CHAPTER 13

MERGERS, ACQUISITIONS & CORPORATE RESTRUCTURING

LEARNING OUTCOMES

After going through the chapter student shall be able to understand

- Conceptual Framework
- Rationale
- Forms
- Mergers and Acquisitions
  - Financial Framework
  - Takeover Defensive Tactic s
  - Reverse Merger
- Divestitures
  - Partial Sell off
  - Demerger
  - Equity Carve outs
- Ownership Restructuring
  - Going Private
  - Management/ Leveraged Buyouts
- Cross Border Mergers

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1. CONCEPTUAL FRAMEWORK

Restructuring of business is an integral part of modern business enterprises. The globalization and liberalization of Control and Restrictions has generated new waves of competition and free trade. This requires Restructuring and Re-organisation of business organization to create new synergies to face the competitive environment and changed market conditions.

Restructuring usually involves major organizational changes such as shift in corporate strategies. Restructuring can be internally in the form of new investments in plant and machinery, Research and Development of products and processes, hiving off of non-core businesses, divestment, sell-offs, de-merger etc. Restructuring can also take place externally through mergers and acquisition (M&A) and by forming joint-ventures and having strategic alliances with other firms.

The topic of Mergers and Acquisition has already been discussed in previous section. It is now proposed to focus on Corporate Restructuring.

The aspects relating to expansion or contraction of a firm’s operations or changes in its assets or financial or ownership structure are known as corporate re-structuring. While there are many forms of corporate re-structuring, mergers, acquisitions and takeovers, financial restructuring and re-organisation, divestitures de-mergers and spin-offs, leveraged buyouts and management buyouts are some of the most common forms of corporate restructuring.

The most talked about subject of the day is Mergers & Acquisitions (M&A). In developed economies, corporate Mergers and Acquisition is a regular feature. In Japan, the US and Europe, hundreds of mergers and acquisition take place every year. In India, too, mergers and acquisition have become part of corporate strategy today.

Mergers, acquisitions and corporate restructuring business in India have grown by leaps and bounds in the last decade. From about $4.5 billion in 2004, the market for corporate control zoomed to $13 billion in 2005 and reached to record $56.2 billion in 2016. This tremendous growth was attributed to the fact that the foreign investors were looking for an alternative destination, preferably a growing economy as their own country was reeling under the pressure of recession. This was caused by the tough macro economic climate created due to Euro Zone crisis and other domestic reasons such as inflation, fiscal deficit and currency depreciation.

The terms ‘mergers; ‘acquisitions’ and ‘takeovers’ are often used interchangeably in common parlance. However, there are differences. While merger means unification of two entities into one, acquisition involves one entity buying out another and absorbing the same. In India, in legal sense merger is known as ‘Amalgamation’.

The amalgamations can be by merger of companies within the provisions of the Companies Act, and acquisition through takeovers. While takeovers are regulated by SEBI, Mergers and Acquisitions (M & A) deals fall under the Companies Act. In cross border transactions, international tax considerations also arise.
Halsburry’s Laws of England defined amalgamation as a blending of two or more existing undertakings, the shareholders of each amalgamating company becoming substantially the shareholders in the amalgamating company. Accordingly, in a merger, two or more companies combine into a single unit.

The term “amalgamation” is used when two or more companies are amalgamated or where one is merged with another or taken over by another. In Inland steam Navigation Workers Union vs. R.S. Navigation Company Ltd., it was observed that in case of amalgamation, the rights and liabilities of a company are amalgamated into another so that the transferee company becomes vested with all rights and liabilities of the transferor company.

An acquisition is when both the acquiring and acquired companies are still left standing as separate entities at the end of the transaction. A merger results in the legal dissolution of one of the companies, and a consolidation dissolves both of the parties and creates a new one, into which the previous entities are merged.

Corporate takeovers were started by Swaraj Paul when he tried to takeover Escorts. The other major takeovers are that of Ashok Leyland by the Hindujas Shaw Wallace, Dunlop, and Falcon Tyres by the Chabbria Group; Ceat Tyres by the Goenkas; and Consolidated Coffee by Tata Tea. The BIFR arranged for the takeover of companies by giants like ITC, McDowells, Lakshmi Machine Works, and the Somani Group.

Many new companies are being incorporated as a result of the fast growing industrialisation of the country which is mainly dependent on agriculture. With the new trends of globalisation, not only in this country but also worldwide, there has been increasing interaction of companies and persons of one country with those of other countries. Today, corporate restructuring has gained momentum and undertakings and companies are merging, demerging, divesting and taking in or taking over companies and undertakings, both unregistered and registered, in India and outside.

Against this corporate backdrop, mergers and acquisitions have to be encouraged in the interest of the general public and for the promotion of industry and trade. At the same time the government has to safeguard the interest of the citizens, the consumers and the investors on the one hand and the shareholders, creditors and employees/workers on the other.

Chapter XV (Section 230 to 240) of Companies Act, 2013 (the Act) contains provisions on ‘Compromises, Arrangements and Amalgamations’, that covers compromise or arrangements, mergers and amalgamations, Corporate Debt Restructuring, demergers, fast track mergers for small companies/holding subsidiary companies, cross border mergers, takeovers, amalgamation of companies in public interest etc.,.

Special restructuring processes such as ‘Reconstruction’ of sick industrial companies envisaged by the Sick Industries (Special Provisions) Act, 1985 and ‘Revival’ of financially unviable companies envisaged by sec 72A of the Income Tax Act, 1961. However, all such mergers and acquisitions are also governed or controlled through relevant provisions of the Foreign Exchange Management Act, 1999; Income Tax Act, 1961; Industries (Development and Regulation) Act,
1951, the Competition Act 2002; the restrictions imposed by other relevant Acts including SEBI Act, 1992, as the case may be.

Amalgamation signifies the transfer of all or some part of the assets and liabilities of one or more than one existing company to another existing company or of two or more existing companies or to a new company, of which transferee company or all the members of the transferor company or companies become, or have the right of becoming, members and generally, such amalgamation is accomplished by a voluntary winding-up of the transferor company or companies.

Under an amalgamation, merger or takeover, two (or more) companies are merged either de jure by a consolidation of their undertakings or de facto by the acquisition of a controlling interest in the share capital of one by the other or of the capital of both by a new company.

Amalgamation is a state of things under which either two companies are so joined to form a third entity or one is absorbed into or blended with another.”

“Generally, where only one company is involved in a scheme and the rights of the shareholders and creditors are varied, it amounts to reconstruction or reorganisation or scheme of arrangement. In an amalgamation, two or more companies are fused into one by merger or by one taking over the other. Amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company become substantially the shareholders of the company which is to carry on the blended undertaking. There may be amalgamation either by the transfer of two or more undertakings to a new company, or by the transfer of one or more undertaking to an existing company. Strictly, ‘amalgamation’ does not cover the mere acquisition by a company of the share capital of the other company which remains in existence and continues its undertaking but the context in which the term is used may show that it is intended to include such an acquisition.”

2. RATIONALE FOR MERGERS AND ACQUISITIONS

The most common reasons for Mergers and Acquisition (M&A) are:

- **Synergistic operating economics**: Synergy May be defined as follows:

  \[ V(AB) > V(A) + V(B) \]

  In other words the combined value of two firms or companies shall be more than their individual value Synergy is the increase in performance of the combined firm over what the two firms are already expected or required to accomplish as independent firms (Mark L Sirower of Boston Consulting Group, in his book “The Synergy Trap”). This may be result of complimentary services economics of scale or both.

  A good example of complimentary activities can a company may have a good networking of branches and other company may have efficient production system. Thus the merged companies will be more efficient than individual companies.
On similar lines, economies of large scale is also one of the reasons for synergy benefits. The main reason is that, the large scale production results in lower average cost of production e.g. reduction in overhead costs on account of sharing of central services such as accounting and finances, office executives, top level management, legal, sales promotion and advertisement etc.

These economies can be “real” arising out of reduction in factor input per unit of output, whereas pecuniary economics are realized from paying lower prices for factor inputs for bulk transactions. Other factors for Synergies are as follows:

- **Diversification:** In case of merger between two unrelated companies would lead to reduction in business risk, which in turn will increase the market value consequent upon the reduction in discount rate/ required rate of return. Normally, greater the combination of statistically independent or negatively correlated income streams of merged companies, there will be higher reduction in the business risk in comparison to companies having income streams which are positively correlated to each other.

- **Taxation:** The provisions of set off and carry forward of losses as per Income Tax Act may be another strong season for the merger and acquisition. Thus, there will be Tax saving or reduction in tax liability of the merged firm. Similarly, in the case of acquisition the losses of the target company will be allowed to be set off against the profits of the acquiring company.

- **Growth:** Merger and acquisition mode enables the firm to grow at a rate faster than the other mode viz., organic growth. The reason being the shortening of ‘Time to Market’. The acquiring company avoids delays associated with purchasing of building, site, setting up of the plant and hiring personnel etc.

- **Consolidation of Production Capacities and increasing market power:** Due to reduced competition, marketing power increases. Further, production capacity is increased by the combination of two or more plants. The following table shows the key rationale for some of the well known transactions which took place in India in the recent past.

<table>
<thead>
<tr>
<th>Rationale for M &amp; A</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instantaneous growth, Snuffing out competition, Increased market share.</td>
<td>• Airtel – Loop Mobile (2014) (Airtel bags top spot in Mumbai Telecom Circle)</td>
</tr>
<tr>
<td></td>
<td>• Google – Motorola (2011) (Google got access to Motorola’s 17,000 issued patents and 7500 applications)</td>
</tr>
<tr>
<td>Acquisition of a competence or a capability</td>
<td>• Airtel – Zain Telecom (2010) (Airtel enters 15 nations of African Continent in one shot)</td>
</tr>
<tr>
<td>Access to funds</td>
<td>Ranbaxy – Sun Pharma (2014) (Daiichi Sankyo sold Ranbaxy to generate funds)</td>
</tr>
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<td>----------------</td>
<td>--------------------------------------------------------------------------------</td>
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<tr>
<td>Tax benefits</td>
<td>Burger King (US) – Tim Hortons (Canada) (2014) (Burger King could save taxes in future)</td>
</tr>
<tr>
<td>Instantaneous growth, Snuffing out competition, Increased market share.</td>
<td>Facebook – Whatsapp (2014) (Facebook acquired its biggest threat in chat space)</td>
</tr>
<tr>
<td>Acquisition of a competence or a capability</td>
<td>Flipkart – Myntra (2014) (Flipkart poised to strengthen its competency in apparel e-commerce market)</td>
</tr>
<tr>
<td>Entry into new markets/product segments</td>
<td>Cargill – Wipro (2013) (Cargill acquired Sunflower Vanaspati oil business to enter Western India Market)</td>
</tr>
<tr>
<td>Access to funds</td>
<td>Jaypee – Ultratech (2014) (Jaypee sold its cement unit to raise funds for cutting off its debt)</td>
</tr>
<tr>
<td>Tax benefits</td>
<td>Durga Projects Limited (DPL) – WBPDCCL (2014) (DPL’s loss could be carry forward and setoff)</td>
</tr>
</tbody>
</table>

As mentioned above amalgamation is effected basically for growth and sometimes for image. But some of the objectives for which amalgamation may be resorted to are:

— Horizontal growth to achieve optimum size, to enlarge the market share, to curb competition or to use unutilised capacity;
— Vertical combination with a view to economising costs and eliminating avoidable sales-tax and/or excise duty;
— Diversification of business;
— Mobilising financial resources by utilising the idle funds lying with another company for the expansion of business. (For example, nationalisation of banks provided this opportunity and the erstwhile banking companies merged with industrial companies);
— Merger of an export, investment or trading company with an industrial company or vice versa with a view to increasing cash flow;
— Merging subsidiary company with the holding company with a view to improving cash flow;
Taking over a 'shell' company which may have the necessary industrial licences etc., but whose promoters do not wish to proceed with the project.

An amalgamation may also be resorted to for the purpose of nourishing a sick unit in the group and this is normally a merger for keeping up the image of the group.

3. FORMS (TYPES) OF MERGERS

A merger is generally understood to be a fusion of two companies. The term “merger” means and signifies the dissolution of one or more companies or firms or proprietorships to form or get absorbed into another company. By concept, merger increases the size of the undertakings. Following are major types of mergers:

(i) **Horizontal Merger**: The two companies which have merged are in the same industry, normally the market share of the new consolidated company would be larger and it is possible that it may move closer to being a monopoly or a near monopoly to avoid competition.

(ii) **Vertical Merger**: This merger happens when two companies that have ‘buyer-seller’ relationship (or potential buyer-seller relationship) come together.

(iii) **Conglomerate Mergers**: Such mergers involve firms engaged in unrelated type of business operations. In other words, the business activities of acquirer and the target are neither related to each other horizontally (i.e., producing the same or competing products) nor vertically (having relationship of buyer and supplier). In a pure conglomerate merger, there are no important common factors between the companies in production, marketing, research and development and technology. There may however be some degree of overlapping in one or more of these common factors. Such mergers are in fact, unification of different kinds of businesses under one flagship company. The purpose of merger remains utilization of financial resources, enlarged debt capacity and also synergy of managerial functions.

(iv) **Congeneric Merger**: In these mergers, the acquirer and the target companies are related through basic technologies, production processes or markets. The acquired company represents an extension of product-line, market participants or technologies of the acquirer. These mergers represent an outward movement by the acquirer from its current business scenario to other related business activities within the overarching industry structure.

(v) **Reverse Merger**: Such mergers involve acquisition of a public (Shell Company) by a private company, as it helps private company to by-pass lengthy and complex process required to be followed in case it is interested in going public.

(vi) **Acquisition**: This refers to the purchase of controlling interest by one company in the share capital of an existing company. This may be by:
(i) an agreement with majority holder of Interest.
(ii) Purchase of new shares by private agreement.
(iii) Purchase of shares in open market (open offer)
(iv) Acquisition of share capital of a company by means of cash, issuance of shares.
(v) Making a buyout offer to general body of shareholders.

When a company is acquired by another company, the acquiring company has two choices, one, to merge both the companies into one and function as a single entity and, two, to operate the taken-over company as an independent entity with changed management and policies. ‘Merger’ is the fusion of two independent firms on co-equal terms. ‘Acquisition’ is buying out a company by another company and the acquired company usually loses its identity. Usually, this process is friendly.


Acquisition of one of the business of a company, as a going concern by an agreement need not necessarily be routed through court, if the transfer of business is to be accomplished without allotting shares in the transferee company to the shareholders of the transferor company. This would tantamount to a simple acquisition. In this case the transferor company continues to exist and no change in shareholding is expected. If the sale takes place for a lumpsum consideration without attributing any individual values to any class of assets, such sales are called slump sales. The capital gains arising on slump sales were being exempt from income tax based on a decision of the Supreme Court of India.
4. **FINANCIAL FRAMEWORK**

4.1 **Gains from Mergers or Synergy**

The first step in merger analysis is to identify the economic gains from the merger. There are gains, if the combined entity is more than the sum of its parts.

That is, Combined value > (Value of acquirer + Stand alone value of target)

The difference between the combined value and the sum of the values of individual companies is usually attributed to *synergy*.

\[
\text{Value of acquirer} + \text{Stand alone value of target} + \text{Value of synergy} = \text{Combined value}
\]

There is also a cost attached to an acquisition. The cost of acquisition is the price premium paid over the market value plus other costs of integration. Therefore, the net gain is the value of synergy minus premium paid.

\[
\begin{align*}
V_A &= ₹100 \\
V_B &= ₹50 \\
V_{AB} &= ₹175 \\
\end{align*}
\]

Where, \( V_A = \text{Value of Acquirer} \)

\( V_B = \text{Standalone value of target} \)

And, \( V_{AB} = \text{Combined Value} \)

So, Synergy = \( V_{AB} - (V_A + V_B) = 175 - (100 + 50) = 25 \)

If premium is ₹ 10, then, Net gain = Synergy – Premium = 25 – 10 = 15

Acquisition need not be made with synergy in mind. It is possible to make money from non-synergistic acquisitions as well. As can be seen from Exhibit, operating improvements are a big source of value creation. Better post-merger integration could lead to abnormal returns even when the acquired company is in unrelated business. Obviously, managerial talent is the single most important instrument in creating value by cutting down costs, improving revenues and operating profit margin, cash flow position, etc. Many a time, executive compensation is tied to the performance in the post-merger period. Providing equity stake in the company induces executives to think and behave like shareholders.
4.2 Scheme of Amalgamation or Merger

The scheme of any arrangement or proposal for a merger is the heart of the process and has to be drafted with care.

There is no prescribed form for a scheme and it is designed to suit the terms and conditions relevant to the proposal and should take care of any special feature peculiar to the arrangement.

An essential component of a scheme is the provision for vesting all the assets and liabilities of the transferor company in its transferee company. If the transferee company does not want to take over any asset or liability, the transferor company before finalising the draft scheme should dispose it off or settle. Otherwise, the scheme would be considered defective and incomplete and the court would not sanction it.

It is equally important to define the effective date from which the scheme is intended to come into operation. This would save time and labour in explaining to the court the intention behind using several descriptions in the scheme. For accounting purposes, the amalgamation shall be effected with reference to the audited accounts and balance sheets as on a particular date (which precedes the date of notification) of the two companies and the transactions thereafter shall be pooled into a common account.

Another aspect relates to the valuation of shares to decide the exchange ratio. Objections have been raised as to the method of valuation even in cases where the scheme had been approved by a large majority of shareholders and the financial institutions as lenders. The courts have declared their unwillingness to engage in a study of the fitness of the mode of valuation. A High Court stated: “There are bound to be differences of opinion as to what the correct value of the shares of the company is. Simply because it is possible to value the share in a manner different from the one adopted in a given case, it cannot be said that the valuation agreed upon has been unfair.”
Similarly, in the case of Hindustan Lever the Supreme Court held that it would not interfere with the valuation of shares when more than 99 per cent of the shareholders have approved the scheme and the valuations having been perused by the financial institutions.

The position of employees also has to be clearly set out. The employment contract is a contract of personal service which may not be transferred by an order of court and may not have an effect of making an employee of the transferor company as an employee of the transferee company. The scheme should provide for the transfer of all employees to the transferee company on the same terms and conditions of service without any break in service. In the event of the transferee company not willing to absorb any of the employees through the merger, the transferor company should settle those employees with applicable law before the scheme is put through.

4.3 Financial Evaluation

Financial evaluation addresses the following issues:

(a) What is the maximum price that should be for the target company?
(b) What are the principal areas of Risk?
(c) What are the cash flow and balance sheet implications of the acquisition? And,
(d) What is the best way of structuring the acquisition?

4.4 Arranging Finance for Acquisition

Once the Definitive Agreement is signed, the Company Secretarial aspects relating to putting through the acquisition process will be taken up by the legal and secretarial department of both the companies. Side by side, the CFO of the acquiring company will move to the next stage which is ‘Financing the Acquisition’.

One of the most important decisions is how to pay for the acquisition – cash or stock or part of each and this would be part of the Definitive Agreement. If the acquisition is an ‘all equity deal’, the CFO’s can breathe easy. However, if cash payout is significant, the acquirer has to plan for financing the deal. Sometimes acquirers do not pay all of the purchase consideration as, even though they could have sufficient funds. This is part of the acquisition strategy to keep the war chest ready for further acquisitions. Another reason to pay by shares would be when the acquirer considers that their company’s shares are ‘over priced’ in the market.

Financing the acquisition can be quite challenging where the acquisition is a LBO. Many times strong companies plan to shore up their long term funds subsequent to the takeover. The immediate funding is accomplished with bridge financing.

5. TAKEOVER DEFENSIVE TACTICS

Normally acquisitions are made friendly, however when the process of acquisition is unfriendly (i.e., hostile) such acquisition is referred to as ‘takeover’). Hostile takeover arises when the Board
of Directors of the acquiring company decide to approach the shareholders of the target company directly through a Public Announcement (Tender Offer) to buy their shares consequent to the rejection of the offer made to the Board of Directors of the target company.

5.1 Take Over Strategies

Other than Tender Offer the acquiring company can also use the following techniques:

- **Street Sweep:** This refers to the technique where the acquiring company accumulates larger number of shares in a target before making an open offer. The advantage is that the target company is left with no choice but to agree to the proposal of acquirer for takeover.

- **Bear Hug:** When the acquirer threatens the target company to make an open offer, the board of target company agrees to a settlement with the acquirer for change of control.

- **Strategic Alliance:** This involves disarming the acquirer by offering a partnership rather than a buyout. The acquirer should assert control from within and takeover the target company.

- **Brand Power:** This refers to entering into an alliance with powerful brands to displace the target’s brands and as a result, buyout the weakened company.

5.2 Defensive Tactics

A target company can adopt a number of tactics to defend itself from hostile takeover through a tender offer.

- **Divestiture** - In a divestiture the target company divests or spins off some of its businesses in the form of an independent, subsidiary company. Thus, reducing the attractiveness of the existing business to the acquirer.

- **Crown jewels** - When a target company uses the tactic of divestiture it is said to sell the crown jewels. In some countries such as the UK, such tactic is not allowed once the deal becomes known and is unavoidable.

- **Poison pill** - Sometimes an acquiring company itself becomes a target when it is bidding for another company. The tactics used by the acquiring company to make itself unattractive to a potential bidder is called poison pills. For instance, the acquiring company may issue substantial amount of convertible debentures to its existing shareholders to be converted at a future date when it faces a takeover threat. The task of the bidder would become difficult since the number of shares to having voting control of the company increases substantially.

- **Poison Put** - In this case the target company issue bonds that encourage holder to cash in at higher prices. The resultant cash drainage would make the target unattractive.

- **Greenmail** - Greenmail refers to an incentive offered by management of the target company to the potential bidder for not pursuing the takeover. The management of the target company may offer the acquirer for its shares a price higher than the market price.
• **White knight** - In this a target company offers to be acquired by a friendly company to escape from a hostile takeover. The possible motive for the management of the target company to do so is not to lose the management of the company. The hostile acquirer may change the management.

• **White squire** - This strategy is essentially the same as white knight and involves sell out of shares to a company that is not interested in the takeover. As a consequence, the management of the target company retains its control over the company.

• **Golden parachutes** - When a company offers hefty compensations to its managers if they get ousted due to takeover, the company is said to offer golden parachutes. This reduces their resistance to takeover.

• **Pac-man defence** - This strategy aims at the target company making a counter bid for the acquirer company. This would force the acquirer to defend itself and consequently may call off its proposal for takeover.

It is needless to mention that hostile takeovers, as far as possible, should be avoided as they are more difficult to consummate. In other words, friendly takeover are better course of action to follow.

### 6. REVERSE MERGER

In ordinary case, the company taken over is the smaller company; in a 'reverse takeover', a smaller company gains control of a larger one. The concept of takeover by reverse bid, or of reverse merger, is thus not the usual case of amalgamation of a sick unit which is non-viable with a healthy or prosperous unit but is a case whereby the entire undertaking of the healthy and prosperous company is to be merged and vested in the sick company which is non-viable. A company becomes a sick industrial company when there is erosion in its net worth. This alternative is also known as taking over by reverse bid.

The three tests should be fulfilled before an arrangement can be termed as a reverse takeover is specified as follows:

(i) the assets of the transferor company are greater than the transferee company,

(ii) equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital, and

(iii) the change of control in the transferee company through the introduction of a minority holder or group of holders.

This type of merger is also known as ‘back door listing’. This kind of merger has been started as an alternative to go for public issue without incurring huge expenses and passing through cumbersome process. Thus, it can be said that reverse merger leads to the following benefits for acquiring company:
13.14 STRATEGIC FINANCIAL MANAGEMENT

- Easy access to capital market.
- Increase in visibility of the company in corporate world.
- Tax benefits on carry forward losses acquired (public) company.
- Cheaper and easier route to become a public company.

7. DIVESTITURE

It means a company selling one of the portions of its divisions or undertakings to another company or creating an altogether separate company. There are various reasons for divestment or demerger viz.,

(i) To pay attention on core areas of business;
(ii) The Division's/business may not be sufficiently contributing to the revenues;
(iii) The size of the firm may be too big to handle;
(iv) The firm may be requiring cash urgently in view of other investment opportunities.

7.1 Seller’s Perspective

It is necessary to remember that for every buyer there must be a seller. Although the methods of analysis for selling are the same as for buying, the selling process is termed *divestiture*. The decision to sell a company is at least as important as buying one. But selling generally lacks the kind of planning that goes into buying. Quite often, the decision and the choice of the buyer is arbitrary, resulting in a raw deal for the selling company’s shareholders. It is important to understand that selling needs the same set of skills required for buying. At some point of time the executives of a company may have to take the decision to divest a division. There is nothing wrong in selling a division if it is worth more to someone else. The decision to sell may be prompted by poor growth prospects for a division or consolidation in the industry. Given the fact that the need to sell may arise any time, it makes sense for executives to be prepared. More specifically, executives need to know their company’s worth. Consideration may be given to strengths and weakness in production, marketing, general management, value of synergy to potential buyers, value of brand equity, skill base of the organisation, etc.

To summarise, the following are some of the ‘sell-side’ imperatives

- Competitor’s pressure is increasing.
- Sale of company seems to be inevitable because company is facing serious problems like:
  - No access to new technologies and developments
  - Strong market entry barriers. Geographical presence could not be enhanced
  - Badly positioned on the supply and/or demand side
• Critical mass could not be realised
• No efficient utilisation of distribution capabilities
• New strategic business units for future growth could not be developed
• Not enough capital to complete the project

• Window of opportunity: Possibility to sell the business at an attractive price
• Focus on core competencies
• In the best interest of the shareholders – where a large well known firm brings-up the proposal, the target firm may be more than willing to give-up.

7.2 Different Forms

Different ways of divestment or demerger or divestitures are as follows:

7.2.1 Sell off / Partial Sell off

A sell off is the sale of an asset, factory, division, product line or subsidiary by one entity to another for a purchase consideration payable either in cash or in the form of securities. Partial Sell off, is a form of divestiture, wherein the firm sells its business unit or a subsidiary to another because it deemed to be unfit with the company's core business strategy.

Normally, sell-offs are done because the subsidiary doesn't fit into the parent company's core strategy. The market may be undervaluing the combined businesses due to a lack of synergy between the parent and the subsidiary. So the management and the board decide that the subsidiary is better off under a different ownership. Besides getting rid of an unwanted subsidiary, sell-offs also raise cash, which can be used to pay off debts. In the late 1980s and early 1990s, corporate raiders would use debt to finance acquisitions. Then, after making a purchase they would sell-off its subsidiaries to raise cash to service the debt. The raiders’ method certainly makes sense if the sum of the parts is greater than the whole. When it isn't, deals are unsuccessful.

7.2.2 Spin-off

In this case, a part of the business is separated and created as a separate firm. The existing shareholders of the firm get proportionate ownership. So there is no change in ownership and the same shareholders continue to own the newly created entity in the same proportion as previously in the original firm. The management of spun-off division is however, parted with. Spin-off does not bring fresh cash. The reasons for spin off may be:

(i) Separate identity to a part/division.
(ii) To avoid the takeover attempt by a predator by making the firm unattractive to him since a valuable division is spun-off.
(iii) To create separate Regulated and unregulated lines of business.
Example: Kishore Biyani led Future Group spin off its consumer durables business, Ezone, into a separate entity in order to maximise value from it.

7.2.3 Split-up

This involves breaking up of the entire firm into a series of spin off (by creating separate legal entities). The parent firm no longer legally exists and only the newly created entities survive. For instance a corporate firm has 4 divisions namely A, B, C, D. All these 4 division shall be split-up to create 4 new corporate firms with full autonomy and legal status. The original corporate firm is to be wound up. Since de-merged units are relatively smaller in size, they are logistically more convenient and manageable. Therefore, it is understood that spin-off and split-up are likely to enhance shareholders value and bring efficiency and effectiveness.

Example: Philips, the Dutch conglomerate that started life making light bulbs 123 years ago, is splitting off its lighting business in a bold step to expand its higher-margin healthcare and consumer divisions. The new structure should save 100 million euros ($128.5 million) next year and 200 million euros in 2016. It expects restructuring charges of 50 million euros from 2014 to 2016.

7.2.4 Equity Carve outs

This is like spin off, however, some shares of the new company are sold in the market by making a public offer, so this brings cash. More and more companies are using equity carve-outs to boost shareholder value. A parent firm 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 a controlling stake in the newly traded subsidiary.

A carve-out is a strategic avenue a parent firm may take when one of its subsidiaries is growing faster and carrying higher valuations than other businesses owned by the parent. A carve-out generates cash because shares in the subsidiary are sold to the public, but the issue also unlocks the value of the subsidiary unit and enhances the parent's shareholder value.

The new legal entity of a carve-out has a separate board, but in most carve-outs, the parent retains some control over it. In these cases, some portion of the parent firm's board of directors may be shared. Since the parent has a controlling stake, meaning that both firms have common shareholders, the connection between the two is likely to be strong. That said, sometimes companies carve-out a subsidiary not because it is doing well, but because it is a burden. Such an intention won't lead to a successful result, especially if a carved-out subsidiary is too loaded with debt or trouble, even when it was a part of the parent and lacks an established track record for growing revenues and profits.

7.2.5 Sale of a Division

In the case of sale of a division, the seller company is demergering its business whereas the buyer company is acquiring a business. For the first time the tax laws in India propose to recognise demergers.
7.2.6 Demerger or Division of Family-Managed Business

Around 80 per cent of private sector companies in India are family-managed companies. The family-owned companies are, under extraordinary pressure to yield control to professional managements, as, in the emerging scenario of a liberalised economy the capital markets are broadening, with attendant incentives for growth. So, many of these companies are arranging to hive off their unprofitable businesses or divisions with a view to meeting a variety of succession problems.

Even otherwise, a group of such family-managed companies may undertake restructuring of its operations with a view also to consolidating its core businesses. For this, the first step that may need to be taken is to identify core and non-core operations within the group. The second step may involve reducing interest burden through debt restructuring along with sale of surplus assets. The proceeds from the sale of assets may be employed for expanding by acquisitions and rejuvenation of its existing operations. The bottom line is that an acquisition must improve economies of scale, lower the cost of production, and generate and promote synergies. Besides acquisitions, therefore, the group may necessarily have to take steps to improve productivity of its existing operations.

8. FINANCIAL RESTRUCTURING

Financial restructuring refers to a kind of internal changes made by the management in Assets and Liabilities of a company with the consent of its various stakeholders. This is a suitable mode of restructuring for corporate entities who have suffered from sizeable losses over a period of time. Consequent upon losses the share capital or net worth of such companies get substantially eroded. In fact, in some cases, the accumulated losses are even more than the share capital and thus leading to negative net worth, putting the firm on the verge of liquidation. In order to revive such firms, financial restructuring is one of the technique to bring into health such firms which are having potential and promise for better financial performance in the years to come. To achieve this desired objective, such firms need to re-start with a fresh balance sheet free from losses and fictitious assets and show share capital at its true worth.

To nurse back such firms a plan of restructuring need to be formulated involving a number of legal formalities (which includes consent of court, and other stake-holders viz., creditors, lenders and shareholders etc.). An attempt is made to do refinancing and rescue financing while Restructuring. Normally equity shareholders make maximum sacrifice by foregoing certain accrued benefits, followed by preference shareholders and debenture holders, lenders and creditors etc. The sacrifice may be in the form of waving a part of the sum payable to various liability holders. The foregone benefits may be in the form of new securities with lower coupon rates so as to reduce future liabilities. The sacrifice may also lead to the conversion of debt into equity. Sometime, creditors, apart from reducing their claim, may also agree to convert their dues into securities to avert pressure of payment. These measures will lead to better financial liquidity. The financial restructuring leads to significant changes in the financial obligations and capital structure of...
corporate firm, leading to a change in the financing pattern, ownership and control and payment of various financial charges.

In nutshell it may be said that financial restructuring (also known as internal re-construction) is aimed at reducing the debt/payment burden of the corporate firm. This results into

(i) Reduction/Waiver in the claims from various stakeholders;
(ii) Real worth of various properties/assets by revaluing them timely;
(iii) Utilizing profit accruing on account of appreciation of assets to write off accumulated losses and fictitious assets (such as preliminary expenses and cost of issue of shares and debentures) and creating provision for bad and doubtful debts. In practice, the financial re-structuring scheme is drawn in such a way so that all the above requirements of write off are duly met. The following illustration is a good example of financial restructuring.

**Illustration 1**

The following is the Balance-sheet of XYZ Company Ltd as on March 31st, 2013.

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Amount</th>
<th>Assets</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 lakh equity shares of ₹100/- each</td>
<td>600</td>
<td>Land &amp; Building</td>
<td>200</td>
</tr>
<tr>
<td>2 lakh 14% Preference shares of ₹100/- each</td>
<td>200</td>
<td>Plant &amp; Machinery</td>
<td>300</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Furniture &amp; Fixtures</td>
<td>50</td>
</tr>
<tr>
<td>13% Debentures</td>
<td>200</td>
<td>Inventory</td>
<td>150</td>
</tr>
<tr>
<td>Debenture Interest accrued and Payable</td>
<td>26</td>
<td>Sundry debtors</td>
<td>70</td>
</tr>
<tr>
<td>Loan from Bank</td>
<td>74</td>
<td>Cash at Bank</td>
<td>130</td>
</tr>
<tr>
<td>Trade Creditors</td>
<td>300</td>
<td>Preliminary Expenses</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cost of Issue of debentures</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Profit &amp; Loss A/c</td>
<td>485</td>
</tr>
<tr>
<td></td>
<td>1,400</td>
<td></td>
<td>1,400</td>
</tr>
</tbody>
</table>

The XYZ Company did not perform well and has suffered sizable losses during the last few years. However, it is now felt that the company can be nursed back to health by proper financial restructuring and consequently the following scheme of reconstruction has been devised:

(i) Equity shares are to be reduced to ₹ 25/- per share, fully paid up;
(ii) Preference shares are to be reduced (with coupon rate of 10%) to equal number of shares of ₹50 each, fully paid up.
(iii) Debenture holders have agreed to forego interest accrued to them. Beside this, they have
agreed to accept new debentures carrying a coupon rate of 9%.

(iv) Trade creditors have agreed to forgo 25 per cent of their existing claim; for the balance sum they have agreed to convert their claims into equity shares of ₹ 25/- each.

(v) In order to make payment for bank loan and augment the working capital, the company issues 6 lakh equity shares at ₹ 25/- each; the entire sum is required to be paid on application. The existing shareholders have agreed to subscribe to the new issue.

(vi) While Land and Building is to be revalued at ₹ 250 lakh, Plant & Machinery is to be written down to ₹ 104 lakh. A provision amounting to ₹ 5 lakh is to be made for bad and doubtful debts.

You are required to show the impact of financial restructuring/re-construction. Also, prepare the new balance sheet assuming the scheme of re-construction is implemented in letter and spirit.

**Solution**

**Impact of Financial Restructuring**

(i) **Benefits to XYZ Ltd.**

<table>
<thead>
<tr>
<th>(a)</th>
<th>₹ in lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction of liabilities payable</td>
<td></td>
</tr>
<tr>
<td>Reduction in equity share capital (6 lakh shares x ₹75 per share)</td>
<td>450</td>
</tr>
<tr>
<td>Reduction in preference share capital (2 lakh shares x ₹50 per share)</td>
<td>100</td>
</tr>
<tr>
<td>Waiver of outstanding debenture Interest</td>
<td>26</td>
</tr>
<tr>
<td>Waiver from trade creditors (₹300 lakhs x 0.25)</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>651</td>
</tr>
<tr>
<td>(b)</td>
<td>Revaluation of Assets</td>
</tr>
<tr>
<td>Appreciation of Land and Building (₹250 lakhs - ₹200 lakhs)</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>701</td>
</tr>
</tbody>
</table>

(ii) **Amount of ₹701 lakhs utilized to write off losses, fictious assets and over-valued assets.**

<table>
<thead>
<tr>
<th>₹ in lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Writing off profit and loss account</td>
</tr>
<tr>
<td>Cost of issue of debentures</td>
</tr>
<tr>
<td>Preliminary expenses</td>
</tr>
<tr>
<td>Provision for bad and doubtful debts</td>
</tr>
<tr>
<td>Revaluation of Plant and Machinery (₹300 lakhs – ₹104 lakhs)</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>
Balance sheet of XYZ Ltd as at_______ (after re-construction) (₹ in lakhs)

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Amount</th>
<th>Assets</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>21 lakhs equity shares of ₹25/- each</td>
<td>525</td>
<td>Land &amp; Building</td>
<td>250</td>
</tr>
<tr>
<td>2 lakhs 10% Preference shares of ₹50/- each</td>
<td>100</td>
<td>Plant &amp; Machinery</td>
<td>104</td>
</tr>
<tr>
<td>9% Debentures</td>
<td>200</td>
<td>Furnitures &amp; Fixtures</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Inventory</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sundry debtors</td>
<td>70</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cash-at-Bank (Balancing figure)*</td>
<td>-5</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>65</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>206</td>
</tr>
<tr>
<td></td>
<td>825</td>
<td></td>
<td>825</td>
</tr>
</tbody>
</table>

*Opening Balance of ₹130/- lakhs + Sale proceeds from issue of new equity shares ₹150/- lakhs – Payment of bank loan of ₹74/- lakhs = ₹206 lakhs.

It is worth mentioning that financial restructuring is unique in nature and is company specific. It is carried out, in practice when all shareholders sacrifice and understand that the restructured firm (reflecting its true value of assets, capital and other significant financial parameters) can now be nursed back to health. This type of corporate restructuring helps in the revival of firms that otherwise would have faced closure/liquidation.

9. OWNERSHIP RESTRUCTURING

9.1 Going Private

This refers to the situation wherein a listed company is converted into a private company by buying back all the outstanding shares from the markets.


Going private is a transaction or a series of transactions that convert a publicly traded company into a private entity. Once a company goes private, its shareholders are no longer able to trade their stocks in the open market.

A company typically goes private when its stakeholders decide that there are no longer significant benefits to be garnered as a public company. Privatization will usually arise either when a company’s management wants to buy out the public shareholders and take the company private (a
management buyout), or when a company or individual makes a tender offer to buy most or all of the company’s stock. Going private transactions generally involve a significant amount of debt.

9.2 Management Buy Outs

Buyouts initiated by the management team of a company are known as a management buyout. In this type of acquisition, the company is bought by its own management team.

MBOs are considered as a useful strategy for exiting those divisions that does not form part of the core business of the entity.

9.3 Leveraged Buyout (LBO)

An acquisition of a company or a division of another company which is financed entirely or partially (50% or more) using borrowed funds is termed as a leveraged buyout. The target company no longer remains public after the leveraged buyout; hence the transaction is also known as going private. The deal is usually secured by the acquired firm’s physical assets.

The intention behind an LBO transaction is to improve the operational efficiency of a firm and increase the volume of its sales, thereby increasing the cash flow of the firm. This extra cash flow generated will be used to pay back the debt in LBO transaction. After an, LBO the target entity is managed by private investors, which makes it easier to have a close control of its operational activities. The LBOs do not stay permanent. Once the LBO is successful in increasing its profit margin and improving its operational efficiency and the debt is paid back, it will go public again. Companies that are in a leading market position with proven demand for product, have a strong management team, strong relationships with key customers and suppliers and steady growth are likely to become the target for LBOs. In India the first LBO took place in the year 2000 when Tata Tea acquired Tetley in the United Kingdom. The deal value was Rs 2135 crores out of which almost 77% was financed by the company using debt. The intention behind this deal was to get direct access to Tetley’s international market. The largest LBO deal in terms of deal value (7.6 Billion) by an Indian company is the buyout of Corus by Tata Steel.

9.4 Equity buyback

This refers to the situation wherein a company buys back its own shares back from the market. This results in reduction in the equity capital of the company. This strengthen the promoter’s position by increasing his stake in the equity of the company.

The buyback is a process in which a company uses its surplus cash to buy shares from the public. It is almost the opposite of initial public offer in which shares are issued to the public for the first time. In buyback, shares which have already been issued are bought back from the public. And, once the shares are bought back, they get absorbed and cease to exist.

For example, a company has one crore outstanding shares and owing a huge cash pile of ₹ 5 crores. Since, the company has very limited investment options it decides to buyback some of its outstanding shares from the shareholders, by utilizing some portion of its surplus cash.
Accordingly, it purchases 10 lakh shares from the existing shareholders by paying ₹ 20 per share. total cash of say, ₹ 2 crore. The process of buyback can be shown with the help of following diagram:

**Example** Cairn India bought back 3.67 crores shares and spent nearly ₹ 1230 crores by May 2014.

**Effects of Buyback**

There are several effects or consequences of buyback some of which are as follows:

(i) It increases the proportion of shares owned by controlling shareholders as the number of outstanding shares decreases after the buyback.

(ii) Earning Per Share (EPS) escalates as the number of shares reduces leading the market price of shares to step up.

(iii) A share repurchase also effects a company’s financial statements as follows:

(a) In balance sheet, a share buyback will reduce the company’s total assets position as cash holdings will be reduced and consequently as shareholders’ equity reduced it results in reduction on the liabilities side by the same amount.

(b) Amount spent on share buybacks shall be shown in Statement of Cash Flows in the “Financing Activities” section, as well as from the Statement of Changes in Equity or Statement of Retained Earnings.

(iv) Ratios based on performance indicators such as Return on Assets (ROA) and Return on Equity (ROE) typically improve after a share buyback. This can be understood with the help of following Statement showing Buyback Effect of a hypothetical company using ₹ 1.50 crore of cash out of total cash of ₹ 2.00 for buyback.

<table>
<thead>
<tr>
<th></th>
<th>Before Buyback</th>
<th>After Buyback (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (₹)</td>
<td>2,00,00,000</td>
<td>50,00,000</td>
</tr>
</tbody>
</table>

© The Institute of Chartered Accountants of India
As visible from the above figure, the company's cash pile has been reduced from ₹ 2 crore to ₹ 50 lakh after the buyback. Because cash is an asset, this will lower the total assets of the company from ₹ 5 crore to ₹ 3.5 crore. Now, this leads to an increase in the company’s ROA, even though earnings have not changed. Prior to the buyback, its ROA was 4% but after the repurchase, ROA increases to 5.71%. A similar effect can be seen in the EPS number, which increases from 0.20 to 0.22.

10. PREMIUM AND DISCOUNT

Premiums and discounts are typically attached to a business valuation, based on the situation. These could be market share premium, controlling stake premium, brand value premium, small player discount or unlisted company discount. In addition, it may be required to work out various potential scenarios in each methodology and arrive at the likely probabilities of each while deriving the values.

Timing is very critical while divesting a business since valuation depends on the timing. Timing of sale is crucial keeping in mind economic cycles (deal valuation takes into consideration GDP growth rates), stock market situations (which would decide market multiples), global situations (like a war or terrorist attacks).

In times like the above, the price expectations between the buyer and the seller would widely vary. For example, during a stock market lull, there could be a situation where there are more buyers but not sellers due to the low valuation.

The basis for M&A is the expectation of several future benefits arising out of synergies between businesses. There is a risk involved in realizing this synergy value. This could be due to corporate, market, economic reasons or wrong estimation of the benefits/synergies. A key case in point here is the high valuations at which internet companies were acquired in the year 2000 (such as Satyam Infoway acquisition of India World).

It is also important to try and work out valuations from as many of the above methods as possible and then try and see which methodology is to be taken in and which are to be rejected and derive a range of values for the transaction in different situations in case one is called upon to assist in advising the transaction valuation. Some methods like Net Asset Value or past earnings based methods may prove inadequate in case of growing businesses or those with intangible assets.
11. CASE STUDIES

Some case studies are listed below based on actual Indian situations and an analysis based on published data is given below.

11.1 Case Study – Rationale for M & A and Valuation – Largest Customer Base

Bharti Airtel to buy Loop Mobile for ₹ 700 crores

In February 2014, Bharti Airtel (“Airtel”), a leading global telecommunications services provider with operations in 20 countries across Asia and Africa has announced to buy Mumbai based Loop Mobile. Although the price was not stated it is understood to be in the region of around ₹ 700 crores. The proposed association will undergo seamless integration once definitive agreements are signed and is subject to regulatory and statutory approvals. Under the agreement, Loop Mobile’s 3 million subscribers in Mumbai will join Airtel’s over 4 million subscribers, creating an unmatched mobile network in Mumbai. The merged network will be the largest by customer base in the Mumbai circle. The proposed transaction will bring together Loop Mobile’s 2G/EDGE enabled network supported by 2,500 plus cell sites, and Airtel’s 2G and 3G network supported by over 4000 cell sites across Mumbai. It will also offer subscribers the widest exclusive retail reach with 220 outlets that will enable best in class customer service. The agreement will ensure continuity of quality services to Loop Mobile’s subscribers, while offering them the added benefits of Airtel’s innovative product portfolio and access to superior services, innovative products like 3G, 4G, Airtel Money, VAS and domestic/international roaming facilities. Loop Mobile subscribers will become part of Airtel’s global network that serves over 289 million customers in 20 countries. Globally, Airtel is ranked as the fourth largest mobile services provider in terms of subscribers.

(Based on Press release hosted on Bharti Airtel’s website)

11.2 Case Study – Valuation Analysis

Listed software company X to merge with unlisted company Y

Company X and company Y were in the software services business. X was a listed company and Y was an unlisted entity. X and Y decided to merge in order to benefit from marketing. Operational synergies and economies of scale. With both companies being mid-sized, the merger would make them a larger player, open new market avenues, bring in expertise in more verticals and wider management expertise. For company X, the benefit lies in merging with a newer company with high growth potential and for company Y, the advantage was in merging with a business with track record, that too a listed entity.

The stock swap ratio considered after valuation of the two businesses was 1:1.

Several key factors were considered to arrive at this valuation. Some of them were very unique to the businesses and the deal:
Valuation based on book value net asset value would not be appropriate for X and Y since they are in the knowledge business, unless other intangibles assets like human capital, customer relationships etc. could be identified and valued.

X and Y were valued on the basis of

a) expected earnings  
b) market multiple.

While arriving at a valuation based on expected earnings, a higher growth rate was considered for Y, it being on the growth stage of the business life cycle while a lower rate was considered for X, it being in the mature stage and considering past growth.

Different discount factors were considered for X and Y, based on their cost of capital, fund raising capabilities and debt-equity ratios.

While arriving at a market based valuation, the market capitalization was used as the starting point for X which was a listed company. Since X had a significant stake in Z, another listed company, the market capitalization of X reflected the value of Z as well. Hence the market capitalization of Z had to be removed to the extent of X’s stake from X’s value as on the valuation date.

Since Y was unlisted, several comparable companies had to be identified, based on size, nature of business etc. and a composite of their market multiples had to be estimated as a surrogate measure to arrive at Y’s likely market capitalization, as if it were listed. This value had to be discounted to remove the listing or liquidity premium since the surrogate measure was estimated from listed companies.

After arriving at two sets of values for X and Y, a weighted average value was calculated after allotting a higher weight for market based method for X (being a listed company) and a higher weight for earnings based method for Y (being an unlisted but growing company). The final values for X and Y were almost equal and hence the 1:1 ratio was decided.

11.3 Case Study – Rationale for M&A and Valuation – Acquisition at Premium

(1) Ranbaxy to Bring In Daiichi Sankyo Company Limited as Majority Partner – June 2008

Ranbaxy Laboratories Limited, among the top 10 generic companies in the world and India’s largest pharmaceutical company, and Daiichi Sankyo Company Limited, one of the largest pharmaceutical companies in Japan, announced that a binding Share Purchase and Share Subscription Agreement was entered into between Daiichi Sankyo, Ranbaxy and the Singh family, the largest and controlling shareholders of Ranbaxy (the “Sellers”), pursuant to which Daiichi Sankyo will acquire the entire shareholding of the Sellers in Ranbaxy and further seek to acquire the majority of the voting capital of Ranbaxy at a price of Rs737 per share with the total
transaction value expected to be between US$3.4 to US$4.6 billion (currency exchange rate: US$1=Rs43). On the post closing basis, the transaction would value Ranbaxy at US$8.5 billion.

The Share Purchase and Share Subscription Agreement has been unanimously approved by the Boards of Directors of both companies. Daiichi Sankyo is expected to acquire the majority equity stake in Ranbaxy by a combination of (i) purchase of shares held by the Sellers, (ii) preferential allotment of equity shares, (iii) an open offer to the public shareholders for 20% of Ranbaxy’s shares, as per Indian regulations, and (iv) Daiichi Sankyo’s exercise of a portion or all of the share warrants to be issued on a preferential basis. All the shares/warrants will be acquired at a price of Rs737 per share. This purchase price represents a premium of 53.5% to Ranbaxy’s average daily closing price on the National Stock Exchange for the three months ending on June 10, 2008 and 31.4% to such closing price on June 10, 2008.

The deal will be financed through a mix of bank debt facilities and existing cash resources of Daiichi Sankyo. It is anticipated that the transaction will be accretive to Daiichi Sankyo’s EPS and Operating income before amortization of goodwill in the fiscal year ending March 31, 2010 (FY2009). EPS and Operating income after amortization of goodwill are expected to see an accretive effect in FY2010 and FY2009, respectively.

Why would Daiichi Sankyo wanted to acquire majority stake in Ranbaxy, that too at a premium?

Ranbaxy’s drive to become a research-based drug developer and major manufacturer has led it straight into the welcoming arms of Japan’s Daiichi Sankyo, that’s why it announced to buy a majority stake in the Indian pharma company. After Sankyo completes a buyout of the founding Singh family’s stake in the company, Ranbaxy will become a subsidiary operation. The deal is valued at $4.6 billion and will create a combined company worth about $30 billion. That move positions Daiichi Sankyo to become a major supplier of low-priced generics to Japan’s aging population and accelerates a trend by Japanese pharma companies to enter emerging Asian markets, where they see much of their future growth. The acquisition stunned investors and analysts alike, who were caught off guard by a bold move from a conservative player in the industry. (Source: Fiercebiotech.com)

Also, from a financial and business perspective Ranbaxy’s revenues and bottom lines were continuously on the rise since 2001; the R&D expenses were stable around 6%. In FY 2007 the company had revenues of 69,822 million INR ($1.5billion) excluding other income. The earnings of the company were well diversified across the globe; however the emerging world contributed heavily to the revenues (Emerging 54%, Developed 40%, others 6%). However the Japan market, with low generics penetration contributed just $25 million to the top line. The company had just begun to re-orient its strategy in favour of the emerging markets. The product, patent and API portfolio of the company was strong. The company made 526 product filings and received 457 approvals globally. The Company than served customers in over 125 countries and had an expanding international portfolio of affiliates, joint ventures and alliances, operations in 56 countries. (Source: ukessays.com)
Sun Pharma to acquire Ranbaxy in US$4 billion – April 2014

Sun Pharmaceutical Industries Ltd. and Ranbaxy Laboratories Ltd today announced that they have entered into definitive agreements pursuant to which Sun Pharma will acquire 100% of Ranbaxy in an all-stock transaction. Under these agreements, Ranbaxy shareholders will receive 0.8 share of Sun Pharma for each share of Ranbaxy. This exchange ratio represents an implied value of ₹457 for each Ranbaxy share, a premium of 18% to Ranbaxy’s 30-day volume-weighted average share price and a premium of 24.3% to Ranbaxy’s 60-day volume-weighted average share price, in each case, as of the close of business on April 4, 2014. The transaction is expected to represent a tax-free exchange to Ranbaxy shareholders, who are expected to own approximately 14% of the combined company on a pro forma basis. Upon closing, Daiichi Sankyo will become a significant shareholder of Sun Pharma and will have the right to nominate one director to Sun Pharma’s Board of Directors.

What prompted Daiichi Sankyo to decide on divestiture of the Indian Pharma company which it had barely acquired just about six years ago?

It has been a rocky path for Japanese pharma major Daiichi Sankyo ever since it acquired a 63.5 per cent stake in Indian drug maker Ranbaxy in June 2008. The Japanese drug-maker was expected to improve manufacturing process at Ranbaxy, which has a long history of run-ins with drug regulators in the US, its largest market, going back to 2002. Instead, serious issues persisted, resulting in a ban by the US Food & Drug Administration on most drugs and pharmaceutical ingredients made in Ranbaxy’s four Indian manufacturing plants. Soon after the deal was inked, in September 2008, the US drug regulator - Food and Drug Administration - accused Ranbaxy of misrepresenting data and manufacturing deficiencies. It issued an import ban on Ranbaxy, prohibiting the export of 30 drugs to the US, within three months after Daiichi announced the acquisition. Following this, Ranbaxy’s sales in the US shrank almost by a fourth, and its stock price slumped to over a fifth of the acquisition price. It has since taken Ranbaxy four years to reach a settlement with the US regulatory authorities. In 2013, The Company agreed to pay a fine of $500 million after admitting to false representation of data and quality issues at its three Indian plants supplying to the US market. The company’s problems in the US are far from done with. It continues to face challenges in securing timely approval for its exclusive products in the US markets. (Source: thehindubusinessline.com)

Why Sun Pharma take interest in acquiring Ranbaxy?

The combination of Sun Pharma and Ranbaxy creates the fifth-largest specialty generics company in the world and the largest pharmaceutical company in India. The combined entity will have 47 manufacturing facilities across 5 continents. The transaction will combine Sun Pharma’s proven complex product capabilities with Ranbaxy’s strong global footprint, leading to significant value creation opportunities. Additionally, the combined entity will have increased exposure to emerging economies while also bolstering Sun Pharma’s commercial and manufacturing presence in the United States and India. It will have an established presence in key high-growth emerging markets. In India, it will be ranked No. 1 by prescriptions amongst 13 different classes of specialist doctors.
Also, from a financial and business perspective on a pro forma basis, the combined entity’s revenues are estimated at US$ 4.2 billion with EBITDA of US$ 1.2 billion for the twelve month period ended December 31, 2013. The transaction value implies a revenue multiple of 2.2 based on 12 months ended December 31, 2013. Sun Pharma expects to realize revenue and operating synergies of US$ 250 million by third year post closing of the transaction. These synergies are expected to result primarily from topline growth, efficient procurement and supply chain efficiencies.

(Major contents are derived from press releases hosted on website of Ranbaxy)

In summary, the challenge to valuing for M&As is to obtain a thorough understanding of the business dynamics of both the parties, the rationale for the merger, the industry dynamics, the resulting synergies as well as the likely risks of the transaction are required in order to ensure that the valuation is such that it is a ‘win-win’ for both the parties and is financially viable. It is also important to understand that there are no hard and fast rules since one is projecting the future which is ‘unknown’ based on current understanding. Therefore, experience, good judgment and diligence are important in working out values.

11.4 Case Study – Rationale for M&A and Valuation – Turnaround

JLR acquisition by Tata motors and How JLR was turned around by Tata’s

Tata’s growth strategy was to consolidate position in domestic market & expand international footprint through development of new products by:

- Leveraging in house capabilities
- Acquisitions & collaborations to gain complementary capabilities

Why Tata Motors want to acquire Jaguar Land Rover (JLR)?

There are several reasons why Tata Motors want to acquire Jaguar Land Rover (JLR)

i) Long term strategic commitment to Automotive sector.
ii) Build comprehensive product portfolio with a global footprint immediately.
iii) Diversify across markets & products segments.
iv) Unique opportunity to move into premium segment.
v) Sharing the best practices between Jaguar, Land rover and Tata Motors in the future.

Introduction of JLR

(i) Global sales of around 300,000 units, across 169 countries
(ii) Global revenue of $15 Billion
(iii) Nine Car lines, designed, engineered and manufactured in the UK.
(iv) 16000 employees
TATA Motor's position after acquiring JLR

![Graph showing Tata Motors' BSE closing price from Dec 29, 09 to Dec 24, 10 with a 1-year return of 66%]

Tata Motors' market value plunged to 6,503.2 crore, with the stock hitting rock bottom 126.45 on 20 November 2008 (after the acquisition of JLR in 2008)

How Tata Motors turned JLR around

(i) Favorable Currency Movements
   - Significant export in dollars- North America
   - Net importers of Euros in terms of material

(ii) Improved market sentiments.
   - Retail volumes in America, Europe and China improved

(iii) Introduction of newer, more fuel-efficient and stylish models
   - Launch of XK & New XZ Jaguar models

(iv) Refreshing the existing ones

(v) Revival of demand in the firm’s key markets such as the UK, the US and Europe

(vi) Costs reductions at various levels and the formation of 10-11 cross-functional teams
A number of management changes, including new heads at JLR, were made.

Workforce being trimmed since July 2008 by around 11,000

**There were five key issues that persuaded Tata Motors to go ahead**

Firstly, Ford had pumped in a great deal of cash to improve quality and it was just a matter of time before this made a difference.

Secondly, JLR had very good automobile plants.

Thirdly, the steadfastness of the dealers despite losses over the past four-five years.

Fourthly, Jaguar cars had already started moving up the ranks of the annual JD Power customer satisfaction rankings.

And, lastly, besides that, there was a crop of great new models in the pipeline, among them the Jaguar XJ and XF and the upcoming Land Rover, which convinced Tata Motors that JLR was on the verge of change.

### 11.5 Case Study on Demerger – Rationale - Dabur India Ltd.

Dabur India Ltd. ("Dabur") initiated its demerger exercise in January 2003, after the agreement of the Board of Directors to hive off the Pharma business into a new company named Dabur Pharma Ltd. ("DPL"). After the demerger, Dabur concentrated on its core competencies in personal care, healthcare, and Ayurvedic specialties, while DPL focused on its expertise in oncology formulations and bulk drugs. The demerger would allow investors to benchmark performance of these two entities with their respective industry standards.

**Results of Demerger Analysis.**

<table>
<thead>
<tr>
<th></th>
<th>Dabur FMCG</th>
<th>Dabur Pharma</th>
<th>Composite</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beta Equity</td>
<td>0.50</td>
<td>0.53</td>
<td>0.56</td>
</tr>
<tr>
<td>$R_e$</td>
<td>11.52%</td>
<td>11.74%</td>
<td>11.95%</td>
</tr>
<tr>
<td>$R_d(1 - t)$</td>
<td>5.20%</td>
<td>5.20%</td>
<td>5.20%</td>
</tr>
<tr>
<td>D/E</td>
<td>0.22</td>
<td>0.07</td>
<td>0.4</td>
</tr>
<tr>
<td>E/V</td>
<td>0.82</td>
<td>0.93</td>
<td>0.71</td>
</tr>
<tr>
<td>D/V</td>
<td>0.18</td>
<td>0.07</td>
<td>0.29</td>
</tr>
<tr>
<td>WACC</td>
<td>10.38%</td>
<td>11.31%</td>
<td>10.02%</td>
</tr>
<tr>
<td>ROCE</td>
<td>27.70%</td>
<td>8.35%</td>
<td>19.40%</td>
</tr>
<tr>
<td>EVA</td>
<td>51.16</td>
<td>-8.49</td>
<td>47.08</td>
</tr>
</tbody>
</table>
The results of the analysis

The Dabur FMCG business unlocked value for shareholders, since the EVA of the FMCG business was more than that of the composite business. Dabur Pharma had a negative EVA, clearly indicating that its capital was not properly used in the composite company.

The total EVA of the FMCG and Pharma division was lesser than that of the composite business indicating a negative synergy between the two divisions. The EVA disparity between the demerged units is expected as FMCG and Pharma are two distinctly different businesses, where FMCG is a low capital intensity business, the pharmaceutical business requires higher capital due to R&D activities.

11.6 Case Study on Demerger – Rationale - Bajaj Auto Ltd.

The Board of Directors of Bajaj Auto Ltd agreed to a demerger on 17th May 2007. Under the scheme, BAL, the parent company, would be renamed Bajaj Holdings and Investment Ltd ("BHIL") and the business was to be demerged into two new incorporated subsidiaries – Bajaj Auto Ltd ("BAL") and Bajaj Finserv Ltd ("BFL"). The auto and manufacturing businesses of the company would be held by BHIL while the wind power project, investments in insurance companies and consumer finance would go to BFL. All the shareholders of the parent company became shareholders in the new companies and were issued shares of the two new companies in the ratio 1:1.

Results of Demerger Analysis

<table>
<thead>
<tr>
<th></th>
<th>Composite</th>
<th>Bajaj Auto</th>
<th>Bajaj Fin. Services</th>
<th>BHIL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beta Equity</td>
<td>0.67</td>
<td>0.72</td>
<td>0.77</td>
<td>0.53</td>
</tr>
<tr>
<td>Re</td>
<td>12.67%</td>
<td>13.04%</td>
<td>13.39%</td>
<td>11.71%</td>
</tr>
<tr>
<td>R_d(1 – t)</td>
<td>5.20%</td>
<td>5.20%</td>
<td>5.20%</td>
<td>5.20%</td>
</tr>
<tr>
<td>D/E</td>
<td>0.30</td>
<td>0.84</td>
<td>0.26</td>
<td>0.19</td>
</tr>
<tr>
<td>E/V</td>
<td>0.77</td>
<td>0.54</td>
<td>0.79</td>
<td>0.84</td>
</tr>
<tr>
<td>D/V</td>
<td>0.23</td>
<td>0.46</td>
<td>0.21</td>
<td>0.16</td>
</tr>
<tr>
<td>WACC</td>
<td>10.95%</td>
<td>9.46%</td>
<td>11.70%</td>
<td>10.67%</td>
</tr>
<tr>
<td>ROCE</td>
<td>18.84%</td>
<td>39.13%</td>
<td>4.35%</td>
<td>6.79%</td>
</tr>
<tr>
<td>EVA</td>
<td>138.17</td>
<td>474.91</td>
<td>-139.40</td>
<td>-156.46</td>
</tr>
</tbody>
</table>

The results of the analysis

The Auto division unlocked value for shareholders (its EVA more than that of composite business). BFL and BHIL showed negative EVA, clearly indicating that capital was not properly used by them.
The sum total EVA of the three divisions after the demerger is greater than the composite business EVA, indicating a successful value unlocking for the shareholders. Both these cases highlight that demergers can unlock significant shareholder value. The markets also reacted positively, with both scrips appreciating when the news of the demerger broke out.

12. MERGERS AND ACQUISITIONS FAILURES

There are five principal steps in a successful M & A programme.

1. Manage the pre-acquisition phase.
2. Screen candidates.
3. Eliminate those who do not meet the criteria and value the rest.
5. Post-merger integration.

During the pre-acquisition phase, the acquirer should maintain secrecy about its intentions. Otherwise, the resulting price increase due to rumours may kill the deal.

Academic studies indicate that success in creating value through acquisitions in a competitive market is extremely difficult. Jensen and Ruback (1983) highlighted this point by summarising results from mergers and acquisitions over a period of 11 years. They found that in case of a merger, the average return, around the date of announcement, to shareholders of the acquired company is 20 per cent, whereas the average return to the acquiring company is 0 per cent. Another study by McKinsey indicates that 61 per cent of the 116 acquisitions studied were failures, 23 per cent were successes. Despite such statistics why do companies acquire? Why do mergers fail? The reasons for merger failures can be numerous. Some of the key reasons are:

- Acquirers generally overpay;
- The value of synergy is over-estimated;
- Poor post-merger integration; and
- Psychological barriers.

Companies often merge in the fear that the bigger competitors have economies of scale and may destroy them by exercising a stranglehold on raw material supply, distribution etc. What they do not realise is the drawbacks of being big. The acquiring company’s executives would have drawn up elaborate plans for the target without consulting its executives which leads to resentment and managerial attrition. This can be avoided by honest discussions with the target company’s executives.

Most companies merge with the hope that the benefits of synergy will be realised. Synergy will be there only if the merged entity is managed better after the acquisition than it was managed before.
It is the quality of the top management that determines the success of the merger. Quite often the executives of the acquiring company lose interest in the target company due to its smallness. The small company executives get bogged down repairing vision and mission statements, budgets, forecasts, profit plans which were hitherto unheard of. The elaborateness of the control system depends on the size and culture of the company. To make a merger successful,

- Decide what tasks need to be accomplished in the post-merger period;
- Choose managers from both the companies (and from outside);
- Establish performance yardstick and evaluate the managers on that yardstick; and
- Motivate them.

13. ACQUISITION THROUGH SHARES

The acquirer can pay the target company in cash or exchange shares in consideration. The analysis of acquisition for shares is slightly different. The steps involved in the analysis are:

- Estimate the value of acquirer’s (self) equity;
- Estimate the value of target company’s equity;
- Calculate the maximum number of shares that can be exchanged with the target company’s shares; and
- Conduct the analysis for pessimistic and optimistic scenarios.

Exchange ratio is the number of acquiring firm’s shares exchanged for each share of the selling firm’s stock. Suppose company A is trying to acquire company B’s 100,000 shares at ₹ 230. So the cost of acquisition is ₹ 230,00,000. Company A has estimated its value at ₹ 200 per share. To get one share of company B, A has to exchange (230/200) 1.15 share, or 115,000 shares for 100,000 shares of B. The relative merits of acquisition for cash or shares should be analysed after giving due consideration to the impact on EPS, capital structure, etc.

Normally when shares are issued in payment to the selling company’s shareholders, stockholders will find the merger desirable only if the value of their shares is higher with the merger than without the merger. The number of shares that the buying company will issue in acquiring the selling company is determined as follows:

1. The acquiring company will compare its value per share with and without the merger.
2. The selling company will compare its value with the value of shares that they would receive from acquiring company under the merger.
3. The managements of acquiring company and selling company will negotiate the final terms of the merger in the light of (1) and (2); the ultimate terms of the merger will reflect the relative bargaining position of the two companies.
The fewer of acquiring company’s shares that acquiring company must pay to selling company, the better off are the shareholders of acquiring company and worse off are the shareholders of selling company. However, for the merger to be effected, the shareholders of both the buying and selling company will have to anticipate some benefits from the merger even though their share swap deal is subject to synergy risk for both of them.

**Impact of Price Earning Ratio:** The reciprocal of cost of equity is price-earning (P/E) ratio. The cost of equity, and consequently the P/E ratio reflects risk as perceived by the shareholders. The risk of merging entities and the combined business can be different. In other words, the combined P/E ratio can very well be different from those of the merging entities. Since market value of a business can be expressed as product of earning and P/E ratio \((P/E \times E = P)\), the value of combined business is a function of combined earning and combined P/E ratio. A lower combined P/E ratio can offset the gains of synergy or a higher P/E ratio can lead to higher value of business, even if there is no synergy. In ascertaining the exchange ratio of shares due care should be exercised to take the possible combined P/E ratio into account.

**Illustration 2**

Company X is contemplating the purchase of Company Y, Company X has 3,00,000 shares having a market price of ₹ 30 per share, while Company Y has 2,00,000 shares selling at ₹ 20 per share. The EPS are ₹ 4.00 and ₹ 2.25 for Company X and Y respectively. Managements of both companies are discussing two alternative proposals for exchange of shares as indicated below:

(i) in proportion to the relative earnings per share of two companies.

(ii) 0.5 share of Company X for one share of Company Y (0.5:1).

You are required:

(i) to calculate the Earnings Per share (EPS) after merger under two alternatives; and

(ii) to show the impact of EPS for the shareholders of two companies under both the alternatives.

**Solution**

**Working Notes:** Calculation of total earnings after merger

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Company X</th>
<th>Company Y</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding shares</td>
<td>3,00,000</td>
<td>2,00,000</td>
<td></td>
</tr>
<tr>
<td>EPS (₹)</td>
<td>4</td>
<td>2.25</td>
<td></td>
</tr>
<tr>
<td>Total earnings (₹)</td>
<td>12,00,000</td>
<td>4,50,000</td>
<td>16,50,000</td>
</tr>
</tbody>
</table>

(i) (a) Calculation of EPS when exchange ratio is in proportion to relative EPS of two companies
Company X

2,00,000 x 2.25/4
3,00,000

Company Y

Total number of shares after merger
2,00,000 x 2.25/4
1,12,500

Total number of shares after merger
4,12,500

Company X

EPS before merger
EPS after merger = ₹ 16,50,000/4,12,500 shares
= ₹ 4

Company Y

EPS before merger
EPS after merger
= EPS of Merged Entity after merger x Share Exchange ratio on EPS basis

= ₹ 4 x \frac{2.25}{4}

= ₹ 2.25

(b) Calculation of EPS when share exchange ratio is 0.5 : 1

Total earnings after merger = ₹ 16,50,000

Total number of shares after merger = 3,00,000 + (2,00,000 x 0.5) = 4,00,000 shares

EPS after merger = ₹ 16,50,000/4,00,000 = ₹ 4.125

(ii) Impact of merger on EPS for shareholders of Company X and Company Y

(a) Impact on Shareholders of Company X

<table>
<thead>
<tr>
<th></th>
<th>(₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPS before merger</td>
<td>4.000</td>
</tr>
<tr>
<td>EPS after merger</td>
<td>4.125</td>
</tr>
<tr>
<td>Increase in EPS</td>
<td>0.125</td>
</tr>
</tbody>
</table>

(b) Impact on Shareholders of Company Y

<table>
<thead>
<tr>
<th></th>
<th>(₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equivalent EPS before merger</td>
<td>2.2500</td>
</tr>
<tr>
<td>Equivalent EPS after merger</td>
<td>2.0625</td>
</tr>
<tr>
<td>Decrease in EPS</td>
<td>0.1875</td>
</tr>
</tbody>
</table>

Illustration 3

A Ltd. is studying the possible acquisition of B Ltd. by way of merger. The following data are available:
### Strategic Financial Management

<table>
<thead>
<tr>
<th>Firm</th>
<th>After-tax earnings</th>
<th>No. of equity shares</th>
<th>Market price per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Ltd.</td>
<td>₹ 10,00,000</td>
<td>2,00,000</td>
<td>₹ 75</td>
</tr>
<tr>
<td>B Ltd.</td>
<td>₹ 3,00,000</td>
<td>50,000</td>
<td>₹ 60</td>
</tr>
</tbody>
</table>

(i) If the merger goes through by exchange of equity shares and the exchange ratio is set according to the current market prices, what is the new earnings per share for A Ltd.?

(ii) B Ltd. wants to be sure that its earnings per share is not diminished by the merger. What exchange ratio is relevant to achieve the objective?

**Solution**

(i) The current market price is the basis of exchange of equity shares, in the proposed merger, shareholders of B Ltd. will get only 40,000 shares in all or 4 shares of A Ltd. for every 5 shares held by them, i.e.,

\[
\frac{50,000 \times 60}{75} = 40,000
\]

The total number of shares in A Ltd. will then be 2,40,000 and, ignoring any synergistic effect, the profit will be ₹ 13,00,000. The new earning per share (EPS) of A Ltd. will be ₹ 5.42, i.e., ₹ 13,00,000/2,40,000.

(ii) The present earnings per share of B Ltd. is ₹6/- (₹ 3,00,000 ÷ 50,000) and that of A Ltd. is ₹5/-, i.e., ₹ 10,00,000 ÷ 2,00,000. If B Ltd. wants to ensure that, even after merger, the earnings per share of its shareholders should remain unaffected, then the exchange ratio will be 6 shares in A for every 5 shares in B.

The total number of shares of A Ltd. that will produce ₹ 3,00,000 profit is 60,000, (3,00,000 ÷ 5), to be distributed among shareholders of B Ltd., giving a ratio of 6 shares in A for 5 shares in B.

Proof:

The shareholders of B Ltd. will get in all 60,000 share for 50,000 shares. It means after merger, their earning per share will be ₹ 5/-, i.e., ₹13,00,000/2,60,000.

In all they will get ₹3,00,000, i.e., 60,000 x 5, as before.

**Illustration 4**

Simpson Ltd. is considering a merger with Wilson Ltd. The data below are in the hands of both Board of Directors. The issue at hand is how many shares of Simpson should be exchanged for Wilson Ltd. Both boards are considering three possibilities 20,000, 25,000 and 30,000 shares. You are required to construct a table demonstrating the potential impact of each scheme on each set of shareholders:
Solution

The following table demonstrates the potential impact of the three possible schemes, on each set of shareholders:

<table>
<thead>
<tr>
<th>Number of Simpson Ltd.’s shares issued to shareholders of Wilson Ltd.</th>
<th>Exchange ratio [(1)/10,000 shares of Wilson Ltd.]</th>
<th>Number of Simpson Ltd.’s shares outstanding after merger [50,000+(1)]</th>
<th>Fraction of Simpson Ltd. (Post merger) owned by Wilson Ltd.’s shareholders [(1)/(3)]</th>
<th>Value of shares owned by Wilson Ltd.’s shareholders [(4)x 35,00,000]</th>
<th>Fraction of Simpson Ltd. (combined Post-merger owned by Simpson Ltd.’s shareholders [50,000/(3)]</th>
<th>Value of shares owned by Wilson Ltd.’s shareholders [(6) x 35,00,000]</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td>(7)</td>
</tr>
<tr>
<td>20,000</td>
<td>2</td>
<td>70,000</td>
<td>2/7</td>
<td>10,00,000</td>
<td>5/7</td>
<td>25,00,000</td>
</tr>
<tr>
<td>25,000</td>
<td>2.5</td>
<td>75,000</td>
<td>1/3</td>
<td>11,66,667</td>
<td>2/3</td>
<td>23,33,333</td>
</tr>
<tr>
<td>30,000</td>
<td>3</td>
<td>80,000</td>
<td>3/8</td>
<td>13,12,500</td>
<td>5/8</td>
<td>21,87,500</td>
</tr>
</tbody>
</table>

14. CROSS-BORDER M&A

Cross-border M&A is a popular route for global growth and overseas expansion. Cross-border M&A is also playing an important role in global M&A. This is especially true for developing
countries such as India. Kaushik Chatterjee, CFO, of Tata Steel in an interview with McKenzie Quarterly in September 2009 articulates this point very clearly. To the following question

The Quarterly: Last year was the first in which Asian and Indian companies acquired more businesses outside of Asia than European or US multinationals acquired within it. What’s behind the Tata Group’s move to go global?

His response is as follows:

“India is clearly a very large country with a significant population and a big market, and the Tata Group’s companies in a number of sectors have a pretty significant market share. India remains the main base for future growth for Tata Steel Group, and we have substantial investment plans in India, which are currently being pursued. But meeting our growth goals through organic means in India, unfortunately, is not the fastest approach, especially for large capital projects, due to significant delays on various fronts. Nor are there many opportunities for growth through acquisitions in India, particularly in sectors like steel, where the value to be captured is limited—for example, in terms of technology, product profiles, the product mix, and good management.”

Other major factors that motivate multinational companies to engage in cross-border M&A in Asia include the following:

- Globalization of production and distribution of products and services.
- Integration of global economies.
- Expansion of trade and investment relationships on the International level.
- Many countries are reforming their economic and legal systems, and providing generous investment and tax incentives to attract foreign investment.
- Privatisation of state-owned enterprises and consolidation of the banking industry.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. Explain synergy in the context of Mergers and Acquisitions.
2. What is take over by reverse bid or Reverse Merger.
3. What is an equity curve out? How does it differ from a spin off.

Practical Questions

1. B Ltd. is a highly successful company and wishes to expand by acquiring other firms. Its expected high growth in earnings and dividends is reflected in its PE ratio of 17. The Board of Directors of B Ltd. has been advised that if it were to take over firms with a lower PE ratio than it own, using a share-for-share exchange, then it could increase its reported earnings
per share. C Ltd. has been suggested as a possible target for a takeover, which has a PE ratio of 10 and 1,00,000 shares in issue with a share price of ₹ 15. B Ltd. has 5,00,000 shares in issue with a share price of ₹ 12.

Calculate the change in earnings per share of B Ltd. if it acquires the whole of C Ltd. by issuing shares at its market price of ₹12. Assume the price of B Ltd. shares remains constant.

2. **Elrond Limited plans to acquire Doom Limited.** The relevant financial details of the two firms prior to the merger announcement are:

<table>
<thead>
<tr>
<th></th>
<th>Elrond Limited</th>
<th>Doom Limited</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market price per share</td>
<td>₹ 50</td>
<td>₹ 25</td>
</tr>
<tr>
<td>Number of outstanding shares</td>
<td>20 lakhs</td>
<td>10 Lakhs</td>
</tr>
</tbody>
</table>

The merger is expected to generate gains, which have a present value of ₹200 lakhs. The exchange ratio agreed to is 0.5.

What is the true cost of the merger from the point of view of Elrond Limited?

3. A Ltd. wants to acquire T Ltd. and has offered a swap ratio of 1:2 (0.5 shares for every one share of T Ltd.). Following information is provided:

<table>
<thead>
<tr>
<th></th>
<th>A Ltd.</th>
<th>T. Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit after tax</td>
<td>₹18,00,000</td>
<td>₹3,60,000</td>
</tr>
<tr>
<td>Equity shares outstanding (Nos.)</td>
<td>6,00,000</td>
<td>1,80,000</td>
</tr>
<tr>
<td>EPS</td>
<td>₹3</td>
<td>₹2</td>
</tr>
<tr>
<td>PE Ratio</td>
<td>10 times</td>
<td>7 times</td>
</tr>
<tr>
<td>Market price per share</td>
<td>₹30</td>
<td>₹14</td>
</tr>
</tbody>
</table>

Required:

(i) The number of equity shares to be issued by A Ltd. for acquisition of T Ltd.

(ii) What is the EPS of A Ltd. after the acquisition?

(iii) Determine the equivalent earnings per share of T Ltd.

(iv) What is the expected market price per share of A Ltd. after the acquisition, assuming its PE multiple remains unchanged?

(v) Determine the market value of the merged firm.

4. XYZ Ltd., is considering merger with ABC Ltd. XYZ Ltd.’s shares are currently traded at ₹ 20. It has 2,50,000 shares outstanding and its earnings after taxes (EAT) amount to ₹ 5,00,000. ABC Ltd., has 1,25,000 shares outstanding; its current market price is ₹ 10 and
its EAT are ₹ 1,25,000. The merger will be effected by means of a stock swap (exchange). ABC Ltd., has agreed to a plan under which XYZ Ltd., will offer the current market value of ABC Ltd.’s shares:

(i) What is the pre-merger earnings per share (EPS) and P/E ratios of both the companies?
(ii) If ABC Ltd.’s P/E ratio is 6.4, what is its current market price? What is the exchange ratio? What will XYZ Ltd.’s post-merger EPS be?
(iii) What should be the exchange ratio; if XYZ Ltd.’s pre-merger and post-merger EPS are to be the same?

5. Company X is contemplating the purchase of Company Y. Company X has 3,00,000 shares having a market price of ₹ 30 per share, while Company Y has 2,00,000 shares selling at ₹ 20 per share. The EPS are ₹ 4.00 and ₹ 2.25 for Company X and Y respectively. Managements of both companies are discussing two alternative proposals for exchange of shares as indicated below:

(i) In proportion to the relative earnings per share of two companies.
(ii) 0.5 share of Company X for one share of Company Y (0.5 : 1).

Your are required:

(i) To calculate the Earnings Per Share (EPS) after merger under two alternatives; and
(ii) To show the impact on EPS for the shareholders of two companies under both the alternatives.

6. M Co. Ltd. is studying the possible acquisition of N Co. Ltd., by way of merger. The following data are available in respect of the companies:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>M Co. Ltd.</th>
<th>N Co. Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings after tax</td>
<td>₹ 80,00,000</td>
<td>₹ 24,00,000</td>
</tr>
<tr>
<td>No. of equity shares</td>
<td>16,00,000</td>
<td>4,00,000</td>
</tr>
<tr>
<td>Market value per share (₹)</td>
<td>200</td>
<td>160</td>
</tr>
</tbody>
</table>

(i) If the merger goes through by exchange of equity and the exchange ratio is based on the current market price, what is the new earning per share for M Co. Ltd.?
(ii) N Co. Ltd. wants to be sure that the earnings available to its shareholders will not be diminished by the merger. What should be the exchange ratio in that case?

7. Simple Ltd. and Dimple Ltd. are planning to merge. The total value of the companies are dependent on the fluctuating business conditions. The following information is given for the total value (debt + equity) structure of each of the two companies.
The current debt of Dimple Ltd. is ₹ 65 lacs and of Simple Ltd. is ₹ 460 lacs.

Calculate the expected value of debt and equity separately for the merged entity.

8. Yes Ltd. wants to acquire No Ltd. and the cash flows of Yes Ltd. and the merged entity are given below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Yes Ltd.</th>
<th>Merged Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>175</td>
<td>400</td>
</tr>
<tr>
<td>2</td>
<td>200</td>
<td>450</td>
</tr>
<tr>
<td>3</td>
<td>320</td>
<td>525</td>
</tr>
<tr>
<td>4</td>
<td>340</td>
<td>590</td>
</tr>
<tr>
<td>5</td>
<td>350</td>
<td>620</td>
</tr>
</tbody>
</table>

Earnings would have witnessed 5% constant growth rate without merger and 6% with merger on account of economies of operations after 5 years in each case. The cost of capital is 15%.

The number of shares outstanding in both the companies before the merger is the same and the companies agree to an exchange ratio of 0.5 shares of Yes Ltd. for each share of No Ltd.

PV factor at 15% for years 1-5 are 0.870, 0.756; 0.658, 0.572, 0.497 respectively.

You are required to:
(i) Compute the Value of Yes Ltd. before and after merger.
(ii) Value of Acquisition and
(iii) Gain to shareholders of Yes Ltd.

9. The following information is provided relating to the acquiring company Efficient Ltd. and the target Company Healthy Ltd.

<table>
<thead>
<tr>
<th>Efficient Ltd.</th>
<th>Healthy Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of shares (F.V. ₹ 10 each)</td>
<td>10.00 lakhs</td>
</tr>
<tr>
<td>Market capitalization</td>
<td>500.00 lakhs</td>
</tr>
<tr>
<td>P/E ratio (times)</td>
<td>10.00</td>
</tr>
<tr>
<td>Reserves and Surplus</td>
<td>300.00 lakhs</td>
</tr>
<tr>
<td>Promoter’s Holding (No. of shares)</td>
<td>4.75 lakhs</td>
</tr>
</tbody>
</table>
Board of Directors of both the Companies have decided to give a fair deal to the shareholders and accordingly for swap ratio the weights are decided as 40%, 25% and 35% respectively for Earning, Book Value and Market Price of share of each company:

(i) Calculate the swap ratio and also calculate Promoter's holding % after acquisition.
(ii) What is the EPS of Efficient Ltd. after acquisition of Healthy Ltd.?
(iii) What is the expected market price per share and market capitalization of Efficient Ltd. after acquisition, assuming P/E ratio of Firm Efficient Ltd. remains unchanged.
(iv) Calculate free float market capitalization of the merged firm.

10. T Ltd. and E Ltd. are in the same industry. The former is in negotiation for acquisition of the latter. Important information about the two companies as per their latest financial statements is given below:

<table>
<thead>
<tr>
<th></th>
<th>T Ltd.</th>
<th>E Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>₹ 10 Equity shares outstanding</td>
<td>12 Lakhs</td>
<td>6 Lakhs</td>
</tr>
<tr>
<td>Debt:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10% Debentures (₹ Lakhs)</td>
<td>580</td>
<td>--</td>
</tr>
<tr>
<td>12.5% Institutional Loan (₹ Lakhs)</td>
<td>--</td>
<td>240</td>
</tr>
<tr>
<td>Earning before interest, depreciation and tax (EBIDAT) (₹ Lakhs)</td>
<td>400.86</td>
<td>115.71</td>
</tr>
<tr>
<td>Market Price/share (₹)</td>
<td>220.00</td>
<td>110.00</td>
</tr>
</tbody>
</table>

T Ltd. plans to offer a price for E Ltd., business as a whole which will be 7 times EBIDAT reduced by outstanding debt, to be discharged by own shares at market price.

E Ltd. is planning to seek one share in T Ltd. for every 2 shares in E Ltd. based on the market price. Tax rate for the two companies may be assumed as 30%.

Calculate and show the following under both alternatives - T Ltd.'s offer and E Ltd.'s plan:

(i) Net consideration payable.
(ii) No. of shares to be issued by T Ltd.
(iii) EPS of T Ltd. after acquisition.
(iv) Expected market price per share of T Ltd. after acquisition.
(v) State briefly the advantages to T Ltd. from the acquisition.

Calculations (except EPS) may be rounded off to 2 decimals in lakhs.
ANSWERS/ SOLUTIONS

Answers to Theoretical Questions
1. Please refer paragraph 2
2. Please refer paragraph 6
3. Please refer paragraph 7.2
4. Please refer paragraph 3

Answers to the Practical Questions
1. Total market value of C Ltd is = 1,00,000 x ₹ 15 = ₹ 15,00,000
   PE ratio (given) = 10
   Therefore, earnings = ₹ 15,00,000 /10 = ₹ 1,50,000

   Total market value of B Ltd. is = 5,00,000 x ₹ 12 = ₹ 60,00,000
   PE ratio (given) = 17
   Therefore, earnings = ₹ 60,00,000/17 = ₹ 3,52,941

   The number of shares to be issued by B Ltd.
   ₹ 15,00,000 ÷ 12 = 1,25,000
   Total number of shares of B Ltd = 5,00,000 + 1,25,000 = 6,25,000
   The EPS of the new firm is = (₹ 3,52,941+₹1,50,000)/6,25,000
                           = ₹ 0.80
   The present EPS of B Ltd is = ₹ 3,52,941 /5,00,000
                              = ₹ 0.71

   So the EPS affirm B will increase from Re. 0.71 to ₹ 0.80 as a result of merger

2. Shareholders of Doom Ltd. will get 5 lakh share of Elrond Limited, so they will get:
   = 5 lakh
   20lakh + 5lakh
   = 20% of shares Elrond Limited

   The value of Elrond Ltd. after merger will be:
   = ₹ 50 x 20 lakh + ₹ 25 x 10 lakh + ₹ 200 lakh

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13.44 STRATEGIC FINANCIAL MANAGEMENT

= ₹ 1000 lakh + ₹ 250 lakh + ₹ 200 lakh = ₹ 1450 lakh

True Cost of Merger will be:
(₹ 1450 x 20%) ₹ 290 lakhs – ₹ 250 lakhs = ₹ 40 lakhs

3. (i) The number of shares to be issued by A Ltd.:
The Exchange ratio is 0.5
So, new Shares = 1,80,000 x 0.5 = 90,000 shares.

(ii) EPS of A Ltd. After a acquisition:

| Total Earnings | ₹ 18,00,000 + ₹ 3,60,000 | ₹21,60,000 |
| No. of Shares  | (6,00,000 + 90,000)       | 6,90,000   |
| EPS            | ₹ 21,60,000/6,90,000       | ₹3.13      |

(iii) Equivalent EPS of T Ltd.:

| No. of new Shares | 0.5 |
| EPS              | ₹3.13 |
| Equivalent EPS (£3.13 x 0.5) | ₹1.57 |

(iv) New Market Price of A Ltd. (P/E remaining unchanged):

| Present P/E Ratio of A Ltd. | 10 times |
| Expected EPS after merger   | ₹3.13   |
| Expected Market Price (£3.13 x 10) | ₹31.30 |

(v) Market Value of merged firm:

| Total number of Shares | 6,90,000 |
| Expected Market Price  | ₹31.30   |
| Total value (6,90,000 x 31.30) | ₹2,15,97,000 |

4. (i) Pre-merger EPS and P/E ratios of XYZ Ltd. and ABC Ltd.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>XYZ Ltd.</th>
<th>ABC Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings after taxes</td>
<td>5,00,000</td>
<td>1,25,000</td>
</tr>
<tr>
<td>Number of shares outstanding</td>
<td>2,50,000</td>
<td>1,25,000</td>
</tr>
<tr>
<td>EPS</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Market Price per share</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>P/E Ratio (times)</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

(ii) Current Market Price of ABC Ltd. if P/E ratio is 6.4 = ₹ 1 x 6.4 = ₹ 6.40

Exchange ratio = ₹ 20 = 3.125 or ₹ 6.40 = 0.32

₹ 6.40

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Post merger EPS of XYZ Ltd.

\[ \text{Post merger EPS} = \frac{\text{\text{\text₹} 5,00,000} + \text{\text₹} 1,25,000}{2,50,000 + (1,25,000/3.125)} \]

\[ = \frac{\text{\text₹} 6,25,000}{2,90,000} = 2.16 \]

(iii) **Desired Exchange Ratio**

Total number of shares in post-merged company

\[ \frac{\text{Post-merger earnings}}{\text{Pre-merger EPS of XYZ Ltd}} = \frac{\text{\text₹} 6,25,000}{2} = 3,12,500 \]

Number of shares required to be issued

\[ = 3,12,500 - 2,50,000 = 62,500 \]

Therefore, the exchange ratio is

\[ 62,500 : 1,25,000 \]

\[ = \frac{62,500}{1,25,000} = 0.50 \]

5. (i) **Exchange ratio in proportion to relative EPS (in \text₹)**

<table>
<thead>
<tr>
<th>Company</th>
<th>Existing No. of shares</th>
<th>EPS</th>
<th>Total earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>3,00,000</td>
<td>4.00</td>
<td>12,00,000</td>
</tr>
<tr>
<td>Y</td>
<td>2,00,000</td>
<td>2.25</td>
<td>4,50,000</td>
</tr>
<tr>
<td></td>
<td>Total earnings</td>
<td></td>
<td>16,50,000</td>
</tr>
</tbody>
</table>

No. of shares after merger 3,00,000 + 1,12,500 = 4,12,500

**Note:** 1,12,500 may be calculated as

\[ 2,00,000 \times \left( \frac{2.25}{4.00} \right) \]

EPS for Co. X after merger

\[ = \frac{16,50,000}{4,12,500} = \text{\text₹} 4.00 \]

**Impact on EPS**

Equivalent EPS of Co. Y

Before merger \text₹ 2.25

After merger (EPS before merger X Share exchange ratio on EPS basis)

\[ \text{\text₹} 4.00 \times 0.5625 = \text{\text₹} 2.25 \]

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(ii) **Merger effect on EPS with share exchange ratio of 0.5 : 1**

**Total earnings after merger**

\[ \text{Total earnings after merger} = \text{\textcurrency{16,50,000}} \]

**No. of shares post merger**

\[ \text{No. of shares post merger} = \text{3,00,000 + 1,00,000 (0.5 \times 2,00,000)} = 4,00,000 \]

**EPS**

\[ \text{EPS} = \frac{\text{\textcurrency{16,50,000}}}{\text{4,00,000}} = 4.125 \]

**Impact on EPS**

- **Co. X’ shareholders**
  - **EPS before merger**
    \[ \text{EPS before merger} = 4.00 \]
  - **EPS after merger**
    \[ \text{EPS after merger} = \frac{\text{\textcurrency{16,50,000}}}{\text{4,00,000}} = 4.125 \]
  - **Increase in EPS**
    \[ \text{Increase in EPS} = 0.125 \]

- **Co. Y’ Shareholders**
  - **EPS before merger**
    \[ \text{EPS before merger} = 2.2500 \]
  - **Equivalent EPS after the merger**
    \[ \text{Equivalent EPS} = 4.125 \times 0.5 = 2.0625 \]
  - **Decrease in EPS**
    \[ \text{Decrease in EPS} = 0.1875 \]

6. (i) **Calculation of new EPS of M Co. Ltd.**

**No. of equity shares to be issued by M Co. Ltd. to N Co. Ltd.**

\[ = \text{4,00,000 shares} \times \frac{\text{\textcurrency{160}}}{\text{200}} = 3,20,000 \text{ shares} \]

**Total no. of shares in M Co. Ltd. after acquisition of N Co. Ltd.**

\[ = \text{16,00,000 + 3,20,000} = 19,20,000 \]

**Total earnings after tax [after acquisition]**

\[ = \text{\textcurrency{80,00,000} + 24,00,000} = 1,04,00,000 \]

**EPS**

\[ \text{\textcurrency{1,04,00,000}} \]

\[ \text{19,20,000 equity shares} \]

\[ = \text{\textcurrency{5.42}} \]

(ii) **Calculation of exchange ratio which would not diminish the EPS of N Co. Ltd. after its merger with M Co. Ltd.**

**Current EPS:**

- **M Co. Ltd.**
  \[ \text{\textcurrency{80,00,000}} \]
  \[ \text{16,00,000 equity shares} \]
  \[ = \text{\textcurrency{5}} \]

- **N Co. Ltd.**
  \[ \text{\textcurrency{24,00,000}} \]
  \[ \text{4,00,000 equity shares} \]
  \[ = \text{\textcurrency{6}} \]

**Exchange ratio**

\[ = \frac{6}{5} = 1.20 \]
No. of new shares to be issued by M Co. Ltd. to N Co. Ltd.
\[ = 4,00,000 \times 1.20 = 4,80,000 \text{ shares} \]

Total number of shares of M Co. Ltd. after acquisition
\[ = 16,00,000 + 4,80,000 = 20,80,000 \text{ shares} \]

\[
\text{EPS [after merger]} = \frac{\text{₹ 1,04,00,000}}{20,80,000 \text{ shares}} = \text{₹ 5}
\]

Total earnings in M Co. Ltd. available to new shareholders of N Co. Ltd.
\[ = 4,80,000 \times \text{₹ 5} = \text{₹ 24,00,000} \]

**Recommendation:** The exchange ratio (6 for 5) based on market shares is beneficial to shareholders of 'N' Co. Ltd.

### 7. Compute Value of Equity

<table>
<thead>
<tr>
<th>Simple Ltd.</th>
<th>₹ in Lacs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High Growth</td>
</tr>
<tr>
<td>Debit + Equity</td>
<td>820</td>
</tr>
<tr>
<td>Less: Debt</td>
<td>460</td>
</tr>
<tr>
<td>Equity</td>
<td>360</td>
</tr>
</tbody>
</table>

Since the Company has limited liability the value of equity cannot be negative therefore the value of equity under slow growth will be taken as zero because of insolvency risk and the value of debt is taken at 410 lacs. The expected value of debt and equity can then be calculated as:

### Simple Ltd.

<table>
<thead>
<tr>
<th></th>
<th>₹ in Lacs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High Growth</td>
</tr>
<tr>
<td>Debt</td>
<td>0.20</td>
</tr>
<tr>
<td>Equity</td>
<td>0.20</td>
</tr>
<tr>
<td>820</td>
<td>550</td>
</tr>
</tbody>
</table>

### Dimple Ltd.

<table>
<thead>
<tr>
<th></th>
<th>₹ in Lacs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High Growth</td>
</tr>
</tbody>
</table>
Equity
Debt

<table>
<thead>
<tr>
<th></th>
<th>0.20</th>
<th>0.20</th>
<th>65</th>
<th>0.60</th>
<th>0.60</th>
<th>65</th>
<th>0.20</th>
<th>0.20</th>
<th>65</th>
<th>65</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>985</td>
<td>65</td>
<td>760</td>
<td>65</td>
<td>525</td>
<td>65</td>
<td>758</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1050</td>
<td>825</td>
<td>590</td>
<td>823</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Expected Values

<table>
<thead>
<tr>
<th></th>
<th>Equity</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simple Ltd.</td>
<td>126</td>
<td>450</td>
</tr>
<tr>
<td>Dimple Ltd.</td>
<td>758</td>
<td>65</td>
</tr>
<tr>
<td></td>
<td>884</td>
<td>515</td>
</tr>
</tbody>
</table>

8. (i) Working Notes:

Present Value of Cash Flows (CF) upto 5 years

<table>
<thead>
<tr>
<th>Year</th>
<th>CF of Yes Ltd. (₹ lakhs)</th>
<th>PVF @15%</th>
<th>PV of CF (₹ lakhs)</th>
<th>CF of Merged Entity (₹ lakhs)</th>
<th>PV of CF of Merged Entity (₹ lakhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>175</td>
<td>0.870</td>
<td>152.25</td>
<td>400</td>
<td>348.00</td>
</tr>
<tr>
<td>2</td>
<td>200</td>
<td>0.756</td>
<td>151.20</td>
<td>450</td>
<td>340.20</td>
</tr>
<tr>
<td>3</td>
<td>320</td>
<td>0.658</td>
<td>210.56</td>
<td>525</td>
<td>345.45</td>
</tr>
<tr>
<td>4</td>
<td>340</td>
<td>0.572</td>
<td>194.48</td>
<td>590</td>
<td>337.48</td>
</tr>
<tr>
<td>5</td>
<td>350</td>
<td>0.497</td>
<td>173.95</td>
<td>620</td>
<td>308.14</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>882.44</td>
<td></td>
<td>1679.27</td>
</tr>
</tbody>
</table>

PV of Cash Flows of Yes Ltd. after the forecast period

\[
TV_5 = \frac{CF_5(1 + g)}{K_e - g} = \frac{350(1 + 0.05)}{0.15 - 0.05} = \frac{367.50}{0.10} = \text{ ₹}3675 \text{ lakhs}
\]

PV of TV_5 = ₹3675 lakhs x 0.497 = ₹1826.475 lakhs

PV of Cash Flows of Merged Entity after the forecast period

\[
TV_5 = \frac{CF_5(1 + g)}{K_e - g} = \frac{620(1 + 0.06)}{0.15 - 0.06} = \frac{657.20}{0.09} = \text{ ₹7302.22 lakhs}
\]

PV of TV_5 = ₹7302.22 lakhs x 0.497 = ₹3629.20 lakhs
Value of Yes Ltd.

<table>
<thead>
<tr>
<th></th>
<th>Before merger (₹lakhs)</th>
<th>After merger (₹lakhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PV of CF (1-5 years)</td>
<td>882.440</td>
<td>1679.27</td>
</tr>
<tr>
<td>Add: PV of TV₅</td>
<td>1826.475</td>
<td>3629.20</td>
</tr>
<tr>
<td></td>
<td>2708.915</td>
<td>5308.47</td>
</tr>
</tbody>
</table>

(ii) Value of Acquisition

= Value of Merged Entity – Value of Yes Ltd.

= ₹5308.47 lakhs – ₹2708.915 lakhs = ₹2599.555 lakhs

(iii) Gain to Shareholders of Yes Ltd.

Share of Yes Ltd. in merged entity = ₹5308.47 lakhs x \(\frac{1}{1.5}\) = ₹3538.98 lakhs

Gain to shareholder = Share of Yes Ltd. in merged entity – Value of Yes Ltd. before merger

= ₹3538.98 lakhs - ₹2708.915 = ᴧ830.065 lakhs

9. Swap Ratio

<table>
<thead>
<tr>
<th></th>
<th>Efficient Ltd.</th>
<th>Healthy Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market capitalization</td>
<td>500 lakhs</td>
<td>750 lakhs</td>
</tr>
<tr>
<td>No. of shares</td>
<td>10 lakhs</td>
<td>7.5 lakhs</td>
</tr>
<tr>
<td>Market Price per share</td>
<td>₹50</td>
<td>₹100</td>
</tr>
<tr>
<td>P/E ratio</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>EPS</td>
<td>₹5</td>
<td>₹20</td>
</tr>
<tr>
<td>Profit</td>
<td>₹50 lakh</td>
<td>₹150 lakh</td>
</tr>
<tr>
<td>Share capital</td>
<td>₹100 lakh</td>
<td>₹75 lakh</td>
</tr>
<tr>
<td>Reserves and surplus</td>
<td>₹300 lakh</td>
<td>₹165 lakh</td>
</tr>
<tr>
<td>Total</td>
<td>₹400 lakh</td>
<td>₹240 lakh</td>
</tr>
<tr>
<td>Book Value per share</td>
<td>₹40</td>
<td>₹32</td>
</tr>
</tbody>
</table>

(i) Calculation of Swap Ratio

EPS 1 : 4 i.e. \(4.0 \times 40\%\) = 1.6

Book value 1 : 0.8 i.e. \(0.8 \times 25\%\) = 0.2

Market price 1 : 2 i.e. \(2.0 \times 35\%\) = 0.7

Total 2.5
Swap ratio is for every one share of Healthy Ltd., to issue 2.5 shares of Efficient Ltd. Hence, total no. of shares to be issued 7.5 lakh × 2.5 = 18.75 lakh shares.

Promoter’s holding = 4.75 lakh shares + (5 × 2.5 = 12.5 lakh shares) = 17.25 lakh
i.e. Promoter’s holding % is (17.25 lakh/28.75 lakh) × 100 = 60%.

Calculation of EPS, Market price, Market capitalization and free float market capitalization.

(ii) Total No. of shares 10 lakh + 18.75 lakh = 28.75 lakh
Total capital 100 lakh + 187.5 lakh = ₹ 287.5 lakh
EPS \[
\text{Total profit} \quad \frac{50 \text{ lakh} + 150 \text{ lakh}}{28.75 \text{ lakh}} = \frac{200}{28.75} = 6.956
\]
(iii) Expected market price EPS 6.956 × P/E 10 = ₹ 69.56
Market capitalization = ₹ 69.56 per share × 28.75 lakh shares
= ₹ 1,999.85 lakh
(iv) Free float of market capitalization = ₹ 69.56 per share × (28.75 lakh × 40%)
= ₹ 799.94 lakh

10. As per T Ltd.’s Offer

<table>
<thead>
<tr>
<th>(i) Net Consideration Payable</th>
<th>₹ in lakhs</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 times EBIT, i.e. 7 × ₹ 115.71 lakh</td>
<td>809.97</td>
</tr>
<tr>
<td>Less: Debt</td>
<td>240.00</td>
</tr>
<tr>
<td></td>
<td>569.97</td>
</tr>
</tbody>
</table>

| (ii) No. of shares to be issued by T Ltd | ₹ 569.97 lakh/₹ 220 (rounded off) (Nos.) | 2,59,000 |

<table>
<thead>
<tr>
<th>(iii) EPS of T Ltd after acquisition</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total EBIT (₹ 400.86 lakh + ₹ 115.71 lakh)</td>
<td>516.57</td>
</tr>
<tr>
<td>Less: Interest (₹ 58 lakh + ₹ 30 lakh)</td>
<td>88.00</td>
</tr>
<tr>
<td></td>
<td>428.57</td>
</tr>
<tr>
<td>Less: 30% Tax</td>
<td>128.57</td>
</tr>
<tr>
<td>Total earnings (NPAT)</td>
<td>300.00</td>
</tr>
<tr>
<td>Total no. of shares outstanding (12 lakh + 2.59 lakh)</td>
<td>14.59 lakh</td>
</tr>
</tbody>
</table>
### Expected Market Price:

<table>
<thead>
<tr>
<th>Pre-acquisition P/E multiple:</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIDAT</td>
</tr>
<tr>
<td>Less: Interest ( \frac{580 \times 10}{100} )</td>
</tr>
<tr>
<td>Less: 30% Tax</td>
</tr>
<tr>
<td>No. of shares (lakhs)</td>
</tr>
<tr>
<td>EPS</td>
</tr>
<tr>
<td><strong>Hence, PE multiple</strong></td>
</tr>
<tr>
<td><strong>Expected market price after acquisition</strong></td>
</tr>
</tbody>
</table>

#### As per E Ltd’s Plan

<table>
<thead>
<tr>
<th>(i) Net consideration payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 lakhs shares x ₹ 110</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(ii) No. of shares to be issued by T Ltd</th>
</tr>
</thead>
<tbody>
<tr>
<td>₹ 660 lakhs ÷ ₹ 220</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(iii) EPS of T Ltd after Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>NPAT (as per earlier calculations)</td>
</tr>
<tr>
<td>Total no. of shares outstanding</td>
</tr>
<tr>
<td>Earning Per Share (EPS) ₹ 300 lakh/15 lakh</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(iv) Expected Market Price (₹ 20 x 11)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>(v) Advantages of Acquisition to T Ltd</th>
</tr>
</thead>
</table>

Since the two companies are in the same industry, the following advantages could accrue:

- Synergy, cost reduction and operating efficiency.
- Better market share.
- Avoidance of competition