrous Metal Industries Ltd. at BSE and offered the last contracted price of Rs 200 per equity share to the shareholders of Non-Ferrous Metal Industries Ltd.

As per newspaper reports, insurance companies and other financial institutions tendered in their entire holding of around 38 per cent for purchase by MALCO on 2 June 2001.

You are required to discuss at length the above developments in light of the prevailing Takeover Code in March 2001 and the increases in shareholder value that took place as a result of the deal. Please also discuss critically the position of the small shareholders of Non-Ferrous Metal Industries Ltd. in the entire process and what improvements, if any, you would suggest in the Takeover Guidelines. Also examine the fate of those shares which were owned by small shareholders and which were already offered to SIL for purchase.

NUGGET 4

TAKEOVER OF SOUTH INDIAN CEMENT BY UNIVERSAL CEMENT

Application of SEBI Takeover Code

The following is the chronology of events, as reported in the media, with respect to the takeover of South Indian Cement Ltd. by Universal Cement Ltd. Analyse the case and give your comments, wherever warranted.

(a) On 3 June 2000, UCL Service Ltd., UCL Securities Ltd. (both wholly owned subsidiaries of Universal Cement Ltd.) and Tristar Investment Private Ltd. acting in concert with Universal Cement Ltd, offered to acquire 30,00,000 equity shares, representing 20 per cent of the paid-up equity share capital of South Indian Cement Ltd, at a price of Rs 400 per fully paid-up equity share for cash.

(b) EPS for South Indian Cement Ltd., as on 31 March 2000, was Rs 15.20 and average P/E ratio for cement majors in South India was 5.0 as per Capital Market dated 8 May 2000.

(c) Market price of Universal Cement Ltd. fell sharply immediately after the offer while the price of South Indian Cement Ltd. scrip rose to Rs 185.

(d) A meeting of few local industry leaders was held to counter the raid of South Indian Cement Ltd. and reports indicated the possibility that some corporates might agree to play "White Knight" to the company and that the existing promoters might make a counter offer.

(e) The Director of South Indian Cement, Mr. Murlidhar sold his stake in the company to Universal Cement Ltd., thereby taking the stake of UCL in South Indian Cement to 28.3 per cent.

(f) There were reports that the management of South Indian Cement Ltd. had already transferred its 35 per cent stake in

Krishna Cement to another group company so as to make it less attractive to the predator Universal Cement Ltd. (a well known mode for takeover defense).

(g) *South Indian Cement chief sold his 30.2 per cent stake in the company to Universal Cement Ltd. UCL subsequently advised the FIs about its plans to buy the entire stake of the promoters and others in South Indian Cement.*

(h) *Krishna Cement's scrip moved up in the hope of an open offer by Universal Cement Ltd. Promoters made open offers in KCL to consolidate their stake in the company.*

(i) *South Indian Cement (under the new promoter UCL Group), filed a complaint against the move to make a public offer to acquire 20 per cent stake of KCL by its ex-promoter.*

(j) *Mr Murlidhar bought stakes in KCL amounting to 10,00,000 shares (7 per cent) @ Rs 70 per share from a FI.*

(k) *He bought 7 per cent stake in KCL at around the same price from another institution.*

(l) *He picked up another 18 per cent stake at a price of Rs 80 to Rs 85 per share from institutional investors. The open offer price was revised to Rs 85 per share.*

(m) *UCL was reportedly mopping up KCL shares.*

(n) *Mr Murlidhar faced problems as auditors qualified the accounts of South Indian Cement. However, he did go ahead with KCL open offer.*

(o) *The UCL and South Indian Cement Ltd. merger was likely in a couple of months.*

(p) *The whole deal may come under the scanner for investigation.*

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NUGGET 5

DRUG MANUFACTURERS LTD. (DML)

Merger for Maximising Shareholder Value

Drug Manufacturers Ltd. (DML) was a private sector listed company from Western India, which had a track record of nearly half a century of operations. Besides being an established name in the domestic market, DML had made commendable advances in exports as well.

The company had an annual turnover of over Rs 1000 crore, of which exports accounted for around 40 per cent. Its share of the domestic market was well above 10 per cent and it was a market leader in the range of products it manufacturesd. DML had ambitious growth and diversification plans. Towards this end, it was considering the following options:

a. *Acquisition of and merger with established domestic manufacturers of other drug items.*
b. *Purchase of companies abroad.*
c. *Joint venture participation from multinationals.*

DML spent extensively on R&D, with a view to breaking and consolidating fresh grounds.

Dream Drug Co. Ltd. (DDCL) had been around for three decades, with its headquarters in South India. The company was initially set up by two medical professionals who had trained in the USA. From a modest beginning, it expanded its business and reached a turnover level of Rs 100 crore per annum.

The product range of DDCL was limited. It had not gone for aggressive diversification. But, the company was able to secure more than 1per cent share of the domestic market and established itself firmly over the years in its own product segments. All its products were distinct from those of DML and hence there was no competition between the two. Like DML, DDCL had cultivated the *market religiously and had skillfully developed a dedicated marketing network in the domestic arena. However, DDCL did not spend as much as DML on R&D; it restricted itself to its original range of products. Although its turnover witnessed a greater increase than the market average in its own product range, the company had not explored its export potential seriously.*

DML was exploring the possibility of a merger with DDCL and took into account the following facts:

(i) DML and DDCL were both healthy, profit making companies and their merger would help in achieving synergy and complementarity of products and markets.

(ii) The merged entity would be able to capture about 15 per cent of the domestic market. As a stronger company, with an edge over the others in its entire range of products and an excellent marketing network, the merged organisation would be well positioned to thrive in a competitive environment comprising various global players.

(iii) DML had a strong presence in the international market and would be able to push the products of DDCL as well through its network.

(iv) There was no overlapping of products and the proposed merger would augment the marketing base. DML was strong in the west and north while DDCL had an active network in the south. Thus, rationalisation of manpower might not be called for.

(v) The merged entity would emerge as a stronger player in the drug and pharmaceutical market and was likely to be in a position to access funds from financial markets at cheaper rates.

(vi) The strong debt-equity position of DML and its much larger balance sheet size as compared to DDCL would enable the merged entity to easily leverage its immediate growth plans.

(vii) Since both DML and DDCL had been booking profits over the years, there were positive cash flows available to the shareholders and DCF method of valuation was being considered by

DML management as the most appropriate for valuing the shares of the two companies and working out the swap ratio.

Would you structure a merger deal between the two companies?

NUGGET 6

RAINBOW METAL LTD.

Disinvestment through Joint Venture and Preferential Allotment

Rainbow Metal Ltd., a well-known metal manufacturing company, was part of a reputed business house, whose activities, including corporate office and manufacturing facilities, were mostly located in the north and the west, although it had a certain presence in the east and south as well.

Rainbow was a cash rich company and its financials, including debt-equity ratio and current ratio, were extremely good. It was perceived as a true blue-chip in the capital market as well as by all lenders, both in and outside the country. The management of the company was considered progressive and extremely professional.

Eastern Packing Ltd. was a metal packaging company located in the east. It was known for its quality performance and had recently acquired the requisite ISO certification. It had modernised its production facilities and also expanded its capacity in the recent past. The company had state-of-the-art technology and its customers included blue-chip tea, tobacco and health food companies. The management was, however, still family-run and yet to be professionalised. The group had good earnings from tea estates in the east and north-east. It had acquired a big company, engaged neither in tea nor in metal packaging, some time back. As the primary market for equity continued to be depressed for a very long time, the group garnered support from various group companies in order to meet the cost of acquisition. In particular, Eastern was over-stretched with excessive debts by way of inter-corporate deposits. The over-extended debt:equity ratio, coupled with high cost of borrowing and low dividend yield on investment, had strained the company's profitability. It had overdue interest on term loans from FIs and irregularities in working capital loan account from *consortium banks. It had become cash strapped and delayed payment to suppliers had added to its procurement costs. The group did not have any facility for production of primary metals and was thus vulnerable to price fluctuation in the London Metal Exchange. Eastern was listed in the Stock Exchanges and a significant percentage of its shares were held by ordinary shareholders and FIs. It had carved out a niche market for its products and its exports had shown a steady growth over the last few years. Its quality had earned goodwill for itself and also a brand image in the market.*

A consultant was appointed to put in place a re-engineering deal between the two companies so that the shareholders of both could benefit. The following facts and data were available:

1. *For Rainbow, some parts of Eastern's business would be a downstream project.*
2. *Eastern had a ready and established market in the east and enjoyed a brand image.*
3. *If various activities of the group were excluded, Eastern was viable on its own and had the ability to service its own financial commitments. It, however, needed infusion of long term funds on an urgent basis to tide over the liquidity problem and also to set right the over-extended gearing.*
4. *The promoters of Eastern held 60 per cent of its equity capital. For forming a 50:50 joint venture with Rainbow, if the owners were required to sell half of their existing holding in Eastern to Rainbow, they would receive payment for the same from Rainbow.*
5. *Valuation of the shares needed to be done through employing the DCF method and estimating the possible value of the brand.*
6. *In case of preferential allotment of shares to Rainbow by Eastern, the relevant SEBI guidelines would have to be complied with. The price for the shares to be allotted would have the floor dictated by such guidelines and the funds would flow to Eastern.*

7. *Eastern was badly in need of long-term funds in the form of equity to restructure its balance sheet and to reduce finance charges, thereby improving profitability as well as its capacity to service.*

According to you, which route would best suit the shareholders of both the companies? In case a joint venture (50:50) is agreed upon between the companies, how would you engineer the disinvestments deal?

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NUGGET 7

PETROLEUM PRODUCTS INDIA LTD.

Strategic Disinvestment through Structured Deals

Petroleum Products India Ltd. was a PSU in the oil sector under the Ministry of Petroleum with a very large number of marketing outlets. It had been earning profits consistently over a number of years.

The company has plans for substantial modernisation and expansion of the unit, to be carried out over the next five years, which would require funding to the tune of Rs 1000 crore. These projects are vital for maintaining the company's competitive edge on a long-term basis in a free market environment.

Petroleum Products was a listed company. Its equity shares numbered 4,00,00,000 as on date, with each share carrying a face value of Rs 10. In the depressed capital market, the shares of the company were quoted at Rs 240 as against the book value of Rs 300.

Petroleum Products featureed in Government of India's disinvestment programme and the plan was to bring down GOI's stake in Petroleum Products from the current level of 60 per cent to 26 per cent in the first phase. GOI did not want to bring down the stake below 26 per cents, at least not in the next five years.

The Disinvestment Commission had suggested that GOI might like to sell 34 per cent of its existing stake to get the best possible price as part of its budgetary plans for the year. Initial market assessment indicated that a strategic partner might be willing to pay Rs 400 per share provided it was allowed to acquire a controlling stake in the company. It was noted that the impressive retail network of Petroleum Products would be attractive to international as well as domestic oil majors, who might be interested in using the company as a vehicle for gaining entry into the Indian petroleum sector. The company in turn would have access to such a strategic partner's technical and financial resources.

Additional information available on the company is as follows:

1. *Petroleum Products' latest balance sheet showed a healthy debt-equity ratio and the aggregate liabilities outstanding as on the date of the balance sheet were Rs 1000 crore.*
2. *Lenders for the project and existing lenders of Petroleum Products India Ltd. were agreeable to allow an overall Debt-Equity ratio of 1:1.*
3. *A public offer for sale of 34 per cent of the existing equity by GOI may only fetch a price far below the quoted market price. If GOI decides to sell the entire 34 per cent stake (60 per cent less 26 per cent) to a strategic partner, it may get considerable funds that may help it bridge the fiscal deficit. But this will not give Petroleum Products any funds inflow.*
4. *If at all GOI sells its 34 per cent stake to any strategic partner, it cannot allow Petroleum Products to come up with any fresh equity infusion during the next five years as such a step will immediately lead to dilution of GOI's stake below the strategic minimum of 26 per cent.*
5. *It is not possible to implement the company's modernisation-cum-expansion plans, scheduled for the next five years, with the help of debt financing alone as the resulting debt-equity ratio will be unacceptable to prospective lenders.*
6. *Any Public Issue or Rights Issue of equity shares will be constrained by the current market price of Petroleum Products' equity shares. Moreover, marketing any large issue without any participation / with renouncement from GOI would be uncertain, given the existing market conditions.*
7. *Preferential allotment, if any, of Petroleum Products' shares can be made only subject to SEBI's guidelines in this regard. In a falling market for share prices, the price at which preferential allotment can be made would be higher than the current market price, and the existing or new shareholders may not be enthusiastic about picking up fresh shares of the company at a price which is higher than the current market price. However, a strategic partner may be ready to pay the same by way of control premium.*

8. *A strategic partner would be ready to pay adequate control premium only if it sees reasonable opportunity to gain a majority stake in Petroleum Products.*
9. *Any preferential allotment of shares with proper disclosures does not trigger the Takeover Code that prevailed at the end of year 2000. However any purchase of existing shares by any strategic partner in excess of 15 per cent of Petroleum Products' paid-up voting shares from GOI would trigger the code.*
10. *If GOI refuses any infusion of equity into Petroleum Products, the strategic projects, proposed to be implemented by the company during the next five years, cannot be implemented and this may jeopardise the company's long-term competitiveness, which in turn may result in the prospective strategic partners shying away from the company or offering a much lower price.*
11. *If Petroleum Products could raise the necessary equity through the preferential allotment route, GOI could achieve the target of disinvestment up to 26 per cent by selling the balance through a negotiated deal. It might be possible in such a case for a strategic partner to acquire a controlling stake in Petroleum Products through a Public Offer under the Takeover Code, even if only 10 per cent of the existing shareholders offered their shares under such an offer*

If Petroleum Products India Ltd. engages you as a merchant banker/consultant, how would you go about structuring the disinvestment programme? Ignore the possibility of any non-voting shares.

NUGGET 8

CALCUTTA METALS LTD.

Asset Hive-off and Strategic Disinvestment through Joint Venture

Calcutta Metals Ltd. had several divisions. One of its divisions was not self-sustaining. It had state-of-the-art manufacturing facilities that involved large investment. However, the Indian market was not developed prior to the commissioning of the project and lack of adequate orders had been affecting the performance of this division virtually since its inception. Hence, Calcutta Metals was compelled to cross-subsidise its activities to keep it afloat.

The economic recession in India in the late 1990s changed the position of Calcutta Metals drastically and it was no longer in a position to continue the old practice of cross-subsidisation. The company wanted to induct a joint venture partner in the business of this beleaguered division so that the partner could use the manufacturing facilities in India as the production base and access the global market .

Some of the issues relating to the joint venture proposal were as follows:

1. *The joint venture partner should be in a position to access the global market for selling the products of the loss-making division of Calcutta Metals Ltd. This being the case, the joint venture partner should be an MNC, with a global marketing network. It would be preferable if this partner takes a dominant stake in the division because in that case it would want to introduce modern technologies into the operations of the division as and when such upgradation is required by the market. Moreover, for a major stake in the company, the joint venture partner would be ready to pay a substantially higher price by way of Control Premium.*

2. *It was clear to Calcutta Metals that it would not mind if the joint venture partner decided to pick up 74 per cent stake in the operations of the division but it would not allow any stake to this partner in Calcutta Metals Ltd.*

Calcutta Metals was able to find a joint venture partner who met the above two requirements and accordingly, on a specified date, the company hived off all assets of the division to a shell company formed for this purpose, at the negotiated price. On the same day, the shell company paid 74 per cent of the consideration money to Calcutta Metals Ltd. in cash and issued shares for the balance amount of 26 per cent in the name of Calcutta Metals Ltd. The joint venture partner paid 74 per cent of the consideration amount in cash to the shell company in lieu of the 74 per cent shares issued by this company in its favour.

For transferring the assets of the ailing division to a shell company, Calcutta Metals required prior clearance from the creditors of this division. On receipt of 74 per cent of consideration money in cash, the company repaid the dues to the lenders in full.

The sale of assets required sales tax, besides the registration of land and building in the name of the shell company. This attracted stamp duty as per the law. Moreover, the foreign company, for bringing in 74 per cent equity in the shell company, required the necessary FIPB clearance. Compliance with all such formalities, formation and incorporation of the shell company, settlement of the percentage holding by the joint venture partner and the price for such a holding were worked out by a merchant banker. The merchant banker also assisted the joint venture partner in manpower related matters, including the possibility of offering a suitable VRS package in order to rationalise the workforce.

How, as a merchant banker, would you evaluate the deal?

NUGGET 9

POTENT COMPANY LTD.

Disinvestment and Financial Restructuring

Potent Company Ltd. was a reputed PSU with a proven track record in performance. Its production, sales and profit went up consistently over the years, and it developed facilities, including its captive power plant, which were considered state-of-the-art. Incidentally, the unit's manufacturing facilities required a lot of electricity and, without a captive power plant, these would have been considered incomplete.

The return on investments of Potent Company Ltd. compared favourably with that of the private sector blue-chips in the same industry. But its shares, which were listed on the Stock Exchanges, quoted at rather low prices. This was because of the low EPS of Potent Company Ltd. and also the low discounting attributed to it due to its skewed capital structure. The unfavourable capital structure stemmed from its bloated equity base. Government of India had pumped in plan assistance into Potent Company Ltd. from time to time and all such funds were capitalised at par. The company's balance sheet allowed for substantial debt-equity ratio.

Potent Company Ltd. had a large expansion project in hand and it proposed to access the global market with a GDR or ADR issue. The company was not clear as to what kind of changes would be required in its capital structure before it could go ahead with this plan.

The following is the additional information that is available:

1. *Potent Company's balance sheet had ample scope for additional gearing. Its profitability was good enough to be able to service some additional loans.*
2. *The company had excess equity capital, most of it issued at par. Such a bloated equity base had depressed its share prices and EPS. If the shares could be reduced in number, the book*

value as well as EPS of the shares would go up. The worth of each share too was likely to go up in the process. However, such a decrease in the equity base need not result in proportionate reduction in share value of GOI.

3. *It appeared that an equity-debt swap might be adequate to take care of the ailment afflicting the company. This would boost the company's EPS and share price.*
4. *However, such a swap would adversely affect GOI's holding in Potent Company Ltd. But a GDR/ADR issue might lead to disinvestment of GOI's stake and the proposed swap, by boosting pre-floatation EPS and share price, might bring down the number of shares to back up the offer price for a GDR/ADR. Accordingly, for the same amount of fund raising, the number of shares to be floated would be less and the extent of resultant disinvestment would thus be less. In sum, prior to a global disinvestment programme, it might be feasible to work out an equity-debt swap strategy without unduly diluting GOI's holding.*
5. *The debt in favour of GOI, arising out of conversion of equity, would yield regular income for the Government. As the debt gets redeemed in a reasonable period of time, this would result in the much desired inflow of funds for GOI, which the latter might use for allocation as per its revised priorities—say, for the social and infrastructural sector. As a matter of fact, the funds might become available to GOI immediately by placing privately, with suitable FIs and mutual funds, the debt instruments to be issued by the company in lieu of their equity*

What would be your suggestion regarding changing the capital structure of Potent Company Ltd. prior to going ahead with the euro offering? What might be the likely impact of such restructuring on the interest of the Government?

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NUGGET 10

METALS AND ALLOYS LTD.

Disinvestment and Financial Restructuring through Equity-Debt Swap

Metals and Alloys Ltd. was a well-known company in India in the mining sector. It was a public sector unit with a steady track record of performance and profitability. However, its EPS and share price never showed a healthy growth because of its bloated equity base. There was a proposal lying with the government suggesting an equity-debt swap under which half of GOI's current holding would be replaced by a five-year debt carrying a market-linked coupon rate.

In the recent past, just before the end of the financial year, the Union cabinet decided to partly disinvest its stake in the company. The money was required urgently by the government to cover a part of its targeted fund raising to meet the budgetary deficit. However, there was hardly any time for the government or the company to go through the elaborate process of bidding and price-discovery for off-loading part of its equity stake.

The restructuring plan, suggesting an equity-debt swap, whereby half of the government's existing equity holding was to be converted into a five-year debt, could be an attractive option to the investors and could be quite comfortably placed with the Commercial Banks and Financial Institutions. The management expected that the five-year bonds to be issued by Metals and Alloys would get the highest rating (AAA) from the Indian Rating Agencies. Such a process would be quite fast and the rating exercise could be completed in a week's time.

The management of Metals and Alloys felt that the proposal for equity-debt swap would help achieve the goal of the company and also that of the government without any disinvestment by the latter.

How would you, in the capacity of an Investment Banker, structure the deal?

NUGGET 11

BEST CEMENT COMPANY LTD.

Share Buyback to Augment Shareholder Value

Best Cement Company Ltd. was a private sector listed company in the cement sector. It had several intrinsic advantages and with strict cost control and continuing high productivity, it was able to strengthen its financial position considerably. It had developed large reserves over the years and its balance sheet showed substantial liquid assets. Its position as per the latest balance sheet is summarised as follows:

Liabilities	*(Rs in millions)*	*Assets*	*(Rs in millions)*
Paid-up Capital	*100*	*Land & Building*	*250*
Reserves	*700*	*Plant & Machinery*	*300*
Term Liabilities	*20*	*Cash /Bank*	*100*
Current Liabilities	*30*	*Liquid Investment*	*120*
		Other Current Assets	*80*
	850		***850***

Best Cement Company Ltd. had 10,000,000 equity shares that had a face value of Rs 10 each, fully subscribed. The promoters held 4,000,000 shares. For the latest completed financial year, Best Cement posted a PAT of Rs 50 million. The market price of its share was Rs 40.

Cement Industry was among the favourites of the corporate raiders. The performance and potential of Best Cement attracted many of them. The company was apprehensive that some attempts at hostile takeover might be on the anvil.

The promoters had, in the recent past, gone in for some unrelated diversification in the area of international trading through an unlisted group company. They had made a good deal of investment for this purpose but did not have the required funds to augment their holding from 40 per cent to beyond 50 per cent.

A Merchant banker, appointed to recommend a suitable option to boost the promoters' holding by leveraging the financial strength of Best Cement Company Ltd., took note of the following factors in this context:

1. *The promoters, who wished to augment their holding in the company beyond 50 per cent but did not have adequate funds to purchase additional shares, favoured the buyback of shares by the company itself. They believed that the company could do this on the strength of its balance sheet.*
2. *The promoters held 4.0 million shares. If this number had to account for 51 per cent holding, Best Cement would need to bring down the number of issued shares to 4.0/0.51 million, i.e. nearly 7.8 million. This meant a reduction in the number of issued shares by 22 per cent.*
3. *The EPS for Best Cement Company Ltd. was Rs 5 and the P/E ratio was 8. Post-Buyback, the EPS would go up to nearly Rs 6.41 provided that the PAT remained the same during the post-buyback phase. This may boost the market price of its equity shares to Rs 51.*

The merchant banker took note of the above information and decided to recommend a buyback proposal based on the following guidelines:

a. *To induce ordinary shareholders to part with their shares, Best Cement Company Ltd. will need to pay them a slightly higher price of, say, Rs 54 per share. On this basis, the total payment required to be made by Best Cement on account of buyback will work out to about Rs 119 million.*

b. *On the basis of the Balance Sheet of the company, the buyback proposal will be able to satisfy the regulatory provisions prevailing at the time of recommendations, the key provisions being:*

   - *For share buyback, the funds will need to come entirely from Free Reserves and Share Premium Accounts.*
   - *Post-buyback debt-equity ratio must not exceed 2.*

- *The amount of buyback must be within 25 per cent of company's net worth.*
- *The number of shares to be bought back must be less than 25 per cent of the company's nominal capital.*

The merchant banker worked out the restructured balance sheet of Best Cement, as it would look during the post-buyback phase:

Liabilities	*(Rs in millions)*	*Assets*	*(Rs in millions)*
Paid-up Capital	*78*	*Land & Building*	*250*
Reserves	*603*	*Plant & Machinery*	*300*
Term Liabilities	*20*	*Cash & Liquid Investment*	*101*
Current Liabilities	*30*	*Current Assets*	*80*
	731		***731***

The merchant banker, while submitting his recommendations, pointed out to the promoters that the book value of the shares would increase due to the buyback and so also would its EPS.

The merchant banker assumed that share buyback would be permitted in India subject to the terms and conditions as enumerated in this case. The expenses to be incurred for carrying out such a buyback were ignored by him

Do you agree with the recommendations made by the merchant banker?

NUGGET 12

SUN AND GLORY LTD.

Financial Restructuring through Consolidation

Sun and Glory Ltd. (SGL) was a multinational company operating in India and dealing in a number of consumer goods. The USA based parent company of SGL had set two immediate goals for the Indian subsidiary: First, that the company should increase its turnover by 25-30 per cent in the next two to three years. Secondly, the parent wanted to increase its stake in SGL by as much as possible because it felt that its current holding in the company was not adequate.

SGL management was wondering what strategies it should adopt in order to achieve these twin goals. Some of the aspects that dominated the management's thinking were:

1. *In order to achieve an impressive growth in sales, the company might have to embark upon an expansion project. Such a project would require substantial funding, a part of which would have to be met through infusion of additional equity.*
2. *The primary market for equity shares remained highly depressed and a Public Issue was virtually ruled out.*
3. *Rights Issue of equity might not get an enthusiastic response either unless issue price was at a substantial discount to the market price. If the equity price reflected the intrinsic worth of the company, the non-promoter group of shareholders may not pick up their share of the additional equity shares.*
4. *One advantage of the rights issue was that it was outside the purview of the "Takeover Code" so long as there was no change in control of the company. Also, the unsubscribed portion of a rights issue could be picked up by the promoters provided a suitable disclosure has been made to this effect in the Letter of Offer.*
5. *An increase in the holding by the foreign parent might call for prior clearance by the Foreign Investment Promotion Board.*

If you are appointed as a consultant to SGL, state your recommendations in this case in so far as financing of the expansion project is concerned.

NUGGET 13

SERVICES INDIA LTD.

Structuring to Maximise Shareholder Value

Services India Ltd. was a well established, reputed company with its headquarters in the west and operations spread mostly in the west and north. It was a service-oriented company and its track record showed consistent performance and profitability. Its shares were listed in BSE and NSE and were reasonably well traded.

The company had positioned itself quite well and tied up with some reputed travel agencies, both domestic and international. Consequently, it was able to benefit from the increased flow of tourist traffic into India. To top it all, much of the company's income stream was denominated by foreign currencies, thereby entitling it to enjoy the benefits—tax and otherwise—associated with deemed export. The company thus paid only MAT.

The company expected further spurt in India-bound traffic and wanted to expand its facilities to cater to the needs of the growing number of foreign tourists. Such projects involved capital expenditure to the tune of Rs 200 crore during the current year. Of this, nearly half could be met out of the company's cash accruals; it planned to raise the balance amount in the most cost effective manner.

The company had to decide how it could structure such fund raising. It took into account the following:

1. *Services India Ltd. was a well established and reputed organisation, with a track record of consistent profitability and dividend payment.*
2. *With its excellent financials and comfortable liquidity position, it was likely to get an 'AAA' rating for its medium-term (five years) debt instruments.*

3. *In spite of its growing profits and healthy profitability, the company paid only MAT because of its substantial foreign exchange earnings.*

4. *The Central Government of India had, in its latest budget proposals, waived Income Tax on income to investors arising out of dividends. Accordingly, a 10 per cent dividend received out of investment in Preference Shares meant an effective return of more than 16 per cent per annum for an investor in the highest tax bracket (38.5 per cent.)*

5. *Dividends were paid out of post-tax profits of issuer companies. For a MAT paying company issuing 10 per cent Preference Shares, the effective pre-tax cost issue turned out to be less than 12.5 per cent per annum.*

6. *The difference in tax brackets of the issuer company and the investors made it quite cost effective for a well rated company to issue, on a private placement basis, 'AAA' rated Preference Shares with suitable dividend yields. The target investors would be profit making banks and corporates in the highest tax bracket.*

Based on the above, how would you structure the arrangement?

NUGGET 14

POPULAR HOUSING FINANCE LTD.

Turnaround Strategy

Popular Housing Finance Ltd. (PHFL) was a private sector Housing Finance Company (HFC), whose operations were governed by the guidelines of the National Housing Bank (NHB). It had been earning profits consistently for 10 years and recently, it went in for aggressive fund raising through unsecured deposits from the public by offering high brokerage of 2 per cent and also a high incentive to potential investors. A part of this fund was deployed in high return loans and leases to corporates and the balance was used for making investments in bonds, preference shares and equities.

Some corporate loans and leases unfortunately went bad and became non-performing assets (NPAs). The persistent decline in the equity market as well as poor performance and consequential default by certain corporates had hit PHFL's return on investment quite badly. Provisioning on account of NPAs and loss of income on such assets, coupled with adverse return on investments, led to losses for PHFL.

The losses eroded the net worth of Popular Housing Finance Ltd. and the company consequently slipped from compliance with capital adequacy requirements. Augmentation of capital thus became an urgent requirement of PHFL. But, such augmentation was permissible only if long-term viability of the company could be established.

PHFL's latest balance sheet size was nearly Rs 650 crore, which was supported by a net worth of around Rs 30 crore. Rs 15 crore was its paid-up capital and the net loss during the year amounted to Rs 10 crore (approx.). Loans amounted to nearly Rs 450 crore and investment aggregated Rs 150 crore. Public Deposits accounted for nearly Rs 500 crore and secured loans amounted to about Rs 100 crore. Individual loans were low-yielding, but stable in nature and good in quality. PHFL's experiment with big loans to builders/developers had been a bad experience.

A consultant was appointed, who, after conducting the initial study, recommended the following course of action in order to proceed further in this matter:

- *A detailed analysis of realisability of the company's assets, both loans and investments, should be done for arriving at the amounts and timings of its inflows on a realistic basis.*
- *The quanta and exact timings of the company's possible outflows should also be worked out by examining all its liabilities, including the maturity profile of the Public Deposits.*

The consultant also concluded that:

- *Acceptance of fresh deposits may need to be suspended at least for the time being.*
- *A one-time settlement (OTS) may need to be worked out, wherever possible, to recover at least a good portion of the NPAs.*
- *Some relaxation will need to be sought from NHB for compliance with Capital Adequacy Requirement/Norm*
- *Publication of the company's Annual Report will need to be deferred to allow for the maximum time possible to do a quick but critical review of the company's assets and liabilities and to draw up an action plan*

The consultant apprehended that the company's entire net worth would erode and it would end up posting a large accumulated loss once the recoverability of its loan assets and investments was fully taken into account. If such a scenario did develop, the promoter would have to arrange—if necessary by infusing temporary liquidity—for timely redemption of its existing liabilities. The consultant also felt that once the true worth of the company's shares could be arrived at, the promoters might either buy the assets at their realisable value and form a new company to take over such assets as well as run the housing finance business or they might buy the shares of other parties at the intrinsic value of such shares.

If you were the consultant, would you adopt the above approach?

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NUGGET 15

POWER AND FUEL COMPANIES

Proposal to Securitise Receivables

Power and Fuel Companies in India had considerable dues from various State Electricity Boards, many of whom were not strong financially. Many of these outstanding debts were quite old and some were disputed. At the time of writing this case, the amount of settled upon dues worked out to around Rs 10000 crores. The creditor companies urgently needed to recover this large amount in order to finance their various capital expenditures in the coming years.

If funds are to be raised by way of issue of bonds, to be collateralised by means of an escrow account meant to collect the outstanding receivables from various State Electricity Boards, the bonds would not have the requisite ratings or the necessary response from investors. Since the debts are long outstanding, escrow mechanism to be funded out of inflows from these receivables would not enhance the rating of the bonds.

In a policy declaration, the government proposed infusion of liquidity in Power and Fuel Companies, against their long outstanding receivables, to enable them to meet their requirements for capital expenditure. One option that can be considered for this purpose is the securitisation of long standing receivables, to execute which there will be a need for a Special Purpose Vehicle (SPV).

Some of the key issues to be kept in view for securitising the long standing receivables are:

1. *For a SPV mechanism to be effective, sale of debts needs to be given a legal status. For example, Pass Through Certificates (PTCs) are be categorised as security under Security Contract Regulation Act (SCRA).*

2. *PTCs attract 0.1 per cent Stamp Duty in some of the states in the west, north and south. In other places, the duty is much higher. Incidentally Stamp Duty is required to be paid at two stages—once for sale of debts and thereafter for issuing of PTCs.*

3. *The creditor companies have firm agreements with the State Electricity Boards for payment of interest @ 2 per cent per month on their outstanding receivables.*

4. *If the Government of India has to guarantee payment of principal and interest under the proposed instruments, it has to have some mechanism for realising the amounts from either the SEBs or from the concerned state governments from out of their plan allocations. The GOI can recover the entire guaranteed amount by appropriating, say 15 per cent, from the plan allocations (which are adequate enough) of the respective State Governments.*

5. *Since the lenders are comfortable with the balance sheet position of the Power and Fuel Companies, bonds issued by them and guaranteed by GOI are likely to be picked up by the banks and FIs. The route may be Private Placement rather than Public Issue in order to minimise delay and costs. However, as many such institutional investors have internal guidelines to pick up only rated securities with some minimum ratings, the issuer companies may be advised to have the securities duly rated.*

6. *Although the Union Government may not be willing to guarantee the interest payable on such bonds/PTCs, they might ultimately have to do so as the interest on securities to be issued should logically be borne by the concerned SEBs. Also, the recovery thereof should be ensured by GOI by appropriating this component from the amount of deduction effected by it from the plan allocations of the respective State Governments who would now have to work out ways and means of effective recovery from their own SEBs.*

7. *This is only a one-time solution to a very old mess. Hereafter, in order to ensure that such a situation does not recur, the*

government should put in place firm arrangements for timely payment of the receivables, say, through the mechanism of irrevocable Letters of Credit. Suitable restructuring of SEBs and privatisation, as and when necessary, may also be considered.

8. *The interest cost on such Bonds may be minimised by giving them a tax-free status.*

Do you think securitisation on the above lines is feasible? Will there be takers for such a proposal? What safeguards will the investors insist upon? Would it be possible for the power and fuel companies and the government of India to offer such safeguards, given the prevailing realities?

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NUGGET 16

GENERATOR COMPANY LTD.

Financial Restructuring to Augment Shareholder Value

Generator Co. Ltd., a power generating company, acquired substantial fixed assets towards implementation of its major expansion programme. These assets included pollution control equipment valued at Rs 50 crore, on which 100 per cent depreciation was available for income tax purpose during the first year itself. It was estimated that there would be no tax liability, because of the tax shield, during its current year of operations.

The Company's project under implementation has undergone a cost overrun of Rs 60 crore due to unavoidable circumstances. It badly needed some cash infusion which it would be in a position to service over the next five years. The lending financial institutions were reluctant to increase their exposure to the project. However, they might agree to relax the existing debt-equity ratio approved for the project under implementation.

A merchant banker, appointed to structure the financing, took note of the following in addition:

1. *While the existing lenders did not show interest in extending additional credit, they did not object to Generator arranging the extra credit from any other source.*
2. *Generator would not be required to pay any income tax during the current year on account of the significant depreciation shield available to it as a result of its acquisition of substantial fixed assets in connection with implementation of its expansion projects. Acquisition of pollution control equipment worth Rs 50 crore would enable the company to claim 100 per cent depreciation in the first year itself.*
3. *The company could resort to a sell and lease-back deal in respect of the pollution control equipment and thereby avail of*

immediate cash inflow of Rs 50 crore. It could also avail of cheap lease finance, which would help it minimise the adverse impact of cost escalation. The balance amount of Rs 10 crore would have to be garnered from its promoters, either by way of. additional equity or by way of long-term, interest-free sub-ordinated debts.

The merchant banker, however, needed to check whether the proposal to sell and lease back would comply with the statutory requirement in regard to pollution control. Also critical was whether future cash flows of the company would allow for servicing of the additional debt of Rs 50 crore within permissible norms.

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NUGGET 17

INTERNATIONAL BANK

Risk Management to Maximise Shareholder Value

The value of India's imports has always been known to exceed the value of its exports. This means that India had a trade deficit, which needed to be funded through capital inflows. A special scheme was launched for Non-Resident Indians to remit their savings to India in hard currencies. Under this Foreign Country Non-Resident (FCNR) Deposit Scheme, Non-Resident Indians could maintain deposits with their banks in India, denominated in US Dollars, GB Pounds, Japanese Yens and the Euro.

Prior to adoption of Current Account Convertibility by India, the entire foreign currency mopped up by banks in India was passed on to RBI against receipt of equivalent amount of Indian Rupee payments. As and when the deposits matured, RBI would sell the foreign currency to the respective bank at the "original rate of exchange" to enable the latter to repay the depositor in the currency of deposit (FCNR (A) Scheme).

Subsequently, following the introduction of Current Account Convertibility for the rupee, this system was withdrawn by RBI, implying that the foreign exchange fluctuation risk would be borne by the commercial bank holding the deposit rather than by RBI (FCNR (B) Deposit). The question for the treasury manager of any bank was how to manage the foreign exchange fluctuation risk associated with FCNR (B) deposits. He had to restructure the balance sheet of the bank suitably so as to eliminate or minimise such a risk.

The Treasury Manager of International Bank was examining the following options to manage the foreign currency risks:

1. *Accept foreign currency deposits from customers and keep the same in deposits for appropriate maturities with foreign banks operating abroad (New York, London, Tokyo, Frankfurt, etc.). It was noted by the treasury manager that since India's rating was*

worse than that of these developed countries, the Government of India / RBI offered a somewhat higher rate of interest on FCNR deposits of corresponding maturities than what was available in the international markets.

2. *The bank could convert the FCNR (B) deposits into Indian Rupee funds for funding its assets. On maturity, the bank could buy an appropriate amount of foreign currency to repay the deposit.*
3. *The bank had a scheme for extending pre-shipment export credit in foreign currency known as "Packing Credit in Foreign Currency" (PCFC), which was availed of by exporters from time to time. One option would be to use the FCNR (B) deposits for extending PCFC credits. Incidentally, it was well known that apart from PCFC, exporters also had the option to avail of a rupee denominated, pre-shipment export credit known as "Export Packing Credit" (EPC) and, normally, exporters compared the interest differential on the two types of loans (viz. PCFC and EPC) with the forward premium on foreign currencies before making a choice. The treasury manager was not sure whether the deployment of FCNR (B) under the PCFC route will be feasible if the exporters did not prefer PCFC under all circumstances.*
4. *Another option would be to approach RBI and GOI for getting approval to extend general purpose credits to clients, denominated in foreign currency. The treasury manager wondered what kind of hedging mechanisms would be required in case the RBI approved his application. His other concern relating to this option was whether the prime customers would be interested in availing of general purpose loans denominated in foreign currency.*

The treasury manager was also not too sure of the types of special facilities his bank should seek from RBI to hedge its foreign currency fluctuation risk arising out of FCNR (B) deposits.

Advise the treasury manager on the pros and cons of all the four options and also what facilities he needs in order to hedge his foreign currency fluctuation risk arising out of FCNR (B) deposits.

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NUGGET 18

THE INVESTMENT BANK LTD.

Financial Derivatives to Maximise Shareholder Value

Mr. Chatterton was in charge of the investment desk at a foreign office of an Indian commercial bank named Investment Bank Ltd. The foreign office was located at a prominent Asian centre. According to the requirements of the local regulatory authorities, investment in some local securities is desirable.

Solomon Brothers Asia, a prominent international investment banker, offered a three year FRN denominated in US Dollars, with a face value of USD10 million. The coupon rate, payable semi-annually, is 1.85 per cent above 6 months' LIBOR and the FRN is rated BBB by an international rating agency.

Reserve Bank of India stipulated certain guidelines for investment in foreign securities by foreign offices of Investment Bank Ltd. The requirements warranted that:

(a) The exposure should be short term.

(b) The rating of the paper to be invested in did not fall short of grade A.

(c) There should be complete match funding in the sense that the assets and liabilities should be denominated in the same currency, the interest rate basis should be identical and the start as well as end date should be identical.

As India was facing BOP crisis at the material time, Salomon Brothers had problem taking exposure on any Indian entity.

Mr. Chatterton was aware of the following:

1. *There was some derivative product to manage liquidity risk and curtail the effective duration of any asset/liability. This option was embedded even in many domestic long term bonds issued by corporates or financial institutions.*

2. *There were credit enhancement mechanisms available for enhancing the rating of instruments. For instance, a strong company in the group may guarantee payment of principal and interest under an instrument to enhance the rating of FRN. However, with increase in rating, the spread associated with return was likely to drop. For example, the spread on the FRN may come down from 1.85 to 1.50 per cent over six months' LIBOR.*

3. *The Investment Bank Ltd. enjoyed a line of credit from a local insurance company under which a fixed interest rate three-year loan denominated in the local currency and equivalent to USD10 million could be availed of from a certain date of choice.*

4. *Complete match funding as required by RBI can be ensured with the help of a suitable cross-currency swap deal, also to be offered by Salomon Brothers Asia.*

Examine how Mr. Chatterton should structure the deal and the balance sheet of the foreign office in order to meet the apparently conflicting requirements of the Central Banks of the two countries. Also, how to ensure that Salomon Brothers Asia can stand as a counter-party to Investment Bank Ltd. (Indian risk is to be avoided through a suitably structured mechanism).

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NUGGET 19

SMART BANK LTD.

Innovative Structuring to Maximise Shareholder Value

Following the testing of nuclear devices by a country, some powerful donor countries slapped on it a variety of economic and trade sanctions. In order to boost the flow of foreign exchange into the country and give a favourable signal to the global community as well as the international rating agencies, the government of the country decided to issue a medium term bond denominated in US Dollars and sell the same to non-residents of the country employed abroad. The government mandated a leading financial entity of the country, the Smart Bank Ltd., to work out the whole gamut of activities for this purpose.

Some of the key facts to be noted were:

1. *A survey of such international bond offerings indicated that a standard tenure for the bonds could be sixty months, i.e. five years.*
2. *The country's sovereign rating was downgraded in the recent past by one notch. A trend analysis of the recent debt offerings denominated in US Dollars in the international market indicated the correlation between coupon rates and the ratings of the papers. A small push-up on this benchmark rate might be called for to ensure smooth sailing in the face of the recent downturn in the sentiment of prospective investors with respect to the country's economic future.*
3. *The international investment bankers, who were asked to submit their bids for the job were unanimous in that the successful marketing of the bonds would depend on hedging of the associated market risks effectively. As the bonds were to be denominated in repatriable US Dollars, there should either be considerable avenues for investments in foreign currency or adequate guarantee/cover to take care of the exchange fluctuation risk.*

4. *There were quite a few existing papers issued by the country and its nationalised entities in foreign markets at fine rates prior to the post-nuclear testing situation. Due to a sudden shift in people's perception about the country's rating and economic future, these papers, marketed at much better prices earlier, were quoting at substantial discounts to their face values and there was a distinct selling pressure as well. Booking such assets at much-below-par prices might provide complete hedge against the foreign exchange rates, besides providing a considerably higher yield to match the possible high cost of raising funds in an adverse situation.*

5. *In case the US Dollars were to be swapped—at least in part—with the domestic currency of the country, the huge inflow of additional funds generated thereby would require to be managed efficiently by the monetary authorities. Besides, such funds would have to be channelised into proper investment requirements and not used for meeting budgetary shortfalls. But, the commercial banks had problems in undertaking long-term investments because of assets-liability mismatch and the large investments were mostly in the infrastructure sector, which were long-term in nature. Thus, some innovative arrangement was needed if commercial banks were to handle the swapped funds.*

6. *The government owed substantial payments to the nationalised oil companies and towards this end it had issued non-tradable bonds against which the oil companies wanted to borrow in part at special concessional rates from the commercial banks. The government was willing to tie up this facility, with the swapping facility, likely to be offered against the proposed foreign currency bonds.*

Head of the treasury department of Smart Bank Ltd. took note of the above and also took into account the following key factors:

a. *One US Dollar bond of sixty month tenure carrying a slightly higher rate of interest may be structured. Both cumulative and non-cumulative (Annual Interest Payment) options may be considered.*

b. *The foreign currency fund raised may be used partly to acquire foreign currency assets issued by the country's sovereign/quasi-sovereign issuers, with residual maturity of similar duration.*

c. *The balance amount may be swapped by the monetary authorities into domestic currency funds, at a special rate, part of which may be used to lend to the oil companies at concessional rates. The rest may be used to fund a long-term infrastructure project against a specially crafted take-out financing structure with the governmental agency for infrastructural lending.*

d. *The inflow of such huge amounts of money into the system would cause imbalances which the monetary authorities may like to rectify by resorting to Open Market Operations (OMO). The interest rates would have a tendency to soften, which would boost the commercial bank's gains from investments in gilt-edged securities. At the same time, the net interest income of the banks may take a knock on this count.*

e. *A global investment bank may be appointed on the basis of competitive bidding and a string of marketing agents may be recruited to maximise the interest in the bonds.*

Given the problems faced by the concerned country, evaluate critically whether the thinking of the head of the treasury department of Smart Bank Ltd. is in the right direction.

NUGGET 20

INTERNATIONAL AIRLINES LTD.

Structured Deals using Credit Enhancement and Negative Correlation

International Airlines Ltd., the international carrier of a country, had a fleet that was quite old. It wanted to replenish its assets substantially and towards this end required about USD1 billion for the acquisition of new aircraft. However, during the period that the company was considering this modernisation proposal, it was confronted with a severe resource crunch. One international rating agency had downgraded the country's sovereign rating by two notches to Ba2. This had put International Airlines Ltd. into a tight spot vis-a-vis the international financial markets.

International Airlines Ltd. had, over the years, developed an international flight network and it had foreign exchange earnings of about USD 25 million per month. The operational department had reviewed the problems being faced due to the age of the aircraft and could convince the Board that renewal of its fleet was a sine qua non from overall operational consideration. The finance department was, however, in no position to shell out the amount required for acquisition of new aircraft. They were also extremely concerned about the uncertainty involving fuel prices, which constituted the largest component of cost for them. They did not mind bearing a higher cost on account of finance charges provided the fuel cost did not go out of reach.

A consultant was appointed to recommend a cost effective approach to fund the acquisition of new aircraft. He had obtained the following additional information in this connection:

1. *Findings of an independent study, based on extensive dialogue with important syndication managers located mostly in Hong Kong and London, showed that given the country rating , raising of requisite resources for International Airlines Ltd. from the global financial markets appeared impossible unless some of*

mechanism for credit enhancement could be built into the system.

2. *The large and unforeseeable fluctuation in the price of petrol was a source of risk for International Airlines Ltd. In case the cost of fuel remained within a certain limit, the company did not even mind paying a slightly higher interest on its debts. However, if the cost of fuel moved upward beyond such a limit, the company would like to economise on its interest burden so as to ensure profitability of its operations.*

Given the above background, what are the critical issues that you would consider before deciding on how to raise the funds required by the Airlines? Examine the following aspects in particular:

- *International Airlines Ltd.'s profitability was highly sensitive to petrol prices. How can you engineer the deal so as to reduce this market risk?*
- *Under the circumstances, how can you arrange for 'credit enhancement' of debt instruments from International Airlines Ltd.? What assurance/guaranty can be offered to the provider of credit enhancement?*
- *What mechanism can you work out for building in a negative correlation between the cost of debt and the fuel cost for International Airlines Ltd.? Examine what kind of investors may like to pick up such type of securities for managing their own business risk.*

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NUGGET 21

SMART COMPANY LTD.

Funding Options to Augment Shareholder Value

Smart Company Ltd. implemented a project with the help of loan and equity in the ratio of 1.5:1. The loans were denominated in Indian Rupee and were repayable over a period of seven years with a moratorium of 1½ years. Smart Company Ltd. just completed one full year of operation and its performance was much better than what the lenders had conservatively estimated. Its entry in the market had been very timely and the demand for its products was very high. Quality of its products was good enough to attract a premium in the market. There was no delay in implementation of the project and also no cost overrun.

Smart Company Ltd.'s products had good export potential and around 60 per cent of its produce was for export. The sharp fall of the Indian Rupee (INR) against the US Dollar (USD) had further boosted the company's earnings and profit. However, in view of the major adjustment in the exchange rate of INR, the likelihood of a further sharp fall of the Indian currency has waned, particularly in the mid-term view of the analysts.

The technology for the project was state-of-the-art. But since such a technology was yet to be tested in India and the promoters were from the semi-corporate sector, the appraisal of the project was carried out by the financial institutions and banks quite conservatively, and the loans carried none-too-small spreads over the Prime Lending Rates.

The surge in inflation rate in India in the recent past, which resulted in sharp decline of the exchange rate of the INR, had led to hardening of the domestic interest rates and PLRs had started moving upwards, thereby threatening higher costs for Smart Company Ltd.'s project loans as well as its working capital facilities.

The treasury manager of Smart Company Ltd. was not clear as to what kind of financial re-engineering would be needed for his *company in order to address developments such as hardening of interest rate and reducing the possibility of the INR declining further against the USD. He had kept in view the following additional points:*

1. *The company had substantial exports, implying that it had a natural hedge against exchange fluctuations of the INR.*
2. *The company had already commissioned its project, and given its good performance, it was not impossible for it to access the foreign currency loan market. There was a substantial difference between the interest rates in the domestic and the foreign currency loan markets.*
3. *Foreign banks were quite active in the Commercial Paper (CP) market and well rated papers could command competitive pricing because this provided a good arbitraging opportunity between the call money and CP markets.*
4. *Any reduction in the weighted-average cost for funding the project would be welcome even by the existing lenders and they might be interested in quoting rates for foreign currency loans and Commercial Papers.*
5. *There was a growing trend among banks to offer foreign currency short-term loans even for replacing part of working capital facilities. For exporters in particular, PCFC (Packing Credit in Foreign Currency) loans for pre-shipment finance were available as an alternative to the INR denominated export packing credit finance. A selection between these two facilities could be carried out to optimise gains by monitoring the movement of the forward premium in the foreign exchange market.*

Given its performance, profitability, demand for products in the market, level of technology deployed and last but not the least, a strong balance sheet, the company expected a good rating in the short as well as medium term.

What will be your advice to the treasury manager?

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NUGGET 22

GIANT COMPANY LTD.

Restructuring through Debt-Equity Swap

Giant Co. Ltd. had a dozen subsidiaries with diverse profitability patterns and varying infrastructure. Four of them had accumulated losses in their balance sheets. Prices of quite a few of the other subsidiaries were regulated by the government, though there were indications that pricing of products would be deregulated shortly..

The company had been taking care of the funding needs of its subsidiaries in the pre-liberalisation era through accessing capital markets, including the external ones. However, following liberalisation, the subsidiaries were increasingly coming under pressure to meet their funding requirements on their own. The four loss-making subsidiaries were not in a position to raise funds on the strength of their own balance sheets. Moreover, there was the possibility of their being referred to BIFR unless some capital restructuring could be done immediately. The debt:equity ratios of these four subsidiaries were obviously over-extended. The other eight subsidiaries did not, however, have such problems and together, they had far less borrowings as compared to what their balance sheets could accommodate.

The accumulated losses in the balance sheets of the four loss-making subsidiaries aggregated Rs 720 crore. The total loan and equity held in these four subsidiaries by Giant Co. Ltd. were Rs 800 crore and Rs 400 crore, respectively. The other eight subsidiaries had aggregate loan and equity to the tune of Rs 200 crore and Rs 800 crore respectively. Giant could grant a one-time waiver of Rs 300 crore towards adjustment of the losses accumulated by the loss-making subsidiaries. But, it was not in a position to grant any additional fund for restructuring.

The folowing additional information is available:

1. *Consequent upon the proposed waiver of loan to the extent of Rs 300 crore, the loans outstanding in the books of the four*

loss-making subsidiaries would stand reduced to Rs 500 crore. The equity amount would continue to be Rs 400 crore.

2. *The net losses in the books of these subsidiaries, after the waiver, would stand at Rs 420 crore. Thus augmentation of equity was required in order to ensure that they are not referred to BIFR.*

3. *The eight profit making subsidiaries were in the pink of health and had enough leveraging capacity as on date. The loan and equity in their balance sheets stood at Rs 200 crore and Rs 800 crore respectively.*

4. *Consequent upon price deregulation, all the subsidiaries were expected to operate on profitable lines. Besides, as a sequel to capital restructuring, the subsidiaries were expected to stand on their own in so far as their additional requirement of resources was concerned.*

5. *Without changing the overall loan and equity investments to the subsidiaries in the books of Giant Co. Ltd., there was scope for debt-equity and equity-debt swaps to bring about the necessary capital restructuring in the balance sheets of its dozen subsidiaries.*

What capital restructuring proposal would you suggest for Giant and its subsidiaries?

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NUGGET 23

RADIANT COMPANY LTD.

Project Funding Option to Maximise Shareholder Value

Radiant Company Ltd. was a very large and reputed joint venture company in northern India. It had been in existence for about 35 years, but, in this short span, it had been able to accomplish extensive forward and backward integration in its production facilities. It was able to emerge as the most dominant Indian player in all areas of its operations. As a matter of fact, it had all the characteristics of a true global player. Its foreign partner, who had been a regular provider of technology, also enjoyed the reputation of being a very strong and technology-driven market leader in its areas of operation.

Economies of scale, lower vulnerability to fluctuation of prices of intermediate products, ability to book large margins of profit through presence in the retail market and a strong brand image made Radiant a formidable leader in its chosen areas of operation. Small players were indeed wary of this giant and tried to stay clear of its course.

The company had finalised its plans for embarking upon its latest project, which would cost nearly Rs 5000 crore, i.e., about USD l billion, and the company proposed to fund it with a project debt: equity ratio of 1:1. The debt component of around USD 500 million had been tied up, almost in full, with an attractively priced foreign currency loan of USD 250 million syndicated by a consortium of international lenders and the balance amount sanctioned in Indian Rupees by the Financial Institutions by way of long-term project loans. The equity component was planned to be garnered out of internal accruals worth USD 200 million and fresh raising of equity for the balance amount.

At the time the project was being planned, the domestic equity market was passing through a phase of prolonged depression and the possibility of an early revival looked remote. The company's *share was quoting at Rs 480, which was a little less than the intrinsic worth of its equity as computed by its promoters and merchant bankers. It was also estimated that in case the company proposed to come up with a fresh issue of equity shares in the domestic market, it would be required to offer the fresh shares at a discount to the market price of Rs 480 in order to ensure that an issue of the size of nearly Rs 1500 crore could be pushed through comfortably. The apprehension that the shares would need to be offered at a discount to the market price prompted the management to decide that no fresh issue of shares would be made to fund the new project. As an alternative, many, including quite a few global investment bankers, strongly recommended that Radiant should opt for a GDR issue.*

The following information is relevant to evaluating the GDR route.

1. *In case Radient proposed to go ahead with an international offering by way of a GDR issue, it might be possible for the company to price its equity shares at the prevalent market price of Rs 480 per share. International investors were not in the habit of demanding that the issue prices be at a discount to the market price, particularly if they could be convinced that the ruling price was below the intrinsic worth of the company's equity shares.*
2. *Radiant was a very strong company from the subcontinent and was a darling of the global lenders. It was well positioned in respect of all its brands in the international arena and its first ever international offering was likely to evoke a very enthusiastic response. The robust image and technological edge of its foreign partner might also facilitate such an issue.*
3. *If the issue could be made at par with the ruling market price, i.e., at Rs 480 per equity share, the amount of the GDR issue would be USD 300 million, representing 30 million fresh shares of Radiant Company Ltd. assuming that the INR/USD exchange rate is USD1 = INR 48. This was an acceptable size for an international offering. The favourable liquidity of Radiant's equity shares in the Indian bourses would also make the prospective investors feel more comfortable.*

4. *The share capital of the company consisted of 100 million shares of Rs 10 each. Of this, 70 million shares were held by the two promoters in the ratio 60:40. In other words, foreign holding accounted for 28 per cent of the company's equity. Following the issue of an additional 30 million shares on account of the proposed GDR of USD 300 million, the foreign stake in the company would go up to about 45 per cent. This stake being still below the benchmark of 51 per cent, automatic approval from RBI would do and no prior clearance from the Foreign Investment Promotion Board (FIPB) would be required.*

5. *Although extensive road shows abroad (required for the purpose of book-building) would be costly, the overall issue expenditure might be capped at a reasonable level, particularly so in case of a private placement to the Qualified Institutional Investors (QIIs).*

6. *Maximisation of value for the existing shareholders of the company would require targeting as high an EPS as possible in the post-project scenario. Thus, an issue of the least possible number of additional shares to raise the project related equity would be desirable from the point of view of the company's existing shareholders.*

7. *For a company of the size and strength of Radiant, creating a large investor base internationally made a lot of sense. Moreover, with the strength of its balance sheet and its infrastructure, it might, with some amount of extra effort, comply with the requirements of the globally accepted accounting principles. This would enable Radiant to go ahead with a full-fledged GDR issue, rather than adopting the private placement route being followed so far by most Indian entities accessing the global financial markets. Such a process would provide the company with a wide investor base abroad and establish its brand image more firmly in the global markets, both of which would be of immense help at the time of future fund raisings by the company.*

How do you assess this option? ■■

NUGGET 24

SANKAR WONDERS LTD. (SWL)

Restructuring for Turnaround Strategy

Sankar Wonders Ltd. (SWL), a manufacturer of wheels for all varieties of commercial vehicles, was a company of long standing. It was set up nearly half a century ago by a famous engineering company in India with joint venture participation from a U.K. based engineering firm. Although, the domestic promoter held around 25 per cent stake in the company as against the foreign promoter's stake of nearly 35 per cent, the former was, for all practical purposes, considered to be the chief promoter of the joint venture company.

From its very inception, the joint venture company's performance was far from satisfactory. However, until 1993, it could earn some marginal profit. But, since 1994, SWL had continuously been incurring losses. The main reasons leading to such losses could be identified as:

1. *Dependence on imported basic raw materials resulted in high cost on account of high customs duty and decline in the exchange value of the Indian Rupee. Consequently, raw material cost accounted for between 60 to 70 per cent of the sale value of production during the period 1988-93.*
2. *Negligible investment in replacement of machinery during 1988-93: There was negligible addition to the plant and machinery except in 1989. This was in spite of breakdowns in different sections from time to time.*
3. *High cost of operations: The cost of production was between 80 to 90 per cent of the sale value during the period 1988-93. Since 1994, the contribution had ranged between 10 to 18 per cent of the sale value.*
4. *Poor labour management resulting not only in low productivity but also in excess manning: From 1988-93, maximum capacity utilisation was only 55 per cent. On the other hand, the cost of*

labour was proportionately higher, and salary and wages accounted for between 13 and 17 per cent of sales for the same period. This position was further aggravated by labour militancy, which even resulted in a lockout in 1998.

5. *Rate of rejection was above the normal level: Technological improvement to bring this rate down had been rather insignificant.*

6. *Till 1993, SWL was among the three major producers of its products and its market share remained more or less steady at about 20 per cent. However, with liberalisation gaining momentum, an increasing number of foreign companies had set up facilities in India and import of components as well as technology had become easier. Non-servicing of important segments such as cars had led to decline in the market share of SWL. As a matter of fact, SWL's sales had stagnated in the recent past whereas its competitors had been able to record an annual growth rate of 10 per cent.*

7. *Persistent losses eroded the net worth of the company and SWL had to make a reference to BIFR in 1993 for adoption of a suitable revival plan for its rehabilitation. While declaring the company sick under SICA, BIFR observed that it would not be able to turnaround its position on its own within a reasonable period of time. Accordingly, BIFR appointed IIBI as the operating agency for assessing the viability of SWL and preparing a rehabilitation package for it. IIBI found out, from its joint meeting with the existing lenders of SWL, that the FIs and banks wanted SWL to be merged with its Indian promoter—Sankar Enterprises Ltd. IIBI took note of this unanimous view and worked out the details of such a scheme for a merger, which was finally cleared by BIFR. The scheme approved by BIFR provided for the following:*

   a. *SWL would be merged with the Indian promoter and the share swap ratio would be 8:1.*

   b. *To overcome over-dependence on imports, alternative indigenous sources for supply of raw materials would be* *tapped. This would help bring down the raw material cost as a percentage of the cost of sales.*

c. *Rationalisation of work force was to be achieved by offering Voluntary Retirement Scheme (VRS) to about 250 employees.*

d. *Existing machines were to be overhauled and a few new machines were to be added in order to upgrade the technology.*

e. *The existing lenders, both banks and financial institutions, had agreed to offer the standard package of reliefs and concessions to SWL.*

f. *The total project cost of the revival package came to about Rs 20 crore of which the existing lenders agreed to fund 60 per cent provided that the promoter company agreed to contribute the balance amount.*

g. *The trade union representing the workers of SWL agreed not to press for increase in salary/wages for the next three years and also to maintain a decent standard of productivity.*

h. *SWL would break-even from the third year and overdue loans from the existing lenders would be repaid over a period of* $6^1/_2$ *years thereafter.*

i. *The usual concessions allowed by the Central as well as the State Government including exemption under the IT Act would be available to SWL as a part of the package.*

j. *The foreign partner agreed to the entire arrangement. It also sought and obtained necessary approval for sale of the shares to be allotted to it by the Indian promoter company in the market and to repatriate the proceeds thereof.*

Analysts found the proposal generally satisfactory in view of the following:

(i) *The merger with the promoter company with strong financials would make the overall debt/equity position comfortable, thereby facilitating timely flow of funds required for rehabilitation.*

(ii) The additional loans/liabilities would come to the promoter company's balance sheet at reduced cost and with a good deal of reliefs and concessions. They were properly re-phased as well. This would give the much needed breathing time for the turnaround strategy to work.

(iii) The benefits of accumulated losses under the IT Act would allow the promoter company to save some money; this would be available for meeting the requirements of the sick division.

(iv) Impact of temporary adverse development during the period of rehabilitation could be withstood because of the strength of the parent company.

(v) Improved risk perception following the merger would allow the suppliers and clients to continue their existing arrangements with SWL.

What are the possible gains of such a revival package for the investors of SWL?

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NUGGET 25

OIL AND GAS LTD. (OGL)

Innovative Structure to Maximise Shareholder Value

Oil and Gas Ltd. (OGL) was a blue-chip public sector company which had registered a steady growth over the years and had always carried out operations on commercial lines. It was a professionally managed company with skilled manpower and a forward looking policy framework. Since the time of its inception, it had been actively negotiating deals in the global market and hence could adapt itself to the changing international scenario. It was considered one of the strongest corporates, with the skill to take on the toughest possible competition from various multinational giants.

The company had regularly upgraded its technology and skill, and maximised its gains through optimum utilisation of its resources. Large international deals, both in the spot and forward segments of the financial and commodity markets, had also yielded good dividends through smart analysis of the market movements and appropriate timing of such deals by the company. Its short-term and long-term funds management had been the envy of many corporates. Also, proper and timely adjustments in the composition of its multi-currency portfolio of funds, required for its international operations, garnered substantial gains for its pro-active treasury. With regard to product processing and distribution, the company was strategically placed as a result of meticulous planning of its operations over the years.

OLG was deservedly considered as a jewel in the crown of the corporate world. Although there were many suitors, the government was reluctant to dilute its holding for diverse political and strategic reasons. However, with strong winds of liberalisation sweeping the entire world, priorities were changing and it was becoming difficult for the government to continue to meet the growing needs of this blue-eyed corporate out of budgetary support alone. So, an "equity carveout" in respect of OGL was on the cards and a GDR/

ADR issue at an appropriate price was being considered to achieve this objective.

Some of the considerations relating to this proposal were as follows:

1. *A company of the size and nature of OGL should be allowed to implement its strategies for keeping pace with the latest technology and requirements of the market. Such a corporate could not be allowed to suffer for dearth of resources. This was particularly so against the background of changed governmental priorities which did not allow large scale infusion of budgetary funds into a company, indicating the need to search for other options for meeting the long-term fund requirements of OGL. The proposal to examine the equity carveout for OGL was an outcome of such a viewpoint.*
2. *OGL, being a blue-chip and virtually an Indian multinational, should get proper pricing for its equity offer and the quantum of its requirements justified a large and well-informed set of investors with very deep pockets.*
3. *While the practice in the domestic capital market was to expect a price at a discount to the market price of the issuer's equity shares, global markets were ready to take such shares even at a premium to the market price provided the investors could be convinced about the company's growth potential.*
4. *The company could go in for a suitable GDR/ADR issue to garner a handsome amount, and various international investment bankers of repute were extremely bullish about such an issue. However, the political uncertainty dogging the country, the border skirmishes, the prolonged depression in the domestic stock prices and the extreme volatility marking the Indian Rupee/US Dollar rate, all conjured to suggest a defensive pricing strategy for the time being. This was obviously not to the liking of OGL and the government. But, they two were hesitant to take the plunge with an aggressive pricing in the light of past bitter experiences.*

5. *RBI was earlier against permitting any Indian entity to issue Foreign Currency Convertible Bonds (FCCB) in the international markets inasmuch as such an instrument added to the country's external liabilities until it was actually converted to equity/GDR. However, amidst such high level uncertainties prevailing in both the capital and foreign exchange markets, RBI had very prudently relaxed this restriction and decided to allow, on a selective basis, Indian entities to access the FCCB route. This was a defensive strategy suitable for extracting a decent bargain from the potential investors in a bad market scenario by offering them the much sought after hedging options.*

6. *Since FCCBs were part of the country's external liabilities, their maturity profile needed to conform to the guidelines governing External Commercial Borrowings (ECB). The ECB guidelines stipulated that any small loan (up to USD 15 million) must have an average maturity period of not less than three years and other loans (above USD 15 million) of not less than seven years. FCCBs needed to be issued in line with these guidelines with the conversion date(s) specified at appropriate point(s) of time depending on certain milestones for performance/project implementation, etc.*

How do you view such a proposal?

NUGGET 26

KMP FINANCE AND MERCHANT BANKERS LTD.

Split-up to Maximise Shareholder Value

KMP Finance and Merchant bankers Ltd. was a large non-banking finance company which had a role in both fund-based and non-fund based activities. It had assiduously built up a large portfolio of lease and hire-purchase assets of excellent quality. It was also fairly active in the area of merchant banking and was associated with a good number of issue management assignments in the capacity of 'Lead Manager'. Besides, it had cards in the BSE, NSE and CSE.

Following the infamous capital market scandal, regulators ruled that no NBFC would be allowed to carry out both fund-based and fee-based activities. In other words, lease and hire purchase activity must be completely segregated from merchant banking. Merchant bankers had also been debarred from undertaking securities broking. This too had sharply divided the areas of control between SEBI and RBI. Companies with fund-based activities and eligible to raise public deposits came under the purview of only RBI now, while those engaging in merchant banking or securities broking activities came entirely under the supervision of SEBI.

The prolonged depression in the primary equity market, coupled with the above guidelines had seen the demise of many less active merchant bankers.

The management of KMP Finance and Merchant Bankers Ltd. was wondering what strategy it could adopt to reposition itself under the new regulatory regime. Some of the factors that were taken into account for this purpose were:

1. *KMP had both fund and non-fund based activities under its fold, and it had been successful to a fair measure in the area of Lease and Hire Purchase as well as Merchant Banking. It had also built up an attractive portfolio of assets with a low rate of NPA.*

2. *KMP had the wherewithal to go in for fresh lease and hire purchase business and there was no reason for it to give up this activity altogether. So, KMP Finance and Merchant Bankers Ltd. could be split into KMP Finance Ltd., KMP Merchant Bankers Ltd., and KMP Securities Ltd. The first company could take over all existing assets and deposits. It could also continue to book fresh lease and hire purchase/investment business. The second company could, on the other hand, pursue the merchant banking activities. The securities broking activity could be taken up by the third Company.*

3. *The Finance Company could get itself registered with RBI and rated by an approved agency for the purpose of raising public deposits. The Merchant Banking Company could, on the other hand, get itself registered with SEBI. The Securities Broking arm of KMP could also get itself registered likewise.*

4. *The leasing and hire purchase outfit could step up its operations and go for large volume infrastructure deals. For this, it could even take a foreign joint venture partner with FDI inflow. The norms governing such FDIs in the finance sector were as follows:*

a. *For up to 51 per cent foreign equity participation, the minimum capitalisation must be USD 0.5 million.*

b. *For foreign equity above 51 per cent but up to 75 per cent, minimum capitalisation must be USD 5 million.*

c. *For foreign equity above 75 per cent, minimum capitalisation must be USD 50 million.*

5. *The securities broking arm could also tie up with some foreign firms for carrying out work on their behalf.*

6. *Subsequently SEBI relaxed the norms and also allowed merchant banking outfits to undertake securities trading. Accordingly, one could even consider merging the securities broking arm with the merchant banking company with a view to achieving a greater degree of synergy of operations.*

7. *Prudential norms for asset classification, income booking and provisioning should be strictly adhered to as per the extant guidelines. Liquidity as required by the guidelines must be provided for and rating should always be gone in for wherever needed. Portfolio of securities should be marked to market as per the guidelines and proper care must be taken to avoid market related risks as far as possible.*

What would you recommend?

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NUGGET 27

EXPORT IMPORT COMPANY LTD.

Financial Derivative to Maximise Shareholder Value

Export Import Company Ltd. was a large-sized listed company with its registered office in western India. The company had been in existence for more than 50 years and enjoyed a track record of steady growth in operations as well as uninterrupted profit and dividend payment. Over the last decade or so it had given a sustained thrust for promotion of exports and accessed the facilities offered by Export Import Bank of India for this purpose. Its efforts had met with great success and its export turnover had, of late, increased manifold. The exports were primarily to the USA and all the export bills drawn by the company were denominated in US Dollars.

Encouraged by the spurt in export turnover, the company had gone in for modernisation of its production facilities. It had imported state-of-the-art equipment for this purpose from Germany with the help of a suppliers' line of credit, denominated in Deutsche Mark (DM)/Euro. The instalments and interest under the loan agreement were payable semi-annually.

The company's profitability had looked up with the gradual softening of the Indian Rupee vis-à-vis the US Dollar. It was, however, extremely wary of the possible impact of exchange rate fluctuations on its loan portfolio. The company had a natural hedge on account of its regular stream of Dollar denominated inflows arising out of exports and proposed to use the outstanding balance in its EEFC A/c (Export Earners' Foreign Currency Account) for servicing the loan account denominated in DM/Euro.

The US Dollar was ruling at a high against the DM/Euro and it was likely to strengthen further. The company wanted to keep its options open for enjoying the benefit of such hardening. However, at the same time, it did not want to get hit by a possible decline in *the DM/USD exchange rate. The company was also reluctant to incur any up-front cost on account of hedging of exchange risk. To hedge such an exposure, the company was exploring what best strategy it could pursue and noted the following:*

1. *The company's objective was to hedge its foreign currency exposure arising out of the loan denominated in DM/Euro.*
2. *It had a steady income stream denominated in US Dollars on account of its exports and the balance available in its EEFC A/c was adequate to service the loan account.*
3. *It would require to peg its DM/USD or Euro/USD rate at reasonable levels over the life of the loan.*
4. *The USD had become strong against the DM/Euro. But the company would not like to lose the opportunity arising out of possible hardening of the USD beyond the current level, albeit by a small amount.*
5. *Purchasing an option would involve some up-front payment. But the company was not agreeable to incurring this expense.*

Some of the queries which the company managers could not resolve in this regard were:

a. *What is the possible zero-cost structure that leaves enough scope for gains from limited favourable movements of the exchange rate and at the same time provides a shield against risks arising out of large adverse movements of the rate, in exchange for foregoing the opportunity to aim for 'larger than stipulated' gains.*

b. *What are the cash flow patterns from 'Range Forwards' and 'Bullish Spreads', and in what circumstances are they suitable for risk hedging?*

What would you recommend?

■■

NUGGET 28

Structured Deal to Raise Funds for a Less Developed Country

An Asian country,"I-Asia" belonged to the league of "Less Developed Countries"(LDCs). However, it was quite rich in oil (petroleum) deposits and had considerable exportable surplus in oil products. Political turmoil and uncertainty had, of late, dogged the country. Its rating was downgraded by the international rating agencies some time back. The country was in urgent need of funds for implementing a social sector project. An investment banker was appointed to structure the fund-raising deal. He carried out a preliminary study, and drew the following conclusions:

- *I-Asia was a Less Developed County that had poor sovereign rating. Raising a large chunk of fund for it from the international market in the usual manner (plain vanilla deal) might be difficult.*
- *Working out a suitable structured-finance deal and placing the debt privately with a select class of investors might be the best possible avenue for raising the requisite fund for the country. Any public issue in the global market was ruled out.*
- *The country's ability to service the periodical interest payment on time was doubtful in view of its poor performance on the economic front. However, if the interest could be denominated in terms of petrol, it would not have much difficulty in meeting its obligations. Moreover, this would mean that the country would be getting a steady price for its product on a long-term basis.*
- *Fuel cost accounted for a large portion of the operating cost of international airlines. High volatility of fuel prices had exposed them to grave risk and subjected their long-term profitability to unprecedented threat. A firm arrangement for receipt of fuel at regular intervals on a long-term basis at a pre-determined price would be very attractive to them.*

What approach do you think the investment banker should follow to structure the deal? Give your suggestions.

■■

NUGGET 29

SUNRISE COMPANY LTD.

Debt Buyback to Maximise Shareholder Value

Sunrise Company Ltd., a fast growing Indian company with a proven track record of performance and investor base, both in India and abroad, was considered by many as the first Indian Global Corporate. It had fully integrated operations and a very strong financial and marketing base.

Over the years, as the company set up large capacity plants with a view to achieving the economies of scale, it also established excellent marketing channels-both within the country and overseas. Its exports were substantial and geographically well-distributed, with a major portion going to the USA and Europe.

Following the introduction of Current Account Convertibility, GOI had permitted exporters to retain a part of their foreign exchange earnings in foreign currency in what was known as EEFC A/cs (Exchange Earner's Foreign Currency Accounts). Sunrise took advantage of this new policy and has been maintaining a good portion of its export earnings in its EEFC A/c. The company has also built up a considerable balance in the EEFC over the last few years.

For several years, sunrise had issued both GDRs and long-term bonds denominated in Foreign Currency (US Dollars, GB Pounds, Japanese Yens and Deutsche Marks). The coupon rates for such bonds had been quite competitive. For example, for USD denominated Bonds, the typical coupon rate was (six months LIBOR + 1) per cent.

Following the blast in Pokhran, sanctions were slapped on India by various developed countries and flow of foreign funds became doubtful all of a sudden. India's rating was promptly downgraded by international rating agencies and the investor confidence in global markets plummeted. Consequently, with the consequence that global offerings of equity or debt by Indian entities became well-nigh impossible, at least in the short-term. The market price for *existing Indian papers nose-dived as the spread required by the international investors on any Indian security shot up overnight, literally.*

The management of Sunrise was debating as to what positive signals it could give to the international investor community at such a juncture and how such sudden market movements in prices of its bonds can be leveraged by it to generate shareholder value. The management was aware of the following facts:

1. *The global bond issue of Sunrise was floated at a time when the perception about India risk was good. Since there is a sudden change in this risk perception in the global financial market, such bonds are quoting at lower price.*
2. *The company's performance and operating results being good, the domestic capital market was quite favourably disposed towards it. There was, however, some concern in international markets about the possible movement in the exchange value of the Indian Rupee. There was a lull in the GDR market for Indian papers and the market was looking for possible signals.*
3. *The company had considerable balance in its EEFC A/c. It had also large foreign currency balances parked abroad from out of its latest global fund- raising exercises. The central bank of the country was not too worried by the sanctions and did not want to display any signs of panic. It was likely to grant permission to Sunrise for use of its balance in EEFC A/c.*
4. *The company has the funds to buy back its existing bonds—at least a good part thereof, at a substantial discount, and thereby book a large amount of additional profit. This would give a tremendous boost to its PAT and EPS and also give a very unmistakable signal to its GDR holders abroad.*
5. *Once the market sentiment improved, which was expected to happen after some time, the company could once again access the global markets to raise fresh foreign currency debts at a better rate.*

What would be your suggestion to the Sunrise management? Explain giving reasons.

■■

NUGGET 30

PETROCHEMICALS INDIA LTD.

Credit Enhancement through Structured Deals

Petrochemicals India Ltd., a blue-chip public sector company, was well known in the global markets for its regular activities both on commodity and financial fronts. The company's exports amounted to around USD600 millions per annum (mostly to countries in Europe and the USA), and its export base had become quite stable over the years. Its import requirements were insignificant. The company had certain expansion projects in hand which were considered vital for its growth and for retaining its competitive edge

At the time of writing this case, India's sovereign rating had suffered because of the country's prolonged political uncertainty and this became an inhibiting factor with the international investors in picking up any Indian security. Besides, with the continuance of such uncertainties, flow of foreign funds into India had also been put on hold by many prospective investors. In such a situation, raising a substantial amount of foreign currency through long-term debts at reasonable rates of interest, for implementation of Petrochemical's expansion projects, appeared very difficult.

If you are appointed as an investment banker, how would you structure the deal? The following additional information and insights are available in this context:

1. *A reasonable amount of foreign currency funds raised by way of long-term debts at fine rates of interest would be quite desirable from Petrochemical's point of view. The management team believed that there would be a reasonably good demand for its debt papers if placed appropriately in the global financial market.*
2. *The latest perception about India's country risk in the international arena was not suitable for raising such debts at competitive rates unless arrangements could be made to pierce the*

sovereign rating through suitable credit enhancement mechanism.

3. *The company had substantial export earnings and its export base was quite stable. The import requirements, on the other hand, were insignificant and the net foreign exchange inflow per annum was quite handy for payment of loan installment and periodical interest thereon.*
4. *An internationally reputed bank with the highest (AAA) rating might be persuaded to add its guarantee to the debt papers of Petrochemicals India Ltd. on the basis of an "Escrow" mechanism worked out with an "Over collateralisation" (excessive inflows surpassing obligations).*

■■

NUGGET 31

COMMERCIAL BANK OF INDIA

Financial Restructuring through Asset Swap

Commercial Bank of sIndia, a scheduled bank, had its overseas office in London. It had given certain trading advances to a few firms owned by Indians settled in the UK. These firms were engaged in exporting electronic and other items to various LDCs (Less Developed countries) in Africa against Letters of Credit (LCs) opened by the local banks. The firms were not manufacturing these items, but were mere traders in items with good brand images.

The political situation of LDCs in Africa was volatile, and administration of one of them was taken over by the military. These military rulers had suspended all outflows of foreign currency from the country, but following intense pressure from various western leaders, they agreed to issue Promissory Notes covering obligations under such Letters of Credit where goods had already been received, payable over a period of twenty years with a negotiable rate of interest.

The London Branch of Commercial Bank was holding nearly USD50 million worth of such Promissory Notes, which had a rather poor reputation in the market. Each of these notes was quoted at only around 40 per cent of its face value in the "LDC Debt market". Consequently, the London Branch was required to build up suitable provisions in its books amounting to about 60 per cent of its holding of the relative debt.

Indian entities had, from time to time, privately placed foreign currency bonds abroad, some of which were guaranteed by the Government of India. When India faced a BOP (Balance of Payment) crisis, the prices of these outstanding Indian bonds suddenly nose-dived and were quoting at a discount of about 60 per cent to their face value. As a result, all foreign offices of Indian banks faced difficulty raising foreign currency funds abroad and as such, all *were asked not to book or renew any foreign currency asset until the position improved.*

Commercial Bank was aware of the precise situation in this context and was looking for an attractive option to at least partially retrieve the situation. The following points were taken note of by its management in this regard:

- *An "Asset Swap" (implying swapping of an asset with another one of the same market value) can still be put thorough by it.*
- *The Branch had USD50 million worth of NPAs, for which 60 per cent of provisions are required to be created by it out of its profit over the years. However, a swap between the Promissory Notes and the Indian Sovereign Debt Papers could immediately convert the whole of the asset, valued at USD50 million, into a performing asset. This would allow a write-back of the provisions already created by the Branch.*
- *There were global investment bankers who were active in the area of trading in "LDC Debts" and who might be willing and in a position to put through such swaps.*

As an investment banker, how would you structure the deal for augmenting shareholder value?

■■

NUGGET 32

WESTERN INDUSTRIES LTD.

Exchange Risk Management to Enhance Shareholder Value

Western Industries Ltd. was a blue-chip private sector company with equity participation from IFC Washington. It was a listed company from western India with a long track record of profitability and dividend payment. It was sanctioned a medium-term loan denominated in Japanese Yen by the Export Import Bank of Japan for import of equipment for modernisation of its manufacturing facilities. The amount of loan was equivalent to US Dollars 100 million.

The company was happy with the low interest rate charged on the Japanese Yen loan. But prior to disbursement of the loan, the Japanese Yen was on a roller-coaster ride against the US Dollar and the company was anxious about the Yen hitting a trough vis-à-vis the Dollar on the dates of loan disbursement.

The company was examining the options available to it to contain the risk arising out of the fluctuating USD/JPY exchange rate. It had taken into consideration the following points:

1. *Although the Japanese Yen was passing through a bearish phase, the forward Yen was still at a premium compared to the spot, on account of interest rate differential.*
2. *The Japanese Yen/US Dollar exchange rate was characterised by marked volatility. It was possible to keep a close watch on the movement of this rate and sell forward Yen against the US Dollar at crests or on the upswing and then unwind the position, if necessary, at troughs or on the downswing to book handsome gains. Such gains could create a cushion against the exchange fluctuation risk faced by the company.*
3. *The company could even work out the levels or ranges at which it would like to enter into or get out of specific foreign exchange deals. Such levels could then be left with a selected*

authorised dealer with orders to buy/sell specified amounts whenever such pre-determined levels were either reached or breached.

4. *If the precise dates of disbursement were known beforehand, forward sale contracts for Japanese Yen against the US Dollar might be entered into with authorised dealers so as to match the value dates with the dates of disbursement, provided of course, the rates were not adverse on the dates of booking the forward contracts.*

What course of action would you recommend?

NUGGET 33

SOUND ENGINEERS LTD.

Turnaround through Financial and Business Re-engineering

Sound Engineers Ltd. was a multi-divisional PSU, which had been in existence over a long period. It had five divisions and some subsidiaries. Its paid-up capital as on date was Rs 50 crore.

Two of the company's divisions viz. D1 and D2 had not been performing well and its overall performance had taken a plunge in the last few years. This had considerably eroded its net worth and stretched its Total Outside Liability/Tangible Net Worth ratio. The lenders and other creditors sought an urgent infusion of capital into the company. The primary market for equity was unduly depressed and the company's shares had been showing a downward trend. Being listed in the Stock Exchanges, there was the possibility that preferential allotment of shares to the promoter, i.e., GOI might attract SEBI's guidelines unless the company succeeded in obtaining special dispensation from the Regulator.

D1 and D2 were not self-sustaining in nature. D1, however, had a modern plant with some imported machinery. The products from D1 were not yet in great demand in the Indian markets. But the chances of an increase in their demand in the near future were bright. In the short run, it had some export potential and support from one of the international giants in this area of operations appeared a distinct possibility. A technical tie-up with one such international player would also help in constant upgradation of the division's production facilities.

D2 was an old division which badly needed to be modernised in order to with stand competition and become viable. Modernisation required infusion of both technology and capital into the division. The management also felt the need for support from an able partner in order to make the project viable.

GOI had, from time, to time extended plan loan assistance to the company, which together with interest thereon, had become very substantial. The working capital loan accounts with various banks had also become irregular and most of these were no longer operational. Conversion of these irregularities into working capital term loans and release of full working capital limits would require either infusion of funds or extension of guarantee by GOI.

The severe cash crunch did not allow Sound Engineers to pay suppliers on time and consequently they loaded interest on account of delayed payment by way of additional cost on raw materials. Delay in supply occasionally affected the production cycle.

A study carried out by an internal restructuring group revealed the following facts:

a. *The company's bankers were not willing to give it further working capital facilities. Sound Engineers had submitted prima-facie projections to the lenders, which were not acceptable to them as they perceived these to be over-optimistic. The projections would hence need to be independently validated.*
b. *While examining the projections, it was found that mere financial restructuring would not take care of the problems facing Sound Engineers. A business restructuring was also called for on an urgent basis.*
c. *Long-term viability of the two divisions—D1 and D2—on "as is where is" basis was not proven. Without infusion of technology and long-term financial inflows/global marketing support, these divisions would not be able to operate profitably. GOI was agreeable to allowing joint venture participation up to 74 per cent by suitable domestic/multinational companies.*
d. *Sound required infusion of additional funds by way of equity at least to the tune of Rs 50 crore. In an extremely bad primary market, subscription from public, even at par, was ruled out. The other (non-promoter) existing shareholders too were not expected to pick up their entitlements under a Rights Issue. Preferential allotment to GOI was ruled out in falling market in*

view of SEBI's relevant guidelines regarding price of such a placement.

You are advised to respond to the following queries:

1. *What restructuring plan would you like to suggest for the company?*
2. *What kind of organisation restructuring would you recommend and what process would you follow to achieve this end?*
3. *What course of action would you suggest to improve Sound's debt/equity gearing?*
4. *Considering that GOI was not in a position to infuse any additional loan, how would you de-freeze the working capital loan accounts so that the company can function normally? Also, how do you propose to reschedule the dues, particularly the existing loans from GOI and the interest overdue thereon? Assume the aggregate overdues in loan accounts to be Rs 60 crore.*
5. *With business restructuring, some rationalisation of manpower will also be required. What kind of support would you look for from GOI for this purpose?*

While responding to the above, you can assume the following:

A. *That the profitable divisions, if allowed to function smoothly can generate a net surplus adequate to service the existing term liabilities as also an additional sum of Rs 60 crore with a reasonable Debt Service Coverage Ratio within a time span of six/seven years.*

B. *That the existing working capital facilities, after transfer of overdue therefrom to working capital term loan accounts, are adequate for smooth functioning of Sound Engineering Ltd. in the post-restructuring phase.*

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NUGGET 34

BEHEMOTH INDUSTRIES LTD.

Restructuring through Financial and Business Re-engineering

Behemoth Industries Ltd. was a PSU which had been in existence for many years. It had a number of manufacturing units at various centres and a very large number of employees. For several years the company had been incurring losses and the huge accumulated losses in Behemoth Industries' balance sheet were primarily supported by budgetary inflows by way of loans and interest thereon. These loans were not serviced for quite some time and as a result, the debt/equity ratio of the company was extended.

Over the years, order flow to Behemoth Industries Ltd. had dwindled, rendering a large part of the work force surplus. However, a section of the manpower was skilled enough to diversify into related areas and it was felt by the management that such a diversification, if possible, would help absorb some of the excess employees.

Behemoth had executed work worth nearly Rs100 crore for a department of the Government of India (GOI), for which it did not get payment. The company requested the latter to adjust this receivable against its outstanding loan as well as interest that was pending for some time. The GOI was apparently not averse to such a course of action. Moreover, payment on account of an overseas job executed on behalf of GOI (Project Export) had remained unpaid for nearly three and a half years. This resulted in the company losing around Rs 50 crore towards interest on account of delayed payment as well as depreciation in the exchange parity of the Indian Rupee.

The working capital loan given by a consortium of banks to Behemoth had already become irregular for obvious reasons and a sum of Rs 50 crore needed to be converted into working capital term loan in order to ensure that Behemoth could operate the *account. However the banks were not ready to allow free operations in the account without GOI guaranty as the account would otherwise be classified as NPA.*

Behemoth was fairly clear about the following:

1. *GOI would be ready to prune down its outstanding loan and interest by Rs 100 crore towards adjustment of Behemoth's unrealised receivables.*
2. *GOI seemed to be agreeable in principle to allow a one time write-off of its dues towards adjustment of Behemoth's cumulative losses. Thus, a reduction of outstanding loan and interest from GOI to the time of Rs 500 crore might be feasible.*
3. *The operating limit in Behemoth's working capital loan accounts was Rs 100 crore; GOI's guaranty was required in order to persuade the banks to continue the facilities.*
4. *The working capital term loan of Rs 50 crore and other liabilities could not be serviced by Behemoth within the reasonable period unless 500 persons were given voluntary retirement (VR) right away. The VR package, if designed attractively as per guidelines declared by the Finance Minister in the 1998-99 budget, was likely to be accepted by 500 employees on account of its improved terms.*
5. *Even after the above adjustments, a cash shortfall of Rs 70 crore would remain. Since shares of Behemoth were not listed at the Exchanges, GOI might even infuse budgetary funds into it in the form of equity, to be issued at par.*
6. *After adjustment/extension of a substantial sum of GOI loan, the debt/equity ratio would still not be up to the mark and infusion of long-term funds in the form of capital would be required.*
7. *The diversification proposal contemplated by Behemoth would require infusion of further long-term funds worth Rs 50 crore. However, this could be serviced only after five years, which was the period required for repayment of the existing liabilities and the working capital term loan.*

8. *GOI could be requested to waive, as a special case, the commission payable by Behemoth on account of the guaranty worth Rs 100 crore to be issued on their behalf by GOI to enable them to avail of working capital facilities.*

How would you restructure Behemoth Industries Ltd. to make its operations viable?

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PART III

CORPORATE RESTRUCTURING: ETHICAL CONSIDERATIONS

CHAPTER

8

Corporate Restructuring and Ethical Considerations

8.1 Introduction

Corporate restructuring, while it can translate into benefits for certain groups of stakeholders, can also adversely affect some others. Table 8.1 lists the different types of decisions or actions that may be involved during the pre-restructuring and post-restructuring phases and indicates the nature of outcome in each case as may be applicable to different groups of stakeholders. Though the list is not exhaustive, these decisions cover a wide spectrum of issues relating to corporate restructuring as experienced in India during the first five years of reforms. The examples illustrate the kind of decisions where ethical issues were involved. A case in point is the takeover of the second largest soap and detergent company by the Indian subsidiary of the Unilever Group, which itself is the largest company in the same business, being perceived by many as an effort to limit competition. The same undertaking has also been charged by Securities & Exchange Board of India for indulging in insider trading prior to its announcement to merge with another Unilever subsidiary in India. Similarly, Indian associate of British American Tobacco (BAT) allegedly undertook a number of corporate restructuring decisions such as entering into new business areas, buying up shares of overseas subsidiary, building export revenue, etc., that apparently amounted to breach of accepted ethical and various corporate governance procedures. In another case, a large blue-chip company, controlled by a non-resident Indian businessman, took loans under inter-corporate deposit scheme at a very high interest rate and then siphoned off the same to a number of small companies controlled by the said promoter at lower interest. Attempts are also being made by this group to restructure its activities through selling businesses and assets which many perceive is not being done in compliance with the ethical standards in force. The Indian Takeover Code had to be revised twice to protect minority shareholders' interests. Cases of asset stripping, faulty and incomplete disclosure, poor treatment of acquired company staff have also come to light in a number of instances.

As illustrated in Table 8.1, most corporate restructuring decisions that translate into benefits for some people, invariably end up harming some others. While accepting the inevitability of such an outcome, it needs to be stressed that every effort must be made to address the "moral" problem of causing harm to others in a manner that gives them no say in the matter. Moral problems, defined as causing harm to others in a way that renders them helpless, are now considered important in any discourse on managerial ethics[26]. What, however, should be strived for is to evolve an approach that will minimise, if not totally eliminate, the harmful effects of corporate restructuring, while at the same time retaining the majority of the beneficial effects to whatever extent feasible. The approach developed should be robust enough to withstand the test of time, culture, country and religion, and should be objective so that it can be built into the strategic decision-making processes of the firm.

8.2 Significance of Ethical Principles in Corporate Restructuring

Ethical principles enable organisations and individuals to assess objectively the fairness of decisions taken by them i.e. whether they are likely to cause harm to others (while simultaneously

Table 8.1 *Harmful and Beneficial Effects of Corporate Restructuring Decisions: Some Examples*

Corporate Restructuring Decisions in the areas of Mergers, Acquisitions and Divestment	*Harmful effects*		*Beneficial effects*	
	Type	*On whom*	*Type*	*For whom*
I Pre-Restructuring (a) Decision to acquire major competitor(s)	Limit competition	Consumers/customers	Enhanced market power, more profit	Acquiring company & its shareholders
(b) Actions taken to maximise shareholder value (through acquisition/divestment)	Lower benefit or gain	Other stakeholders	Return on shareholder funds	Shareholders of the acquiring firm
(c) Share price manipulation to reduce cost of takeover	Lower returns	Shareholders of acquired firm	Lower cost of acquisition	Acquiring company/individual bidder
(d) Access to certain special information on target company that is	Unequal opportunity	Bidders who do not have access to internal information	Lower cost of acquisition and ability to evaluate target	Bidder with access to special information

(*Contd.*) →

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not available openly				
(e) Preferential allotment of shares to promoter gro-up at less than market price	Lower cash flow	Company in general and other shareholders	Increased control at lower cost	Owner/promoter group
(f) Inadequate/faulty disclosure and at the same time making false promises	High risk and/or low return	Shareholders of both acquiring and acquired company	Lower cost of restructuring and benefit during post-restructuring	Promoter group/management
(g) Acquisition of companies that employ child labour, follow illegal labour practices, etc. with a view to reduce overall cost of operation	Continuation/support of unethical practices	Employees of the acquired companies	Lower cost of operation	Acquiring company and its shareholders
(h) Structuring the deal in a manner that involves illegal payment	Low returns	Minority shareholders of target company; also government's revenue dept (by way of	Financial gain	Owner/promoter group

(Contd.) →

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		lower taxes on transaction)		
(i) Undertaking divestments without taking care of difficulties of outgoing employees	Uncertainty discomfort	Employees of divested divisions	Maximisation of shareholder value	Shareholders of divesting company
(j) Acquisition for short-term monetary gain and divestment thereafter (aim being to make some quick gains in the process) and not having any concern for "adding value" to the business of	Cultural shock	Employees of acquired company (which is divested later)	Financial gain	Promoter group/shareholders of the acquiring company

(*Contd.*) →

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II Post-Restructuring (i.e. after merger, acquisition or divestment has taken place)				
(a) Large scale retrenchment	Loss of employment	Employees of acquired company	Lower cost of operation	Shareholders of acquiring company
(b) Cultural bias against employees of acquired company and not giving them adequate career opportunity/job protection	Lower career opportunity, demotivation and stress/ fear	Employees of acquired company	Faster career growth and feeling of superiority	Employees of acquiring company
(c) Changing terms and conditions of employment of acquired company's staff	Demotivation/uncertainty	Employees of acquired company	Lower cost/advantage	Acquiring company and its employees
(d) Asset stripping	Reduced security/possible vulnerability in the future	Acquired company employees	Reduction of financial liabilities of acquiring company	Acquired company's shareholders

(*Contd.*) →

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(e)	Siphoning off money from the company taken over to meet funding needs of the promoter group elsewhere	Shortages of working capital and funds for capital investment	Acquired company and its shareholders/employees	Funds for other vantures	Promoter group of acquiring company
(f)	Using assets of acquired company as security for borrowing money to fund other activities (unrelated to acquired company's business)	Reduced scope for raising funds for meeting future needs	Acquired company	Scope for raising funds to meet requirements of other ventures	Promoter group of acquired company
(g)	Misuse of resources of acquired company	Lower profit	Acquired company	Lower cost of resources/personal benefit	Promoter group and managers of acquiring company
(h)	Eliminating efficient long-term suppliers/distributors of the acquired company and replac-	Loss of equity developed over the years	Erstwhile suppliers and distributors of acquired company	Additional business opportunity	Suppliers/distributors of acquiring company

(*Contd.*) →

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ing them with new suppliers/ distributors who have good relations with the promoter group/ managers of the acquiring company				
III Other Issues				
Putting up unethical takeover defence	Opportunity to get best return on investment made	Shareholders of target company	Retaining control of target company	Promoter group and managers of the target company

the acquired company.

Note:

1. Harm to some individuals/groups normally translates into benefits for certain other individuals/groups.
2. Harmful effects, as listed above, are imposed upon certain individuals/groups who, in most cases, have very little option to avoid them.
3. Notwithstanding its, harmful effects, corporate restructuring decisions have to be taken. The question is, how does an organisation achieve an optimum mix of benefit and harm. Table 8.3 tries to provide an answer to this dilemma by showing how ethical principles can be employed to deal with harmful effects of corporate restructuring decisions.

bringing benefits to some), and determine what can possibly be done to minimise, if not eliminate, such harm. As Hosmer[27] observes, ethical principles are objective and they 'transcend countries, religions and times. They are the basic rules or first principles . . . to ensure a "good" society'. At the heart of these ethical principles lies the assumption that people are willing to cooperate for the benefit of all[28].

Hosmer[29] observes that since "normative ethics" focuses attention on the first principles referred to in the previous paragraph one at a time and in exclusion of others, the utility of the same in getting insight into and understanding managerial dilemma in most decision-making situations is rather limited. As against this, "applied ethics" that combine multiple theories can provide a better insight into ways of addressing harmful effects caused by any decision. Table 8.2 gives a summary of key principles, stated in applied ethics as identified by Hosmer.

It is useful to distinguish between ethical principles and moral standards of behaviour; the latter, as defined by Beauchamp and Bowie[30], are not objective and they vary from country to country, religion to religion and society to society. As a result, no one set of moral behaviour can be used as standard across cultures, countries and societies. In the same way, value judgements vary from individual to individual and country to country, and hence are not objective nor can be standardised across countries or cultures. It needs to be pointed out that standardisation of value judgements across countries or cultures, if possible, can be extremely beneficial in these days of globalisation. Such standardisation will also be useful since it is now accepted that one of the most of important tasks of top executives is to set priorities in terms of management values[31].

From the evidence available[32], it is apparent that moral standards and value judgements differ between times, groups and countries and hence are not suitable as a basis for developing universal guidelines that are objective and that do not vary with time or culture. As against this, ethical principles, aimed at achieving what is good or right for human beings[33] and ensuring that right steps are taken to do things correctly[34], are objective, consistent and timeless[35]. Normative ethicists also accept this position, and, this being so, it is possible to use ethical principles as described in Table 8.2 to minimise the harmful effects of a variety of decisions associated with corporate restructuring in a manner that is objective and also not culture or country specific. This approach can be a powerful tool in gauging whether a particular restructuring decision should be modified to reduce its harmful side effects.

Table 8.2 *Ethical Principles that can reduce harmful effects of corporate restructuring decisions*

Type of Principles	*Author(s)*	*Brief Outline*
1. Personal virtues	Aristotle	Avoidance of actions which are not honest open and truthful and which cannot be made public.
2. Theological injunction	St Augustine and St Thomas Aquinas	Do not pursue actions that are not kind and compassionate and which come in the way of building a sense of community; reciprocity and compassion are the key
3. Government requirements	Hobbes and Locke	Do not violate law and regulations
4. Utilitarian benefits	Bentham and Mill	Ensure actions that will lead to greater good than harm for the society
5. Universal rules	Kant	Do not take any action that you will not like others to take
6. Individual rights	Jefferson and King	Actions must not undermine individual rights without due

(*Contd.*) →

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		process (seizure of property, interference with privacy, deprivation of liberty)
7. Economic efficiency	Smith, Friedman Blinder	Aim maximisation of profit within legal and market constraints thereby indicating efficiency
8. Distributive justice	Rawls	Do not take any action which will cause harm to the under-privileged
9. Contributive	Nozick	Do not interfere with individual rights for self development and self fulfillment to the limits of your abilities

Source: Hosmer. L.T. "Strategic Planning as if Ethics Mattered" *Strategic Management Journal*, Vol 15, 1993, pp. 12-34 (adapted in above term by the author)

Table 8.3 lists the range of corporate restructuring decisions during pre and post-restructuring phases and indicates broadly the ethical principles that can possibly be used as a criteria for dealing with decisions that have harmful effects on select stakeholder group(s). While proposing the use of specific ethical principles to deal with corporate restructuring decisions, it is suggested that management processes underlying such decisions be suitably modified to take into account the perspective and measures pertaining to their respective ethical reasonings. For example, restructuring decision to maximise shareholder value, that may have certain harmful effects on other stakeholders, can be examined from the ethical principles of economic efficiency (proposed by Smith, Friedman and Blinder) as well as distributive justice (proposed by Rawls). Likewise, a proposal to use the resources of the acquired firm for certain stakeholder's personal gains, that may lead to the misuse of these resources,

Table 8.3 *Use of Ethical Principles in Corporate Restructuring Decisions*

Examples of Corporate Restructuring Decisions in the areas of Mergers, Acquisitions and Divestment	*Ethical principles that can be used to minimise harm (see Table 8.2 for description of various principles)*
I *Pre-Restructuring*	
(a) Decision to acquire major competitor(s)	Utilitarian principle
(b) Actions taken to maximise shareholder value (through acquisition/divestment)	Economic efficiency; distributive justice
(c) Share price manipulation to reduce cost of takeover	Personal virtues; Government requirements
(d) Access to certain special information on target company that is not available openly	Personal virtues; universal rules
(e) Preferential allotment of shares to promoter group at less than market price	Personal virtues
(f) Inadequate/faulty disclosure and at the same time making false promises	Utilitarian principles; universal rules
(g) Acquisition of companies that employ child labour, follow illegal labour practices, etc. with a view to reduce overall cost of operation	Government requirements; Economic efficiency
(h) Structuring the deal in a manner that involves illegal payment	Personal virtues
(i) Undertaking divestments without taking care of difficulties of outgoing employees	
(j) Acquisition for short-term monetary gain and divestment thereafter (aim being to make some quick gains	Distributive justice

(*Contd.*) →

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in the process) and not having any concern for 'adding value' to the business of the acquired company	
II *Post-Restructuring (i.e. after merger, acquisition or divestment has taken place)*	
(a) Large scale retrenchment	Theological injunction; government requirements; utilitarian principles
(b) Cultural bias against employees of acquired company and not giving them adequate career opportunity/job protection	Individual rights; contributive liberty
(c) Changing terms and conditions of employment of acquired company's staff	Individual rights; distributive justice
(d) Asset stripping	Utilitarian principles; economic efficiency; distributive justice
(e) Siphoning off money from the company taken over to meeting funding needs of the promoter group elsewhere	Utilitarian principles; distributive justice
(f) Using assets of acquired company as security for borrowing money to find other activities (unrelated to acquired company's business)	Distributive justice
(g) Misuse of resources of acquired company	Universal rules
(h) Eliminating efficient long-term suppliers/distributors of the acquired company and replacing them with new suppliers/distributors who have good relations	Universal rules; individual rights; distributive justice

(*Contd.*) →

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with the promoter group/ managers of the acquiring company	
III *Other Issues*	
Putting up unethical takeover defence	Government requirements; utilitarian principles; universal rules

can be examined against the principle of universal rule which says: "don't take any action that you will not like others to take". Table 8.3 lists 19 decisions, each of which should be examined against financial criteria as well as specific ethical principle(s) indicated against each decision. When restructuring decisions are taken against the background of ethical principles that are timeless, objective and are not culture or country specific, chances are that these will be perceived as fair, right and just. The very fact that ethical principles are stable and are not subject to country or culture specific interpretation, as in the case of morals or values, makes them extremely useful not just in terms of providing suitable yardsticks for evaluating decisions but also in terms of making the participants in the decision-making process accept the ethical reasoning willingly and develop the required consensus. The tendency to use hierarchy to brush aside or ignore the harmful effects of corporate restructuring decisions will also be minimised if ethical principles are built into the decision-making process.

8.3 Towards a New Paradigm: Some Thoughts for the Future

What is the significance of ethics in corporate restructuring? What happens if ethical principles are flouted? Hosmer[36] states that companies depend a lot on their stakeholders for their innovative developments. This implies the need to ensure that certain groups of stakeholders are not harmed, while the emphasis is on maximising shareholder value or meeting managerial ambitions such as achieving the desired size of the company or market power or for handsome personal incentives. It is increasingly felt that organisations and their managers need to direct all their activities within the framework of common good[37] that consists of fundamentality (i.e. desire for survival expressed through organisational goods of profitability, efficiency and productivity), excellence (desire for community expressed through organisational goods of just distribution of benefits and burdens) and integration (use of organisational goods for human development attained through integrating fundamental and excellent desires). When viewed against this need to work for common good, many ethicists belive that the philosophy of maximising shareholder value, which is generally the main objective behind any corporate restructuring move, has a number of shortcomings such as: (a) excessive attention to profit as the sole end rather than considering it an essential requirement for retaining orgainsational vitality[38], (b) subsidiary status given to the philosophy of common good[39] and (c) explicit concern for maximising wealth, using community (including other stakeholders) as a key input. Similar criticisms are also heard from various interest groups in respect of different actions that come under the overall purview of corporate restructuring. Some of the areas subject to frequent criticisms are: acquisition of a major competitor by the industry leader, making inadequate and faulty disclosures prior to acquisition, adopting questionable means of financing such as transferring funds from other group companies (thereby burdening the latter with liabilities of starving them of resources), initiating moves such as asset stripping and large-scale retrenchment, misuse of resources and discrimination against staff of the acquired company, and so on.

The scenario that emerges from all these arguments and counter-arguments raises a basic question viz. is it possible to ensure the desired benefit to a particular group of stakeholders with minimum hardship to the rest of the stakeholders, including the community at large? Pushing the question further, is it possible to adopt an ethical approach (i.e. not causing harm to anybody) and yet become profitable and maximise interest of shareholders and/or managers? My view is that it is possible to reconcile these apparently contradictory positions provided that the managers and major stakeholder groups keep in mind certain perspectives. Let me state a few propositions in this regard.

Proposition 1

Companies that adopt an ethical approach to corporate restructuring are able to maximise their shareholder value unlike those that do not

Table 8.3 indicates how the use of ethical principles can result in minimisation of harm to various stakeholder' groups that may be caused as a firm restructures its business or portfolio. Ethical approach enables the firm to develop a network of external and internal relationships, both before and after restructuring, leading to greater commitment and involvement of people to improve the value creation processes within the firm. Such an approach enables it to enlist better suppliers and customers and also obtain far greater support from regulatory bodies, all leading to lowering the transaction cost relating to operations of the business. The firm is also able to attract talented employees from outside and leverage the knowledge and expertise already available within the organisation during the post-restructuring phase. Building ethics into all decisions relating to corporate restructuring thus helps the firm develop an architecture or network of relationships that will facilitate acquisition of distinctive capabilities required to ensure continued success and in the process, maximise shareholder value.

Proposition 2

Adoption or pursuance of unethical practices is generally necessitated as a result of managerial incompetency

Strategy of a company is essentially the strategy of its managers. A company's performance depends a lot on competencies of its managers in choosing the right strategic initiatives and implementing the same within cost, quality and time targets. Whether a company shall be able to sustain its long-term competitive advantage and maximise shareholder value hinges primarily on the quality of managers it has. Whenever managers lack the required competencies, they tend to adopt unethical practices to secure the desired benefits for a select group of stakeholders. For example, lack of competency in retraining and redeploying people in value creating activities during the post-restructuring phase may lead to large-scale retrenchment of employees. Similarly, inability to enhance shareholder value through improved efficiency and productivity of all resources may lead to manipulation of financial figures for projecting a rosy picture during the post-restructuring phase. Stripping of assets and undertaking excessive borrowings to ease the liquidity problem or augment the funds position may not be needed if managers are able to run current operations most efficiently. Many divestment decisions can be avoided if managers are competent and can apply their minds properly while setting up or acquiring new businesses, and then manage the same in a manner that maximises shareholder value. If competencies are used objectively as criteria for rewarding people, discrimination against people of acquired company—while deciding on their future career path—will not be needed. One can find many major and minor activities within an organisation which, if managed with the best of competencies, can help in securing the desired benefits for a select group of stakeholders, without causing harm to anybody.

Proposition 3

If corporate restructuring decisions are to be based on ethical principles, there has to be a paradigm shift at both organisational and individual level

Table 8.3 states how harmful effects of various corporate restructuring decisions can be resolved by basing such decisions on the principles of ethical reasoning. A key question is, how does an organisation and individuals working there actually employ such ethical principles? And, given the steady deterioration of values and ethics over the past so many years in most countries and societies and also the incentives that exist for adopting unethical practices, is it always possible to purse ethical principles while taking decisions? A related but basic question is : why do we need ethical principles? While Table 8.3 also indicates the specific ethical principles that can probably be employed to eliminate the harmful side effects of various corporate restructuring decisions, it will be difficult to build such principles in strategic decision-making processes within the firm unless there is a major paradigm shift at both organisational and individual level.

Figure 8.1 describes how the paradigm has to shift along a variety of parameters such as choice of target beneficiary, attitude to ethics in general, emphasis on use of ethical principles, time span of profit seeking behaviour, decision-making process, managerial priority and quality of appreciation of harm caused to certain groups of stakeholders. A significant shift in each of these variables from current disposition to the desired stage has to be a conscious effort in order to incorporate the ethical principles into corporate restructuring decisions. The urgency and seriousness in shifting to the new paradigm can come about only if there is a shared consensus among the major shareholder group, managers and employees on the need to follow ethical principles.

For an organisation to become ethics oriented, its management will have to internalise ethical principles, as any organisation is ultimately a reflection of the personal integrity of its senior managers, who will have to be above suspicion. Unless this happens, managers will continue to take advantage of their positions and take decisions that are detrimental to stakeholders' interests. Conviction of personal character is a must and moral thoughts flow out of character, an idea expounded in Vedic literature[40] and later reiterated by thinkers such as Tagore, Vivekanand, Gandhi[41] and Nietzsche[42]. However, it needs to be stated that many corporate restructuring decisions may involve complex trade-offs and resolving these is often not easy. Focusing on an option that is ethically correct may not be perceived by major shareholder group as correct or preferable. There can also be situations when a manager, pursuing an ethical guideline, is compelled to resign, implying that ethics at a personal level also has its cost[43]. While accepting that such unfortunate incidents may occur occasionally, it must be stressed that the

Issues	Shift in Perspective: From	Shift in Perspective: To
1 Target beneficiaries	Major shareholders/top executives	All external and internal stakeholders
2 Adherence to law/ attitude towards ethics	Caveat Emptor ('within the law')	Greater good than harm to all stakeholders and also society at large of which the firm is a part
3 Orientation	Short-term; emphasis on immediate return for the preferred stakeholder group(s) at the expense of non-preferred stakeholders	Maximisation of longer term gains and refusal to do anything in the short-term that violates established ethical principles
4 Guiding principles for decision making	Self-interest	Universally accepted ethical principles
5 Characteristics of management process	Over-emphasis on financial criteria to protect/ ensure returns for the preferred stakeholder group(s)	Emphasis on both commercial and ethical standards; special concern for understanding and identifying possible disadvantages that may be caused to non-preferred stakeholders
6 Managerial priority and values	Personal gain (power, ambition, financial gain); lack of awareness of disadvantages experienced by non-preferred stakeholders in such areas as information availability, limited choice, etc.	Personal integrity, pursuance of what is right and just and competency in ensuring efficiency of resource utilisation without violating ethical principles

Fig. 8.1 The new corporate restructuring paradigm

other option of pursuing unethical principles is more dangerous from individual, organisational and society perspectives. What managers need to do is to anticipate such possibilities or fall-outs well in advance and build consensus on the need to pursue ethical principles. By combining such consensus with ever-increasing efficiency and productivity of operations, again through pursuing ethical principles, managers can get the required protection against adverse impacts such as loss of employment or damage to career prospects. Managers must be convinced, individually and collectively, that, as Hosmer observes, "pattern of equitable acts over time does indeed lead to trust, that trust does lead to commitment and that a committed effort ...... leads to success"[44]. Such conviction is easy to come by if managers are competent, have absolute personal integrity and possess the courage to maintain their ethical stance.

Proposition 4

Let market, transparent regulations and people with integrity be the sole judge for determining and curbing unethical behaviour

Firms and their managers often pursue unethical practices or take decisions where integrity is suspect because the environment in which they operate tolerates unethical behaviour and provides incentives to become dishonest. Another reason is asymmetry in information availability among stakeholders, that creates the right environment for making decisions that benefit some and harm the others. What is needed to curb such tendencies is not to have more governmental control but a set of clear, transparent regulations that cannot be interpreted differently by different people. This, coupled with free market operation and abundance of availability of people with integrity (who can act as whistle-blowers and who are not afraid of possible personal losses in the short run), should provide a congenial environment for incorporation of ethical principles in corporate restructuring decisions. Development of public opinion, bringing to light all cases of dishonesty, powerful disclosure norms, consideration of ethical issues in due diligence, etc. can go a long way to improve the quality of environment within which ethically correct decisions can be taken. What is, of course, not required is more government control since the same only vitiates the atmosphere. Free market operation will help in identifying firms that pursue unethical practices and will isolate them in a manner that will make them uneconomical and unviable in the long run. In other words, free market backed up by transparent regulations and proper disclosure norms will discipline firms pursuing restructuring strategies based on unethical practices.

8.4 Building Ethical Principles into Corporate Restructuring Decisions

The central argument, around which this paper is written, states that in the long run it pays to be ethically correct. While prima facie it may appear that adherence to ethical principles may reduce returns to the shareholders or managers of the firm, in reality, such poor returns, if at all there be, take place only in the short-term. Accepting such short-term cost to uphold ethical principles should be seen as an investment to ensure longer-term survival and growth. With liberalisation of government control in many economies and growing public disenchantment with all unethical practices, firms will soon find that basing strategic decisions such as corporate restructuring on the foundations of ethical reasoning acts as protection against future vulnerability.

Figure 8.2 depicts a framework for incorporating ethical principles into corporate restructuring decisions. The framework identifies two key criteria viz. (a) ethical principles and (b) personal integrity and competence of managers. It is suggested that factors that influence a corporate restructuring decision, such as relevant commercial criteria, primary and other stakeholders' interests, country/culture specific values, regulatory provisions, etc, are made to go through these two criteria to ensure decision-making that is ethically correct, and yet leads to efficiency. The quality of various decision processes will improve significantly when (a) ethical principles are considered along with commercial criteria, (b) a longer term perspective, built on ethical pursuit, is kept in view while maximising the interest of a select group of stakeholders, without harming other stakeholders, and (c) managers are confident that they are competent enough to make up for any short-term cost that may have to be incurred to stick to ethical principles. When these conditions are satisfied, corporate restructuring decisions can turn out to be highly ethical and yet commercially correct.

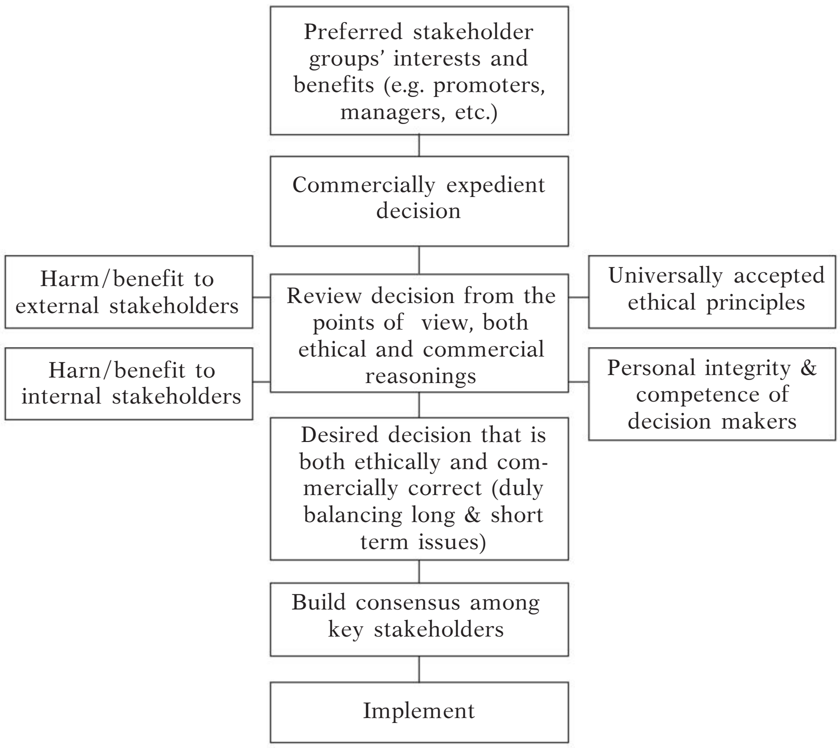

Fig. 8.2 Decision-making process based on ethical principles (in an era of declining ethics and morality)

8.5 Conclusion

The paper brings out clearly the irrelevance of any debate on whether ethics can at all be built into decisions on corporate restructuring. It argues that ethical principles can be used, along with commercial considerations, as criteria for choosing the right restructuring moves. Adopting the observation made by Gilbert, when he introduced the concept of "Strategy Through Convention"[45], it can also be said that every decision on corporate restructuring is and should be about ethics, and managers taking corporate restructuring decisions must take responsibility for the well-being and dignity of each and every stakeholder who is likely to be affected, directly or indirectly, through such moves. The real challenge will be to ensure gains to preferred stakeholder group without causing any harm to others. While accepting intrinsic conflict in achieving both, no one can argue that it is worth striving for the same. This paper suggests four propositions to support this observation and presents a decision process which managers can use to arrive at ethically correct corporate restructuring decisions.

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Authors' Observations on the Nuggets

Nugget-1

Falcon could buy the shares currently held by Cosmos at par. Such a price might be acceptable to Falcon for strategic reasons and this is also the minimum acceptable price for Cosmos.

Nugget-2

The securities company could sell its card to recover as much money as possible. The venture capital company could merge with the NBFC so as to enhance the financial strength of the latter.

Nugget-3

This is a case of competitive bidding as per the Takeover Code. The spurt in value of the share of Non-Ferrous Metal Industries Limited helped the common investors realise the full potential and value of their holding. The fate of the shares offered by common shareholders to SIL remained uncertain for quite some time. This aspect needs to be looked into for future modification. At times of such rapid developments, the possibility of a faster flow of information to the small investors also requires special attention.

Nugget-4

The efforts to delink/take away KCL from SICL, when the latter was facing an open offer from a prospective acquirer might not be in accordance with the relevant guidelines.

Nugget-5

The proposed merger between DDCL and DML seems welcome from considerations of synergy and complementarity.

Nugget-6

Eastern Packaging Limited can make preferential allotment of a suitable number of shares in favour of Rainbow Metal Limited. The price for such allotment, which has a floor dictated by SEBI, is to be decided based on due diligence carried out by a suitable firm of consultants.

Nugget-7

Petroleum Products India Limited could make a preferential allotment of 1,00,00,000 fresh equity shares in favour of a strategic partner. This would fetch additional capital of Rs 400 crore, thereby enabling implementation of the much-needed modernisation programme. GOI could sell 1,10,00,000 shares to the strategic partner (2,40,00,000 – 1,30,00,000). Thus GOI could receive a larger proceed from disinvestment and would still be left with a larger number of residual shares. The strategic acquirer could get a majority stake through the public offer required as per the Takeover Code. Necessary transparency for the transaction could be achieved by means of an open bidding for which the reserve price could be fixed at Rs 400. The actual price may eventually turn out to be much higher.

Before disinvestment, the shares held by Petroleum Products into subsidiary company could be transferred to GOI

Nugget-8

Valuation of the division/shell company can be done based on Asset Value and the Price Earning Capacity Value (PECV).

Nugget-9

Potent Company Limited can convert a part of their equity, say 50 per cent, to debt repayable over a suitable length of time and the debt instruments, which are expected to get the highest rating, can have coupon rates dictated by market conditions.

Nugget-10

Equity-debt swap, whereby rated bonds could be used to replace part of equity, was worthwhile and the bonds, carrying market-linked coupon rates, could be privately placed with banks and FIs to garner funds immediately for GOI.

Nugget-11

The recommendation of the merchant banker is acceptable.

Nugget-12

Sun and Glory Limited could go in for an appropriate Rights Issue at a price somewhat above the current market price, which was substantially lower than its intrinsic price. With necessary FIPB clearance in place and disclosures in the Letter of Offer, the promoter group could increase their holding at a reasonable price.

Nugget-13

Suitable preference shares with a tenure of five years could be issued by Services India Limited, to be privately placed with Financial Institutions and banks in the highest tax bracket.

Nugget-14

If the promoters buy the assets of PHFL at their realisable value, they only lose a good part of their existing investment. But public depositors in PHFL may not get their money back in full in such a situation. In case the promotes are very particular about their brand image and market reputation, they may infuse fresh funds to ensure full repayment of depositors' dues. But, before that they may like to acquire full control of PHFL.

Nugget-15

Securitisation seems to be the appropriate way for recovering such old dues. But the PTCs would be acceptable to investors if guaranteed by the GOI. GOI has to pursue with the State Governments the issue of state sector reforms and a practical arrangement has to be worked out whereby State Electricity Boards pay the future dues to Power and Fuel Companies on a regular and mutually acceptable basis. Tax-free status may be accorded to the PTCs in order to minimise the interest burden on the SEBs and State Government. The old dues may be recovered in suitable tranches as per an agreed formula from SEBs/ State Governments.

Nugget-16

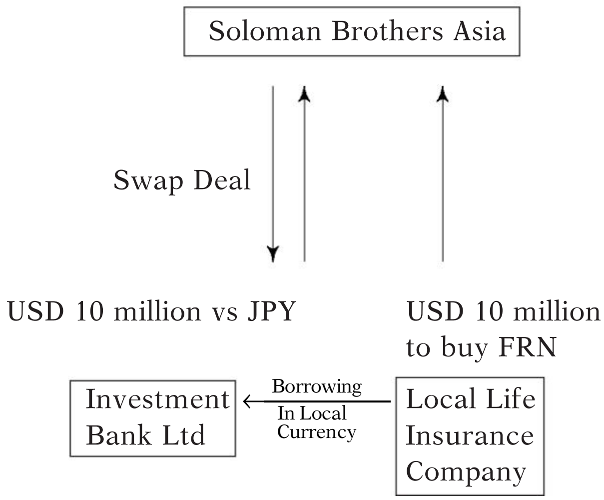
Since Generator Company Limited would not be required to pay any tax during the year under consideration, taking the pollution control equipment on lease from a high-tax-paying lessor at a cheap rate makes much sense. The balance amount may be generated either through infusion of additional equity or by way of interest-free, long-term, subordinated unsecured loan.

Nugget-17

International Bank can extend foreign currency loan as long as the same is in demand. The customers are to be selected carefully, with special emphasis on the ones with a kind of a "natural hedge". It can also approach RBI for permission to invest in suitable foreign currency securities or with a request to open a special swap window.

Nugget-18

Payments under the FRN are to be guaranteed by a suitable group company so as to ensure adequate credit enhancement. Call and Put options at the end of first and second year are to be attached to the FRN. Under a suitably drafted tri-partite agreement between the issuer, Investment Bank Limited and Salomon Brothers Asia, payments made under the FRN are to be received directly by Soloman Brothers Asia for credit to a special account in the name of Investment Bank Limited. This would eliminate the India Risk for Saloman Brothers Asia.



Nugget-19

The approach of the Treasury Department of Smart Bank Limited is acceptable.

Nugget-20

Payments under the bond to be issued by International Airlines Limited are to be guaranteed by an international bank which has the highest rating, which opens an escrow account in the name of International Airlines Limited and credits its forex earnings there. The bond is to have an inverse-floater structure linked to the petrol price and is to be marketed to petrol companies and petrol producing countries.

Nugget-21

Smart Company should replace its existing project loans with foreign currency loans that have corresponding residual maturities. The working capital facilities could be replaced by short-term foreign currency loans/PCFC/commercial papers (a judicious mix of the three facilities depending on prevalent market conditions).

Nugget-22

Giant Company Limited can convert a suitable amount, say Rs 400 crore, of debt extended to the loss making subsidiaries to equity and simultaneously convert to debt an equal amount of equity investment in the profit making subsidiaries.

Nugget-23

A regular GDR issue of USD 300 million by Radiant Company Limited seems acceptable.

Nugget-24

With successful implementation of the turnaround strategy, SWL is expected to improve its net worth gradually. This will augment the shareholder wealth of the company.

Nugget-25

Issue of suitably structured FCCBs by OGL appears to be in order under the circumstances.

Nugget-26

In this situation, a split-up of KMP Finance and Merchant Bankers Limited into a NBFC and a merchant banking cum broking outfit seems to be in order.

Nugget-27

Range Forward or Bullish Spread is suitable in the given situation. These are mechanisms whereby the exchange rate becomes range bound between two strike rates, say E1 and E2.

Nugget-28

A suitable commodity bond to be issued by I-Asia could be privately placed with various International Airlines.

Nugget-29

The company could buy back a part of its outstanding international debt at a discount. Besides giving a strong signal to global lenders and investors, this action would mean substantial profit for the company out of its treasury operations.

Nugget-30

If an AAA-rated International Bank adds guarantee to the debt paper issued by Petrochemicals India Limited based on the Escrow Account opened by them, Petrochemicals India Limited can pierce India's sovereign rating and place their long-term debt papers at competitive rates.

Nugget-31

The asset-swap opportunity is a temporary and unique one, which provides the Commercial Bank of India the scope to get rid of substantial NPAs from its balance sheet at one stroke. This should be availed of with due care and promptitude so as to strike the best possible deal.

Nugget-32

As part of its liability management, Western Industries Limited could undertake a combination of the strategies mentioned.

Nugget-33

A strategic partner may be inducted for Division 1 after its assets are transferred to a new company formed for this purpose. This inflow of funds may be used for restructuring the operations of Division 2. Rationalisation of manpower may be supported from the National Renewal Fund (NRF) of GOI. The working capital facilities of Sound Engineers Limited may be guaranteed by GOI and the dues of GOI can be converted into a term loan repayable over next six to seven years.

Nugget-34

The restructuring has to be on the lines indicated in the case.

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