

MERGERS ACQUISITIONS & CORPORATE RESTRUCTURING

I. A **Merger** is the **fusion of two or more companies into one**, with the goal of creating a larger entity that benefits from increased resources, market share, and operational synergies.

Below are the key types of mergers :

1. Horizontal Merger : A merger between two companies operating in the **same industry** and often producing similar or competing products or services. *Example: Two telecom companies merging to consolidate their market presence like Swiggy and Zomato Merging.*

Purpose: To reduce **competition**, possibly moving closer to a monopoly or dominant market position.

2. Vertical Merger : A merger between two companies in a **buyer-seller relationship** within the same supply chain. One company is usually a supplier or distributor of the other. *Example: A car manufacturer merging with a Tyre supplier.*

Purpose: To achieve **cost efficiencies** by controlling the supply chain. To ensure **seamless production** and distribution.

3. Conglomerate Merger : A merger between companies operating in **completely unrelated businesses**. *Example: A food manufacturing company merging with a technology firm.*

Purpose: To diversify risk by entering new industries.

4. Congeneric Merger : A merger between companies that are related through **technologies, production processes, or markets**. It often involves extending the product line or customer base within the same industry. *Example: A smartphone manufacturer merging with a company specializing in mobile software.*

Purpose: To expand into **related business activities**.

5. Reverse Merger : A private company acquires a public company (often a "shell company") to **bypass the lengthy and complex IPO process**. *Example: A private technology company merging with a dormant public entity to list its shares on a stock exchange.*

A **reverse merger** is a unique type of merger where a smaller company gains control of a larger or healthier company. Unlike traditional mergers, where a strong company takes over a weaker one, a reverse merger allows the weaker or smaller company (often sick or non-viable) to absorb the larger or healthier company.

This concept is also known as a **reverse takeover** or **backdoor listing**, as it provides an alternative route for a private company to become publicly traded without the complex and expensive process of an IPO.

Three Tests for Identifying a Reverse Takeover

- 1. The Assets of the Transferor (acquired) Company Are Greater Than the Transferee (acquirer) Company.**
- 2. Equity Capital Issued by Transferee to the shareholders of transferor Exceeds Its Original Issued Capital.**
- 3. A change in control** occurs in the acquiring (transferee) company, with **minority holders or a group of holders** from the acquired (transferor) company gaining control.

Benefits of Reverse Merger

- 1. Easy Access to Capital Markets:** A private company can become public without incurring the costs and regulatory hurdles of an IPO.
- 2. Increased Visibility:** The merged entity gains recognition and visibility in the corporate world.
- 3. Tax Benefits:** Losses of the acquired company (public entity) can be carried forward and set off against future profits, reducing tax liabilities.

6. Acquisition : An acquisition refers to the process by which **one company gains controlling interest in another company**. Types of Acquisitions:

1. **Agreement with Majority Holders:** Direct negotiation with majority shareholders.
2. **Private Agreement:** Purchase of new shares by private negotiations.
3. **Open Market Purchase:** Shares are bought via open offers in the stock market.
4. **Buyout Offer:** Public offer to purchase shares from all shareholders.

7. Slump Sale: The sale of one business division or undertaking as a **going concern** for a lump sum payment, without assigning individual values to specific assets or liabilities. **Slump Sales** enable companies to sell divisions or undertakings as a whole for **cash** without complex restructuring. *Example: A company sells its manufacturing division as a single unit to another company for a lump sum amount.*

II. Corporate Restructuring

It refers to the reorganization of a company's structure, assets, ownership, or operations to improve efficiency, profitability, or competitiveness. This process has gained importance due to globalization, liberalization, and changing business environments.

Types of Corporate Restructuring

1. **Internal Restructuring** Involves changes within the company, such as: **New investments in plant and machinery, Research and Development (R&D)** for products or processes, **Divestment of non-core businesses, Sell-offs, demergers, Financial Restructuring etc**

2. **External Restructuring** Involves collaboration or consolidation with other firms, such as: **Mergers and Acquisitions (M&A), forming Joint ventures** and having strategic alliances with other firms.

Key Forms of Restructuring :

1. Merger : A Merger is the consolidation of two or more companies into one entity, where **one company survives, and the other ceases to exist**. Shareholders of both companies often become shareholders of merged entity.

Example: Hindustan Unilever Limited (HUL) merged with GlaxoSmithKline Consumer Healthcare in 2020. GlaxoSmithKline Consumer Healthcare ceased to exist, and HUL absorbed its operations to expand its product portfolio (e.g., Horlicks).

2. Acquisition : An acquisition occurs when one company **purchases a controlling interest in another company**. Acquisitions can be friendly (with board approval) or hostile (against the target company's wishes). The acquired company may either:

- Continue as an independent entity under new management, or
- Be absorbed by the acquirer, losing its identity.

Example: Tata Steel acquired Corus, a British steel company, for \$12 billion. Corus retained its operations under Tata Steel's control.

3. Amalgamation : An amalgamation involves the **blending of two or more companies into a completely new** entity. Both **original companies cease** to exist, and their combined resources are transferred to the newly formed company.

Example: Vodafone India and Idea Cellular amalgamated to form a new entity Vodafone Idea Ltd (now Vi).

4. Takeovers : **Takeover** refers to the acquisition of one company (the target) by another (the acquirer). While takeovers can be either friendly or hostile, the term often carries a negative connotation, especially when the acquisition is unsolicited or opposed by the target company's management.

Hostile Takeover: In a **hostile takeover**, the acquiring company seeks to gain control without the consent of the target company's board of directors.

Example : The Hinduja Group acquired a significant stake in Ashok Leyland, a leading commercial vehicle manufacturer in India, enhancing its presence in the automotive sector.

III. Financial restructuring

It involves reorganizing a company's financial structure to address challenges such as **significant losses, eroded net worth, or potential insolvency**. This process aims to restore financial health and improve future performance by making internal changes to assets and liabilities with stakeholder consent.

Key Objectives of Financial Restructuring:

1. **Addressing accumulated losses** that may have led to negative net worth, thereby preventing potential liquidation.
2. **Eliminating losses and fictitious assets** to present a true representation of the company's financial position.
3. **Engaging with shareholders, creditors, and lenders** to obtain necessary **approvals** and support for restructuring plans.
4. Implementing measures such as **debt reduction, interest rate adjustments, or converting debt into equity** to alleviate payment obligations.

Common Strategies in Financial Restructuring:

1. **Shareholders** may forgo certain benefits or **agree to a reduction in share capital** to reflect true asset values.
2. **Creditors** might consent to **waive a portion of their claims, accept lower interest rates, or convert debt into equity** to support the company's recovery.
3. Reassessing asset values to accurately reflect their current worth.

IV. Ownership Restructuring (one type of Restructuring)

Ownership restructuring refers to significant changes in a company's ownership structure aimed at achieving specific financial, strategic, or operational goals.

1. Going Private : A publicly traded company is converted into a private company by **buying back all its outstanding shares** from the public market. Once private, the company's shares are no longer traded on stock exchanges. *Example: Essar Energy Plc was delisted from the London Stock Exchange in 2014 after its shares were bought back.*

Why Go Private?

- To **avoid high costs** and **strict regulations** of being a public company.
- Allows management to **focus on long-term strategies** without worrying about quarterly performance pressures or market fluctuations.

2. Management Buyout (MBO) : A management buyout occurs when a **company's management team purchases the company**, making it private. Essentially, the people who run the company become its owners. It enables companies to offload divisions that are not aligned with their main business.

Example : Suppose a conglomerate decides to sell its consumer goods division because it's not part of the core business. The management of that division can buy it out through an MBO.

3. Leveraged Buyout (LBO) : An LBO is the acquisition of a company (or a division) financed primarily with borrowed funds (debt). In most cases, over 50% of the purchase is funded through debt, making the transaction "leveraged."

Examples: Tata Tea bought Tetley in the UK for ₹2,135 crores, with 77% of the deal financed by debt.

Key Features of LBOs:

- The acquired company's assets are often used as collateral for the loans.
- Post-acquisition, the company focuses on improving operations and increasing cash flow to pay off the debt.

4. Equity Buyback : In an equity buyback, a company **repurchases its own shares** from the market using surplus cash. This reduces the number of outstanding shares and strengthens the promoter's stake in the company. Once bought, the shares are canceled and cease to exist, reducing the total equity base.

Effects of Buyback:

1. The proportion of shares owned by the controlling shareholders increases.

2. Fewer outstanding shares mean EPS escalates, often leading to higher share prices.

3. **Improves Financial Ratios:**

- **Return on Assets (ROA):** Increases as cash (an asset) is reduced.
- **Return on Equity (ROE):** Improves as equity is reduced.

4. **Impact on Financial Statements:**

- **Balance Sheet:** Cash decreases (assets), and equity reduces proportionately.
- **Cash Flow Statement:** Buyback appears under "Financing Activities."
- **Earnings Statement:** EPS increases due to the reduced number of shares.

V. Rationale for Mergers and Acquisitions (M&A) : Below are primary **reasons** why companies opt for M&A:

1. Synergistic Operating Economics : **Synergy Formula:** $V(AB) > V(A)+V(B)$

The combined value of two firms after a merger is greater than the sum of their individual values.

Why Synergy Occurs: Example: A company with a strong branch network merges with a company with an efficient production system, creating better operational efficiency. Large-scale operations reduce the average cost of production by sharing overhead costs (e.g., accounting, management, legal services).

2. Diversification : Merging with **unrelated companies** reduces business risk by diversifying income streams. Example: A manufacturing firm merging with a software company.

3. Taxation Benefits: Losses of the acquired company can be set off against the profits of the acquiring company under the Income Tax Act. **Example: Burger King's acquisition of Tim Hortons helped it save taxes by operating in Canada.**

4. Faster Growth : M&A allows companies to grow faster than through organic methods by avoiding delays in: Setting up plants, Hiring personnel, Building market presence etc. **Example: Airtel's acquisition of Zain Telecom gave it immediate access to 15 African markets.**

5. Consolidation of Production Capacities and Increased Market Power : Due to reduced competition, marketing power increases. Further, production capacity is increased by the combination of two or more plants. **Example: Facebook acquired WhatsApp to eliminate competition in the chat space.**

VI. Financial Framework for Mergers and Acquisitions – Steps

1. Gains from Mergers or Synergy : The first step in the merger analysis is to identify the **economic gains or synergies** that arise from the transaction. The combined value of the merged entity should be greater than the sum of the standalone values of the acquirer and the target company.

Formula for Synergy: Value of Synergy = $VAB - (VA + VB)$

(Where: VAB: Combined value of the merged entity, VA: Standalone value of the acquirer, VB: Standalone value of the target.)

Example: $VA = ₹100$ million, $VB = ₹50$ million, $VAB = ₹175$ million \therefore Synergy = $₹175 - (₹100 + ₹50) = ₹25$ million

If a **premium** of ₹10 million is paid for the acquisition: Net Gain = Synergy - Premium = $₹25 - ₹10 = ₹15$ million

2. Scheme of Amalgamation or Merger : It is a formal document that outlines how two entities will merge and what terms and conditions will apply. Since every merger is different, there is no fixed format for this scheme. It includes details about :

1. Vesting of **assets and liabilities of transferor co. in its transferee co.**
2. Disposition of unwanted assets/liabilities by the transferor before finalization.
3. Mention the **effective date from which merger will take effect.**
4. **Valuation of shares** and deciding the **exchange ratio.**

The scheme must be approved by: Shareholders and creditors of both companies and Regulatory authorities (e.g., SEBI, NCLT).

3. Financial Evaluation : This step assesses whether the merger is financially viable. **Key Questions :**

1. What is the **maximum price** that should be paid for the target company?
2. What are the **principal areas of risk**?
3. What are the **cash flow** and **balance sheet implications**?
4. What is the **best way of structuring** the acquisition (cash, stock, or hybrid)?

4. Arranging Finance for Acquisition : Once the acquisition plan is finalized, the next step is to determine **how to pay for the deal**. Payment options include **cash, shares or a mix of cash and shares**.

VII. Special Purpose Acquisition Companies

SPACs, also called *blank cheque companies*, are entities created to **raise money through an IPO** with the sole purpose of acquiring a target company. The **target company is not identified at the time of the IPO**. SPACs have no existing business, operations, or revenues at the time of formation.

They must complete the acquisition within a stipulated period (usually 2-3 years). If they fail to do so, the SPAC is delisted, and investors get their money back.

The money raised by the SPAC during its IPO is **kept in an escrow account** (a secure bank account). This money can only be used for acquiring the target company or returned to shareholders in case of redemption or liquidation. After the SPAC announces the target company for the merger, shareholders evaluate the deal. If they are not satisfied with the proposed merger, they can choose not to support the merger. Instead, they can redeem their shares and get their proportionate amount of the funds held in escrow.

Example : *Virgin Galactic, a commercial spaceflight company founded by Sir Richard Branson, became one of the most prominent companies to go public via a SPAC. The SPAC involved was **Social Capital Hedosophia (SCH)**, led by Chamath Palihapitiya, a well-known entrepreneur and investor*

Indian laws, like the Companies Act 2013, don't currently support SPACs as they require companies to start operations within one year of incorporation. SEBI is yet to develop a clear framework for SPACs

VIII. DIVESTITURE

Divestiture refers to the process where a company sells off a portion of its business, division, or assets to another company or creates a separate entity. There are various reasons for divestment or demerger :

1. To focus on core areas of business
2. To get rid of divisions that are not contributing significantly to revenue.
3. The size of the firm may be too big to handle
4. The firm need cash urgently to fund other investment opportunities.

Forms of Divestiture

1. **Sell-Off / Partial Sell-Off:** The company sells a factory, a division, subsidiary, or asset to another entity for cash or securities.

Why Do It? 1) *When a division does not align with the parent company's core strategy.*
2) *To raise cash for paying debts or reinvesting.*

2. **Spin-Off:** A parent company separates a division or subsidiary into a new, independent company by distributing 100% shares of the new entity to its existing shareholders. The parent company has no control over the spun-off entity post-transaction. No fresh cash is raised.

Example : *Ferrari spin-off from Fiat Chrysler.*

Why Do It? 1) *To give a division its own identity.*
2) *To make the parent company unattractive to takeovers.*

3. **Split-Up:** The entire company is broken into several smaller entities, each operating independently. The original company ceases to exist.

Why Do It? 1) *Smaller entities are easier to manage.*
2) *To enhance shareholder value and operational efficiency.*

Example: *A company with divisions A, B, C, and D might split into four independent firms.*

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4. **Equity Carve-Outs:** The parent company sells a portion (minority stake) of a subsidiary's equity to the public to generate cash through an IPO. The parent retains a majority stake, while the public acquires a minority interest. A parent may use an equity carve-out as a step toward a complete spin-off.
Example : Agilent Technologies equity carve-out from HP.
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5. **Demerger or Family Business Division:** Often used in family-managed businesses to separate operations into distinct entities.

Why Do It? 1) To address succession challenges or consolidate core operations.
2) To focus on profitable divisions while shedding unprofitable ones.

IX. Acquisition Through Shares

When a company (acquirer) buys another company (target) using its own shares instead of cash, the acquisition involves exchanging shares between the two companies.

Key Steps in the Analysis:

- (i) Determine the value of acquiring company's equity based on its share price and market value.
- (ii) Calculate the total value of the target company based on its share price and outstanding shares.
- (iii) **Calculate Exchange Ratio** = $\frac{\text{Target Company's Share Price}}{\text{Acquiring Company's Share Price}}$
This ratio determines how many shares of the acquiring company will be given for each share of the target company.
- (iv) Assess the financial outcomes (like changes in EPS, value, and risks) under different assumptions about future performance.

Example: A Ltd (Acquirer): Share price = ₹200, **B Ltd. (Target):** Share price = ₹230; Total shares = 100,000
Exchange Ratio = $\frac{₹230}{₹200} = 1.15 \text{ shares}$ (To acquire all 100,000 shares of B, A will issue **115,000 shares**)
The cost of acquisition is the equivalent of ₹2,30,00,000 (₹230 x 100,000 shares).

Key Considerations for Acquiring Through Shares:

1. **Impact on EPS (Earnings Per Share):** The acquirer must assess how the additional shares issued will affect its EPS. If the combined company's EPS is higher, the merger is considered beneficial for both shareholders.
2. **Capital Structure Changes:** Issuing more shares dilutes the ownership of existing shareholders of the acquiring company. A balance must be maintained to avoid excessive dilution.
3. **P/E Ratio and Synergy Risk:** The combined **P/E ratio** of the merged entity may differ from that of the individual companies. A higher combined P/E ratio can increase the overall business value, even without synergy. However, if the combined P/E ratio is lower, it can reduce the perceived gains from the merger.
4. **Negotiation Between Acquirer and Target:** The acquiring company ensures it issues the minimum number of shares while still making the deal attractive to the target company.

X. Premium and Discount in Business Valuation

When valuing a business, certain **premiums** (additions) or **discounts** (reductions) are applied to reflect specific factors related to the business, market, or economic conditions.

Types of Premiums and Discounts:

1. **Premiums:**

- **Market Share Premium:** Added value for a company with significant market dominance.
- **Controlling Stake Premium:** A buyer is willing to pay more to acquire a controlling interest in the company.
- **Brand Value Premium:** Extra value due to the company's brand reputation or goodwill.

2. Discounts:

- **Small Player Discount:** Applied to smaller companies due to perceived higher risk or limited market presence.
- **Unlisted Company Discount:** Lower valuation for private companies as their shares are not publicly traded (lack of liquidity).

XI. Takeover Defensive Tactics

A **takeover** is classified as **hostile** when the acquirer seeks to gain control of a target company without the consent of its Board of Directors. In such cases, the acquirer directly approaches the shareholders of the target company, often through a **public tender offer**. To protect itself, the target company can adopt various **defensive tactics** to thwart or discourage the hostile takeover attempt.

1. Takeover Strategies by Acquiring Company :

(a) Street Sweep: The acquiring company purchases a significant number of shares in the target company in the open market before announcing an offer.

Objective: *To reduce the target company's ability to resist by controlling a majority of its shares.*

(b) Bear Hug : The acquirer **threatens to make a public offer** directly to the shareholders if the target company's board does not agree to the takeover.

Outcome: *The board of the target company may agree to the takeover to avoid the disruption of a hostile public offer.*

(c) Strategic Alliance : The acquirer enters into a **partnership** with the target company rather than a direct buyout, gaining influence and eventually control from within.

Outcome: *Over time, the acquirer establishes dominance in the target company.*

(d) Brand Power: The acquirer **collaborates with powerful brands** to weaken the target company's market position and force it into a sale.

2. Defensive Tactics by Target Company :

(a) Divestiture : The target company sells or spins off a part of its business to reduce its attractiveness to the acquirer. **Example:** *Divesting profitable divisions or subsidiaries.*

(b) Crown Jewels : The target company sells its most valuable assets (referred to as "crown jewels") to make itself less attractive to the acquirer.

(c) Poison Pill : The target company takes measures to dilute the acquirer's control by issuing convertible securities or additional shares to existing shareholders.

Impact: *It makes the acquisition more expensive and complicated for the acquirer.*

(d) Poison Put : The target company issues bonds with provisions allowing bondholders to redeem them at a premium if a takeover occurs.

Impact: *This drains cash from the target company, making it less attractive to the acquirer*

(e) Greenmail : The target company offers to buy back its shares from the acquirer at a premium to prevent the takeover. **Outcome:** *The acquirer exits with a profit, and the target company avoids a hostile acquisition.*

(f) White Knight : The target company seeks a "friendly" buyer who is willing to acquire it to protect it from the hostile acquirer.

Outcome: *The company is acquired on terms favorable to its management and shareholders.*

(g) White Squire : Similar to the white knight, but the target company sells a portion of its shares to a friendly investor who is not interested in taking full control.

Outcome: *This creates a blocking stake, preventing the hostile acquirer from gaining majority control.*

(h) Golden Parachutes : The target company offers hefty severance packages or compensation to key executives if they are ousted following a takeover.

Impact: *This increases the cost of acquisition, making it less appealing for the acquirer.*

(i) Pac-Man Defense : The target company counters the hostile takeover by making a **counter-bid** to acquire the acquirer.

Impact: *This forces the acquirer to defend itself, often leading to a withdrawal of its takeover attempt.*

XII. Unlocking Value Through Mergers, Acquisitions, and Business Restructuring due to following reasons :

1. **Horizontal Mergers** help companies **grow in size, enlarge market share, curb competition and use of unutilised capacity.**
2. **Vertical Mergers** help in **reducing costs and eliminating unnecessary taxes/duties.**
3. **Helps in Business Diversification**
4. **Efficient Use of Idle Funds** - Sometimes, one company has **excess cash**, while another needs funds for expansion. A merger can help channel this money effectively.
5. Some companies have **licenses, approvals, or permits** but are not operating. Another company can **take over these "shell" companies** to quickly start a project. **Example:** *A new airline acquiring a defunct airline that already has flight permits.*

XIII. Mergers & Acquisitions Failures - Some of the key reasons are:

1. Acquirers generally overpay.
In 2008, Microsoft tried to acquire Yahoo for \$44.6 billion, but analysts believed the price was too high. The deal failed, and Yahoo's value later dropped significantly.
2. The value of synergy is over-estimated.
AOL and Time Warner (2000) – The merger was expected to create huge synergies in media and internet services, but cultural and strategic differences led to failure.
3. Poor post-merger integration.
Example - Daimler-Chrysler (1998) – The German (Daimler) and American (Chrysler) companies had huge cultural differences, which led to conflicts, making integration unsuccessful.
4. Psychological barriers. **(Ego and Overconfidence lead to bad decisions)**
(Example - HP's acquisition of Autonomy (2011) – HP's management was overly confident about Autonomy's value but later discovered accounting fraud, leading to a \$9 billion loss.)