

Mergers, acquisitions, and corporate restructuring: Conceptual issues¹

Class work:

Each student attending the class, shall read this document and facilitate class discussion. He or She may further the discussion or add further issues to this note.

A quiz may also be administered on the basis of the two sets of material provided here with (along with the case study of ABC).

Backdrop

Mergers, acquisitions and takeovers have always played an important part in the corporate world. The pattern of M&As have always been seen as the reflection of general economic and financial condition. The financial market and the economic growth have always been the driving forces for M&As.

Relationship with the Stock Market

Mergers, acquisitions, and takeovers have been integral part of the capital markets in general, and stock market in particular. Historically, boom in stock market has contributed acceleration in activities in mergers and acquisitions. There are broadly two reasons for this correlation. One, stock market rises when prospects of economic activities are bright. Mergers and acquisitions help businesses to become bigger and wider contributing to higher level of growth in economy. Often they are also result of such higher level of growth in economy. Second, during stock market buoyancy, share prices reach their peak levels. These over-valued stocks are then used to finance buying out of the companies. Seemingly, cheaper stock financing provides vital boost to mergers and acquisitions.

Functions of capital market

Capital market essentially performs three functions. One, it mobilizes, using market platform, the savings of the society, be it individuals, businesses, government, or even foreign entity, for productive purposes. Second, it is expected to efficiently allocate those mobilized savings through its pricing in primary market depending on risk and return profile of the issuer. Third, it is expected to ensure that those allocated resources should be continuously utilized efficiently through market for corporate control. It is in this third function, mergers, acquisitions, takeovers and other form of corporate restructuring help the market. Investment bankers supply vital fuel to this activity by providing brokerage services (by identifying and bringing buyer and seller of companies together), advisory services (by advising clients for enlarging or appropriate re-allocation of resources), arranging for finance for such transactions.

Market for corporate control

Each share represents proportionate corporate control to an extent of its face value. The share price represents price for such control. Therefore, stock market also represents market for corporate control. It represents a market where corporate control is traded. The participants are the competing management(s) who continuously look out for

¹ This note is prepared by Dr. Jinesh Panchali, Indian Institute of Capital Markets, Navi Mumbai.

controlling stakes in companies at comparatively cheaper rates. The shareholders when unhappy with the existing management's strategies and performances, start selling the shares resulting into depressing the share prices of the company – becomes potential "target". When the prices fall below its intrinsic value, it offers an opportunity to the competing management(s) in the market to offer a price higher than the existing depressed prices but lower than its intrinsic value to the remaining shareholders. When effective, the competing management may like to replace the existing management with their own. This poses threat to the existing or incumbent management's job, prestige and other perquisites it enjoys for being in control of the company. This threat incites the incumbent management to perform better to the satisfaction of the shareholders. Thus, market for corporate control continuously evaluates the performance of companies in the market by its pricing mechanism and tries to ensure efficient performances either by continuously posing the threat of competitive replacement or by actual replacement.

Corporate restructuring

Mergers & Acquisitions (M&A) are part of corporate restructuring exercise. The corporate restructuring aims at re-allocation of the corporate resources to optimize its value either by adding the related or divesting the unrelated businesses. It also includes swapping of existing equity with any other form financial instruments or obligation. Thus capital restructuring has two dimensions. First, restructuring of assets side of the business which commonly known as business restructuring or asset restructuring. Second, restructuring of liability side which is known as financial restructuring. The latter aims at optimizing on capital structure of the company without disturbing the businesses the company is in. The ultimate aim of all these exercises is to optimize corporate value given the assets and liabilities of the company.

Mergers and acquisitions

In common parlance, fusion of more than one entities leads to range of transactions in domain of mergers and acquisitions. Merger, commonly take two forms. One, in case of *amalgamation*, two entities combined together and forms a new entity extinguishing both the existing entities. Second, in case of *absorption*, one entity get absorbs into another. The latter does not lose its entity. Thus, in any type of merger, at least one entity loses its entity. While acquisitions is more general term enveloping in itself range of acquisition transactions. It could be acquisition of control leading to takeover of company. It could be acquisition of tangible assets, intangible assets, rights and other kind of obligations. They could be independent transactions and may not lead to any kind of takeovers or mergers.

Divestitures

In contrast to range of mergers & acquisitions transactions under corporate restructuring where the purpose is to combine or add the resources to parent entity, the other extreme is range of divestitures where the purpose is to "demerge" or trim the resources to sharpen the focus of the business to ultimately enhance corporate value. Brief introduction to divestiture and its variants are mentioned as under.

Divestitures involves selling of assets/product line(s)/division/ subsidiary for cash/stock/ both. It is aimed at achieving following: focus in core areas, disposing of under performing assets, selling assets which are worth more as part of buyer's organisation, release funds to pay off other prior commitments to raise funds, greater strategic focus and therefore sometimes better market (stock market) acceptance, and disposing off saturated or declining business. More importantly, it does not mean failure in performance but sometimes it is more appropriate strategy to periodically enhance shareholder's value by re-allocation of resources. There are number of transactions in divestitures like, spin offs, split offs, split ups and equity carve outs.

Joint ventures

Joint ventures and alliances are often precursor to mergers and acquisition transactions. Joint venture generally refers to joint equity ownership in a venture where two partners bring complementary resources. While alliances generally does not denote equity ownership in the venture. It is simply providing technology know how, research support, distribution support, licensing of brand or any other rights etc.

Buyouts

Another popular term with which investment bankers are closely associated and often their role is debated in that phenomenon is buyouts. Buyout means buying out the company by a group of existing or new shareholders. It means taking company private. The process leads to a process generally known as "re-aligning ownership with control" violation of which by invention of company form of organisation, led to agency theory which fed financial economics in last one and a half decade. Buyout can take many forms. One, leveraged buyout means buying out the company by taking very high degree of leverage. Second, management buy out means buying out the company by the existing management. Third, employee buyout means buying out the company by the employees. There are couple of Indian examples, like, Triveni Tubes Ltd, of employee buyouts, but we have yet to see LBOs or MBOs. Tata Tea's acquisition of Tetley was a variant of leveraged buyout for Indian scene.

Strategic dimensions

In addition to two broad categories of mergers & acquisitions mentioned earlier, strategically mergers & acquisitions transactions may be divided into three categories. *Horizontal mergers & acquisitions* involve two corporates operating and/or competing in same kind of product or market come together. It is generally initiated to gain economies of scale, increase competitiveness and reduce competition. *Vertical mergers & acquisitions* involve two corporates which are vertically linked to each other, either forward or backward, come together. It is initiated generally for achieving operating efficiencies through reliability of inputs, better material control, gaining competitive power through controlling input prices and to create entry barrier in terms of scale, market and technology. *Conglomerate mergers & acquisitions* involve two firms operating in unrelated market or product come together. It could be either product extension, market extension or pure conglomerate merger or takeover transaction. In this case, the centralized corporate office provides each operational unit with expertise and counsel on general management functions across diverse businesses. It is initiated to gain

competitive and cost advantage through synergistic effect. Diversification into unrelated businesses reduces the overall corporate risk. It requires special competence and skill to manage different functions pertaining to each diversified business.

Theories of mergers

Researchers have attempted to find explanations to the activities of mergers and acquisitions. These explanations have later become testable hypotheses. Following are some important theories of mergers and acquisitions.

One, *inefficient management*. This means that existing management is simply inefficient, and hence, another management whether his best or not, would replace the existing one and increase the efficiency of the business.

Second, *differential management*. This means that target is not always inefficient. But only relatively inefficient. Hence, mergers is driven by differential efficiency between the target and bidder management.

Third, *operating synergy*. This states that even when both the target as well as bidder are equally efficient, simply combining their resources would lead to synergistic benefits due to economies of scale and complementary benefits. Thus, mergers are driven by synergy.

Fourth, *diversification*. This is based on principle of diversification per se. Diversification may have value in reducing the risk of overall business portfolio. Demand for diversification may be by managers, employees, for preservation of organisation, and reputation capital.

Fifth, *financial synergy*. This inter alia means that debt capacity of two combined firm will be larger than summation of debt capacities of two individual firms. Financial synergy also arises from credit rating of both the firms, tax differential of both the firms, proportion of use of internal and external funds.

Sixth, *strategic realignment*. Due to dynamically changing environment, mergers provide perhaps fastest route to respond the changes in industry and market.

Seventh, *Undervaluation by market*. This means the target is generally undervalued by the market. This may not be due to inefficiency of the target and that is what differentiate this theory from the inefficiency theory. The undervaluation may be only due to non-release of private information which only the bidder have at that point of time.

Eighth, *information and signaling*. There are two versions of this theory. Sitting on the golden mine. The tender offer by a bidder it self signifies undervaluation and lead to revaluation of shares by market. Second, kick in the pants, which means, the offer itself inspires the target to implement more powerful strategy. The tender offer on target firm signals that there is a potential untapped in the target. Use of stock by bidder to finance

acquisition, means, one, stock is over valued and second, the expected benefits from the acquisition is not certain.

Ninth, *agency and managerialism*. As explained earlier, managers initiate mergers to gain private benefits from the transaction irrespective of loss (or loss of profit) to the shareholders. Managers also tend to involve in mergers as they tend to be arrogant or overconfident about the success of the deal and land up entering into often inefficient transactions.

Tenth, *market power*. Mergers are initiated by dominating the market. This is different from economies of scale discussed earlier. Increased relative market share of the bidder provides it a potential to realize monopoly gains.

Eleventh, *tax credits and concessions*. This means, firms with tax losses provide an opportunity to bidder with high taxable gains to reduce net tax liability through merger. Besides, merging of high growth firm with a mature firm may lead to conversion of dividend (ordinary income) into capital gain. This is helpful when there is substantial tax rate differential between dividend and capital gain.

Accounting

At a global level, accounting for business combination has been debated for a long. There are two accepted methods for accounting for business combinations. One is pooling of interest method and other one is purchase of business method. Pooling of interest method has been widely adopted despite its difficult pre-requisites. However, this method is criticized by the market investors and policy makers for its lack of transparency and providing scope for unfair trade practices.

As per recent practice, this method has been banned and only purchase of business method has been accepted with certain modifications.

Policy issues

Motivations of the managers to initiate these activities have always been focus of controversies due to various reasons. One, empirical evidence suggest that mergers do not create wealth for the shareholders of the acquiring companies. Therefore, it is believed that managers initiate these activities to enlarge the scope of their control and remuneration (in kind and monetary terms). Since their prestige, remuneration and control is the function of the size of the business he or she heads, manager has a motivation other than improving shareholder or corporate value. However, recent research are carrying out deeper analysis in terms of productivity gains arising out of mergers, wealth effect on broader range of stakeholders and impact of nature and structure of merger transactions on their post merger performances.

At macro level, mergers are looked from two dimensions. One, should they be encouraged or allowed at all? Question arises because mergers affect larger sections the economy through its impact on market structure and communities of stakeholders other than shareholders. Mergers lead to concentration of economic power in few. The industry

structure may reduce to only few players and raise potential abuse to competition by creating an oligopoly if not monopoly. Unscrupulous and unrestrained merger activities adversely affect the public interest by creation of such anti-competitive structures. Besides, mergers generally lead to re-allocation of labour resources which is very painful for the society at large and difficult to quantify its costs in monetary terms. Mergers have also resulted into reduction in tax revenues for the government, reduction in value of debt in the market and above often lead to killing of two successful teams. Taking all together, the costs of mergers may wipe out even the gains to shareholders of the acquired companies. The potential synergistic gains might get distributed among stakeholders; some of them land up with net gain while others with net loss; therefore, what is important for society is whether, in net terms after the distribution of gains and loss among stakeholders, it land up with net gain or loss. Gains from promising synergy are far less than the costs of implementing the transactions. When one takes wholistic view, mergers fail and drain on the society. Second issue is, whether all mergers are value destructive. Many mergers may as theory indicates add value to the society. They are the mergers whose gains do not arise from redistribution of gains and loss among stakeholders as explained above, but the source of its gain is due to increased productivity of existing resources. Hence, mergers which are likely to raise productivity and having possible out come in terms of net gain to society should be encouraged. The policy makers need to have machinery that evaluate potentially damaging mergers. When spotted, either they should not be allowed or if allowed their structure need to modified to convert net loser to net gainer for the society.

Corporate governance and M&A

The evidence that three fourth of mergers fail and bidding companies shareholders lose in mergers along with validity of hubris and agency theories raises serious questions about the motivations of executives initiating the mergers. This has also raised pointed questions on the role of investment bankers in the whole process of mergers and acquisitions activities. Also brought in focus was the dormant role of pension funds and other institutional investors who hold substantial equity ownership in US listed stocks and expected to perform fiduciary responsibilities. During last five years, corporate world saw active involvement of institutional investors in preventing many potentially value eroding mergers. Managerial remuneration and equity stock options, and golden handshake to the management during the process of mergers and acquisitions raise many eye brows and lead to pronouncement of some of the land mark verdicts in US courts. In Indian scene, number of defensive tactics and greenmail attempts were criticized. At a macro level, for orderly governance of companies, the Competition Commission of India is set up to avoid monopolistic impact of mergers and acquisition in industry as well as economy as a whole.

Areas of interests for researchers

- a. Impact of M&A on productivity / efficiency
- b. Assessment of premium paid: whether justified in broader capital budgeting exercise?
- c. Success or failure of the transaction on the basis of stakeholders' analysis
- d. Competition, industry structure, and M&A transactions

- e. Reasons for no change in accounting standards for accounting for business combinations
- f. Result of merger depends on nature of transaction, financing, and human integration.

To sum up

Mergers and acquisitions are part of resource reallocation exercise in the economy. In involves multi-dimension exercise, viz. strategic, governance, finance, valuation, personnel, accounting, etc. These transactions are often large enough to change the industry structure and impact wide range of stakeholders and its effect percolate deep into the society.