LESSON – 16

FINANCIAL COMBINATIONS

16.0 Objective :

After studying this unit, readers should be able to

- Understand the meaning, definition and importance of various types of financial combinations.
- Know the reasons for mergers, amalgamations and acquisitions.
- Highlight the various types of mergers and dangers of mergers.
- Explain financial considerations of various types of combinations and problems encountered etc.

STRUCTURE

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16.2 Meaning of Merger, Amalgamation and Acquisition
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16.1 Introduction

Every organization must grow over a period of time for its survival. Growth in terms of sales, profits and assets. Increase in sales is a direct indicator of growth in a firm’s operations which indicates its competitive edge and has enlarged its market. Similarly, increase in profits enhances shareholders returns. This becomes a major incentive for shareholders to contribute liberally for the organisation’s growth. Increase in value of assets is another significant parameter to measure growth. All these criterias of increased sales, increased profits and increased assets values should be used in conjunction with each other to get a realistic picture of the growth of an organization.

A firm may grow internally and externally. A firm is said to grow internally when it expands its area of operations. It may expand its activities in the same product or different lines of product etc.

A firm may grow externally through combining or joining with other firms, or acquiring other firms. Combination of firms is probably the fastest way to grow. There are various forms of business combinations, which can result in external growth. Three forms of combination which are usually applied with the objective of expansion are:
(i) Mergers; (ii) Amalgamations or Consolidations; and (iii) Acquisitions or Take Overs.

16.2 MEANINGS OF MERGER, AMALGAMATION AND ACQUISITON

(a) Merger: The term *'merger'* refers to a situation where one company acquires the net assets of another company (or companies) and the latter is (are) dissolved. The acquired company pays the shareholders of the merged company (or companies) cash or securities and continues to operate with the resources of the merged company (or companies) together with its own resources. It is thus, synonymous with the term `absorption'.

(b) Amalgamation: The term "*amalgamation*" or "*consolidation*" refers to a situation where two ore more existing companies are combined into a new company formed for the purpose. The old companies cease to exist and their shareholders are paid by the new company in cash or in its shares or debentures.

Thus, technically, there is difference between merger and amalgamation. In case of merger, one existing company takes over the business of another existing company or companies, while in case of amalgamation, a new company takes over the business of two or more existing companies. However, in practice, no such distinction is observed.

c) Acquisition: The term "acquisition" or "takeover" refers to acquiring of effective working control by one company over another. The control may be acquired either through purchase of majority of shares carrying voting rights exercisable at a general meeting, or controlling the composition of the Board of Directors of the other company. The company acquiring controlling shares or voting power is termed as the holding company, while the company in which the shares are acquired is termed as the subsidiary company. It may be noted that for acquiring effective control over another company it is not necessary to own 51% of the share capital of another company. For a widely held company ownership of 20% or as little as 10% of the share capital outstanding may constitute effective working control. The advantage of acquisition is that it allows a company to acquire control over another company by investing much less than what would be necessary for a merger.

16.3 REASONS FOR MERGERS OR ACQUISITIONS

The following are the important reasons for mergers, amalgamations and acquisitions of firms.

i. Increase in effective value The principal reason for these external combinations is that the value of the company so formed by combining resources is greater than the sum of the independent values of the merged companies. For example if A Ltd., and B Ltd., merge and form a company C Ltd., the effective value of C Ltd., is expected to be greater than the sum of the independent values of A Ltd., and B Ltd. Symbolically this can be put as follows:

$$V(C) > V(A) + V(B)$$

Where = V(C) = Value of the merged company;
V(A) = Value of A Ltd.,
V(B) = Value of B Ltd.

ii. Economies of scale: The amalgamated company can have larger volume of operations as compared to individual operations of the amalgamating companies. It can, thus, have economies of scale by having intensive utilization of production plants, distribution network, engineering services, researches and development facilities etc. However, such an advantage accrues only when the companies in the same line of business are combined, i.e. there is a horizontal merger.

It may be noted that the amalgamated company can have economies of operations only up to a point. Beyond this point, increase in volume may cause more problems. The per unit average cost may start increasing rather than decreasing beyond this point.

iii. Operating Economies: Combination of two or more companies results in a number of operating economies. Duplicate facilities can be eliminated. Generally, non-operation functions like Marketing, Accounting, Purchasing, Computer Resources and other similar operations can be consolidated and shared, leading to reduction in overheads.

iv. Elimination of Competition: The combining of two or more companies under the same name, would result in elimination of competition between them. They would save in terms of advertising cost. This may probably benefit the consumer, in terms of goods being available at lower price.

v. Tax implications: In several amalgamation schemes, tax implications play a crucial role. A company with heavy cumulative losses may have little prospects of taking advantage of carrying forward the losses and meeting them out of future profits and thus taking advantage of the tax benefits. However in case this company is merged with another profit making company, its losses can be set-off against the profits of profit making company resulting in substantial tax benefits to the amalgamated company.

vi. Growth: As mentioned earlier, the desired rate of growth may not be achieved through internal expansion. A company may find that through external combination faster and balanced growth can be achieved. Growth by acquisition will also be cheaper and simpler in terms of cost and efforts involved as compared to internal expansion.

vii. Stabilisation through diversification: External combinations like merger, amalgamation or acquisition, helps a company in achieving stabilization in its earning by diversifying its scope of operations.

viii. Better Financial Planning: Merger results in better financial planning and control. For example, a company having a long gestation period may merge itself with another company having short gestation period. As a result of this merger, the profits coming from the company with short gestation period can be used to improve the financial requirements of the company with long gestation period. Later, when the company with long gestation period starts giving profits, it will benefit the amalgamated company as a whole. Similarly, the surplus funds of acquiring company may be more effectively utilized in the acquired company.

ix. Backward /Forward Integration: The company which does the assembly of the products manufactured by some other company may merge with that company for manufacturing and assembling the entire range of products under the same roof. It may also merge with its main consumers. This would bring a better interaction between different functional areas, resulting in improved efficiency, reduced costs, effective control and reduction in prices for the company's products.

x. Personal Reasons: The shareholders of a closely held company may desire that their company be acquired by another company that has an established market for its shares. This will also facilitate the valuation of their shareholders' holdings for wealth tax purposes. Moreover, shareholders of such a company can also improve their liquidity position by selling some of their shares and diversifying their investments.

xi. Economic Necessity: The Government may also direct the merger of two or more sick units into a single unit to make them financially viable.

The reasons listed above are not an exhaustive list of reasons for seeking external growth. Other factors like socio-economic conditions, economic, fiscal and trade policies of the Government, Statutes governing the company may induce, the mergers or acquisitions of companies for achieving long term benefits to the company and its shareholders.

16.4 TYPES OF MERGERS

Mergers can be of the following types:

i. Horizontal Merger: This is the joining of two or more companies in the same area of business. Thus, in case of this merger, two or more companies which are producing essentially the same products or providing the same services or which are in direct competition with each other join together. For example, two manufacturers of motorcycles may merge with each other. Thus, merger results in economies of scale, operating economics and eliminations of duplication of facilities.

ii. Vertical Merger: This is the joining of two or more companies involved in different stages of the production or distribution of the same product or service. In case of this merger, two or more companies which are engaged in the production of same goods or services but at different stages of production or service routes join together. For example, a coal mining company and a railway company which carries coal to different industrial units may merge together. Such a merger will be termed as a vertical merger.

The essential objective of such a merger is to ensure a source of supply required for production of goods or services or ensure a ready market for the goods or services produced.

iii. Conglomerate Merger: This is joining of two or more companies whose business are not related with each other either vertically or horizontally. The companies involved in the merger may be manufacturing totally different products. Of course, there may be some common features between them such as same channel of distribution or technological area. For example, a company engaged in manufacturing activities may get itself merged with a company engaged in insurance business. The two businesses are totally different and, therefore, such merger is termed as conglomerate merger.
The basic objective behind such a merger is the diversification of activities.

16.5 DANGERS OF MERGERS

Mergers involve the following dangers.

i. Elimination of healthy competition: Merger may involve absorption of small, efficient and growing units into a larger unit. Thus, it eliminates individual undertakings competent to offer stiff competition necessary for healthy growth of industrial units.

ii. Concentration of economic power: All types of mergers have the inherent tendency of concentration of economic power. Monopolistic conditions may be created which are ultimately to the disadvantage of the consumers.

iii. Adverse effects on national economy: Concentration of economic power, elimination of competition etc., may ultimately result in deterioration in the performance of the merged undertakings. This is going to affect adversely the national economy,

Mergers are essential for the growth of the organization. Mergers lead to economies of scale, maximum utilization of capacity, operating economies, mobilization of financial resources, rehabilitation of sick units, reduction in cost etc. The dangers of mergers are, therefore, more than off-set by advantages of mergers. However, every scheme of amalgamation or merger should be examined keeping in view its advantages and the dangers it would impose on the economy. The scheme should be taken up only when it is to the advantage of economy in general and it is in public interest.

16.6 PROBLEMS ENCOUNTERED DURING AMALGAMATION

The problems encountered during amalgamation can be studied under the two heads:

a) **Pre-merger problems**
b) **Post merger problems**

a) Pre-merger problems. These problems are as follows.

(i)Type of combination: The acquiring company has primarily to decide whether it would like to have an amalgamation or a merge or simply a take over. The selection of the type of combination depends upon nature of business, size of the units, management philosophy, tax implications and other technical and legal considerations. A merger may be preferred to amalgamation if the acquiring company has a very high goodwill. Similarly, companies of the same size may prefer amalgamation to merger.

(ii) Financial consideration: This refers to the amount to be paid by the acquiring company to the acquired company. Its form has also to be determined, i.e. shares, debentures and cash. The exchange ratio has to be fixed up. All these aspects are generally determined by the capital structure of the acquiring company.

(iii) Taxation aspects: The tax implications of the proposed merger scheme have to be properly examined. The merger should not lead to increase in tax liability rather it should result in tax benefits to the merged company. It is, therefore, necessary that merger is done as per the requirements of the Income tax Act.

b) Post-merger Problems: These problems are as follows:

(i) Duplication of functions, such as finance, marketing, research and development have to be avoided.

(ii) The accounting methods, procedures and policies have to be made uniform for the amalgamated company.

(iii) Registration of the merged company under proper laws has to be done for the purposes of sales-tax, excise etc.

(iv) All creditors and customers have to be informed about the merger.

(v) Outstanding contracts in the name of the amalgamating companies have to be transferred to the amalgamated company.

(vi) Arrangements with bankers, appointments of auditors and solicitors have to be reviewed.

(vii) Adequate care is to be taken to satisfy all conditions necessary for amalgamation to be valid under the provisions of Companies Act, Income-Tax Act, Monopolies & Restrictive Trade Practice Act, etc.

16.7 PROBLEMS IN ACQUISITION

Acquisition of a company is not a smooth affair. Besides the legal and procedural problems discussed in the following pages, the acquiring or purchasing firm will face resistance against acquisition from the management, shareholders, employees etc. of the firm to be acquired.

Management may for various reasons feel that the company should not be acquired. This is because the company management may feel that the future plans of the acquiring company are not in the interests of their shareholders. The other reason could be that the exchange ratio is too low and unfavourable for existing shareholders. The most common fear is that acquiring firm will make all efforts to identify the dead wood in the old management and may even replace it entirely. Hence, all-out efforts may be made to foil the attempt of acquiring firm. The various tactics adopted by the target firm are mentioned below:

(i) Make shareholders and workers to resist the acquisition: Shareholders may be advised to vote against the takeover, as the acquisition may not be in their long term interests. Similarly, employees may be convinced not to accept the new management. In case the relations between employees and existing management are good, employees will also resist the acquisition.

(ii) Propagation against acquisition: The management may be willing to fight publicly against the proposed takeover. This act of management to publicly resist the acquisition will have detrimental effect on the acquisition process.

(iii) Involve Government agency: Involvement of a Government agency will make acquisition more difficult. The Monopolies Inquiry Commission investigates for concentration of economic wealth in a few hands. The *MRTP* Act in India seeks to exercise control over the additional acquisition by a giant undertaking with a view to prevent it from becoming still bigger.

(iv) Invite known entities to buy the shares: The company may invite individuals or organizations, known to it, to buy its shares and ask them to vote against the takeover. Through this process the management can transfer control in more friendly hands.

16.8 FINANCIAL CONSIDERATIONS IN MERGERS, AMALGAMATIONS AND ACQUISITIONS

When two or more companies are combined, there has to be some financial consideration for the amalgamating or acquired company. The financial consideration in generally in the form of exchange of shares. This requires that relative value of each firm’s share be evaluated and a particular exchange ratio is determined. This exchange ratio reflects the relative weightage of the firms under consideration.

The determination of the exchange ratio is, therefore, based on the value of the shares of the companies involved in the merger. The objective of merger is to maximise the owners wealth in the long run. A successful merger would be one that increases the earnings per share (EPS) and the market price of the shares of the amalgamated company over what they would have been if the merger had not taken place. The following are the three different approaches for determining the exchange ratio:

i) Earnings Approach
ii) Market Value Approach

iii) Book Value Approach
iv) Fair Value Approach

i) Earnings Approach

In evaluating a possible merger or acquisition, the acquiring firm must consider the effect the merger will have on the earnings per share of the merged or amalgamated corporation.

This can be understood with the following illustration:

Illustration : *A* Ltd., is considering the acquisition of *B* Ltd. The financial data at the time of acquisition is as follow:

	A Ltd.	B Ltd.
Net Profit after tax (Rs./lakhs)	30	6
Number of shares (lakhs)	06	2.50
Earning per share (Rs.)	05	2.40
Market Price per share (Rs.)	75	24
Price Earning Ratio	15	10

Assuming that the net profit, after tax of the two companies would remain the same after amalgamation (i.e. it would be Rs.36 lakhs), explain the effect on *EPS* of the merged company under each of the following situations:

(a) A Ltd., offers to pay Rs.30 per share to the shareholders of B Ltd.
(b) A Ltd., offers to pay Rs.40 per share to the shareholders of B Ltd.

The amount in both cases is to be paid in the form of shares of A Ltd.
Do you have any comments to offer?

Solution:

Situation (a) In case A Ltd., offers to pay Rs.30 per share the share exchange ratio would be 30/75 = 0.4

In other words, A Ltd., would give 0.4 share for every one share of B Ltd. The total number of shares to be issued by A Ltd., to the shareholders of B Ltd., would be, therefore, amount to 1,00,000 (i.e. 2,50,000 x 40.4).

The total number of shares of A Ltd., after acquisition of B Ltd., would now increase to 7,00,000. The earning per share (EPS) of the amalgamated company will now be Rs.5.14 calculated as follows:

$$\text{EPS} = \frac{\text{Total net profit after interest and tax}}{\text{Total number of shares}} = \frac{36,00,000}{7,00,000} = \text{Rs.}5.14$$

Thus, as a result of amalgamation, the EPS of A Ltd., will improve from Rs.5 to Rs.5.14.

However, the former shareholders of B Ltd., would experience a reduction in their EPS. Their EPS would now amount to 5.14 x .4 = Rs.2.05, which is lower than Rs.2.4 before merger.

Situation (b). In case A Ltd., offers Rs.40 per share to the shareholders of B Ltd., the exchange ratio would be 40/75 = 0.533 share of A Ltd., for each share of B Ltd.

Thus, A Ltd., would issue in all 1,33,250 (i.e. 2,50,000 x .533) shares to shareholders of B Ltd.

The EPS of the merged company would be Rs.4.91 i.e. 36,00,000/7,33,250.

Thus, on account of merger, there is a dilution in the earning per share of A Ltd. However, the former shareholders of B Ltd., would stand to gain. The EPS would amount to Rs.2.62 (i.e. Rs.4.91 x .533) as compared to the EPS of Rs.2.4 before merger.

Inferences

It may be noted that initial increases and decreases in earnings per share, are both possible in case of merger. Generally the dilution in EPS will occur wherever the P/E ratio of the acquired company calculated on the basis of price paid exceed the P/E ratio of acquiring company and vice-versa. This is verified with the figures given in case of the present illustration.

In situation (a), the price offered by A Ltd., per share of B Ltd., is Rs.30 and the EPS of B Ltd., is Rs.2.4, which would become the earnings of A Ltd., after merger. Thus, the price earning ratio on account of merger would be Rs.30/2.4 = 12.5. Since, this is lower than the P/E Ratio of A Ltd., before merger (i.e. 15) the EPS of A Ltd., after amalgamation increases to Rs.5.14.

In situation (b), the price earnings (P/E) ratio offered for merger is 40/2.4 = 16.7, which is higher than the P/E Ratio of A Ltd., before merger. Hence, the EPS of A Ltd., after merger would get diluted.

Future Earnings

Merger generally results in higher earnings for the merged company as compared to the earnings of the individual companies before merger.

In the illustration given in the preceding pages, we have assumed that the total earnings of A Ltd., after merger would continue to remain at Rs.36 lakhs (i.e. the total net profits after tax of A Ltd., and B Ltd.) and hence, a higher exchange ratio was not justified. However, if the earnings of B Ltd., are expected to grow at a faster rate than those of A Ltd., a higher exchange ratio may be justified, despite the fact that there in initial dilution in EPS of A Ltd. The higher growth in earnings of B Ltd., may result eventually in higher EPS of A Ltd., relative to earnings without merger.

ii) Market Value Approach

According to this approach, the exchange ratio is determined keeping in view the market values of the companies shares involved in the merger. The market price of a company's share reflects, to a great extent, the confidence of the investors, earning potentials and the financial position of the company concerned. The exchange ratio is determined as follows:

$$\frac{\text{Market price per share of the acquired company}}{\text{Market price per share of the acquiring company}}$$

For example, if A Ltd., whose market value of a share is Rs.50 is acquiring B Ltd., whose market value of a share is Rs.25. The share exchange ratio will be 0.5 (25/50). In other words, A Ltd., would issue one share for every two shares of B Ltd., or in case B Ltd., has 10,000 shares, it would get 5,000 shares of A Ltd., in exchange for its own shares.

The determination of the exchange ratio on the basis of the market price involves the following difficulties:

(1) The market price is easily available only for those shares which are quoted at a stock exchange.
(2) Market prices keep on fluctuating.
(3) Market prices can be manipulated or influenced on account of extraneous factors.

Capitalised Value of EPS

On account of the above difficulties, companies, prefer to determine the market value on the basis of capitalized value of earning per share for determining the exchange ratio. This involves taking of the following steps:

(a) Determination of average annual future earning: The future annual average earning is determined on the basis of the past performances of the company, future growth aspects, etc. For this purpose profits of the last few years are generally used applying suitable weights. The weighted annual average earning so calculated is divided by number of equity shares to get the earning per share.

(b) Determination of a Capitalisation rate: This is the normal rate of earnings expected from the type of the company whose shares are to be evaluated. In case of some industries, the rate of capitalization is fixed by the Government while in other cases, it is fixed keeping in view the average profits earned by the industry in general.

(c) Determination of market value: The market value per share is determined as follows:

<u>Earning Per Share (EPS)</u>

Capitalisation Rate

For example, if the EPS is Rs. 30 and the Capitalisation rate if 15%, the market value of share will be Rs.200 (i.e. 30 x 100/15).

(d) Determination of the exchange ratio: The exchange ratio can now be determined as follows:

$$\frac{\text{Market price per share of acquired company}}{\text{Market price per share of acquiring company}}$$

iii) Book Value Approach:

According to this approach, the exchange ratio is determined according to the book values of the concerned companies' shares. The book value of a share is determined as follows:

$$\frac{\text{Shareholders' funds}}{\text{Number of equity shares}} \quad \text{or} \quad \frac{\text{Net worth}}{\text{No. of equity shares}}$$

After determining the book value of the shares of the companies to be merged, the exchange ratio is determined as follows:

$$\frac{\text{Book value per share of acquired company}}{\text{Book value per share of acquiring company}}$$

The book value approach has several limitations. Some of the severe limitations are as follows:

(1) The net worth of the company on which the book value of a share is based can easily be manipulated by the accounting practices employed by the company.
(2) The book value does not give proper consideration to the earning capacity of the company.

On account of the above limitations, the book value approach is generally not followed as a basis for valuation in most mergers. However, this approach becomes important in those cases when the book value per share of a company is significantly higher than the market value of its shares.

iv) Fair Value approach

The approaches explained in the preceding pages for determination of the exchange ratio are hardly used singly in practice. Normally, share exchange ratio is determined on the basis of the fair values of the concerned companies' shares. The fair value of a share in fact may be the average of values calculated according to all the three approaches, explained in the preceding pages.

Having determined the fair value of the shares of the companies going in for a merger, the exchange ratio is determined as follows:

$$\frac{\text{Fair value per share of acquired company}}{\text{Fair value per share of acquiring company}}$$

Moreover, to certain extent, the exchange ratio also depends upon negotiations between companies. Both the companies would desire that the market price per share after the merger should be equal to or greater than the market price per share prevailing before the merger. This sets the boundaries for the exchange ratios to be negotiated. The upper boundary would be the maximum exchange ratio agreeable to the acquiring company so that the market price of the share after the merger atleast remains the same as that before the merger.

The lower boundary would be the minimum exchange ratio acceptable to the acquired company so that the market price of its shares after merger atleast remains the same as that before merger.

The final exchange ratio would lie anywhere between these two limits depending upon the negotiations.

16.9 LEGAL AND PROCEDURAL ASPECTS OF AMALGAMATIONS OR ACQUISITIONS:

The implementation of an amalgamation or a merger or an acquisition scheme involves the following steps:

(i) Analysis of the proposal: Having conceived the idea of amalgamation or merger between two or more companies, the managements of respective companies have to look into the pros and cons of the amalgamation or merger scheme. The extent of the benefits due to amalgamation or merger viz., economies of scale, operational economies, benefits of diversification etc., are carefully evaluated. The likely reaction of the shareholders, creditors and others is also assessed. The tax implications are also studied. The scheme is pursued further in case it offers attractive potential benefits.

Similarly, for acquisitions, a suitable company is identified. This is usually done by the firm's top management, in consultation with legal advisor and outside consultants. The prospects of the target firm are evaluated, with respect to its overall contribution after acquisition.

(ii) Determination of exchange ratio: The amalgamation, merger or acquisition requires exchange of shares. The shareholders of the amalgamating company or acquired company are offered shares in the amalgamated or the purchasing company for their shareholdings. The exchange ratio is to be negotiated.

(iii) Approval of the Board of Directors: The scheme of amalgamation or acquisition evolved as a result of negotiations, is put finally before the Board of Directors of the respective companies for their approval.

(iv) Approval by the shareholders: The scheme of amalgamation, as approved by the respective Boards, is placed before the shareholders of the respective companies for their approval.

(v) Consideration of the interest of the creditors: The scheme should also be discussed with the creditors of the amalgamated company and their views ascertained.

(vi) Approval of the Court: The scheme of amalgamation as approved has to be submitted to court for its approval. The court would approve the scheme only when it is satisfied that the scheme is just and reasonable for all concerned. The court may accept, modify or reject an amalgamation scheme and pass orders accordingly. In case the scheme is modified by the court, it is up to the shareholders of the respective companies to accept or reject it.

FEMA Act: In case of amalgamations coming within the purview of the amalgamation scheme will not be approved by the court unless the permission of the Reserve Bank of India is obtained.

16.10 FORMS OF FINANCING A MERGER

A merger can be financed through various modes of payment, viz., cash, exchange of shares, debt or a combination of cash, shares and debt. Deferred payment plans, leverages buy-outs and tender offers are also being used as financial techniques in financing of mergers in the recent times. The choice of the means of financing primarily depends upon the financial position and liquidity of the acquiring firm, its impact on capital structure and EPS, availability of debt and market conditions.

i. Cash Offer: After the value of the firm to be acquired has been determined, the most straight forward method of making the payment could be by way of offer for cash payment. The major advantage of cash offer is that it will not cause any dilution in the ownership as well as earnings per share of the company. However, the shareholders of the acquired company will be liable to pay tax on any gains made by them. Another important consideration could be the adverse effect on liquidity position of the company. Thus, only a company having very sound liquidity position may offer cash for financing a merger.

ii. Equity Share Financing or Exchange of Shares: It is one of the most commonly used methods of financing mergers. Under this method shareholders of the acquired company are given shares of the acquiring company. It results into sharing of benefits and earnings of merger between the shareholders of the acquired companies and the acquiring company.

iii. Debt and Preference Share Financing: A company may also finance a merger through issue of fixed interest bearing convertible debentures and convertible preference shares bearing a fixed rate of dividend. The shareholders of the acquired company sometimes prefer such a mode of payment because of security of income alongwith an option of conversion into equity within a stated period. The acquiring company is also benefited on account of lesser or no dilution of earnings per share as well as voting/controlling power of its existing shareholders.

iv. Deferred Payment or Earn-Out Plan: Deferred payment also known as earn-out plan is a method of making payment to the target firm which is being acquired in such a manner that only a part of the payment is made initially either in cash or securities. In addition to the initial payment, the acquiring company undertakes to make additional payment in future years out of the earnings after the merger or acquisition.

v. Leveraged Buy-out: A merger of a company which is substantially financed through debt is known as leveraged buy-out. Debt, usually, forms more than 70 percent of the purchase price. The shares of such a firm are concentrated in the hands of a few investors and are not generally, traded in the stock exchange. It is known as leveraged buyout because of the leverage provided by debt source of financing over equity. A leveraged buy-out is also called Management Buy-Out (MBO). However, a leveraged buy-out may be possible only in case of a financially sound acquiring company which is viewed by the lenders as risk free.

vi. Tender Offer: Under this method, the purchaser, who is interested in acquisition of some company, approaches the shareholders of the target firm directly and offers them a price (which is usually more than the market price) to encourage them sell their shares to him. It is a method that results into hostile or forced take-over. The management of the target firm may also tender a counter offer at still a higher price to avoid the take over. It may also educate the shareholders by informing them that the acquisition offer is not in the interest of the shareholders in the long-run.

16.11 MERGERS IN INDIA:

In developed economics, corporate mergers and amalgamations are a regular feature where hundreds of mergers take place everyday. In India, too mergers have become a corporate game today. In 1988, there were only 15 mergers whereas in 1998 there were over 500 mergers. Corporate takeovers in India, were started by Swaraj Paul when he tried to take over Escorts. Since then, many takeovers have taken place in our country such as 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 Institute of Chartered Accountants of India has issued Accounting Standard 14 on Accounting for Amalgamations. The government has also favoured mergers and amalgamations when these are in the interest of general public. The government has issued SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 to provide greater transparency in the acquisition of shares and takeover of companies.

16. 12 Summary:

Mergers, amalgamations, takeovers (acquisitions) and so on, referred to as financial combinations. These have become a major force in the financial and economic environment all over the world. Business firms resort to a variety of activities that lead to expansion, sell offs and changes in ownership and control. Merger, as used in financial literature, subsume both absorption and consolidation. An absorption involves a combination of two or more firms in

which one firm survives and other dissolves. Amalgamation or consolidation involves a combination of two or more firms as a result of which a new firm comes into being and the existing firms are dissolved. Mergers may be horizontal, vertical and conglomerate. The Principal rationale of financial combinations is to enhance the value of the merged entity, than the sum of independent value of the merging entities. The most plausible reasons in favour of a merger are: economies of scale, strategic tax shields, utilization of surplus funds etc. Often mergers are motivated by a desire to diversify, lower financing cost and achieve a higher rate of earnings growth. Mergers can be horizontal, vertical and conglomerate. Sometimes financial combinations may cause, lead to the dangers of elimination of healthy competition, concentration of economic power, duplication of functions, resistance from shareholders, creditors and workers and so on. Companies which are in the process of merger, amalgamation, acquisition have to observe the legal and procedural aspects of financial combinations. The merger can be financed through various modes of payment viz., cash, exchange of shares, debit or a combination of cash, shares and debt. In developed economies, mergers, amalgamations and takeovers are a regular feature of a corporate world. In India also, mergers have become a corporate game today.

16.13 KEYWORDS

1. Merger refers to a situation where one company acquires the net assets of another company (or companies) and the latter is dissolved.

2. An amalgamation refers to a situation where two or more existing companies are combined into a new company formed for the purpose. The old company ceased to exist.

3. A combination refers to acquiring of effective working control by one company over another.

4. Horizontal Merger is the joining of two or more companies in the same area of business.

5. Vertical Merger is the joining of two or more companies involved in different stages of the production or distribution of the same product or service.

6. Conglomerate Merger is a joining of two or more companies whose businesses are not related with each either vertically or horizontally.

7. EPS Earnings per share which is arrived by dividing net earnings available to the equity shareholders divided by the number of equity shares outstanding.

8. P/E Ratio Price earnings ratio is arrived by dividing market price of an equity stock by its earnings per share.

9. Book Value Book Value per (equity) share can be calculated by dividing the equity shareholders funds by the number of equity shares outstanding.

16.14 SELF ASSESSMENT QUESTIONS

1) Describe briefly the terms “Amalgamations”, “Merger” and “Acquisition”.
2) State the reasons for financial combinations.
3) Can amalgamation, mergers, takeovers are dangerous to the national economy?
4) Explain the various types of mergers.
5) What are the different approaches in determination of exchange ratio in financial combinations? Explain them.
6) State the adverse affects of Mergers.
7) Explain the problems to be encountered in the process of Amalgamation.

16.15 FURTHER READINGS

1) Financial Management Principle and Practice by Dr.S.N.Maheswari.
2) Financial Management Theory and Practice by Prasanna Chandra.
3) Financial Management. by Khan and Jain

KHP