Merger & Takeovers

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A transaction involving two or more companies in the exchange of securities and only one company survives is called Merger. Merger and acquisition result in several advantages in the acquiring company and the target company. There are three types of Merger. The reasons of Merger are mainly to reduce the competition, economies of scale, tax advantage, etc.

Any business firm has a prime objective i.e. profitable growth. This growth can be achieved internally or externally. Internal growth can be achieved either through the process of introducing or developing new products or by expanding or enlarging the capacity of existing products. External growth can be achieved externally by acquisitions of existing business firm. This acquisition may take any of the following forms :—

I. Absorption
II. Amalgamation
III. Combinations
IV. Merger
V. Takeover
VI. Demergers.

Although the legal procedure involved in these are different, in view of the perspective of economic consideration these terms are used interchangeably here

Meaning of terms

Merger is said to occur when two or more companies combine into one company. In detail, Merger is defined as 'a transaction involving two or more companies in the exchange of securities and only one company survives'.

On the other hand acquisition is "a purchase of a company or a part of it so that the acquired company is completely absorbed by the acquiring company and thereby no longer exists as a business entity".

With the increase in the industrialisation and liberalisation, there is freedom to the corporates to enter or exit the freedom. So the market has become more dynamic and competitive. As a result the business firm must strive hard to consolidate their positions and improve in the market place. A firm may use mergers and acquisition to increase competitiveness and consolidate its position.

Types of mergers

There are three types of Merger :

1. Horizontal Merger
2. Vertical Merger
3. Conglomerate Merger

Horizontal Merger

When two or more corporate firms dealing in similar lines of activity combine together then Horizontal Merger takes place. The purpose of Horizontal Merger is elimination or reduction in competition, putting an end to price cutting, economies of sale in production research and development, marketing and management, etc.

Vertical Merger

When a firm acquire its 'upstream' from it and or firm's 'down-stream' then Vertical Merger occurs. In the case of 'upstream' type of merger' it extends to the suppliers of raw materials and in the case of 'downstream' type of merger it extends to those firms that sell eventually to the consumer. The purpose of such merger is the lower buying cost of materials, lower distribution costs, assured supplies and market, increasing or creating barriers to entry for potential competitors.

Conglomerate Merger

In marked contrast, Conglomerate Merger is a type of combination which a firm established in one industry combines with another firm in another unrelated industry. Such merger moves for diversification of risk constitutes the rationale. Reason for Merger and Acquisition. The following are important reasons for merger and acquisition of firms :

Economies of Scale:— The combined firm can have larger volume the operation than the individual firm. Thus the combined firm can enjoy economies of scale. The Merger and acquisitions help the company to produce the goods more economically

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through the full utilisation of plant capacities.

Synergy :— Synergy is simply defined as 2+2=5 phenomenon. The value of the company formed through merger will be more than the sum of the value of the individual companies just merged.

Symbolically

V (A) + V (B) < V (AB)

V(A) = value of A Ltd.

V (B) = value of B Ltd.

V (AB) = value of merged company.

Diversification of risk

When a company produce single product then the company's profits and cash flows fluctuate widely. This increase the risk of a firm. Diversification reduces the risk of the firm. So a company whose earnings are of different nature. The merger of companies whose earnings are negatively correlated will bring stability in the earnings of the combined firm. So diversification reduces the risk of the firm.

Growth

This is possible in two ways— external and internal. Mergers and acquisition help the company to grow quickly without any gestalion period.

Example

RPG group had a turnover of only Rs. 80 crores in 1979, which has increased to about Rs.5600 crores in 1996. This phenomenal growth was due to the acquisitions of several companies by the RPG group. Some of the companies acquired are Asian Cables, Ceat, Calcutta Electricity Supply and Company, SAE, etc.

Reduction in tax liability

Under Income-tax act there is a provision for set off and carry for-ward of losses. A sick company may not be in a position to earn sufficient profits in future to take advantage of the carry forward position. So a sick company with accumulated losses may like some profitable company to merger with it to take advantage of tax benefits. Even the sick company with accumulated losses may be merged with a profitable company and take advantage of income tax benefits with the approval of Government. The following is the list of some companies along with the amount of tax benefits enjoyed :

Ex:— Orissa Synthesis merged with straw product Ltd.(Rs =16 crores)

*Ahmadabad Cotton Mills Merged with Arvind Mills (Rs =3.34 crores) etc.

* Sidhaper Mills merged with Reliance Industries Ltd.(Rs. 3.34 crores)

* Alwyn Nissan merged with Mahinder and Mahindra Ltd. (Rs. 2.47 crores)

* Hyderabad Alwyn merged with Voltas Ltd. (Rs. 1,600 crores)

* Orissa Synthesis with Straw Products Ltd. (Rs. 16 crores).

To increase market power and to kill competition

Merger help the company to reduce competition in the market. It also help to increase the market power.

Ex:- TOMCO and HLL Merger,
Premier and Apollo Tyres,
Blow Fast and Universal Luggage Industries,
Associated Cement Companies etc.

Financial synergy

The following are the financial synergy available in the case of mergers :

* **Better credit worthiness:** This helps the company to purchase the goods on credit, obtain bank loan and raise capital in the market easily.

* **Reduces the cost of capital:** The inverstors consider big firms as safe and hence they expect lower rate of return for the capital supplied by them. So the cost of capital reduces after the merger.

* **Increases the debt capacity:** After the merger the earnings and cash flows become more stable than before. This increases the capacity of the company to borrow more funds.

* **Increases the P/E ratio and value per share:** The liquidity and marketability of the security increases after the merger. The growth rate as well as earnings of the firm will also increase due to various economies after the merged company. All these factors help the company to enjoy higher P/E in the market.

* **Low floatation cost:** Small companies have to spend higher percentage of the issued capital as floatation cost when compared to a big firm.

* **Rising of capital:** After the merger due to increase in the size of the company and better credit worthiness and reputation, the company can easily raise the capital at any time.

Corporate restructuring

As M.B. Athreya says "Earlier, buying was considered hostile and predatory behaviour and selling was regarded as week-kneed failure. But now buying and selling businesses has become psychologically more acceptable. These are early responses to market friendly policies, and more of this is bound to happen." Arun Bharat Ram echoes a similar view "A company may feel that it is not possible to continue in every business that it has been in the past, and so it must divest intelligently. And there will be other companies who will want to buy these business. So restructuring by way of mergers, acquisitions and divestments will accelerate". Corporate restructuring can occur in a myriad ways. Business firms resort to a variety of activities that lead to expansion, sell off and change in ownership and control. Though the classification is some what arbitrary, it helps in clarifying the emphasis of various restructuring practices. The very objective of corporate restructuring is to fight competition and to conduct the business in an efficient and effective manner, so as to consolidate the position of the business.

Financial considerations in merger and acquisitions

A merger can financed by cash or exchange of shares or combinations of cash, shares and debentures.

Cash offer

Here the shareholder of the largest company are paid cash in exchange of their shares in the target company.

Share exchange

Here the acquiring company issues shares to the shareholders of the target company in exchange.

Exchange ratio

The determination of the exchange ratio is based on the value of shares of the companies involved in the merger. The basic objective of financial management is to maximise the shareholder's wealth even the merger decision is to be taken in the light of wealth maximisation.

Conclusion

This section summarises the main points of the discussion relating to mergers and acquisitions as an alternative route to profitable growth.

Shortly the major economic advantages of mergers are:

economies of scale,

synergy,

tax benefits,

diversification, etc.

The scheme and legal procedure for mergers and tax aspects of mergers are also described. The focus of the analysis of mergers and acquisitions is on the financial framework covering three major as-pects: (1) determining the firm's value, (2) financing technique in merger and (3) merger as a capital budgeting decision.

Determining the worth of a firm is the first step. It is a difficult task also. In estimating the value of a firm, several factors are considered in conjunction with one another. The book value although not an effective measure by itself, is useful in specific situations. The appraisal value mayor may not be a good indicator to be paid for a company. Its merit depends upon the approach taken and nature of business. The market value is a key element in valuing the firm particularly in the cases of large listed corporate firms. The EPS is an important criterion for merger decisions.

However, the worth of a firm should not be determined on the basis of a single approach and a single figure, but within a range on the basis of a consideration of all the alternative approaches. The second aspect of merger is the mode of financing. In the case of a firm having a high P/E ratio, issue of equity shares is advantageous both to the acquiring and acquired firms. To meet the investment needs of different types of investors, convertible securities can also be issued. Yet another form of financing merger is the deferred-payment plan.

The tender offer is another alternative to acquire firms. The purchasing firm directly approaches the shareholders of the target firm. This approach may be cheaper provided that the management of the target firm does not attempt to block it. The capital budgeting framework can also be applied to evaluate merger decisions. □