



STUDY NOTE - 3

ALTERNATIVE STRATEGIES REVISITED

This Study Note includes:

- **Joint ventures**
- **Concentric growth and diversification**
- **Mergers and Acquisitions**
- **Hostile takeover**
- **Models for valuation**
- **Divestitures**
- **Corporate Restructuring**

ALTERNATIVE STRATEGIES REVISITED

Four groups of alternative strategies	
Corporate Level Strategy 1. Vertical Integration a. Forward Integration b. Backward Integration 2. Horizontal Integration 3. Concentric Diversification 4. Horizontal Diversification 5. Retrenchment 6. Divestiture 7. Liquidation	Global Level Strategies 1. Vertical Integration a. Forward Integration b. Backward Integration 2. Horizontal Integration 3. Market Penetration 4. Market Development
Business Level Strategy 1. Market Penetration 2. Market Development 3. Product Development 4. Concentric Diversification 5. Horizontal Diversification 6. Divestiture	Functional Level Strategies 1. Market Penetration 2. Market Development 3. Product Development

Companies during the life cycle need to adopt different strategies, which are both organic and inorganic according as the availability of resources as well as the exigency for implementation of the strategy. The above alternative strategies grouped under four levels take on different garbs when they are classified under organic or inorganic.



- **Expansion:** A forward backward and horizontal integration can be an organic expansion or inorganic mergers and acquisitions, tender offers, concentric diversification, horizontal diversification and joint ventures.
- **Divestitures:** Divestitures include spin offs, split offs, split ups, equity carve outs.
- **Corporate Restructuring:** Corporate restructuring includes retrenchment and liquidation, premium buy backs, exchange offers, share repurchases, going private and leveraged buy-outs.

Expansion

A company that wants to grow decides enlarge its activities so that it is in a position to increase its market share. The type of expansion activity depends on the stage of lifecycle of the industry. If the industry in the growth stage of the life cycle there is an urgency to grow and the opportunities will have to be taken immediately. This is where the inorganic expansion in the form of joint ventures, mergers and acquisitions come into reckoning. If the industry is in shake out stage, then the organic expansion in the form of synergy or substantial increase in capacity as adopted.

JOINT VENTURES

Joint ventures are equity arrangements between two or more independent firms. They are usually temporary business partnerships in which two or more business entities (proprietorship, partnership, corporation, or other) join for the purpose of conducting a specific project. Joint ventures are used frequently in the construction business. The joint venture is treated as a separate entity from the other business of the partners, and it keeps a separate set of accounts. When the project is completed, the joint venture is terminated, with all profits distributed to its members (or losses covered by them). In one sense, the joint venture can be considered a temporary form of business organization. In other respects, the possible use of the joint venture form is a strategic alternative.

- Two partners coming together to create a common undertaking contributing money, effort, knowledge, skill or any other asset
- The subject matter of a joint venture is interest in joint property
- Right of management or mutual control of the enterprise
- Presence of “adventure” to anticipate profit
- Right to share in profit
- Normal limitations to the objective of a single undertaking or ad hoc enterprise

Strategic alliances

Strategic alliances have also been classified as *joint venture* except that these alliances are born out of distinctive strategic advantage of one partner being sought by the other partner having good property or technology or products. The strategic advantage can be in the form of providing state-of-art technology, market expertise or market share or distribution network, etc. There are different types of strategic alliances and they are classified as follows:



- a. **Collisions between two partners:** This sort of an alliance arises between two strong competitors and such alliances do not continue for long. Normally, they either end in dissolution or acquisition by one of the partners or even merge
- b. **Evolution to a sale:** Two strong but compatible partners forge an alliance, but here also competitive tensions do develop culminating into a sale by one of the partner to the other
- c. **Alliances between complementary firms:** Two strong and complementary firms come together for strategic alliance and this normally continues well for a period to be determined by both of them
- d. **Disguised sale:** A strong company forges an alliance with a weak company and this eventually ends with the strong partner acquiring the weaker one over a period
- e. **Boot strap alliance:** Here also the alliance is between a strong and weak companies, but the weak company utilizes the strategic alliance to improve its competencies but again over a period the stronger company acquires the weaker one after developing it
- f. **Alliances of the weak:** Two weak companies strike a strategic alliance but the real strategy is missing and the alliance normally fails.

Another classification of strategic alliances is based on the concept developed by Yves L.Doiz and Gary Hamel who feel that

- a. A strategic alliance is developed between two potential competitors to ward off rivalry. Eg. Air bus consortium formed by European countries
- b. Two companies having specialized resources of their own coming together to create added value. Eg. Hitachi and Texas Instruments for development of DRAM chip
- c. This strategic alliance is forged to acquire new knowledge by working together and observing each other. Eg. GM and Toyota. While GM tried to learn lean manufacturing from Toyota, Toyota learnt the superior designs from GM

Motives for joint venture / strategic alliances

Though the above examples as well as the concepts indicate as to how strategic alliances or joint ventures are created a generic way of identifying motives are given below:

- Lack of funds for seizing an opportunity has been a problem where the opportunity is identified in a gray area. The outcome being uncertain due to high risks as well as long gestation period forces two good entrepreneurs to share the risk and mop up resources
- Learning experience followed by experience curve has also been a very strong motive for joint ventures
- Apart from sharing risk and resources the activity in itself may be their main inspiration for the joint venture
- Regulating authorities are more flexible in regard to joint ventures / strategic alliances rather than mergers, especially as the parents continue to be in operation



Reasons for failure of joint ventures

Not all joint ventures lead down the garden path. They end up many a time on the way side due to:

- The research and development for a new technology never materialized
- Preparation and planning for a joint venture might have been inadequate
- Conflicts in regard to the basic objectives of the joint venture cropping up after the formation
- Sense of secrecy and reluctance share expertise with the partner ends in a fiasco
- Difficulties faced in sharing managerial control between the partners made into a dead lock

With all the limitations joint ventures have a purpose to serve. They are very much of a hors d'oeuvre. They often also complete a project on time basis for which purpose they have come together. Eg., BBJ (Braithwite Burn and Jessop) for building the Howrah bridge later 40's and early 50's of the twentieth century, IPCL and Reliance petrochemical coming together on strategic alliance for a period to learn and understand each others competencies.

CONCENTRIC GROWTH

A firm may look for opportunities for growth in the current line of business and stick to one industry wherein it would like to derive value through the expertise gained over the years. Such growth strategy is understood to be concentric growth. The two basic concentration strategies are vertical growth and horizontal.

Vertical growth

Vertical can be achieved by taking over a function previously provided by a supplier or by a distributor. The company, in effect, grows by making its own supplies and / or by distributing its own products. This may be done in order to reduce costs, gain control over a scarce resource, guarantee quality of a key input, or obtain access to potential customers. This growth can be achieved either internally by expanding current operations or externally through acquisitions.

One of the classic cases of vertical integration in India is of Reliance Industries, which starting as a textile trading company into manufacturing and integrated backward to polyester manufacture and so on and finally into petroleum refinery. The group has petroleum transportation business and distribution as well. Apart from them a large number of Indian companies have captive power plants to support manufacturing and also have control over distribution channels. Similarly one of the leading aerated MNC brand as part of entry strategy in 90's took over dealer distribution network to complement its main product distribution network.

Vertical growth results in vertical integration – the degree to which a firm operates vertically in multiple locations on an industry's value chain from extracting raw materials to manufacturing to retailing. More specifically, assuming a function previously provided by a supplier is called backward integration (going backward on an industry's value chain). The



purchase of Millennium Business Solution Ltd., a public limited software solutions developer was bought out by a Company called take solutions which was into software product development in supply chain domain. This is a case in backward integration as the company; Take solutions with its domain knowledge could being a technology solutions developer add on products to its portfolio quickly with development capability.

Normally a function previously provided by a distributor is labeled forward integration (going forward on an industry's value chain). Jubilant Organosys Limited formally took over the Pharmaceuticals business of Max India in March 2003. According to analysts, life sciences business has strong synergies with Jubilant Organosys core specialty chemicals business. In line with their growth model, the company could leverage this business to further their standing in the high value added knowledge based product segments, thus expanding market presence and moving closer to their customers. The company is already a preferred supplier of advanced intermediates to many global international pharmaceutical and agrochemical companies. This entry into life sciences represents a logical forward integration.

Vertical growth is a logical strategy for a corporation or business unit with a strong competitive position in a highly attractive industry-especially when technology is predictable and markets are growing. To keep and even improve its competitive position, the company may use backward integration to minimize resource acquisition costs and inefficient operations as well as forward integration to gain more control over product distribution. The firm, in effect, builds on its distinctive competence by expanding along the industry's value chain to gain greater competitive advantage.

Although backward integration is usually more profitable than forward integration, it can reduce a corporation's strategic flexibility. The resulting encumbrance of expensive assets that might be hard to sell could create an *exit barrier*; preventing the corporation from leaving that particular industry. Transaction cost economics proposes that vertical integration is more efficient than contracting for goods and services in the market place when the transaction costs of buying goods on the open market become too great. When highly vertically integrated firms become excessively large and bureaucratic, however, the costs of managing the internal transactions may become greater than simply purchasing the needed goods externally, thus justifying outsourcing over vertical integration.

A company's degree of vertical integration can range from total ownership of the value chain needed to make and sell a product to no ownership at all. Under full integration, a firm internally makes 100% of its key supplies and completely controls its distributors. Large companies like Reliance Industries and Raymond of Aditya Birla group, are fully integrated. If a corporation does not want the disadvantages of full vertical integration, it may choose either taper or quasi-integration strategies. With taper integration, a firm internally produces less than half of its own requirements and buys the rest from outside suppliers. For example, a third party truck solution company in the logistics industry may have its trucks supplied through its own subsidiaries and engage from market balance requirements adjusting for demand and supply sensitivity. In terms of distributors, a firm sells part of its goods through company-owned stores and the rest through general wholesalers. Both Bata India and Pantaloons are selling their products through their own stores. With quasi integration, a company does not make any of its key supplies but purchases most of its requirements from



outside suppliers that are under its partial control. For example, by purchasing 20% of the common stock of a key supplier, an OE manufacturer can provide access to technology and have committed quality supplies and shorten new product development cycle. Purchasing part interest in a key supplier or distributor usually provides a company with a seat on the other firm's board of directors, thus guaranteeing the acquiring firm both information and a company may not want to invest in suppliers or distributors, but it still wants to guarantee access to needed supplies or distribution channels. In this case, it may use contractual agreements. Long-term contracts are agreements between two separate firms to provide agreed-upon goods and services to each other for a specified period of time. This cannot really be considered to be vertical integration unless the contract specifies that the supplier or distributor cannot have a similar relationship with a competitive firm. In this case, the supplier or distributor is really a *captive company* that although officially independent, does most of its business with the contracted firm and is formally tied to the other company through a long-term contract.

Contemporary business practices are more of cooperative contractual relationships with suppliers and even with competitors rather than adopting vertical growth strategies (and thus vertical integration). These relationships range from outsourcing, in which resources are purchased from outsiders through long-term contracts instead of being made in-house to strategic alliance, in which partnerships, technology licensing agreements, and joint ventures supplement, a firm's capabilities. One can observe such practices among information technology companies with that of solution developers, pure technology companies with IT companies; transport and hospitality services companies are classic cases where they work on such collaborative relationships.

Horizontal growth

Horizontal growth can be achieved by expanding the firm's products into other geographic locations and / or by increasing the range of products and services offered to current markets. In this case, the company expands sideways at the same location on the industry's value chain. For example, in India, Parry sugar business has grown by adding on capacities at different regions. Similarly, few cement manufacturing companies like India Cements and Madras Cements have followed similar strategies. Dell Computers followed a horizontal growth strategy when it extended its mail order business to Europe and to China. A company can grow horizontally through internal development or externally through acquisitions or strategic alliances with another firm in the same industry. Horizontal growth results in horizontal integration – the degree to which a firm operates in multiple geographic locations at the same point in an industry's value chain. Horizontal integration for a firm may range from full to partial ownership to long-term contracts.

Circular growth

With the assembly operation getting more important in the engineering industry, sourcing components has assumed a definite role. Automobiles, connectors, television, computer hardware, entertainment electronics etc have grown phenomenally and also have developed specific managerial processes to make these production operations more efficient and effective. Farming out components which do not form part of core competence of a manufacturing company has created many SMEs. The need to coordinate sourcing and supply of components



to have a strategic fit with the manufacturing programme based on the concepts of JIT and logistics strategy, circular growth concept has emerged. The components suppliers are normally a part of an industrial estate which is close to the manufacturer of the finished product so that the flow of components match the production programme without fail. Especially, when MTO and MTA programmes are on the anvil, circular growth of component industry along with the manufacturing company has become the practice.

CONCENTRIC DIVERSIFICATION

When an industry consolidates and becomes mature, most of the surviving firms have reached the limits of growth using vertical and horizontal growth strategies. Unless the competitors are able to expand internationally into less mature markets, they may have no choice but to diversify into different industries if they want to continue growing. The two basic diversification strategies are concentric and conglomerate.

Concentric (Related) diversification

Growth through concentric diversification into a related industry may be a very appropriate corporate strategy when a firm has a strong competitive position but industry attractiveness is low. By focusing on the characteristics that have given the company its distinctive competence, the company uses those very strengths as it means of diversification. The firm attempts to secure strategic fit in a new industry where the firm's product knowledge, its manufacturing capabilities, and the marketing skills it used so effectively in the original industry can be put to good use. The corporation's products or processes are related in some way: They possess some common thread. The search is for a synergy, the concept that two businesses will generate more profits together than they could separately. The point of commonality may be similar technology, customer usage, distribution, managerial skills, or product similarity.

The firm may choose to diversify concentrically through either internal or external means. Murugappa group's E.I.D. Parry India Ltd., for example, has diversified both internally and externally out of the unpredictable sugar business into a series of related businesses run by the parent company. Building on the expertise of its technology solutions development, Infosys Technologies Ltd. launched a banking solutions product and then went on growing related business geographically as well.

Conglomerate Strategy

When management realizes that the current industry is unattractive compared to market returns and that the firm lacks outstanding abilities or skills that it could easily transfer to related products or services in other industries, the most likely strategy is conglomerate diversification – diversifying into an industry unrelated to its current one. In stead of holding a common link throughout the organizations, strategic managers who adopt this strategy are primarily concerned with financial considerations of cash flow or risk reduction.

The emphasis in conglomerate diversification is on financial considerations rather than on the product market synergy common to concentric diversification. A cash-rich company with few opportunities for growth in its industry might, for example, move into another industry where opportunities are great but cash is hard to find. Another instance of conglomerate diversification might be when a company with a seasonal sales and, therefore, uneven cash



flow purchases a firm in an unrelated industry with complementing seasonal sales that will level out the cash flow. ITC Ltd. in India is one of the leading conglomerate which in business of tobacco, hotels, food, paper and paper boards and so on.

Mergers and Acquisitions

Why firms merge? It is important to understand various conceptual inputs that are available on drives of mergers and acquisitions. One of the key theories of mergers is the efficiencies theories which emanates from economic theory of firms.

Efficiency Theories

The principle of Different efficiency believes that when two forms A and B operate independently there could be redundancy of resources and resource utilization could be inefficient. By merging these two entities, the management could drive higher value through resource reduction or saving.

The Inefficient management theory is also on the same lines where there could be inefficient managerial resource utilization and consolidation of entities brings scope of deploying efficient and highly productive managerial resources which would increase the value to the shareholders.

The operating synergy could arise due to economies of scale, complimentary and vertical integration. The enhanced profitability would arise from mergers through cost reduction and efficient utilizations of resources. The expanded scale of operations brought about through mergers leads to reduction in per unit cost of production. It allows for expanded volume of production without a corresponding increase in fixed costs. This leads to reduced per unit fixed costs. Efficient and optimal use of available fixed resources such as production facilities, management functions and management resources and systems also results in enhanced profitability.

It is possible for a firm that chooses to take the mergers route to achieve economies of scale in all spheres of business activity such as production, marketing, personnel, R & D, etc. Mergers facilitates better coordination and administration of the different stages of business operations such as purchasing, manufacturing and marketing thus eliminating in the process, the need for bargaining with suppliers and customers, and thereby minimizing uncertainty of supply of inputs and demand for product.

Operating economics comes about to the acquiring firm in the following manner:

1. Reducing the cost of production by eliminating some fixed costs
2. Reduction in the R & D expenditure due to the new set up which underscores the need for eliminating similar research efforts and repetition of work already done by the target firm
3. Reduction in management expenses as a result of corporate reconstruction
4. Cost reduction by streamlining of selling, marketing and advertisement department by being in a position to offer a wider product line to make larger sales



Complementary mergers may result in each firm filling in the “missing pieces” of their firm with pieces from other firm. A merger of a firm with strong R & D unit would help to improve new product development while with a firm with a strong distribution network, may benefit better distribution.

As mentioned earlier, **vertical integration** helps a firm to benefit buying of suppliers and manage cost, availability and product development better. Similarly when forward integration is initiated the benefits of distribution management and improving cost efficiency and responsiveness to customers would bring more value to the firm.

When firm strategies’ to grow through external or otherwise called as inorganic growth, it pursues mergers, acquisitions and takeovers. Today in India one could observe how competitive horizon is dramatically changing through such inorganic growth initiatives. For example in aviation business, Air India, Government of India’s international carrier merged with Indian Airlines to form National Aviation Company of India Ltd. Jet Airways took over Sahara Airlines and King Fisher Airlines has bought stakes in Air Deccan.

Scramble for market opportunities

Mergers and Acquisitions (M & A) as forms of business combination are increasingly being used for undertaking restructuring of corporate enterprises the world over. Of late, mergers happen in all the sectors of the economy, the prime driving force being the accomplishment of synergetic effect for both the acquiring and the acquirer companies. As mentioned earlier, Mergers have started happened in India too at an increasing pace, for example exploiting the growing market without gestation.

MERGER

A type of business combination where two or more firms amalgamate into one single firm is known as a ‘merger’, one or more companies may merge with an existing company or they may combine to form a new company. In the Indian context, both the terms ‘mergers’ and ‘amalgamations’ are used interchangeably. For instance, according to Section 2 (IA) of the Income tax Act, 1961, the term ‘amalgamation’ is defined as “the merger of one or more companies with another company or the merger of two or more companies (called amalgamating company or companies) to form a new company (called amalgamated company) in such a way that all assets and liabilities of the amalgamating company or companies become assets and liabilities of the amalgamated company and shareholders holding not less than nine-tenths in value of the shares in the amalgamating company or companies become shareholders of the amalgamated company”.

In a broader sense, the term merger includes consolidation, amalgamation, absorption and takeover. Merger refers to a situation where two or more existing firms combine together and form a new entry. Merger signifies the transfer of all assets and liabilities of one or more existing companies to another existing or new company. A basic feature of merger is that an entity which takes the ownership of another company combines with it, the operations of the merging entity. Merger which takes place either through absorption or consolidation allows for the takeover of the ownership of other companies and combination of their operations with its own operations. The main purpose of merger is to achieve the advantage of synergy through expansion and diversification.



Purpose of merger

Diversification

Another important theoretical framework on merger motives is that the firms seek mergers for achieving market supremacy and dominance by way of diversification into new areas and new products. Diversification brings about magical growth in revenues and profits. The benefits are enormous where the merger takes place for such companies whose risk profiles are negatively correlated. In the same manner, the greatest advantage of merger can be obtained in the case of conglomerate mergers, where two firms could merge where cash flows could offset one's operational risk with others. The conglomerate mergers work well where both the relationship between operational and financial risks are inverse. The biggest advantage of this type of merger is that it results in reduction of total risk through substantial reduction of the risks of operations of individual firms. Risk diversification arises as a result of combination of management and other systems to strengthen the capacity of the combined firm to withstand the severity of the unforeseen economic factors which could otherwise endanger the survival of individual companies. Risk diversification in the case of conglomerate mergers can also be achieved by the shareholders of unquoted companies as they get an opportunity for trading in their shares. Further, diversification helps reduce the total risk of shareholders by holding shares of diversified companies.

Strategic realignment

The most fundamental of all the reasons for mergers is the 'synergy' argument which is the basis of strategic realignment. According to Eugene F. Brigham, the term synergy is defined as "the condition wherein the whole is greater than the sum of its parts; in a synergistic merger, the post merger value exceeds the sum of the separate companies' pre merger values". Accordingly, under 'synergy', the combined value of a firm is much greater than the value of individual firms. The phenomenon of synergy arises due to economies of scale of operation. Besides, the combined mega features such as enhanced managerial capabilities, creativity, innovativeness, R & D and market coverage capacity. Due to the complementary nature of resources and skills a widened horizon of opportunities are also responsible for synergy on a merger situation.

Financial leverage

There could be financial strategy by mergers. The combined assets and debt capacity could help to leverage better and build business better than each firm could do individually.

Information and signaling

One of the arguments in favor of mergers is information and signaling to gain market values of target firm because of information dissemination during the tender offer or media or both. The market values such information better sending values northwards. Similarly, the new found media attention and drive to increase value of their firm, the senior management gets inspired with a kick in pants and works for better valuation.

Market Power

The other driver of merger is becoming bigger. The size and volume gives enough motivation and makes the firms to combine.

**Hubris**

One of the main reasons for merger could be behaviour of agents or managers who drive to increase their utilization and on animal spirits or hubris or for pride drive takeovers. At times, managers commit errors of over optimism in evaluating merger opportunities due to excessive pride, animal spirits or hubris and mergers erode value.

Tax benefit

This is the biggest advantage arising out of a merger move. It allows a sick company to carry forward its accumulated losses to be set-off against its possible future earnings. This happens for the purpose of calculating tax liability. Since it might not be possible for a sick firm to earn profits in future sufficient enough to take advantage of the carry-forward provision, the same can be accomplished by way of combining with a profit making enterprise. This tax benefit is available in many countries of the world. For instance, in India a sick company can merge with a profitable company to set-off the accumulated losses and utilized depreciation of the company. Several mergers have taken place in India in order to avail the benefit of reduced tax liability.

Forms of merger

Merger takes place in the following forms:

- Merger through absorption
- Merger through consolidation

Merger through Absorption

Under the absorption mode of merger, a combination of two or more companies into an existing company takes place. In the case of 'merger through absorption' all companies except one lose their identity. An example of this type of merger is the absorption of Bank of Madura by the ICICI bank. The ICICI Bank was the acquiring company (buyer) which survived after the merger, while the Bank of Madura, an acquired company (seller), which ceased to exist. The Bank of Madura transferred its assets, liabilities and shares to the ICICI Bank.

Merger through Consolidation

Under the consolidation mode of merger, two or more companies merge into a new company. Under this form of merger, all companies are legally dissolved and a new entity is created. The acquired company transfers its assets, liabilities and shares to the acquiring company for cash or for shares. An example of merger through consolidation is the merger or amalgamation of Air India and Indian Airlines to form an entirely new company called 'National Aviation Company of India Ltd. (NACIL).

Merger, acquisitions and takeover have been well articulated, these nomenclatures are used interchangeably. It may be useful to point out various terms and definitions used while dealing with mergers and acquisitions.

Acquisition

An act of acquiring effective control by one company over the assets or management of another company without any combination of companies is referred to as 'acquisition'. A



typical characteristic of acquisition is that while two or more companies remain independent and separate legal entities, there is change in the control of companies.

The term 'acquisition' is used to refer to the act of acquiring of ownership right in the property and assets of another company and thereby bringing about change in the management of the acquiring company. In one of the cases mentioned earlier namely on Jet Airways, the company acquired Sahara Airlines. Sterlite Industries Ltd. bought over Bharat Aluminium Ltd. (BALCO) while it was privatized.

Acquisition could happen in any of the following ways:

1. Entering into an agreement with a person or persons holding controlling interest in the other company
2. Subscribing new shares issued by the other company in the open market
3. Purchasing shares of the other company at a stock exchange
4. Making an offer to buy the shares of other company, to the existing shareholders of that company

Takeover

Another term associated with merger is 'takeover'. In the case of a takeover, one company obtains control over management of another company. Under both acquisition and takeover, it is possible for a company to have effective control over another company even by holding minority ownership. For instance, the Monopolies and Restrictive Trade Practices (MRTP) Act prescribed that a minimum of 25 percent voting power must be acquired as to constitute a takeover. Similarly, section 372 of the Companies Act defines the limit of a company's investment in the shares of another company as anything more than 10 percent of the subscribed capital so as to constitute a takeover. Currently, SEBI guidelines are well defined and regulate effectively mergers and takeover.

Where a distinction between acquisition and takeover is made, takeover usually takes the form of 'hostile' or 'forced' or 'unwilling' acquisition and acquisition happens at the instance and the willingness of the company management and the shareholders. It is for this reason that acquisition is generally referred to as 'friendly takeover'. An example of acquisition is Aditya Birla group, a leading conglomerate in India with substantial interest in textiles and cement, apart from other things, took over from L & T its cement business on a friendly takeover. Similar such transaction was that ORBI Tech by Polaris Software. On the other hand, the acquisition of Raasi Cement by India Cements earlier was a hostile takeover by the India Cements Group. Further, the term takeover is often used to denote the hostile nature of acquisition, where there is an element of resistance and opposition to the takeover bid.

Hostile takeover

Where in a merger one firm acquires another firm without the knowledge and consent of the management of the target firm, it takes the form of a 'hostile takeover'. The acquiring firm makes a unilateral attempt to gain a controlling interest in the target firm, by purchasing shares of the latter firm directly in the open (stock) market. An example of hostile takeover was the takeover of Shah Wallace / Dunlop by Chhabirias Group. Since this type of takeover



is generally prejudicial to the interest of the shareholders, SEBI has come out with relevant code of conduct for the purpose of disciplining the takeover practice in India.

HOSTILE TAKEOVER-STRATEGIC TACTICS

A target firm is one which could be taken over in a hostile takeover and a predator is one who attempts the takeover. When a target firm fears a hostile takeover, the management of the company may initiate the defensive measures and strategies to avoid takeover. The management being the agents of the shareholders has to take decisions in the best interest of the shareholders. Further, the existence of the management of the target firm is also uncertain as there is an all-likely chance of change of management of the target firm, if the takeover bid proves successful.

According to Weston, J.I., Chung, K.S. and Hoag, S.E., a target company which faces the threat of a hostile takeover, would adopt the following strategies:

Poison pill tactics

This strategy aims at initiating action against the predator by destroying the attractiveness of the firm. The following are few methods:

The acquiring company may issue substantial amount of convertible debentures to its existing shareholders which would make it difficult for the potential acquirer as there is a danger of considerable increase in the voting power of the company.

- The target firm either sells or mortgages or leases or otherwise disposes off some of its precious assets.
- The target firm can defend itself from the onslaught of the potential bidder is to dispose of its liquidity by acquiring some asset or other firm.
- The target grants its employees stock options that immediately vest if the company is taken over. This is intended to give employees an incentive to continue working for the target company at least until a merger is completed instead of looking for a new job as soon as takeover discussions begin. However, with the release of the “golden handcuffs”, many discontented employees may quit immediately after they’ve cashed in their stock options. The poison pill may create an exodus of talented employees. In many high-tech businesses, attrition of talented human resources often means an empty shell is left behind for the new owner.
- The target company issues rights to existing shareholders to acquire a large number of new securities, usually common stock or preferred stock. These new rights usually allow holders (other than an acquirer) to convert the right into a large number of common shares if anyone acquires more than a set amount of the target’s stock (typically 10-20%). This immediately dilutes the percentage of the target owned by the acquirer, and makes it more expensive to acquire control of the target.

Green mail tactics

The target firm can purchase its own stocks at a premium to avert a takeover bid. The incentive is offered by management of the target company to the potential bidder for not pursuing the takeover bid.



White Knight tactics

The target company's management may seek out a friendlier potential acquiring company who could offer a higher offer price which would eventually drive away the original bidder. The purpose of 'white knight strategy' is to seek to find a bidder. The objective is to make the takeover exercise as much unviable and unprofitable as possible for the original bidder. Such a strategy will help get the target firm a better deal. There are cases where a white knight has later been aggressive with the target company and consummated the deal at better terms.

Golden Parachutes tactics

Adopted by the target company by offering hefty compensations to its managers if they manage to get ousted due to takeover; this is pursued to reduce their resistance to takeover. This was also mentioned among one of the strategies of poison pill. This is mainly initiated because soft target firms who are managed by professional managers may fear shifting of loyalty by professional managers and to avoid any such attempts set up golden parachutes so that predators may not have incentive to deal with the agents for consummating the deal.

Divestiture tactics: Whereby target the company arranges to divest or spin off some of its businesses in the form of an independent, subsidiary company thus reducing the attractiveness of the existing business to the predator. This clearly changes the valuation of the company and many a times the multiples of valuation for multi divisional businesses would encourage such moves by target companies.

Crown Jewel tactics: Whereby the target company arranges to sell its crown jewel namely highly profitable part of the business or ones which market values better in order to dissuade the predator. However, such strategic initiative requires clear understanding of predators target businesses and valuation guidelines to be effective.

Legal tactics: A target firm can forestall the possible takeover bid through legal mode. It takes the form of 'legal strategy' for guarding against hostile takeovers. In this case, it is possible for the target firm to move a court of law for obtaining injunction against the offer. For this purpose, relevant provisions exist in the Securities Contracts (Regulations) Act, 1956 and the Companies Act, 1956. This strategy is resorted to either to block or delay the tender offer in circumstances where the shares are lodged for the transfer by the bidder. SEBI has come with clear guidelines to discourage hostile takeovers in India.

Tactical Initiatives

The management of the target firm may adopt different types of tactical initiatives to discourage hostile takeover bid. For this purpose, the target company may initiate the following tactics:

- a. Mounting media campaign
- b. Sending letters and circulars to the shareholders dissuading them from accepting the tender offer
- c. Educating the shareholders that the consideration being offered by the acquiring firm is inadequate and that the proposed merger / takeover does not make any economic sense and the performance of the firm may be adversely affected by the takeover.



- d. Causing reduction of floating stock of the target firm by persuading business associates, directors, and employees to purchase the shares of the firm from the market in order to frustrate the efforts of the bidder to acquire the controlling interest.
- e. Allowing the existing shareholders to increase their stake by the issue of warrants or convertible preference shares or convertible bonds, etc. at a relatively low price.
- f. Offensive moves like counter take over move being initiated if financially strong

Reasons for failure of mergers

The following are more commonly found reasons for failure of mergers:

Overoptimistic Appraisal: The investment advisors and the agents' namely professional managers are generally buoyant during pre merger time and are over optimistic while appraising the opportunity. This arises not only in estimating cash flows, profitability and returns but also on soft issues and statutory requirements which lands up in trouble later.

Overestimation of synergies: There is again a tendency to over estimate the synergy and ignore conditionally required for achieving the synergy: Many a times synergy is on paper because of idealistic assumptions. Time lines, investment and managerial resource commitments are ignored while planning for synergies or gaps arise during post merger management on these which lead to failure.

Overbidding: Driven by hubris there has been a tendency to overbid to acquire. However, the economics fail to support leading to failure as the investment sunk can only be recovered through economic returns.

Poor post-acquisition integration: This has been the most common cause for failure of mergers. Like typical case of "marry in haste and repent in failure", corporate rush to merge without implementation plan. The integration derails at the start involving slippages in investment plan, revenue targets and loss of key managerial resources, at times, a lot of cultural issues lead to chaos. Statutory and legal issues, creditors' settlement are also other issues which would arise while managing post merger situation.

Recommended Steps in an Acquisition Process

1. Pre-acquisition phase
 - Evaluate own company and identify readiness and need for external growth
 - Organize and plan areas and seek professional advice
2. Screening and short listing of targets
 - Look at public companies, divisions of companies and privately held companies
 - Identify knock out criteria
 - How to use investment banks
 - Prioritize opportunities
3. Cost and Value imputation
 - Value companies
 - Know exactly how you would recoup takeover premiums



- Identify real synergies
 - Decide on a restructuring plan
 - Decide on a financial engineering opportunity
4. Negotiation
 1. Decide on Maximum reserve price
 2. Understand background and incentives on the other side
 3. Establish negotiation strategy
 4. Conduct due diligence
 5. Post merger implementation
 1. Move quickly to conserve management resources
 2. Recognize continuity and push for growth
 3. Infusion of new and additional resources, if necessary
 4. Carefully manage cultural, legal and statutory issues.

To conclude, mergers and acquisitions provide a great opportunity as a strategic initiative for firms which would like to pursue inorganic growth. The challenges and limitations are phenomenal and one needs to thread carefully while driving such strategic initiative.

Valuation

Cost and Value Imputation: The predator / buyer of any firm or asset would go through certain processes while initiating a merger or takeover move. Similarly, a target company would also go through few critical processes while intending to be a target for a merger or takeover deal. For example, when a company like IBM buys out Daksh a BPO firm out of Gurgaon, New Delhi, both IBM and Daksh go through the decision process. The transaction is arrived at certain value. Ability to close a deal by agreeing to a value and signing off the deal would be one of the key processes where both the firms converge. Here one may look at the various aspects of such valuation techniques and how one must be prepared for the same.

The process of mergers and acquisition

While involving in a merger move, a predator or a buyer would go through the following steps:

1. Contemplation and Approach
2. Confidentiality Agreement
3. Exchange of Information / Evaluation
4. Preliminary Negotiation and Letter of Intent (LOI)
5. Due Diligence
6. Definitive Agreements



7. Financing
8. Closure
9. Post merger integration

It may be observed from the above that there is a number of steps but the key to all these is the valuation as it forms the fulcrum of the deal. Also the buyer and seller have certain objectives for the deal and it must get captured in the value negotiated. Prima facie, the seller would like to get maximum value out of the deal and the buyer would be the best price which need not be what the seller expects. The art of getting into a right transaction price is possible only through a detailed valuation exercise and probably a well meaning negotiation to make a deal happen.

Requirements for valuation

Valuation of an entity or an asset would predominantly depend on the numbers that can be constructed around the same. Then, the same is used for zeroing a value to enable the deal or transaction. When one discusses about quantitative numbers, one may require a profit and loss statement, balance sheet and future projections of the same. When one works out the future projections, one may have to look at the business plan and strategy for constructing the revenues and assets which may be required for generating the same. Typically, the following may be required for a valuation exercise from buyer's angle:

- a. Historic Financial Performance for a period of 3 to 5 years of the Target Company
- b. Current Balance Sheet and Interim Financial Statements
- c. Projections of target company for 3 to 5 years as is where is
- d. Strategic focus: scenario building and likely impact on merged business and this information is to be collected based on chosen models
- e. Forecast for Next 3 to 5 years for the merged company and GAP analysis
- f. Arrive at Maximum Reserve Price for negotiation

Valuation of Target Company by the owner also is a significant part of negotiation for the reserve price / upset price. While the reserve price has been computed by the buyer, the upset price is calculated by the seller below which he would not like to slip. The seller normally keeps the upset price close to his heart as he expects the higher price to be bid by the seller. However, the upset price will have to be computed on the basis of constructive costing estimates on the following steps:

1. Historic financial performance for a period of 3 to 5 years of the target company
2. Current balance sheet and interim financial statements of the target company
3. Strategic focus: scenario building and likely impact on the target company's performance following the owners (seller's) strategy
4. Identify the synergy between the buyer's company and the seller's company and evaluate the distinctive competence of the target company (Seller's) and develop a premium for this entity



5. If there is brand equity, good will or such other intangible assets they need to be valued using specific models and include such value into the upset price.

Caution

From the above it will be clear that there is no single value for the target company that is to be merged. The view point of the buyer will be to minimize the value so that the purchase price is lower; while the seller would like to improve the value so that he gets a fair deal and its upset price is fully covered. Towards this both the seller and the buyer will have to be careful about the following factors:

1. The valuation exercises being different from the buyer and the seller, there is no objective known as true value. Actually, there will be two valuations that have to be marched and negotiated.
2. Precision is not the objective in valuation as estimates well into the future of quantifiable components as well as valuation of intangibles are involved.
3. Models need to be employed for valuation and it will be prudent for both the buyer and the seller to agree on the prime variables that should form part of the model. Model selection is the crux of consensus.

MODELS FOR VALUATION

There are a number of models to valuation which are as follows:

1. Asset based valuation model
2. Discounted cash flow model
3. Relative valuation model
4. Contingent claim models or option pricing models

Most of the above measures are market related. There could be some approaches which are opinions and expert views. The use of valuation models in investment decisions (i.e. in decisions on which assets are under valued and which are over valued) are based upon:

1. A perception that markets are inefficient and make mistakes in assessing
2. An assumption about how and when these inefficiencies will get corrected.

In an efficient market, the market price is the best estimate of value. The purpose of any valuation model is then the justification of this value. There are other situations where valuation models are useful are:

1. When the asset or the firm is not publicly traded and there is a need to arrive at an appropriate value
2. When an analyst or a buyer has reasons to believe that a new business model can be deployed and a new set of values can be arrived at based on the management perception which is different from the market.

1. Asset Based Valuation

There are a number of assets a company has. It could be tangible assets like, land and building, machinery and so on or intangibles like human resources, good will, rights of



distribution and so on. A firm would look at asset based valuation only when it decides to handle liabilities independent of the assets. The situations in which this model is useful are as below:

- To sell of a business unit as an asset and retain liabilities so that it could be settled independently
- To sell an asset from a group of assets for enabling replacement or change of plans with respect to its productive use
- In the condition of distress where liabilities could be more and require to be handled through a settlement process similar to bankruptcy or liquidation.

The most commonly used asset based valuation methods are:

1. Liquidation value
2. Replacement value

Liquidation method

Many factors can contribute to tough financial times for a business, including a struggling economy, natural disaster, or illegal activity such as fraud. When a business encounters this type of financial distress, it may be forced to claim bankruptcy and liquidate some of its assets in order to regain some of its investment. The liquidation value is the approximate amount a business can expect to get back when this type of sale takes place.

Usually this amount is less than the market value as the book value. The reason for this decrease in value is that liabilities are subtracted from the value of the assets in order to determine the liquidation value of the business. The liquidation value is usually determined by qualified professionals, who will provide an estimate so that the company can decide if it actually wants to go through with the process. Another factor that can influence liquidation values is the state of the market at the time of the liquidation. When a firm in financial distress needs to sell assets, its industry peers are likely to be experiencing problems themselves, leading to asset sales at prices below value in best use. Such illiquidity makes assets cheap in bad times.

There are two types of liquidation values, depending on the urgency of the situation. Orderly liquidation value applies to a business that can afford to take its time to field offers from a multitude of bidders in order to get the best price for its assets. Often, in these cases, the business can sell items individually instead of selling the whole collection of assets at one time. Distress liquidation values come into play when a business is desperate to liquidate its assets. Usually the assets are sold all at once and often to firms or dealers who specialize in purchasing liquidated items. Distress liquidation values are always lower than orderly liquidation values and in some instances drastically lower.

It should be noted that liquidations are not necessarily a sign of failure. While much liquidation occurs during poor financial times, others do not. Often a business may be forced to liquidate



some of their assets in an effort to keep up with changes in the market place. For example, new products or technologies can come out that make older ones obsolete and therefore force a business to buy the new product in an effort to keep up. Some experts contend that some form of liquidation is taking place even amongst the most successful companies. If these trends are closely monitored and quickly dealt with, a company should be able to stay ahead of the game and avoid any negative financial repercussions.

Replacement cost method

Normally the balance sheet of a company as certified by the auditors gives a fair and true picture of the company. However, in reality values of the assets as per the balance sheet represents the depreciated value as also the original value of a by gone era. Towards this it becomes necessary to update the values of physical assets like land, buildings, plant and machinery, tools and spares, etc. As land is never depreciated the original cost at which it was bought still represents the value in the current balance sheet. This is normally updated on the basis of guideline values available with the Registrar. When it comes to other physical assets that are depreciated, the replacement cost model takes into consideration two major factors:

1. The residual economic life of the asset
2. The present cost of replacement of the particular asset, i.e., the into factory cost including the present market price of the asset adjusted for the residual life of the asset.

For arriving at replacement cost where the market price of the type of asset the company possesses is not available currently this replacement cost is built up taking into consideration the whole sale price index for the materials and for the labor the cost of living index. With these indices and selecting the proper method of costing the replacement cost of an asset is arrived.

This model is a fair substitute to infuse a semblance of reality into the valuation of a company's assets. However, this does not take into consideration the impact of intangibles like technology, experience curve and intellectual property.

Another interesting facet of replacement cost model is the existence of old economy companies and new economy companies producing the same commodity. For example, cement, sugar and steel. While comparing these companies the significant fact that comes out is the low capitalization of the old economy as against as a new economy ones and a necessity for a correction for the inflationary values. Tobins'Q is one such technique which has given an insight into relating market value of a company to its replacement value of assets.

$$\text{Tobin's Q} = \text{Market value of company} / \text{Replacement value of its assets}$$

Tobin's Q will be 1, if the recorded assets of the company reflect a market value. The other two cases where $Q > 1$ or < 1 , will have to be moderated by taking into consideration the three following factors.

1. The recorded assets of the company
2. The market perception about the company
3. The intellectual capital of the company



2. Discounted cash flow models

In discounted cash flow valuation, the value of an asset is the present value of the expected cash flows on the asset. Suppose if one has to buy an asset which is a single property business class hotel, the value of the property would depend upon the business it would bring over the years. The future net cash flow are discounted at the cost of capital and the value of the property is arrived at. This is based on the rationale that every asset has an intrinsic value that can be estimated, based upon its characteristics in terms of cash flows, growth and risk.

To use discounted flow valuation, one would need

1. to estimate the life of the asset
2. to estimate the cash flows during the life of the asset
3. to estimate the discount rate to apply to these cash flows to get present value

These are the three key inputs which require good assessment on future of the business and business acumen. The quality of valuation precisely depends on the same.

$$\text{Value} = \sum_{t=1}^{t=n} \frac{CF_t}{(1+r)^t}$$

Where CF_t is the cash flow in period t , r is the discount rate appropriate given the riskiness of the cash flow and t is the life of the asset.

Equity valuation method

The value of equity is obtained by discounting expected cash flows to equity, i.e., the residual cash flows after meeting all expenses, tax obligations and interest and principal payments, at the cost of equity, i.e., the rate of return required by equity investors in the firm.

$$\text{Value of Equity} = \sum_{t=1}^{t=n} \frac{CF \text{ to Equity}_t}{(1+ke)^t}$$

Where,

$CF \text{ to Equity}$ = Expected Cash flow to Equity in period t

Ke = Cost of Equity

The above method is based on the free cash flows available to equity shareholders after payment of obligations including debt fund providers.

Dividend based method

An alternative to the above method is the dividends based method. The dividend discount method is a specialized case of equity valuation, and the value of a stock is the present value of expected future dividends. In the more general version, one can consider the cash flows left over after debt payments and reinvestment needs as the free cash flow to equity.



Firm value method

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

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

Adjusted Present Value (APV) approach: The value of the firm can also be written as the sum of the value of the unlevered firm and the effects (good and bad) of debt.

Firm Value = Unlevered Firm Value + PV of tax benefits of debt – Expected Bankruptcy Cost

Adjusted present value method

In the adjusted present value approach, the value of the firm is written as the sum of the value of the firm without debt (the unlevered firm) and the effect of debt on firm value

Firm Value = Unlevered Firm Value + (Tax Benefits of Debt – Expected Bankruptcy Cost from the Debt)

1. The unlevered firm value can be estimated by discounting the free cash flows to the firm at the unlevered cost of equity
2. The tax benefit of debt reflects the present value of the expected tax benefits. In its simplest form, Tax Benefit = Tax rate * Debt
 - The expected cost is a function of the probability of bankruptcy and the cost of bankruptcy (direct as well as indirect) as a per cent of firm value.

Excess returns method

One can present any discounted cash flow model in terms of excess returns, with the value being written as:

$$\begin{aligned} \text{Value} = & \text{Capital Invested} + \text{Present value of excess returns on current} \\ & \text{Investments} + \text{Present Value of Excess returns on future} \\ & \text{Investments} \end{aligned}$$

This model can be stated in terms of firm value (EVA) or equity value.

3. Relative Valuation Model

The value of any asset can be estimated by looking at how the market prices “similar” or ‘comparable’ assets. This is useful when the asset is not traded directly in market or when the intrinsic value of an asset is impossible to estimate for want of appropriate input data. Then, the value of an asset is whatever the market is willing to pay for it based upon its characteristics of similar or comparable assets.



For arriving at a relative valuation, one would need

- an identical asset, or a group of comparable or similar assets
- a standardized measure of value (in equity, this is obtained by dividing the price by a common variable, such as earnings or book value)
- and if the assets are not perfectly comparable, variables to control for the differences

Pricing errors made across similar or comparable assets are easier to sport, easier to exploit and are much more quickly corrected.

Variations on Multiples that are used are as below:

Equity versus Firm Value

- Equity multiples (Price per share or Market value of equity)
- Firm value multiples (firm value or Enterprise value)

Scaling variable

1. Earnings (EPS, Net Income, EBIT, EBITDA)
2. Book value (Book value of equity, Book value of assets, Book value of Capital)
3. Revenues
4. Sector specific variables

Base year

1. Most recent financial year (current)
2. Last four quarters (Trailing)
3. Average over last few years (Normalized)
4. Expected future year (Forward)

Comparables

5. Sector
6. Market

4. Contingent Claim (Option) Valuation

Options have several features

1. They derive their value from an underlying asset, which has value
2. The payoff on call (put) option occurs only if the value of the underlying asset is greater (lesser) than an exercise price that is specified at the time the option is treated. If this contingency does not occur, the option is worthless.
3. They have a fixed life



Any security that shares these features can be valued as an option.

Choice of models

Model	Method	Applicable	Not applicable
Asset Based Valuation	Liquidation	Mature businesses, separable and marketable assets	Growth businesses, linked and non marketable assets
	Replacement cost	Mature businesses, separable and marketable assets	Growth businesses, linked and non marketable assets
Discounted Cash Flow Valuation	Equity valuation Dividend based Firm based	1. Where cash flows currently are available or in new future 2. Unique assets or business	Where cash flow if a contingency occurs or assets that will never generate cash flows
Relative Valuation	Using multiples like equity vs. firm value	1. Where cash flows currently are available or expected in near future 2. Assets that will never generate cash flows 3. Large number of similar assets that are priced 4. Growth businesses linked and non marketable assets	5. Mature businesses with separable and marketable assets 6. Unique asset of business
Contingent Claims or Option Pricing Valuation	Derivatives (Put and Call Options)	7. Unique asset or business 8. Growth businesses, linked and non marketable assets	9. Where cash flows currently are available or expected in near future 10. Mature businesses with separable and marketable assets 11. Large number of similar assets that are priced

More on Due Diligence

Due Diligence is the most important aspect in doing a merger and takeover deal. During the process of takeover, the predator and the target extend a lot of information on an informal mode and predator's deal progress is based on a number of assumptions and data inputs are



primarily from public source and competitive intelligence. The process of due diligence gives the predator the authority to validate the “Homework” of the Deal. Hence the management gives a lot of importance for this activity during the transaction.

While doing the due diligence the focus would be to assert whether the deal is worth the bill. When someone triggers such a thought, the following aspects would prop up:

1. **Confirmation of the strategy and feasibility of the target’s business:** The initiation of deal progress and reaching up to a stage of signing the letter of intent would have taken care of the business potential of the target. One always believes so! But quite a number of deals have failed because the synchronization was not perfect. For example, if a predator wants to buy out a casting company, one would have evaluated the business potential, technology and so on. The target could be an old vintage company and run successfully by the current management in a traditional environment with the local workmen and line expansion could have been driven by convenience rather than industrial engineering. If the predator wants to replace the production process with automated system and reduce labor for improving the size and productivity, it may not fit in as the style of the target been traditional and conventional growth. This one would realize after making detailed enquiry. More importantly even though during prior stages there could have been opportunities to validate the same, predator moves with confidence to realign and due diligence gives an opportunity for revalidation.
2. **Verifying operations and assets and liabilities are as represented:** This process means physically verifying operations and doing a technical due diligence. The asset register might be shared and the number, quality and realizable life of the assets would be validated as per the record. Though it means physically demanding, there are experts who are available to execute such processes. These experts have methodology like random checking and asserting high value items, etc. Similarly the target company provides the liabilities statement. It is important that the buyer validates the same. This is purely from financial angle as the balance sheet must be true and realizable.

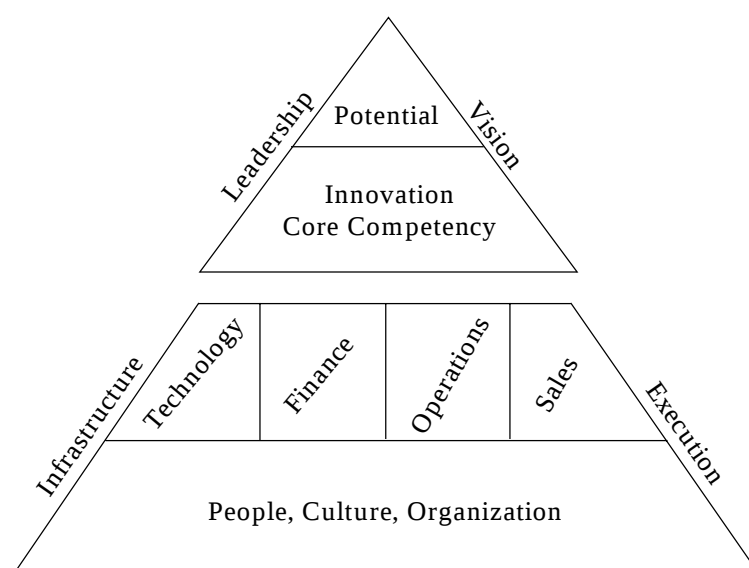
There is another aspect on the same which the physical executable capability of the assets. The books may show that the captive power plant to have an installed capacity of 100 mw. Especially, if the buyer is planning for modernization and expansion, the normal rate of generation need to be ascertained. Similarly there are a number of such productive capacities whose productive efficiencies need validation. A due diligence process precisely does the same.

3. **Develop and evaluate opportunities to best fit the target with the buyer:** The buyer / acquirer while negotiating the acquisition, develops certain alternatives or scope of business based on the information provided. Generally, when one starts probing into businesses, few more alternatives are likely to develop as the validation process starts. For example, when a buyer was looking at taking over a 5000 tcd sugar plant, he evaluates the option with a matching capacity of creating a co-generation plant which could be anywhere between 24 – 32 MW depending upon certain specifications and consumption requirement. While doing due diligence a new scope may arise where the buyer could spot opportunities for multi fuel boiler with adequate space and other economies supportive of the same and move up to 40 MW. This generates a quite bit of additional scope in the viability of the

deal. Similarly in every business there would one such new vista or otherwise hampering aspect which needs more validation and assertion.

4. **Cultural fit:** Though a buyer looks at the composition and structure of employees, a lot relating to cultural fit would emerge during the due diligence process. The aspects of cultural fit may be on style of relationship, exertion of power, peer relationship and so on. Some of it comes from the gender mix, sociological factors, entrepreneurial and professional management involvement, power hierarchy and power versus process driven factors. There are numerous cases where good buy outs are not the best because of cultural divergence. The classic example in the international scenario one could think would be between Daimler and Chrysler where there was a marriage between technology driven German auto manufacturer and market savvy American auto major. Similarly, it could be within the same country and same industry like IBM and Lotus. In finale, two merging groups have same cultural attitudes to vibe for making the merger move successful!
5. **Understanding the seller's financial and legal structure:** The buyer would be progressing on broad indicators for consummating the deal. The buyer would have discussed on "sale of assets" or as a "going concern" or an SBU or buying controlling interest or any such combination. The actual financial structuring would depend upon the rights and limitations of the powers vested with the shareholders. Likewise, the banks, institutions and debt funders like lessors may have various charges on the assets who may have to approve such transactions. Also a substantial impact would be based on the statutory implications binding on the transaction and the company and also the accounting policies followed. There could be again a number of legal issues which need to be addressed for doing the transaction. A buyer has to necessarily be aware of these. Moreover, there could some aspects which buyer would have presumed while working the deal. This could be like transferring of liabilities. But the debt fund institution or individual may not agree for the same. Hence the due diligence process helps to iron out those areas.

To sum up, due diligence addresses the following pyramid and asserts a "Take over".



**Spirit and Action on due diligence**

The buyer must go with the spirit of confirming the value of the deal agreed to at the earlier stage and if corrections required, one must ascertain the same. Then the buyer must probably see how value generating activities could be driven on the post deal stage. If the buyer goes with the intention of finding gaps, probably the whole process may destabilize. There may not be perfect information sharing or mapping at Letter of intent stage. However, the margin of error would be provided for while working the deal structure and value. At the due diligence stage the buyer must ascertain whether the margin provided for is appropriate or is there a need to revisit the deal value or structure.

Similarly, the target company must also view due diligence process as a means to facilitate the deal rather than an interrogative process. If a firm is being sold, it could be for skimming the value or stop losses or an opportunity for turnaround. In such situation, there could be scope for identification of wrong moves or management gaps. If there are any adverse new revelations, those should not hurt the process of the transaction.

Information Exchange

Most acquirers have a standard form or checklist. The investment advisors facilitate for revisiting such formats and make it specific to the transactions. There are cross functional experts who would handle the same. Typically, the request should go to seller immediately after execution of the LOI.

Typically seller is requested to respond to each specific request as soon as possible. In the interest of the deal and his own, the seller must quickly respond. The information shared is specific to the transaction and is confidential. Hence the buyer must be aware of the need to handle the “Non disclosure and Confidentiality” clause sensibly. Or else, it could potentially hurt the future transactions. Many a times a dedicated team from the buyer and seller would handle the due diligence part to have control on secrecy and proprietorship of the information exchanged.

The following are the indicative areas of due diligence:

1. Legal

What Must Happen to Approve the Transaction?

1. Articles of Incorporation
 - a. Basic capital structure
 - b. Rights & privileges of equity owners
2. Bylaws/Operating Agreements
 - a. Ascertain necessary approvals and procedures
3. Board minutes
 - a. Understand corporate history
 - b. Understand how it handles substantive transactions



2. Corporate Governance

1. Stockholder Agreements
 - a. Stockholder rights and preferences
2. Capitalization Table
 - a. Understand all of the ownership and votes within the company
3. Stock Options and Warrants
 - a. Understand change of control provisions
 - b. Do options and warrants vest? Convert? Cancel?

3. Key Operating Agreements

1. Customer Agreements
 - a. Are there any parts of agreement limit the ownership structure change?
 - b. What are the penalty clauses for non-compliance of customer contract?
 - c. Are contracts executed in full and to the satisfaction of the customers?
2. Employment Agreements
 - a. Non-competition agreements
 - b. Confidentiality agreements with key employees
 - c. Electronic data and information security and policies that involve employees
 - d. Golden parachutes that kick in with Change of Control

4. Human Resources

- Obtain and review employee benefit plans
 1. Employee manual – ‘contract’ with the employee
 2. Health and retirement plans
 3. Statutory payments with respect to employees

5. Bank or Credit Arrangements

- Is there the change of control provisions?
 - ☐ Do banks have “veto” power or debt acceleration?
 - ☐ Is there a default that could complicate the deal?
 - ☐ If we need permission, how long will it take?
 - ☐ Are assets pledged?

6. Strategic Partner and Vendor Agreements

1. What are the changes of control provisions?



1. Do they have “veto” power, or worse?
2. If we need permission, how long will it take?

7. Supplier Agreements

1. Change of control – right to re-price?
2. Notice provisions

8. Intellectual Property

1. Patents, Trademarks, Copyrights
2. Trade secrets, licenses
3. Are they protected?

The above list is only indicative and a very detailed and exhaustive questions need to be prepared and administered.

Interactions and the review process would keep going during this stage. There would be questions, review, analysis, consideration, more questions until understanding is reached. After review, buyer typically prepares a due diligence memorandum based on the materials and information reviewed.

Buyer then typically requests follow-up information on certain points which could be:

- i. Concern areas usually warrant further investigation
- ii. May have implications on LOI and Definitive Agreements.
- iii. Additional representations and warranties hold-back of purchase

Price or even adjustment of consideration

The objective of the due diligence is to finalize the agreement which is called as the Definite Agreement Process. Ideally there would be coordination with Definitive Agreement Process. Typically, the definitive purchase agreement is being drafted simultaneously with the due diligence review in an effort to speed the process. The diligence group must coordinate with document drafting group to ensure concerns are incorporated in documents as appropriate.

DIVESTITURES

Sell offs or Divestitures are interchangeable though strictly sell offs is a generic term which includes spin offs, split offs, split ups and equity carve outs.

A *spin off* is the process of creation of a separate legal entity when the shares are distributed to the existing shareholders of the parent company on a proportionate basis. This method creates a new entity, which can take independent decisions, which it could not when it was a parent company.

There are two types of spin offs again, which are described as split offs and split ups. When some of the existing shareholders are given stocks in a subsidiary in exchange for the stocks of the parent company a *split off* is born. When the entire firm is fragmented into a number of spin offs the resulting firms exists but not the parent company. This is called *split up*.



When divestiture is used in a specific sense, it involves sale of a part of the company to a third party. Since the buying firm already exists no new legal entity is born. Another method of specific divestiture is the *equity carves out* when part of a company is sold to a third party or a group of outsiders through an equity offer giving them the ownership for the portion sold. Now it becomes an independent company owned by outsiders.

The above methods of getting away from a particular activity by a parent company happen when it finds the following reasons:

1. A particular activity has not been viable and needs to be phased out
2. A particular activity does not form part of the distinctive competence or even the core competence
3. A particular activity which was viable until recently has become unviable due to technological obsolescence
4. From the angle of financial restructuring
5. When the company want to go for strategic alliance for a particular activity, this is done

CORPORATE RESTRUCTURING

Towards the end of the 20th century recessionary economic conditions loomed large forcing many companies in the developed countries to look inward. The concept of restructuring was born and it is concerned with the reduction in size of a company to improve both efficiency and effectiveness. The restructuring process can involve either *downsizing*, *right sizing* or *de-layering*, thus reducing the size of the firm in terms of the number of employees as well as number of divisions or units or the number of hierarchical levels in an organization. The concept of job security and lifetime employment had a jolt and many companies entered into lengthy negotiations with the labor unions to chalk out elaborate programme of retrenchment with huge severance cheques.

As the process of restructuring involved lengthy negotiations with the labor unions and complicated legal processes, this mode of improving a company's effectiveness and efficiency has not been preferred. Though, many companies had to resort to restructuring for survival rather than improving effectiveness and efficiency. The process of restructuring culminated in a company becoming smaller better and faster, but this strategy is more for catching up with the competitors who out smart them. Though restructuring can be a pause it cannot become a panacea for all its evils. Another glaring factor is that the restructuring is concerned more with the well being of the shareholder rather than taking care of the employee. It is a cynical travesty that in the name of efficiency and effectiveness a company becomes smaller and smaller without addressing the fundamental factors facing the company. At best restructuring is a beginning of reforms to be followed by a turnaround strategy based on reengineering and regeneration.

The prime reason for restructuring has been that conglomerates that are highly diversified were assigned a diversification discount in respect of its stocks to the capital markets. This arises due to the fact that the stock of highly diversified company is very frequently assigned



a lower valuation in relation their earnings compared to a less diversified company. Two main factors flow out of this premise; firstly, the complex nature and not so transparent consolidated financial statements of highly diversified companies normally put off investors. This is because they are not in a position to get a fair and true picture of the segmented activities of the company and the risk involved in such activities. Secondly, greater diversification for its sake has not provided the required viability and as such the company as a whole has been saddled with unprofitable ventures. In effect, the administrative and other fixed cost tend to increase and the company becomes obese. In the above two cases restructuring is the immediate remedy to arrest declining financial performance.

Some times restructuring becomes necessity in case of failed acquisitions. Hurried decisions to acquire another company with out adequate preparation and cultural fit have led to slowing down of post acquisition performance. In these cases restructuring is the initial step to cut losses and then think of a divestiture or turnaround strategy.

Another area, which has become significant to recommend restructuring, is that the economic laws of diminishing advantages start working when there is an overdose of vertical integration or diversification. This diminishing advantage is aggravated due to innovation in management process and strategy. For instance, long term relationships between suppliers and a company were considered as a mature exercise and a vertical integration is a logical sequence. However, with the innovations in supply chain management through effective solutions using information technology highly diversified companies have come to grief. Here again, prima facie, restructuring becomes the first stage. Latterly, turnaround management always follows restructuring exercises.

Normally, a company starts introspection when its performance starts plummeting and reaches a nadir (Lowest point). And this phase is the decline phase of the company. As a result of introspection, it starts initiating response in the form of restructuring and reengineering. The period during which various activities leading to turnaround are carried out takes time and is the transition period. In the final stage the outcomes of the various steps taken are evaluated as to whether the adventure has been a success or a failure.

The whole processes of turnaround as indicated involve four stages and are punctuated with key events. The theoretical approach to turnaround strategy can be classified into two types on the basis of decline K – extinction and R – extinction. K-extinction relates to the macro or the environmental factors responsible for the decline of the company. R- Extinction relates to internal factors of a company resulting in a decline irrespective of the external environment. The magnitude of the decline naturally will have to be analyzed on the basis of the impact of the external forces and internal inefficiencies separately. This will lead to the identification of actions for intervention, which can trigger bigger action. On the basis of this analysis an identification of intervention activities the second phase of response initiation starts. Responses can be two fold, strategic and operative. Strategic responses lead to change or adjustment of businesses of a firm and involve change management. Operating responses deal with the modus operandi of business. Normally, they aim at cost reduction and revenue generation. These activities need acceptance and absorption within the company and a temporal phase sets in. This period of gestation is a transition period and results start showing up only gradually. However, business process reengineering has honed many skills leading to



dramatic outcomes by identifying critical success factors through process analysis followed by gap analysis. Thus, in the final stage the outcome will have to be measured compared with controls and regulated.

A failure or success of turnaround strategy depends on the following:

1. A proper plan laying down mile stones at definite intervals
2. Resource commitment will have to be clear
3. Policies and programmes will have to be evolved in an inclusive manner
4. Structural changes need to be accepted by properly providing safety nets, rewards and incentives for achievement of targets set for the employees

When implementing contingency plans to combat a downturn in the fortunes of a company, Gary Hamel and C.K.Prahalad in their book “Competing for the future” talk about “numerator driven business strategy” and “denominator driven strategy”. Increasing profitability through improvement of productivity is considered as numerator focused management. Denominator driven management involves reduction of head count, disposal of assets and reducing investment.