

CHAPTER 13: Mergers, Acquisitions & Restructuring

Mergers, Demergers, Spin-offs, Acquisitions, Takeovers etc. are the common things that are taking place in today's corporate world. Though meaning of each of them is different, at times some of them are used synonymously like merger, amalgamation, takeover and demerger, spin-off, sell-off etc.

Merger means unification of two or more entities into one whereby after the process of merger only one entity exists and rest do not exist.

Amalgamation can be by merger of companies and is governed by the Companies Act.

Accounting for Transferee Company in case of amalgamations are governed by **AS 14** which prescribes two methods viz. Pooling of assets method and Purchase method. An amalgamation to be treated as merger needs to fulfil the following:

- a. All assets and liabilities of the transferor company become the assets and liabilities of transferee company;
- b. Shareholders holding atleast 90% of the equity of the transferor company become the shareholders of the transferee company.
- c. Consideration for amalgamation is paid by transferee company by issue of fresh shares in it except in the case of fractional holdings;
- d. Business of transferor company is carried by transferee company after amalgamation;
- e. No adjustment is made to the book value of assets and liabilities except to the extent required to confirm with uniform accounting policies.

If all the above conditions are fulfilled, then accounting is to take place as pooling of assets method else it should take place as per purchase method.

Acquisition means one entity buying another and absorbing the same. In case of acquisitions, both the acquiring and acquired companies can continue the business even after the process of acquisition. Only the controlling power in the acquired company changes. Acquisitions by way of takeovers are governed by SEBI regulations.

In case of **Consolidation**, two or more companies join together to form a new company by losing their individual existence.

Types of mergers:

Horizontal merger: In this case two companies of same industry are merged with a view to gain a monopoly or a near monopoly control. Eg. 2 steel mfg. companies.

Vertical merger: Two companies of different but related fields are merged. Eg. Steel mfg. Company And an iron ore mining company

Reverse merger (Reverse bid): This method is usually adopted to take benefit of tax backlogs which are allowed for setoff only by the company that had incurred. Usually a small company making profits is merged with a big company having accumulated losses. Three aspects are to be fulfilled to call a merger as reverse merger:

- a. Assets of the transferor company are greater than the transferee company;
- b. Capital to be issued by the transferee company Exceeds its original issued capital;
- c. Change of control in the transferee company Through the introduction of minority holder or holders i.e. the target company Takes the control of the transferee company

The term reverse merger is also used when a private unlisted company acquires a listed company with control passing to the shareholders of unlisted company. This is also known as backdoor listing. This is cost effective method of getting listed whereby all the formalities and incidental procedures of public issue are short circuited to get listed. Usually companies which are listed but not actively traded are considered for this purpose.

Conglomerate merger: In this case two companies from totally unrelated fields join together. Eg. Hotel company With cement mfg. Company.

Congeneric merger: In this case the acquirer and target company are related through basic technologies, production processes or markets. Eg. Cement Mfg. Company With Steel Mfg. Company

Reasons / benefits of merger:

- a. To gain the benefit of synergy in operations and economies of scale. (eg. Merging of FMCG company With a Mktg. Company)
$$\text{Value of acquirer} + \text{Value of target co} + \text{Value of synergy} - \text{transaction cost} = \text{Combined Value.}$$
- b. To get diversified and spread the business risk of investment thereby increasing market value.
- c. To get and avail tax benefits which are unique to large plants; (eg. Duty free imports for Power industry, duty benefit for major cement plants etc.)

- d. To achieve faster growth by saving time of gestation periods.
- e. For consolidating production capacities and thereby increasing the market power.

Problems of M & A in India:

- a. Indian corporates are mostly promoter and / or family controlled.
- b. In several cases the concurrence of financial institutions is also required apart from complying with SEBI regulations.
- c. Financial institutions usually do not fund acquisitions directly.
- d. BIFR route, though tedious is usually preferred to take benefit of financial concessions.
- e. Lack of simple and proper exit policy.
- f. Valuation of corporates is still at its initial stages.

Methods of Acquisition / Takeover:

- a. Acquisition of companies shares;
- b. Acquisition of business assets;
- c. Acquisition of brands;
- d. Acquisition of companies by friendly / hostile takeovers;
- e. Reverse acquisitions.

Takeover strategies:

- a. Street sweep;
- b. Bear hug: when the acquirer threatens the target company, with an open offer, the target company Makes truce with acquirer for change of control;
- c. Strategic alliance: This involves offering the acquirer a partner status rather than a buyout;
- d. Brand power: In this method, the acquirer enters into alliance with bigger and powerful brands of the target company's competitors, thereby weakening the target company and later buying the weakened company

Acquisition Process:

Acquisition involves the following stages:

- a. Competitive analysis: At this stage, the synergy benefits that are likely to accrue between the own company and target company are studied.
- b. Search and screen
- c. Strategy development
- d. Financial evaluation
- e. Target contact and negotiation

- f. Due diligence (in case of friendly takeover)
- g. Arranging finance
- h. Putting through merger and post acquisition structure

Defending a company in a takeover bid

In the current scenario and prevailing regulations, the avenues open for a target company are limited in case of a hostile takeover. However, the following are some of the tactics which a target company may adopt to thwart a takeover bid:

Divestiture: i.e. spinning off some of the businesses into independent subsidiaries. The process of selling is called divestiture.

Crown jewels: This is a method of divestiture where the target company sells some of its core businesses / divisions / processes to make itself unattractive.

Poison pill: The acquiring company itself becomes a target when it is bidding for another company.

Poison put: In this case the target company issues bonds that can be encashed at higher prices thereby making the takeover more costly.

Green mail: some incentives are offered to the potential bidder by the target company to desist him from pursuing takeover course.

White knight: Target company arranges for a counter bid through a friendly company thereby making the takeover very costly to the acquirer.

White squire: This is similar to white knight. In this case target company sells large number of shares to a friendly company that is not interested, thus ensuring the management retains its control.

Golden parachutes: The company offers hefty compensations to the employees if they are ousted in the process of takeover.

Pac-man defence: In this case the target company makes a counter bid for the acquirer company making the acquirer to defend himself first.

Due diligence:

This is a very important activity in case of friendly takeovers and forms the basis for the acquirer to take a final call on the issue of takeover. This is usually conducted by the statutory auditors or other auditors on behalf of the acquirer to assess the true worth of the company and to know the insights of the company and to ascertain the authenticity of the figures in annual reports. This process should cover atleast the following areas:

Legal issues

Financial and tax issues

Marketing issues

Cross border issues including exchange risks, foreign laws, etc.

Cultural and ethical issues.

Valuation of Target Company

Commonly used methods for valuation of Target Company are:

- A. Earnings based valuations:
 - a. Discounted cash flow or discounted free cash flow method (free cash flow is the cash available to all investors including lenders.
 $FCF = PAT + dep. - capex - W C \text{ incr.}$)
 - b. Cash to create approach
 - c. Capitalised earnings method
 - d. Chop shop method
- B. Market based valuations:
 - a. Market capitalisation in case of listed cos.
 - b. Market multiples of comparables in case of unlisted cos.
- C. Asset based valuations:
 - a. Net adjusted asset value or economic book value;
 - b. Intangible assets valuation;
 - c. Liquidation value: Value arrived under this method should be less than or equal to the value arrived under the adjusted asset value or economic book value method.

Terminal value: This is the present value of cash flows occurring after the forecast period. This is calculated under different methods depending on the information available on a case to case basis.

- a. In case Cash flows grow at a constant rate after the forecast period, it is calculated by the formula:

$$TV = FCF * (1+g) / (k - g) \text{ where,}$$

FCF is the free cash flow in last year,

g is the yearly cash flow growth rate; and

k is the cost of capital or discount rate

- b. In case fixed yearly free cash flows are expected after forecast period, irrespective of increase or decrease in sales, then it is calculated by the formula:

$$TV = FCF / k \text{ where,}$$

FCF is the fixed yearly cash flow after the forecast period and

k is the cost of capital or discount rate.

The above formula also holds well when Capex is zero or Capex = Depn., & Cost of Capital = ROI.

- c. Terminal value may also be calculated by multiplying the capital at the end of forecast period with the ratio of market value of the share to its book value.

$$T V = \text{capital at the end of forecast period} * M V \text{ of share} / B V \text{ of share}$$

- d. Terminal value may also be calculated by multiplying the last year's profits with P/E ratio.

$$T V = \text{Profit of Last year} * P / E \text{ ratio}$$

Corporate restructuring

Restructuring is a common practice that is taking place in current business environment. Restructuring usually involves major organisational changes including change in corporate strategies and plans. Restructuring can be internal or external. Internal restructuring includes hiving off non core activities, investments in R & D, divestments, demergers etc. External restructuring includes entering into JV relationships or strategic alliances, M & As' etc. Demergers are tax neutral subject to compliance of certain conditions as provided in the I T Act. The main reasons for demerger or divestments are as below:

- a. To concentrate on core areas of business.
- b. To hive off low profit or loss making activities.
- c. To bring the organisation to manageable size.
- d. To meet urgent cash needs to invest in better opportunities etc.

The **different ways of divestment** are as follows:

Sell off: selling an asset, factory, division, product line or subsidiary etc.

Spin off: part of business is separated by creating a separate entity.

Split up: This involves breaking up of the parent company into different companies and eventually the parent company will close.

Carve outs: This is spin-off with the additional feature of selling some shares to outsiders and thus involves cash inflows.

Going private: This refers to a case where a listed company gets delisted by buying back all the shares. Eg. Philips India Ltd.

Equity buyback: Company buying back its own shares from market is known as equity buyback. This results in equity reduction of the company and simultaneously increases the shareholding percentage of promoters.

Buy-outs: This also known as management buyouts (**M B O**). The management of the company (usually top management) buys-out a particular part or component of the business of the company from the owners / promoters and incorporates it as a separate entity. This happens due to loss of interest in business by promoters / owners or incurring of continuous losses by the unit. It may also happen when the owners threaten to sell the unit to a third party. In recession times these sort of buyouts happen more often. In such buyouts, if more loan funds are used (viz. PE Funds or VC Funds), such buyouts are called Leveraged buy-outs (**L B O**). L B O's involve participation of third parties also.

Buy-ins: This is similar to the concept of buy-outs. In this, active PEs' keep scouting weak managements and buy stakes in the company. PEs' also bring talented CXOs' to run the company. Once the company turns around they exit at appropriate time. The incoming talented management while coming on board also takes stakes in the equity of the company and hence it is called Buy-ins.

Financial restructuring: This is usually adopted by loss making companies to come off the crisis with fresh financials and forget the past. This involves the restatement of both assets and liabilities and often includes several legal formalities as well. This requires contributions by almost all the participating stake holders. To achieve the desired objective, the firms restart with fresh balance sheet free from losses and fictitious assets and share capital is shown at its true value. C D R can form part of such process.

Reasons for M & A failures: Common reasons for failures are:

- Acquirers generally overpay.
- Value of synergy is over estimated.
- Poor post merger integration
- Psychological barriers.

Cross border M & As'

This is a popular route for global growth. Major factors that motivate MNCs' for cross border M & As' are:

- a. Globalisation of production and distribution of products and services;
- b. Integration of global economies;
- c. To have international trade and investment relations;
- d. To reap investment benefits being offered by various countries;

- e. To take benefit of privatisation measures being adopted by various nations.

Questions:

1. Explain the term “Demerger”
2. Explain the term “Buy-outs”
3. What is takeover by “Reverse Bid”
4. Write a short note on Financial Restructuring.