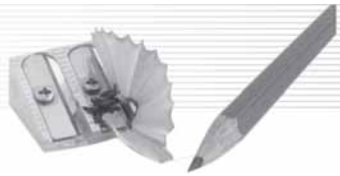

# Structure Mergers & Acquisitions to Exploit the Emerging Opportunities

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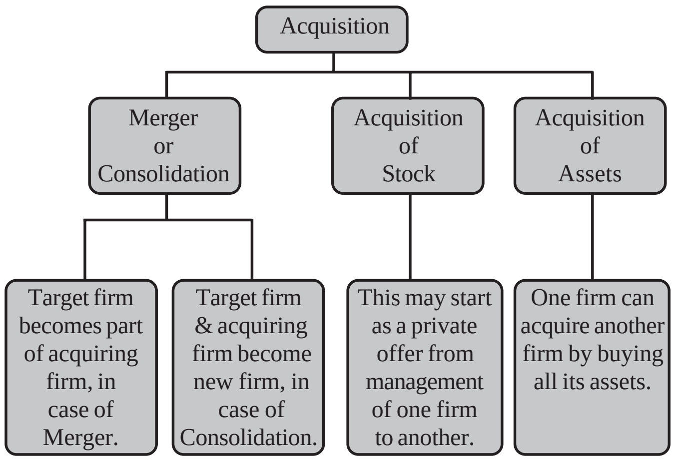
**In today's business world, mergers & acquisitions (as a form of corporate restructuring) have become a major force in the financial & economic environment all over the world primarily due to globalization, liberalization, technological development & intensely competitive business environment. This article focuses on one of the largest mergers in India between Reliance Petroleum Ltd. with Reliance Industries Ltd. in 2002 creating the country's largest private sector company on all financial parameters, including sales, assets, net worth, cash profits & net profits.**

## Introduction

Corporate restructuring refers to those activities that enhance or compress a firm's operations or substantially change its financial structure or bring about a significant change in its organizational structure and internal functioning. It includes mergers, acquisitions, takeover etc.

A merger refers to the absorption of one firm by another firm. The acquiring firm retains its name and its identity, and it acquires all of the assets and liabilities of the acquired firm. After a merger, the acquired firm ceases to exist as a separate business entity. For example, suppose Firm X acquires Firm Y in a merger. Further suppose Firm Y's shareholders are given one share of Firm X's stock in exchange for two shares of Firm Y's stock. From a legal standpoint, Firm X's shareholders are not directly affected by the merger. However, Firm Y's shares cease to exist.

An acquisition refers to an act of acquiring control by one company over the assets or management of another company without any combination of companies. However, a fundamental feature of merger is that the acquiring company takes over the ownership of other companies and combines their operations with its own operations.




When the acquisition is against the will of target management, it is generally called takeover. Takeover generally takes the form of tender offer wherein the offer to buy the shares by the acquiring company will be made directly to the target shareholders without the consent of target management. Though, the terms 'merger', 'amalgamation', 'consolidation', 'acquisition' & 'takeover' have specific meanings but they are generally used interchangeably.

Mergers may be horizontal, vertical or conglomerate. Horizontal merger is a combination of two or more firms involved in similar type of production, distribution or area of business. The firms compete with each other in their product market. Vertical Merger is a combination of two or more firms involved in different stages of production or distribution. Conglomerate merger is a combination of firms engaged in completely unrelated lines of business activity. Further mergers may be 'friendly' or 'hostile'. Generally, mergers are friendly whereas tender offer takeovers are hostile.

Two important points to be noted in case of merger are :

- A merger must be approved by a vote of the stockholders of each firm. Typically, votes of the owners of 2/3rd of the shares are required for approval. Also the shareholders of the acquired firm have appraisal rights. This means that they can demand that their shares be purchased at a fair value by the acquiring firm. Often the acquiring firm and the dissenting shareholders of the acquired firm cannot agree on a fair value, which results in expensive legal proceedings.
- A merger is legally straightforward. It avoids the necessity of transferring title of each individual asset of the acquired firm to the acquiring firm. It does not cost as much as other forms of acquisition.

The principal economic rationale of a merger is that the value of the combined entity is expected to be greater than the sum of the independent values of the merging entities. The most plausible reasons for mergers are strategic benefits, economies of scale, economies of scope, utilization of surplus funds, complementary resources, tax shields, economies of vertical integration and managerial effectiveness.

The synergy from an acquisition is defined as the value of the combined firm V(AB) less the value of the two firms as separate entities V(A) and V(B) or

$$\text{Synergy} = V(AB)-[V(A)-V(B)]$$

The shareholders of the acquiring firm will gain if the synergy from the merger is greater than the premium.

Trautwein (1990) distinguishes between three types of synergy benefits: operating, financial and managerial synergies. Operating synergy assumes that economies of scale exist in an industry and that prior to their M&A, firms are operating at levels of activity that fall short of achieving the potential for economies of scale (Weston *et a*l., 2001). Expansion through a M&A increases the size of the company and hence may reduce per unit cost. Financial synergy refers to the impact of a M&A on the firms combined cost of capital. This can be achieved by lowering the systematic risk of the firm's investment portfolio. Alternatively, increasing firm size may improve company access to cheaper financing and/or create an internal market where capital can be allocated more efficiently. Finally, managerial synergies may arise from combining firms of unequal managerial capabilities.

Operating synergies are those synergies that enable a firm to increase its operating income or increase growth or both. Operating synergies can be categorized into four types:

- **Economies of Scale**, enabling the combined firm to become more cost-efficient and profitable.
- **Combination of different functional strengths**, in case a firm with strong marketing skills acquires a firm with a good product line.
- **Greater pricing power** from higher market share & reduced competition, which should result in higher margins and operating income.
- **Higher growth in new or existing markets**, in case a firm acquires another firm with an already established distribution channels and brand name recognition and is able to increase its sales by using these strengths.

Operating synergies can affect margins and growth, and through these the value of the firms involved in the M&A.

With financial synergies, the payoff can take the form of either higher cash flows or a lower cost of capital. Included are the following:

- A combination of a firm with available cash & few project opportunities and a firm with high return project & limited amount of cash can yield a payoff in terms of higher value for the combined firm. The increase in value comes from the projects that otherwise would not have been taken except with the excess cash available with the combined firm. This synergy becomes available when large firms acquire smaller firms.
- **Debt capacity** also increases when two firms combine thereby making their earnings and cash flows more stable and predictable. This enables them to borrow more than they could have as individual entities. It creates a tax benefit for the combined firm. This tax benefit can either be shown as higher cash flows or take the form of a lower cost of capital for the combined firm.
- **Tax benefits** can arise either from the acquisition taking advantage of tax laws or from the use of net operating losses to shelter income. Thus, a profitable firm by acquiring a loss making firm may be able to use the net operating losses to reduce its tax burden. Also, a firm that is able to increase its depreciation charges after an acquisition will save in taxes and increase its value.

Synergy is a stated motive in many M&As. *Bhide (1993)*, who examined the motives behind 77 acquisitions in 1985 and 1986, reported that operating synergy was the primary motive in one-third of these takeovers. A number of studies examine whether synergy exists and, if it does, how much it is worth. If synergy is perceived to exist in a takeover, the value of the combined firm should be greater than the sum of the values of the bidding and target firms, operating independently.

M&As can also be used as a means to transfer knowledge in situations where collaborative and contractual schemes do not work *(Lehto & Lehtoranta, 2006).* Consistent with the above argument, Lehto & Lehtoranta show that a firms R&D stock positively contributes to its likelihood of its becoming an acquirer.

Mergers and Acquisitions (M&As) are means of growth for many companies. In 2005 alone, 29585 deals were announced worldwide, accounting for an aggregate deal value of US $ 1 trillion in USA and US $ 883 billion in Europe. There are various advantages of growing through M&As instead of expanding internally. It has been observed that the faster way to expand than internal expansion is to acquire a firm in same line of business. It is because of the simple reason that the target firm is an organization which is already in place, has its own production capacity, distribution network, and clientele. This also reduces the risk of investing for the growing company. Besides, growing through M&As may be a cheaper alternative than internal expansion, in particular when the replacement cost of assets is higher that the market value of target assets. Finally, and in contract to organic growth, M&As can be (partly) paid for with stock. This may be interesting for firms that do not have enough cash reserves and/or have fully used their debt capacity.

However, a growing company can choose to grow through M&As in addition to internal expansion. Firms with many investment opportunities and easy access to financial resources may engage in both internal and external growth in order to take full advantage of their competitive advantages in the fastest possible way.

Studies of stock returns around merger announcements generally conclude that the value of the combined firm increases in most takeovers and that the increase is significant. *Bradley, Desai and Kim (1988)* examined a sample of 236 inter-firm's tender offers between 1963 and 1984 and reported that, on the average, the combined value of the target and bidder firms increased 7.48% ($117 million in 1984 dollars) on the announcement of the merger. This result has to be interpreted with caution, however, since the increase in the value of the combined firm after a merger is also consistent with a number of other hypothesis explaining acquisitions, including undervaluation and a change in corporate control. Thus, it is a weak test of the synergy hypothesis.

The merger of Reliance Petroleum Ltd. (RPL) with Reliance Industries Ltd. (RIL) in 2002 represents the largest ever merger in India creating the country's largest private sector company on all financial parameters including sales, assets, net worth etc.

According to *Prashant Kale and Harbir Singh*, in general, acquisitions do not create value. Empirically, in over 70% of the transactions acquirers earn a negative return. This is mainly because acquisitions are often driven by illusory synergies, acquirers have to pay a substantial premium over pre-acquisition value, and post-acquisition integration is not successfully anticipated and managed.

## Merger of Reliance Petroleum Ltd. (RPL) with Reliance Industries Ltd. (RIL)

### Reliance Petroleum Ltd. (RPL)

Reliance Petroleum Ltd. is a subsidiary of Reliance Industries Ltd. RPL is setting up a Greenfield petroleum refinery & polypropylene plant in a Special Economic Zone at Jamnagar in Gujarat. With an annual crude processing capacity of 5,80,000 barrel capacity per stream day (BPSD), RPL will be the sixth largest refinery in the world.

### Reliance Industries Ltd. (RIL)

Reliance Industries Ltd. (RIL) is India's largest private sector company on all major financial parameters with turnover of Rs. 1,50,771 crore (US$ 29.7 billion), cash profit of Rs. 21,566 crore (US$ 4.3 billion), net profit (excluding exceptional income) of Rs. 15,607 crore (US$ 3.1 billion) as of March 31, 2009.

RIL is the first private sector company from India to feature in the Fortune Global 500 list of "World's Largest Corporations" and ranks 103rd amongst the world's top 200 companies in terms of profit. RIL is amongst the 30 fastest climbers ranked by Fortune. RIL features in the Forbes Global List of the world's 400 best big companies and in the FT Global 500 list of the world's largest companies. RIL ranks amongst the "World's 25 Most Innovative Companies" as per a list compiled by the US financial publication-Business Week in collaboration with the Boston Consulting Group.

CRISIL has reaffirmed its ratings of 'AAA/Stable/P1+' on the debt instruments of RIL and 'P1+' on the bank facilities of RPL. The Board of Directors of Reliance Petroleum Ltd. (RPL) & Reliance Industries Ltd. (RIL) unanimously approved the merger of RPL with RIL on 2nd March, 2009 (subject to necessary approvals). The exchange ratio recommended by both Boards is 1(One) share of RIL for every (16) sixteen shares of RPL. RIL will issue 6.92 Crore new Shares, thereby increasing its equity capital to Rs. 1,643 Crore from Rs. 1,574 Crores.

CRISIL in arriving at its analytical approach regarding its rating view on RIL, has taken a consolidated view of the financial and operational profiles of RIL & RPL together with other groups and associate companies, which are strategically important and have a significant degree of operational integration with RIL & RPL.

The shareholders and the creditors of RIL approved the scheme of amalgamation of RPL with RIL on 6th April, 2009.

In the Court convened meeting of equity shareholder, secured creditors and unsecured creditors of RIL held on 4th April, 2009, 98.86% of the shareholders present in person/proxies representing 99.9998% of the total value of equity shares held by them, voted in favour of the Scheme of Amalgamation. Shareholders representing 0.0002% of the total value of equity shares voted against the Scheme. 100% of the Secured Creditors & Unsecured Creditors present in person/proxies voted in favour of the Scheme of Amalgamation.

### Merger Benefits & Synergies

The merger will unlock significant operational and financial synergies that exist between RIL and RPL. It creates a platform for value enhancing growth and reinforces RIL's position as an integrated global energy company.

The merger will enhance value for shareholders of both the companies. The merger is EPS accretive for RIL. Through this merger, RIL consolidates a world-class, complex refinery with minimal residual project risk, while complementing RIL's product range. There will be further gains from reduced operating costs arising from synergies of a combined operation.

The Merger is expected to reduce the earnings volatility for RPL shareholders and allows them to participate in the full energy value chain of RIL.

### The Merger will result in RIL

1. Operating two of the world's largest, most complex refineries.
2. Owning 1.24 million barrels per day (MBPD) of crude processing capacity, the largest refining capacity at any single location in the world.
3. Emerging as the world's fifth largest producer of polypropylene.
4. RIL to be among the top 10 private sector refining companies globally.

The merger will expand the scale of RIL's refining operations. The company's low operating and capital costs, ability to process a wide range of products & capability to produce high-quality products that meet stringent regulatory requirements, will provide it with a sustainable competitive advantage in a commodity industry. The ratings continue to reflect RIL's leadership in the domestic petrochemicals industry, strong competitive position in the global oil-refining business, and exceptional financial flexibility. Further, increasing revenue diversity and highly integrated operations help mitigate the impact of price volatility that is inherent to RIL's business. The company had cash and marketable securities of Rs. 285 billion at the end of Dec, 2008.

RPL's Jamnagar refinery supplied some critical raw materials to the Hazira and Jamnagar complex of RIL. The table below indicates the quantity of raw materials (in million tonnes per annum) that was supplied by RPL to RIL:

| *Raw Material* | *Supplied to* | *Qty* |
|---|---|---|
| Naphtha | Cracker unit at its Hazira Complex | 2.5 |
| Aromatic Naphtha | Paraxylene/PTA plants in the Jamnagar Complex | 1.5 |
| C3 | Production of polypropylene at the Jamnagar Complex | 1.8 |

With the merger, all these transactions would turn into inter-divisional transfers from inter-company transfers. Gujrat Government had given sales tax waiver to RPL. This waiver was predominantly being used for naphtha & propane sales to RIL. By merging these two companies, the sales tax benefit that RPL enjoyed would have been optimized.

RPL also brought with it additional tax shield in the form of depreciation. The book depreciation amounted to Rs. 660.75 crore in FY 2000-01 & Rs. 802 crore in FY 2001-02. This was a valuable tax shield for the merged entity considering the projected rise in polymer prices from the end of 2002.

| *Particulars* | *RIL* | *RPL* | *Merged Entity* |
|---|---|---|---|
| Sales | 24520 | 33996 | 51016 |
| Net Profit | 2856 | 1692 | 4548 |
| Equity | 1053 | 5202 | 1396 |
| Net Worth | 14765 | 8727 | 23492 |
| Book Value (Rs) | 140.2 | 16.8 | 168.3 |
| EPS(Rs) | 27.1 | 3.3 | 32.6 |
| *Loan | 10631 (2001) | 7492 (2001) | 16906 (2002) |

*Source : Outlook Money Magazine; March 31st 2002. Notes: All figures are in Rs crore unless stated. Nine months figures have been annualized; the sales figures have been reduced by the inter-company sales of Rs. 7500-crore.*Source: www.capitaline. com, RIL.*

The most important benefit of the strength of the combined balance sheet was the much needed financial support for marketing of RPL's product.

RIL's debt rating post-merger was to remain the same at AAA+. RPL, however, had a slightly lower AA rating & consequently a relatively higher interest cost on its debts. The merger should have allowed the cost of this debt to be reduced to the levels enjoyed by RIL. ❑

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