A NEED AND ISSUES IN MERGER AND ACQUISITION

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ABSTRACT

Mergers and acquisition (abbreviated M&A) are a big part of the corporate finance world. M&A refers to the aspect of corporate strategy, corporate finance and management dealing with the buying, selling, dividing and combing of different companies and similar entities that can helps an enterprise grow rapidly in its sectors or location of origin, or a new field or new location, without creating a subsidiary, other child entity or using a joint venture. With recession taking toll of .many Indian businesses and the feeling of insecurity surging over our businessmen, it is not surprising when we hear about the immense numbers of corporate restructurings taking place, especially in the last couple of years. Several companies have been taken over and several have undergone internal restructuring, whereas certain companies in the same field of business have found it beneficial to merge together into one company.

In this context, it would be essential for Us to understand what corporate restructuring and mergers and acquisitions. This paper focus on major issues involving mergers and acquisition in corporate sectors. ***Keywords:** Equity Carve-outs, Sell-off, Assets valuation, DCF (Discounted Cash Flow).*

INTRODUCTION

The main idea one plus one makes three: this equation is the special alchemy of a merger or an acquisition. The key principle behind buying a company is to create shareholder value over and above that of the sum of the two companies. Two companies together are more valuable than two separate companies at least, that's the reasoning behind M&A. This rationale is particularly alluring to companies when times are tough. Strong companies will act to buy other companies to create a more competitive, cost-efficient company. The companies will come together hoping to gain a greater market share or to achieve greater efficiency. Because of these potential benefits, target companies will often agree to be purchase when they know they cannot survive alone.

An acquisition is the purchase of one of one business or company by another company or other business entity. Consolidation occurs when two companies combine together to from a new enterprise altogether, and neither of the previous companies survives independently. Acquisition are divided into "private" and "public" acquisitions, depending on whether the acquire or merging company (also termed a target) is or is not listed on public stock markets. An addition dimension or categorization consists of whether an acquisition is friendly or hostile.

Whether a purchase is perceived as being a "friendly" one or a "hostile" depends significantly on how the proposed acquisition is communicated to and perceived by the target company's board of directors, employees and shareholders. In the case of a friendly transaction, the companies cooperate in negotiation; in the case of a hostile deal, the board and/or management of the target of the is unwilling to be bought or the target/s board has no prior knowledge of the offer. Hostile acquisition can, and often do, ultimately become "friendly", as the acquirer secures endorsement of the transaction from the board of the acquiree company. This requires an improvement in the term of the offer and/or through negotiation. "Acquisition" usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of larger and/or longer-established company and retain the name of the latter for the post-acquisition combined entity. This is known as a reverse takeover. Another type of acquisition is the reverse merger, a form of transition that enables a private company to be publicly listed in a relatively short time frame. A reverse merger occurs when a privately held company (often one that has strong prospects and is eager to raise financing) buys a publicly listed shell company, usually one with no business and limited assets.

Types of Mergers

From the perspective of business structures, there is a whole host of different mergers. Here are a few types, distinguished by the relationship between the two companies that are merging:

- **Horizontal Merger:** Two companies that are in direct competition and share the same product lines and markets.
- **Vertical Merger:** A customer and company or a supplier and company. Think of a cone merging with an ice-cream maker.
- **Market-extension Merger:** Two companies that sell the same product in different markets.
- **Product-extension Merger:** Two companies selling different but related products the same market.
- **Conglomeration:** Two companies that have no common business areas. There are two types of merger that are distinguished by how the merger is financed. Each has certain implication for the companies involved and for investors:
- **Purchase Mergers:** As the name suggests, this kind of merger occurs when one purchases another. The purchase is made with cash or through the issue of some kind of debt instrument; the sale is taxable acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company. We will discuss this further in part four of this tutorial.
- **Consolidation Mergers:** With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax term is the same as those of purchase merger.

Motives Behind M&A

The dominant rationale used to explain M&A activity is those acquiring firms seek improved financial performance. The following motives are considered to improve financial performance:

- **Economy of Scale:** This refers to the facts that combined company can often reduce its fixed costs by removing duplicate departments or operations, lowering the costs of the company relative to the same revenue stream, thus increasing profit margins.
- **Economy of Scope:** This refers to the efficiencies primarily associated with demand-side changes, such as increase its market power (by capturing increased market share) to set price.
- **Increased Revenue or Market Share:** This assumes that the buyer will be absorbing a major competitor and thus increase its market power (by capturing increased market share) to set prices.
- **Synergy:** For example, managerial economies such as the increased opportunity of managerial specialization. Another example are purchasing economies due to increased order size and associated bulk-buying discounts.
- **Taxation:** A profitable company can buy a loss maker to use the target's loss as their advantage by reducing their tax liability. In the United States and many other countries, rules are in place to limit the ability of profitable companies to "shop" for loss making companies, limiting the motive of an acquiring company.

- **Geographical or other Diversification:** This is designed to smooth the earnings results of a company, which over the long term smoothens the stock price of a company, giving conservation investors more confidence in investing in the company. However, this does not always deliver value to shareholders (see below).
- **Resource Transfer:** Resources are unevenly distributed firm (Barney, 1991)and the interaction of target and the interaction of target and acquiring firm resources can create value through either overcoming information asymmetry or by combining scarce resources.
- **Vertical Integration:** Vertical integration occurs when an upstream and downstream firm merger (or one acquires the other). There are several reasons for this to occur. One reason is to internalize an externality problem. A common example of such an externality is double marginalization. Double marginalization occurs when both the upstream and downstream firms have monopoly power and each firm reduces output from the competitive level to the monopoly level, creating two deadweight losses. Following a merger, the vertically integrated firm can collect one deadweight loss by setting the firms output to the competitive level. This increase profits and consumer surplus. A that creates a vertically integrated firm can be profitable.

Business Valuation

The five most common ways to valuate a business are:

- Asset valuation.
- Historical earnings valuation.
- Future maintainable earnings valuation.
- Relative valuation (comparable company and comparable transactions).
- Discounted cash flow (DCF) valuation.

Professional who valuate businesses generally do not use just one of these methods but a combination of some of them, as well as possibly others that are not mentioned above, in order to obtain a more accurate value. The information in the balance sheet or income statement is obtained by one of three accounting measures: a notice to Reader review engagement or an audit.

Accurate business valuation is one of the most important aspects of M&A as valuation like these will have a major impact on the prices that a business will be sold for. Most often this information is expressed in a letter of opinion of value (LOV) when the business is being valuated for interest's sake. There are other, more detailed ways of expressing the value of a business. While these reports generally get more detailed and expensive as the size of a company increases, this is not always the case as there are many complicated industries which require more attention to detail, regardless of size.

Restructuring Methods

Sell-offs

A sell-offs, also known as a divestiture, is the outright sale of a company subsidiary. Normally, sell-offs are done because the subsidiary doesn't fit into parent company's core strategy. The market may be undervaluing the combined businesses due to a lack of synergy between the parent and subsidiary. As a result, management and the board decide that the subsidiary is better off under different ownership.

Equity Carve-outs

More and more companies are using equity curve-outs to boost shareholders value. A parent firms makes a subsidiary public through an initial public offering (IPO) of shares, amounting to a partial sell-off. A new publicly- listed company is created, but the parent keeps controlling stake in the newly traded subsidiary. A carve-out is a strategic avenue apparent firm may take when one of its subsidiaries is growing faster and carrying higher valuation than other businesses owned by a parent. A carve-out generates cash because shares in the subsidiary are sold to public, but the issue also unlocks the value of the subsidiary unit and enhances the parent's shareholder value.

Spinoffs

A spinoff occurs when a subsidiary becomes an independent entity. The parent carve distributes shares of the subsidiary to its shareholders through a stock dividend. Since this transaction is a dividend distribution, no cash is generated. Thus, spinoffs are unlikely to be used when a firm needs to finance growth or deals. Like the carve-out, the subsidiary becomes a separate legal entity with a distinct management and goal.

Tracking Stock

A tracking stock is a special type of stock issued by a publically held company to track the value of one segment of that company. The stock allows the different segments of the company to be valued differently by investors.

Recent Merger and Acquisition in India

1. Tata Steel's mega takeover of European steel major Corus for $ 12.2 billion. The biggest ever for an Indian company. This is the first big thing which marked the arrival of India Inc on the global stage. The next big thing everyone is talking about is Tata Nano.
2. Vodafone's purchase of 52% stake in Hutch Essar for about $ 10 billion. Essar group still holds 32% in the Joint venture.
3. Hindalco of Aditya Birla group's acquisition of Novellis for $ 6 billion.
4. Ranbaxy's sale to Japan's Daiichi for $ 4.5 billion. Sing brothers sold the company to Daiichi and since then there is no real good news coming out of Ranbaxy.
5. ONGC acquisition of Russia based Imperial Energy for $ 2.8 billion. This marked the turnaround of India's hunt for natural reserves to compete with China.
6. NTT DoCoMo-Tata Tele services deal for $ 2.7 billion. The second biggest telecom deal after the Vodafone. Reliance MTN deal if went through would have been a good addition to the list.
7. HDFC Bank acquisition of Centurion Bank of Punjab for $ 2.4 billion.
8. Tata Motors acquisition of luxury car maker Jaguar Land Rover for $ 2.3 billion. This could probably the most ambitious deal after the Ranbaxy one. It certainly landed Tata Motors into lot of trouble.
9. Wind Energy premier Suzlon Energy's acquistion of RePower for $ 1.7 billion.
10. -Reliance Industries taking over Reliance Petroleum Limited (RPL) for 8500 crores or $ 1.6 billion.

Conclusion

One size doesn't fit all. Many companies find that the best way to get ahead is to expand ownership boundaries through merger and acquisition. For others, separating the public ownership of a subsidiary or business segment offer more advantages. At least in theory, mergers create synergies and economies of scale, expanding operations and cutting costs. Investors can take comfort in the idea that a merger will deliver enhance market power.

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