Mergers, Acquisitions and Corporate Restructuring
Prof. Chandra Sekhar Mishra
Department of Vinod Gupta School of Management
Indian Institute of Technology – Kharagpur

Lecture – 03
Theories of Mergers and Acquisitions

Hello friends. Welcome to the learning process of mergers and acquisitions and corporate restructuring session. In the previous session we talked about introduction about mergers, acquisition, different types of mergers, acquisitions, also talked about different motives why mergers, acquisition take place. We also talk about the motives in a very little formal approach that is the session we are talking about the different theories of mergers, acquisitions.

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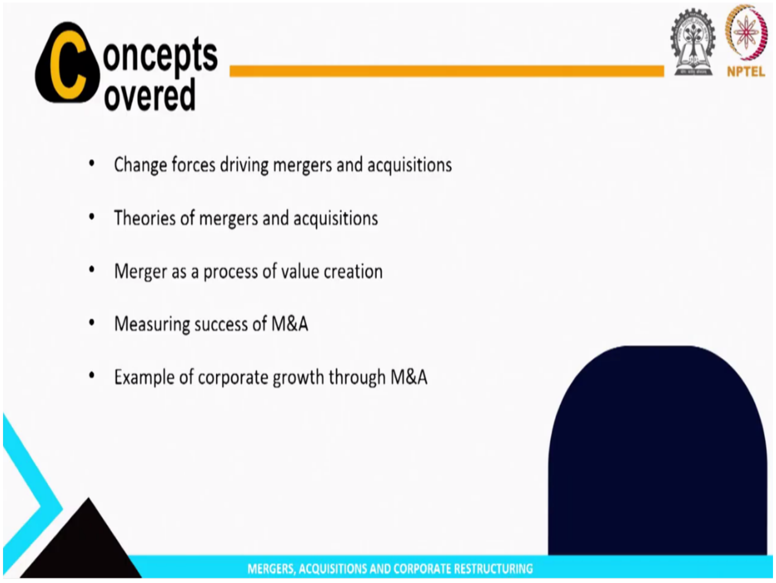

So, these sessions we will be covering this aspects, we will talk about what are the different macroeconomic global changes forces that are driving the mergers and acquisitions and we will talk about theories of mergers, acquisitions as given by different authors in their studies and we will talk about also how merger can be a process of value creation, what are the steps that you can follow then we will see how do you measure the success of mergers.

What could be different approaches to measure the success of merger, acquisition then we have also taken example of one company an Indian company which has grown in the last several years through mergers and acquisitions.

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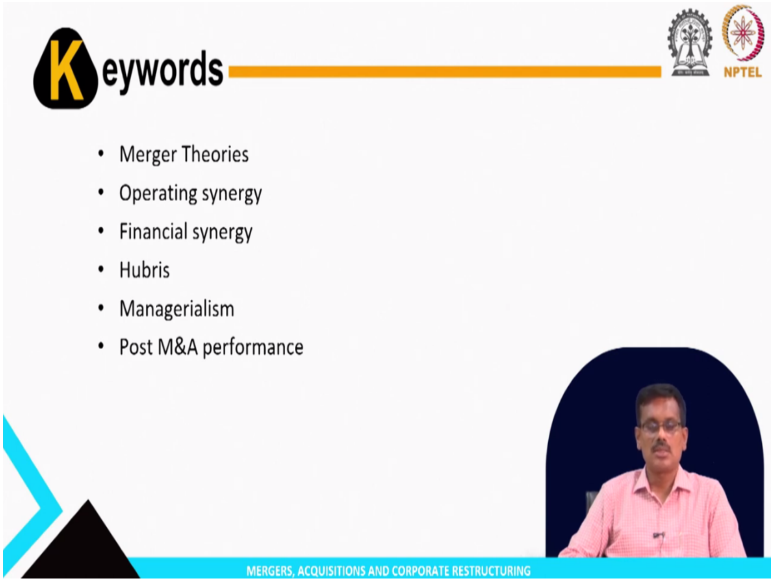

And the keywords that we have is like merger theories, operating synergy, financial synergy, hubris, managerialism, post M and A performance these are the things we are going to cover.

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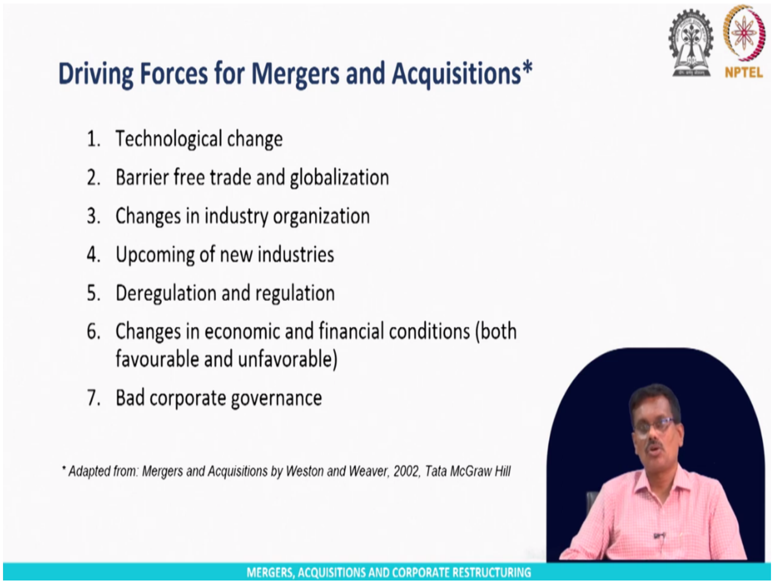

So, when you talk about the driving forces for merger, acquisition why so many mergers, acquisition taking place across the globe. One thing is that yes there is a lot of technological change that is taking place, whichever industry talk about whether it is a metallurgy process industry whether it is a IT sector, whether it is a hardware sector, lot of change are actually taking place.

And the companies instead of doing on their own they feel that somebody might be doing the technology exclusively and that particular technology company can be a right target for the company itself. So, companies have to update themselves technology and when they do particularly public listed companies when they try with new ideas, new ventures they are actually subject to lot of scrutiny.

In such case so getting new things done without any scrutiny is going to be difficult. So, in that case what happens there are several privately held companies, startups are there which are actually doing exclusives they are doing business and they are developing technology in exclusive area. So, those companies what happens they want to scale up, but they need some funds.

And once they have achieved particular technology or product or patent something like that they feel that their job is done and they will like to spent their energy, the enterprenial energy or managerial energy towards developing new things. So, those become new targets, good targets for establish companies. Now establish companies they get like hot cake because they do not have to now spent lot of time developing a particular product or technology.

They got readymade company which is doing and that company also goes for an exit because they will like to take, they must have invested some X rupees and they will exit at may be 2 X, 3 X rupees so they are also happy with that and they will again go for something new because they are good at those things, they are like innovators, they are like creators. So, they will now engage themselves doing something different.

So, technological change has led to lot of new startups, new companies coming up and those become target for the bigger entities who are also challenged by the changes in technology then even if the technological change in there, opportunities are there, but it is possible that when you want to acquire a company the regulatory barrier could be there or the trade barrier should be there.

X country may not permit the companies from Y country to also invest or acquire some company. Now with the globalization and the free trade among the countries then it is the globalization of free trade has become a facilitator for cross border acquisition in mergers. So, if we look at in Indian cases we have seen like in previous session we had talked about Tata Tea acquiring Tetley.

If the cross border acquisition was not permitted by India that would not have been possible for us like a company from India acquiring another company in UK or so. So, because of this laborization etcetera now we see several Indian companies going for acquiring companies outside the country like your Tata Corus deal, Tata went for Jaquar and we also have Hindalco acquired Novelis in 2007, 2008 they acquired Hindalco acquired Novelis.

So, several cases are there where Indian companies are going and acquiring other companies in other countries. Similar also is the case that you find companies from across the world coming and acquiring companies in India. If this free trade and globalization was not there even if there is a good target across the border you still not go for trade because the regulator or the country specific policy do not approve it or do not allow that as such.

So, the barrier free trade and globalization has facilitated lot of cross border mergers and acquisitions then the industry organization itself is changing. Now, for example, if you look at somebody ask somebody about the IBM what does IBM do maybe 20 years back one will say that IBM is into hardware, mainframe, IBM had a desktop, laptop etcetera. Now, if somebody ask that what is IBM then it is more of a software services company.

So, the industry organization itself has changed. So, a hardware company has become almost like a software company. Now, they cannot become overnight software company, they can slowly do it and to now to see that they have got better presence, greater presence in software sector or a new sector for that matter they will like to acquire new companies in that new sector and (()) (06:53) known because the existing products and services that they offer could be redundant for the customers.

And there may not be anyone to buy that or engage with the company. So, in that case the company will like to go to something else. Similarly, let us look at the power sector. The power sector lot of focus is on the renewable energy. So, now you see the solar power company standalone solar power companies have become targets for the existing power sector company because there could be a target that in certain number of years the total if the company is producing let us say 100 units of power.

It maybe company may have set a target for itself that maybe 20%, 30% or 40% unit, 40% of the power generation by this company should be coming for renewable energy and which includes your solar power. So, the industry organization is changing that means from thermal power; thermal power is always there, but people are now going for more renewable energies. So, in that case what do the company do?

So, then these renewable power companies or like solar power companies becomes a good target and the power sector companies can go for acquiring the solar power. So, there is industrial organization that thermal generation power is there, but you have got more focus, emphasis on this sustainable power generation which is (()) (08:15) for environmental pollution, solar power is the best option in that case.

Similarly, now the companies are looking at like they say in steel sector talking about green steel that means the steel that is produced with a less carbon emission etcetera. So, now whether the company will develop the green steel technology or there maybe some scientific units or some experts who maybe working on green steel technology and developing something.

And those technologies can be bought or the company with the technology can itself bought. So that the company can now focus in the green steel as such. So, the industry organization is changing that also helps facilitate more and more acquisitions in different sector as such. So, same thing also (()) (09:02) has talked about green steel, we have new industries, for example, 20 years, 30 years back nobody talked about ITES as such. Now ITES is one of the major employment generator, major contributor of the economy.

So, new industries are coming up and one can go for and let us say online platform for that matter. So, you look at Reliance Jio as an example. So, Reliance if you look at the origin they were into textiles, they are into petrochemicals then they went into petroleum and now you see Reliance is more known as Reliance Jio which is in telecom. The telecom sector was not there so prominently long back in India for that matter.

But once the telecom sector was deregulated we saw major companies grow major industrial groups like Birla Group, Reliance group, Ambani group, Reliance Group for that matter, Tata Group enter in telecom sector because the new industries have come up and the established companies do not want to lose out the opportunity and they also went ahead and invested in those new industries for that matter.

So, coming back to Reliance Jio as an example now if you look at Reliance people say Reliance Jio as such and in that case what happens Reliance Jio for that matter has acquired several companies which is providing online platform, online products and selling and like in some of the class in the previous session talked about like Reliance acquired these Urban Ladder which is a online furniture company.

So, online furniture business or online business is a new industry for that matter relatively and the Reliance Industries wanted to expand it with that, went to go into that particular sector and they found that is a good opportunity and possibly Urban Ladders promoters and management they thought that time to exit because they have to scale up and they needs lot of funds as such and they might available.

And so they got exit option by being acquired by a more prominent player in this country for that matter. Then deregulation and regulation; regulation can lead to merger, acquisition the deregulation also facilitates mergers, acquisition like you talked about in barrier free trade and globalization for that matter and then in which economic conditions are changing in the economy very good recession or boom for that matter.

Both the conditions actually lead to more margin in acquisition. If condition is favorable, companies get more revenue, more cash flow and they like the opportunities to grow with those access cash flow or more cash flow and for that matter organic growth may not be that possible, so they will look for acquisitions. Similarly, if the condition is bad so some companies are not doing well although they have the capability and ability to do something.

They have the technology, they have the manpower, but the funding or sales problem could be there. In that case those companies become good target for the other companies for that matter. So, conditions being good can lead to merger, acquisition. Condition being bad in the economic and also lead to lot of mergers and acquisition then comes another aspect is that the corporate governance.

The bad corporate governance that means management is not managing the efforts of the company well. Company has a lot of potential, but they are not acting in the interest of the investors, shareholders something like that. In that case you become easy target and certainly the market comes to know about it that the company is not governing itself well, the share price is a listed companies, share price will definitely come down.

And then it becomes easy target and there could be open offer or whatever by the other companies and the existing shareholders may find better if the open offer is little more than if it is a premium over the existing market price then the existing investors will like to exit because if they continue the existing management which is not governing well the shares prices of the company may further go down.

So, in that case if there is an exit option available because somebody is making an attempt to takeover and the takeover attempt is facilitated by the existing shareholders because the existing management is not governing itself well. So, in fact it is said the market is the ultimate discipline maker in corporate. So, if I am not doing well, not managing yourself well it is a matter of time that you will become market to discipline you in the form of a takeover attain by some other player as such.

So, it is better that you govern yourself well, you take care of stakeholders, you and the company takes your shareholders wealth also getting maximized unless that is taken care in long term basis the company becomes an easy takeover target.

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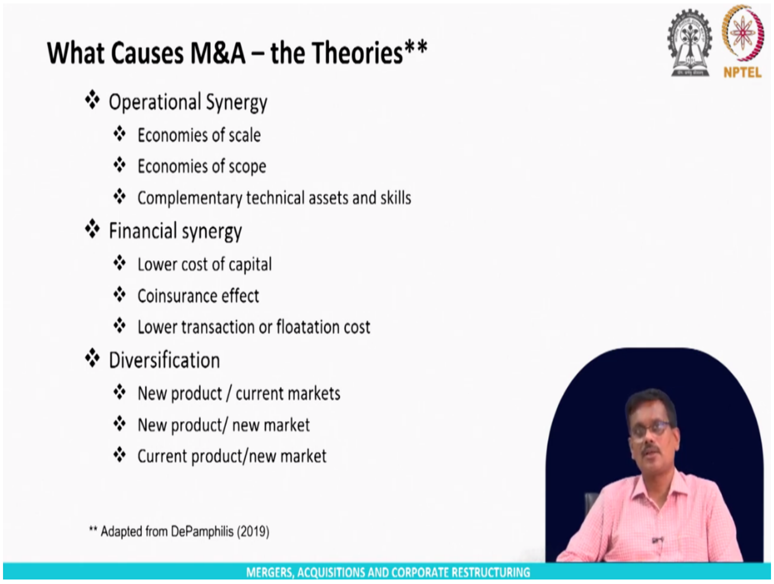

Then we go to different theories that means what causes the mergers and acquisitions whereas in India or elsewhere for that matter. So, first we talked about earlier also called something called operational synergy. By the way what is synergy for that matter?

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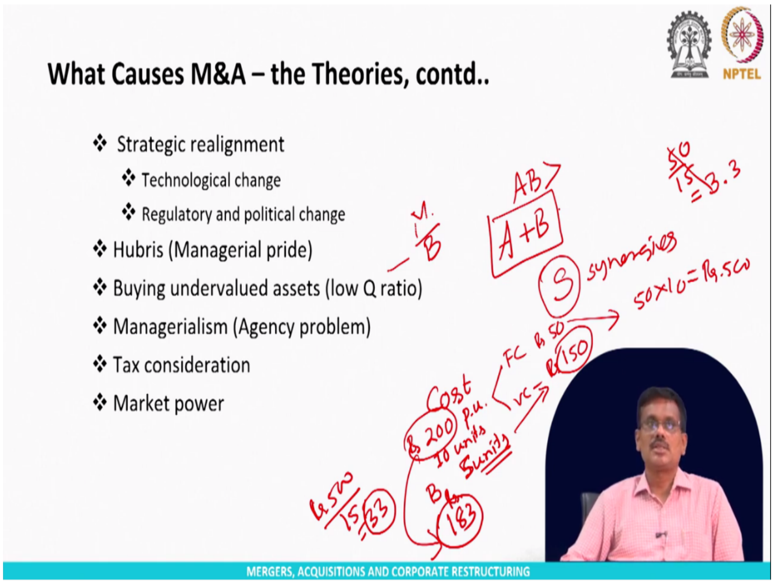

So, if you have got A one has got A unit + B combined together and you got AB for that matter. So, AB is suppose to be more than A + B and this A + B more than means if you look at how AB together means after acquisition. Suppose, A and B merge together and the new company formed is AB; AB is going to be more than A + B and they say that difference between AB together and A + B standalone total sum, simple sum is actually nothing, but synergy.

So, that means if I am going to pay a price or value more to A + B together that valuation is because of presence of synergy. Now, what happens in synergy for that matter, for example, let us say another operating synergy for that matter in the terms of cost also. So, if the company is producing a particular product at let us say Rs. 200 per unit and let us say the company is producing only 10 units.

And Rs. 200 per unit may be in that case you have got fixed cost of rupees let us say 50 and variable cost is actually Rs. 150 that means the total fixed cost for this particular company is nothing, but 50 into 10 rupees 500 and the company A is acquiring company B; B is actually has the capacity and the customer requirements let us say they have got a 5 units capacity. Now, when the company B is acquired by company A.

The company A says that we do not need the facilities of company B because we already have existing facility. We just acquired them so that you got the customers and demand taken care. So, we have to just produce 5 units and assuming that this 5 units can be produced with the existing capacity of company A in that case we will need only to spent 5 into 150 that is called variable cost because fixed cost is already there which will take care of the additional five units also.

So, in that case what will happen your Rs. 50 fixed cost gets divided now by 15 so it comes to now 15 means 10 + 5 15 so it comes to around Rs. 3 something let us say 3.3. So, now you see that this is actually Rs. 500 which gets divided by 15 so it comes to around Rs. 33. Now you see that so 33 + 150 it becomes now Rs. 183. So, in that case what happens the cost of production which was actually Rs. 200 now it has become Rs. 183 because of the synergy as such.

So, you are the customer you are going to take the facility and reduce. So, this is called cost reduction for that matter. So, that is an example of operation in synergy cost reduction and also synergy can also take place with the help of economies of scale that means you are producing more and economies of scope that means you are producing different things. You acquire a company which is into different products.

Then you also complement each other that in terms of technical aspects as well as technical skills for that matter then another synergy that term is called financial synergy. In financial synergy what happens when they combined together you will be able to command a lower interest rate, lower cost of capital and now what happens suppose the company A has 1,000 crore assets, company B has let us say 500 crore assets.

So, now you are a company size of 1,500 crore and they insert against each other. So, company will be able to command and lower interest rate most likely because the cost it is shared that usually unless otherwise some other problem is there usually bigger companies will be able to command a lower interest at only lender so that way cost of debt is going to go down.

And similarly you can also lower transaction cost because you have lot of floatation cost is there and in that case floatation and transaction cost, issue management cost is also going to be lower when a bigger company is there. Next theory that you talk about is called diversification of the business. Diversification come to new area either in the same market you will introduce new product or you entirely new market you enter to have new product or the same products can also be entered into new market for that matter.

So, you will find that several banking companies, for example, you had IndusInd Bank which was taken over by some other bank for that matter. IndusInd Bank had a south presence as such whereas other bank has a mostly Pan India presence, but South presence are lesser for that matter. So, you are able to go to the other bank also other markets. Similarly from long time back you had a problem with the global trust bank the South West bank which was actually taken over by Oriental Bank of Commerce OBC.

In that case OBC had a North India presence whereas GTB had a South India presence. So, with this acquisition the OBC the Oriental Bank of Commerce could have a presence across the country Pan India presence and South India presence could be there because they got the companies the bank readymade with them, lot of branches etcetera and GTB is also who are little technologically advance because there is a private sector bank.

New generation bank was there whether some of the governance issues were there so that company became a target. So, RBI facilitated that time the acquisition of GTB by Oriental Bank of Commerce. So, that is called you have same banking product, but you got new market from OBC point of view for that matter. So, current product and new market in that case.

So, then some other theories that you have is called a strategic realignment that means you have technological changes taking place so that is why you will realign the new technology, so that leads to mergers, acquisition, you have regulatory changes taking place, regulatory facility is there. So, you go for more that also helps merger acquisition. There could be political change.

So, political change may lead to welcoming new companies from across the world or political change also can lead to exit of some of the players let us say foreign players may exit because of the unfavorable political condition in the particular country. In that case the companies that are exiting they become takeover target for that matter then we have an interesting aspect in merger acquisition that is called the hubris that is called managerial pride.

Sometimes the management feel that what they do is the best thing they are doing actually, they do not look at rationale the business rationale for that matter, they are rather bothered about that yes what you are doing, what value we have got to pay for a particular company target is the best value, they have pride for whatever that maybe. So, in that case the lower level management does not have a chance to discuss.

And give some guidance because the management has decided. It is like in managerial instinct, but they have decided it is very difficult to top management to convince that it is not because you will not be able to approach them for that matter also that they are doing something even if it is not the interest of the shareholders still they will go ahead with that and nobody can point it out because they feel what they have done the best thing as such and subsequently those mergers actually become failure for that matter.

Then you for some reason there may be some opportunities why existing companies which are available cheaper. One of the matrix for (()) (22:27) cheaper could be the Tobin's Q Ratio. In Tobin's Q Ratio what happens we have a typically what you do there Q Ratio is nothing, but market to book for that market. So market value of the company divided by book value of the company so that is cheaper, that is lower that means it is available cheaper.

So, comparable market-to-book ratio going to be two times let us say whereas this company is available for less than 2 or 1.5, 1.8 so it become cheaper as such. So, because the company is available cheaper so it maybe that can lead to merger, acquisition, but that should not be ultimate reason for merger acquisition. The company should be strategically fit for the acquiring company then only the things are found to be cheaper than one can go for it also.

So, company will be scouting for acquisition opportunity target for that matter and they come across a good valuation means undervalued companies, for example, Tobin's Q Ratio low Q ratio for that matter and the mergers, acquisition can take place. Managerially means something is called agency problem also in corporate finance there can be agency problem where managers may not be acting in the interest of the promoters or the owners of that company for that matter.

Sometimes the managers feel that if the size become bigger their perks, bonuses, salary itself and incentives can become higher. So, because keeping that in mind that they will have more benefits in terms incentives, bonuses etcetera they will go for acquiring company and make this company size bigger. So, the motive is to make the company bigger because their incentives are linked with the size of the company.

Whether there is a strategically fit, good value creation opportunities is our target that is a secondary for them. So, there the governance that means possibly top governance is now to control their behavior and this problem can also be there then we have a tax consideration. We have unutilized tax benefits of a target company; target company give a loss making company. So, if you acquire them then we can also get some tax benefit in short term.

But we have discussed earlier that tax benefits on its own sooner the main criteria for acquiring a company rather that should be one of the factor because the company is strategically fit that is why I am talking about another reason I can justify to the stakeholders that besides being strategically fit we are also going to get tax benefit over some period of time that is one.

And then last one I am talking about the market power. I just want to be the biggest player. So, some companies say that we want to be the top one, top two player in this particular sector that is my motto as such, that is my motive. In that case I want to eliminate everyone possibly and I will acquire companies and become very big as such that is another thing that yes I want to be the bigger player.

I want to have more market power because I will have market power with respect to the supplier, with respect to customer. So, I am going to have the bargaining power for that matter, but we have discussed this is subject to scrutiny by regulator like in India we have Competition Commission of India which regulates this particular market expansion for that matter. So, these are the causes of merges, acquisition the theory that we discussed.

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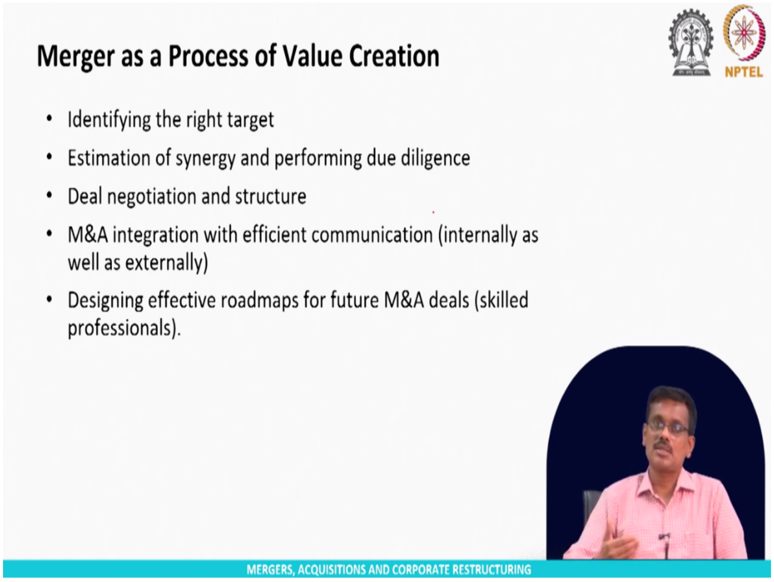

And then we go to what how can make although we are going to discuss this merger process in detail in subsequent session, but we will say that how a particular merger process can be creating lot of value for this stakeholders or shareholders. One is that you have to aim for the right target, right target in terms of technology, management, culture, capability etcetera the bright target that is one of the things you make search for thousand companies finally will lead to one or two companies for that matter.

We will discuss in detail in searching for target in subsequent sessions then you have to also see that how much synergy is going to be there for this new company the existing company the two comes together, are they going to have more synergy or not then we do not go for it as such then of course you have to (()) (26:22) lot of due-diligence what they claim it to or not legal, operational market, HR, accounting, all due-diligence we will be talking about.

We will discuss about proper due-diligence in some other session, but due-diligence is one of the main thing because a due-diligence is not done rightly then when you acquire and you come to know about the problem later then it is already a gone case we have already acquired the company then integration is going to be a bigger problem and those mergers can be actually failure because there will be some cultural problem between two companies.

And the company may not integrate well subsequently then you have to negotiate the deal with the target company what price you are going to pay, how you are going to pay then come the integration. Integration has to be facilitated by good due-diligence and you have to retain the existing management of the target company and then you have to have a good efficient communication with the employees internally, suppliers, outsiders, regulator that communication has to be there very good as such.

Then this four things done correctly then possibly we have learning experience, you have lot of (()) (27:30) and now you can now share, you can apply this knowledge by acquiring another company in future for that matter. So, you become good at acquiring companies.

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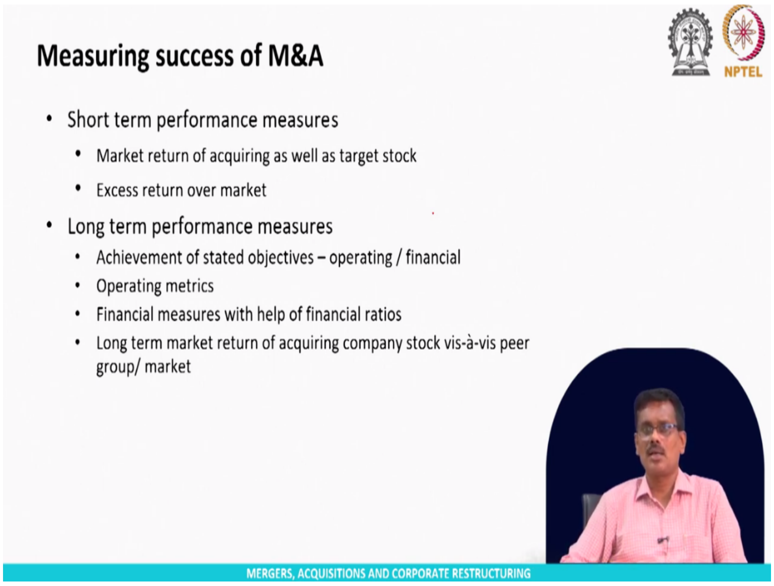

So, then comes merger acquisition is taking place, how do I measure that M and A has been successful or not. There are different matrix we have, different ways we can do that, short term performance could be that, you compare the market return of how the market responded in short term with the announcement, target price has gone up, so acquiring company prices might have gone up or gone down in relation to the market.

Market might have gone up at 10%, but this company share price has gone up by 12% then we can possibly attribute that yes because of the merger, acquisition announcement this market has rewarded 2% extra compared to the rest of the market as such because 12% on its own may not the right matrix you compare 12% return in the stock versus 10% return in the overall market could be like Sunsex or Nifty in Indian context.

So, access return about the market return for that matter then long term performance measures some companies feel that whatever I thought of attending my objective whether I want to expand, I want to have a technology, is that technology has come that market expense has taken place then I can say that my merger acquisition has been successful. I do not bother about anything operating matrix, financial matrix.

I had a stated objective when I acquired a company and I got that particular company and then I achieve that particular objective then it is successful for me. Otherwise operating matrix could be there like capacity expansion, productivity could be there, employee productivity, plant, machine and productivity, sales all those things could be there, market share they are also called to be operating matrix for a particular company to know whether merger acquisition has been successful or not.

Then we got the financial measures like your financial ratios, net profit margin, gross profit margin, return on network, return on equity all those financial matrix also can be seen how it has changed post merger, has it more been pre-merger or not also we have to do a comparison between a peer group how this particular company has done in the financial matrix vis-a-vis industry grow because industry might have grown source growth so you have also grown same then how can we say (()) (29:43) mergers and acquisitions.

Your return, your ratio versus the peer group ratio that one has to compare then we can say the merger, acquisition has been successful financial matrix or not. We can also find out long term market like in the previous term we have talked about short term market return here we will talk about long term market return for that matter and the long term market return yes again we compare the return of the stock of the acquiring companies where target companies has gone by the time most likely that has already merged there.

They might be existing, they might be listed now. So, acquiring company stock is there how this acquiring company stock return has been there over a long term compared with the index could be S and P or Nifty, Sunsex whatever that maybe we have the benchmark we will compare with them that is another approach.

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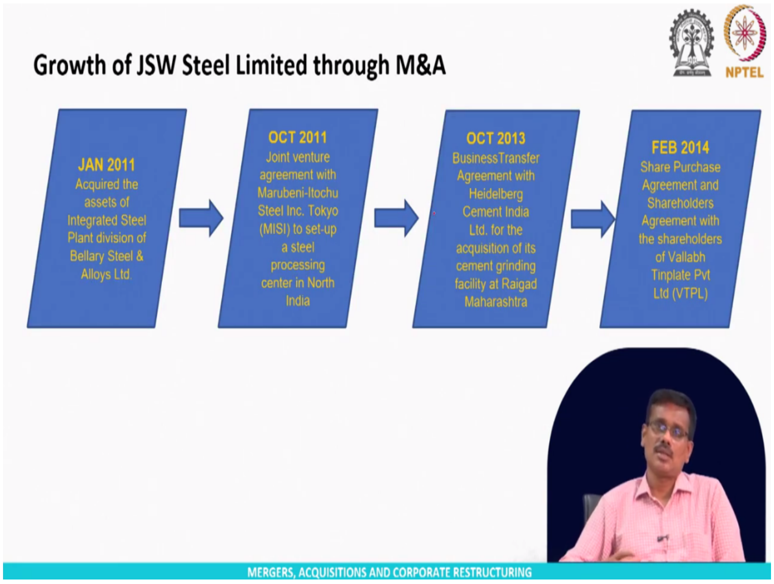

Then next we will look at an example that like JSW Steel it was that how this company has grown in last several years with the help of mergers, acquisitions. So, you have taken only few of the M and A of this company, you have not taken the entire M and A done by this particular company last several years like in January 2021 they acquire the assets of Integrated Steel Plant division of Bellary steel they acquired that particular company.

And October 2000 they went a joint venture with a Tokyo based company Itochu steel so that they can have a steel processing center in North India then in October 2013 they got a business transfer agreement with Heidelberg Cement of India Limited for acquiring their cement grinding facility in Raigad in Maharashtra then in February 2014 they had a share purchase agreement with Vallabh Tinplate Private Limited then this story does not end there.

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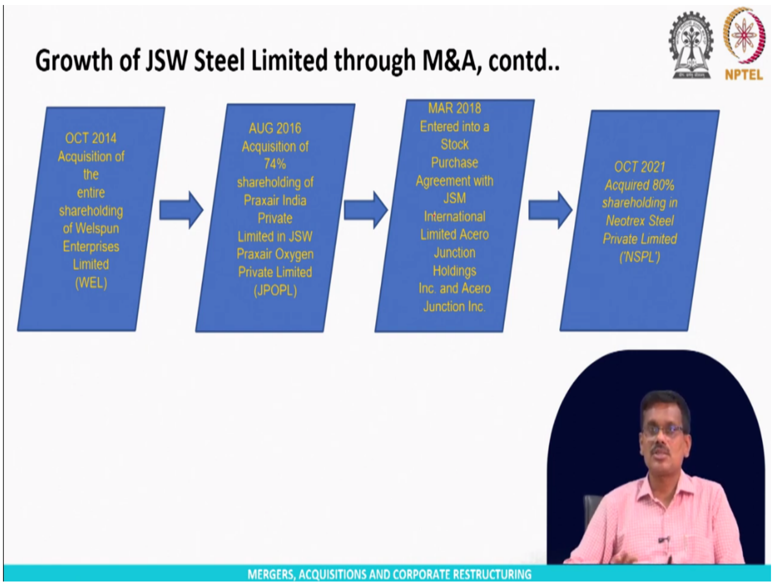

Again 2014 October they acquired Welspun Enterprise Limited a diversified in that way for that matter on the core operation. In August 2016 they acquired 74% shareholding Praxair; Praxair is into air, oxygen for that matter that is used as an input for a steel industry for that matter then in 2018 March they entered into a stock purchase agreement JSM International Limited.

And last October 2021 they have acquired 80% shareholding in Neotrex Steel Private Limited so that shows that how this company has moved from 2011 to 2021 last 10 years they have got 8 to 9 acquisitions or joint ventures or alliances for that matter so that for their growth as such. So, that is what shows there are several other examples we can also cite in some session we can look at all other example for that matter.

Companies do diversify with the help of mergers, acquisitions, they diversify in the same segment, they diverse in same market, they may diversify in the new market, they become conglomerate for that matter with the help of merger, acquisitions there are number of examples in India in context for that matter all this business also look at they have grown now tremendously with the help of mergers, acquisitions in the recent past. So, this is what we want to discuss today.

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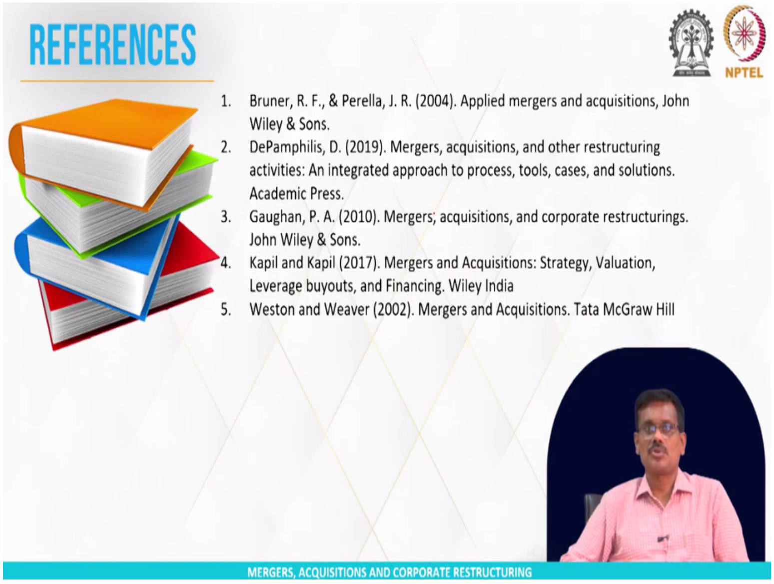

And we will see you in the subsequent session. Thank you.