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Mergers and Acquisitions in The Post-Liberalised Regime - A Review

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ABSTRACT

In the ever changing world economy, mergers and acquisitions have become a popular vehicle for emerging companies to rapidly accessing new opportunities and capacities. The functional importance of Mergers and Acquisitions has been undergoing a sea change since liberalization in India. Mergers and acquisition are a means to a long-term business strategy. M&A is playing a fundamental role in the corporate strategy and in the post 1991 liberalization era, it has acquired a new dimension in the global economy. The major rationale behind such M& A activity has been attributed to the enhancement of the market share, higher profitability and attainment of economies of scale. Given this broad perspective, present study is a re-examination of the performance of some of the companies in the Indian corporate picture which have resorted to this strategy of market expansion. The paper tries to analyse the performance of some of the firms post the event date.

INTRODUCTION

One of the key objectives of any sovereign state is to ensure a high rate of economic goal and to achieve this goal; it continuously changes its policies and introduces various measures from time to time. In pursuance of these goals, India opened up its economy to the world and lifted all the restrictions with a statement on Industrial Policies on 24th June, 19991. The age of globalization witnessed some major trends in the corporate scenario and one of the most promising strategies has been Mergers and Acquisitions (henceforth referred as M&A). The corporate sector all over the world has been restructuring its operations and adopting this consolidation strategy to face the ever growing challenges resulting due to new pattern of globalization. It has gained fresh impetus due to greater integration of national and international markets. With the de-regulation of various government policies as a facilitator of the neo-liberal economic regime the scale of such operations has also been growing. M&A is one of the mechanisms by which firms gain access to new resources through resource redeployment, thus ensuring increase in revenues and reduction in costs. The Indian evidence suggests that the new economic environment of the nineties had facilitated M&As. Firms belonging to the same business groups operating in similar product-lines appeared to dominate the merger wave in India. The participation of foreign controlled firms in the M&As process had increased significantly during the second half of the nineties. Indian corporate enterprises are refocusing in the lines of core competence, market share, global competitiveness and consolidation. The immediate effects of the mergers and acquisitions have also been diverse across the Indian IT and ITES and other sectors of the Indian economy which have proved their potential in the global market. Previously, foreign firms were satisfying their market expansion strategy through the setting up of wholly owned subsidiaries in overseas markets (Jones, 2005), which later became a 'second best option' since it involved

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much time and effort unsuitable for the present global scenario. Given this broad perspective, present study is a re-examination of the performance of certain companies in the post liberalization era of the Indian corporate picture which have taken up M&A as a possible tool of corporate restructuring. The paper is divided into five sections, each dealing with a specific aspect of the study. The first section is the literature review which discusses the previous studies that have been done on this topic. The papers mentioned in here have tried to capture the causal-effect relationship of mergers and other restructuring activities on the performance of the firm. The next section enumerates the different theoretical concepts and ideas which form the fundamental basis of the study and takes the study further. The third section deals with the research design of the paper which forms the elemental block for the next section i.e. the data analysis. Both these sections are the key essence of the paper and establish the purpose of the paper. The next section is an extension of the analysis portion and states the different results of the analysis and presents the concluding remarks along with a brief interpretation. The final section mentions the further areas where the study can be extended.

PAPER REVIEWS

There has been extensive research in this area and the following papers try to bring into focus the various inferences that have been drawn by the papers and enumerate the different school of thoughts regarding the M&A activity. The papers examine both the performance of the acquiring firms and the target firms.

One of the earliest studies in this area has been done by **Healy Palepu and Rubak (1990)** who studied 50 major public industrial firms. This paper compared the operating performance through accounting data even though it was considered that the accounting data is an imperfect measure, as it can be affected by managerial decisions. The pre –tax operating cash flows of the company was also considered and therefore the industry performance was used as a benchmark for the post merger improvement in the firm. The firms mainly use purchase method of transaction. Again post acquisition earnings are also effected by method of financing i.e. if it is a debt financing or a cash financing, but since the operating income had been used (before interest payments and short term investment incomes further deflated by market value of assets), the choice of financing was not a detrimental factor for measurement. Most importantly, they had excluded the change in equity values of the target and acquiring firms at the merger announcement from the asset base in the post-merger year. Also, the industry adjusted results proved that there was an improvement in the post merger performance, whereas the unadjusted results give a diametrically opposite view. The "industry related" has also been checked for any anomalies. There was evidence that the pension per employee had declined after the merger. The overall findings suggested that the operating performance had improved after the merger. Also, the results showed that the post merger operating cash flows did affect the abnormal stock returns. Another vital observation was that stock price reaction to mergers were driven by anticipated economic gains alter the merger.

Another paper by Andrade**, Mitchell & Stafford (2001)** mainly expressed that the merger was clustered in a particular industry. This paper also tried to capture the merger effects of the publicly traded shares of the US firms. Here both the target and acquirer were US concerns. The merger studies concentrated around the type of merger and evidences showed that method of

merger in 1980 was different from 1990, the latter being done through stock purchases. The hostile takeovers are non-existent in the 1980's. In case of a particular industry, it was observed that mergers happened in a wave i.e. for one decade they were active and in another they were dormant. Another key reason was deregulation which brought down the barriers to trade. This paper was able to bring out the evidences that the event studies were used for three days before and after the merger. The relation is positive and suggested that merger create value for the shareholders but the target firm shareholders enjoyed a bigger positive return from the merger activity. According to this paper, a target firm shareholder would earn a return equal to earnings in a 16 month period within that three day event window. This paper also suggested that the method of financing the merger should be considered. It was observed that the target firms performed positively if there was no equity financing. The combined performance of stocks with equity financing does not outgrow the same, if done though non-equity financing. If the long term returns from the mergers were considered, then this paper suggested that the mergers of the small acquirers happened to be the most robust of all. According to the paper the previous studies were not able to precisely enumerate the amount of abnormal returns from the merger and the time frame considered was also not sufficient. The study also revealed that the factor efficiency increased after the merger, if the basis of consideration was productivity. Some researchers argued that the mergers created value for only the target firms as there was proper resource allocation and optimum utilization. Ultimately, it showed that there was zero or negligible difference between the merger decision performance and performance through any other investment decisions.

Another paper **Saboo & Gopi (2009)** aimed at reviewing the operating performance of firms advancing the M&As path for their expansion plans in the Indian corporate scenario post 2000. It was also an attempt to test whether there were any variations in the outcome due to mergers in domestic market as compared to those in overseas market. The results of the analysis show that the performances of the acquiring firms have been impacted negatively after the foreign merger. The decrease in observed when the results are analyzed for performance ratios of pre and post 1-year of merger and pre and post 2 –years of mergers. The hypothesis that Merger of cross – border firms has improved the operating performance of the acquiring firm was rejected. Another point which has emerged from the analysis is that merger has different effect when a domestic firm is acquired or when a cross- border firm is acquired. Therefore, the hypothesis that Merger effect does not depend on whether it is cross border acquisition or domestic acquisition is also rejected. There are certain limitations of the study and the different samples are not of the same characteristics. Another factor which may cloud the real effect is that the sample period is 2000-2007 and there have been two bubble bursts- the dot com bubble and the real- estate bubble during this time frame.

The paper by **Saraswathy (2010)** focuses on the merger wave in the overseas economies where the M&A is the favorite mode of corporate restructure as compared to Greenfield investment. The paper uses firm level data for identifying three distinct phases of merger activity of India. The pre mid 1990s merger scenario was dominated by domestic deals, followed by an increasing number of cross-border deals within the country since the mid 1990s. Finally, the last stage of overseas deals during the post 2000 period shows that the economy is shaping gradually for merger motives. The study shows that the service sector mergers are the major force of the world FDI movement. It was concluded that 35% of the mergers and acquisitions deals occurred in

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India during 1978 to November 2007 were cross-border. It significantly increases only after mid 1990s. Sector-wise, manufacturing has been the largest seller, whereas the service sector made the majority of the purchases. The share of primary sector share remained to be insignificant. Within manufacturing, Drugs and Pharmaceutical industry, other chemicals, domestic appliances, automobiles were the dominant sectors and within services it was banking and finance. The value analysis shows that majority of the deals were small but there was a considerable number of mega deals which accounted for the 87% of the value involved. Another interesting dimension of M&A scenario is the recent increase both in terms of number and value of the acquisitions by the Indian companies as a part of their market expansion strategy. They account for a much higher share than the inbound deals. This phenomenon emphasizes the acquisition spree of the Indian firms. During the time span of 1994 to November 2007, there were 563 such deals of which the majority took place after 2000. A gradual shift from foreign investment to Brownfield investment can be observed which would eventually lead technology spillovers and thereby higher productivity and efficiency. The incidence of large number of horizontal deals principally the cross-border deals raises another issue -foreign control. The data also shows that maximum of the deals are mega deals and are frequently engaging in consolidation strategies in order to grow faster. Thus the current rush in cross-border deals should be viewed in a multi-factor dimension involving the push factors from home country such as market constraint, need for low priced factors of production, increasing global competition as well as the pull factors from foreign countries such as the wider market, technology, efficient operation.

The last paper included in this study is by **Rani, Yadav and Jain (2013)** compares performance of the corporates involved in M&A before and after M&A. The key hypothesis is that acquiring firms have improved post-M&A operating performance. The empirical evidence validates the hypothesis that Indian acquirers have performed better after M&A, compared to their performance in pre-M&A period. The study indicates that M&A appear to have been beneficial for the acquiring companies in the long-run with regard to their operating performance. The findings suggest that profitability of acquiring firms has improved during post-M&A phase. Mergers and acquisitions have resulted to better and improved performance. However, mergers and acquisitions have not resulted improvement in assets turnover ratios, as initially there might not be increase in sales and any consequently, further improvement in combined capacity utilization may not be possible. Therefore, assets turnover ratio improves slowly. It appears that global recessionary conditions in the year 2008 resulted in low assets turnovers of acquiring firms.

THEORETICAL FRAMEWORK

Business firms engage in a broad range of activities including expanding, shrinking and otherwise restructuring asset and ownership structures. The various activities may be grouped into the following categories:

- Expansion-Mergers and acquisitions, Tender Offers and Joint ventures
- Sell-offs-
    - Spin-offs: Split-offs and Split-ups
    - Divestitures: Equity carve-outs

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- Corporate control: Premium buy-backs, Standstill agreements, Antitakeover amendments and Proxy contests.
- Changes in ownership structure: Exchange offers, Share repurchases, going private and leveraged buy-outs.

The terms Merger, Acquisition and Takeovers are used interchangeably but they all have different meaning and various legal impacts on the firms participating in such restructuring activities.

Amalgamation- This can be through merger of companies pertaining to the provisions of the Companies Act. Acquisitions can be through takeovers which are governed by SEBI. In case of cross border transactions, international tax considerations also arise. Amalgamation signifies the transfer of all or some part of the assets and liabilities of one or more existing companies to another existing company(s) or to a new company of which the transferee company or all the members of the transferor company(s) become, or have the rights of becoming, members. In most cases such amalgamation is coupled with voluntary winding –up of the transferor company(s).Under an Amalgamation, merger or takeover, two or more companies are merged *de jure* through consolidation of their undertakings or *de facto* through acquisition of their controlling interest in the share capital of one by the other or of the capital of both by the new company.

Merger- From the perspective of business structures, there can be a number of categories. According to the relationship between the two companies that are merging mergers are of the following types:

- Horizontal merger – it involves two firms operating in the same kind of business activity. Two companies that are directly competitive sharing same product lines and markets may merge together.
- Vertical merger – this merger involves different stages of production operations. For example merger might take place between a customer and company or a supplier and company.
- Conglomeration – This involves firms engaged in unrelated type of business activity. When two companies that have no common business areas merge together, it is called conglomerate merger. There are mainly three types of conglomerate mergers which are as discussed below:
    - Geographic Market-extension merger – involves two firms whose operations have been conducted in non-overlapping geographical areas.
    - Product-extension merger –this merger broadens the product lines of the firm. Two companies selling different but related products in the same market might merge.
    - Pure conglomerate merger- involves unrelated business activities that would not qualify as either product-extension or market-extension mergers.

According to the financing methods, mergers may be categorized into the following. Each has certain implications for the companies and the investors involved:

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- Purchase Mergers - This kind of merger occurs when one company purchases another and the purchase is made with cash or through the issue of some kind of debt instrument. In this case the sale is taxable under law. Acquiring companies often prefer this type of merger since it ensures them tax benefit. Acquired assets are written-up to the actual purchase price. The difference between the book value and the purchase price of the asset is shown as annual depreciation thereby reducing the total tax liability of the acquiring firm.
- Consolidation Mergers – This form of merger brings into existence a brand new entity with both the firms combining into this new firm. Tax terms are identical to the purchase merger.

Acquisition- When a company takes over another one and establishes itself as the new owner, the purchase is called an acquisition. Legally, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded on the exchange.

Types:

- *Asset acquisition:* The acquirer buys some or all of the target's assets/liabilities directly from the seller. If all assets are acquired, the target is liquidated.
- *Stock acquisition:* The acquirer buys the target's stock of from the selling shareholders.
- *Management Buy-out:* It is occurred when the firm is acquired by its own management or by a group of investors, usually with a tender offer.
- *Leveraged buy-outs:* It is nothing but management buy-out with a small variation.
- *Friendly acquisition:* Where the managers of the target firm welcome the acquisition.
- *Hostile acquisition:* Where target firm's management does not want to be acquired.

RESEARCH DESIGN

This section of the paper focuses on the brief background of the deals that have been considered for the study. The fundamental objective of the paper has been mentioned along with the scope of the study. The paper is an attempt to understand the performance of companies which have taken up the merger tool as a restructuring strategy.

✓ ***Background:***

In 2007, there was a huge surge in M&A deals with the valuation shooting up from Rs. 865bn to Rs. 1,576 bn in 2007, a mammoth increase of 82%. The increasing interest of MNEs in financial services, advertising, travel agencies and other business services had been notable. Consumer goods industries such as food and beverages, household appliances, pharmaceuticals and personal care products, automobiles and the like had a high concentration of MNE-related deals. The deals relating to MNEs had been predominantly horizontal rather than vertical in nature. Given this picture, JSW Steel had merged with Southern Iron & Steel Company Limited. Their exchange ratio was 1:22. The other company considered in this paper is Steel Authority of India Limited (henceforth referred as SAIL) which had taken up Indian

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Iron & Steel Company (henceforth referred as IISCO), a 100% subsidiary. The restructuring took place in 2006.

✓ ***Objective:***

- The main objective that the paper focuses on is the post merger operating performances of two firms that have merged with companies of the same sector.
- It is a horizontal merger in both the cases and the data has been selected in a way so that two years before the event date and seven years post the merger the company financials have been considered for the study. The data includes the current performance of both the companies; beyond the initial seven years post the merger date. The major analysis tool has been ratio analysis and leverage comparison. The study uses comparative charts and statistics for understanding the behavior of companies post the merger era.

✓ ***Scope of the study*:**

The study is limited to pharmaceutical sector only and the data has been considered for only two firms in the mentioned sector.

✓ ***Data Set:***

The data set includes the company financials for the time frame of 2006-2015 for JSW steel and 2001-2015 for Steel Authority of India Limited. The merger took place in 2007 and 2004 for JSW Steel and SAIL respectively.

ANANLYSIS

The two companies that have been included in this study both belong to the same sector and they have taken up the merger activity at a fairly later part of the merger wave that was prevailing in the Indian economy post the opening up of the economy in 1991. It can be said that these two mergers were not a result of the huge surge of merger deals that was sweeping over the Indian corporate in the late 90's or the initial turn of the millennium. Taking up each of the company for discussion, it can be seen that both of them had long thought about the merger and then took up this strategy as a restructuring tool. SAIL took up IISCO, its 100% subsidiary since it was an ailing organization and its capacity was not optimally utilized. JSW Steel also has location advantages for taking up Southern Iron & Steel Company Limited. The mergers were duly declared and they were of friendly nature. There was no resistance from the target company in both the cases. Yet the analysis of the financials reveal completely opposite results for the two companies. The reasons of such may be attributed to a number of factors and is mainly due to the fact that SAIL had acquired a subsidiary whereas SISICOL was an independent organization. The ratios considered for this analysis are Gross Profit ratio, Net Profit ratio, Debt-Equity ratio, fixed assets turnover ratio, Return on Capital Employed, Return on Equity. Also some of the key figures of the financial statements have been compared considering few elements which have a major impact on the company performance over the years. The ratios considered in this study have tried to capture the effects of the merger activity of the two companies.

- *Gross profit and Net Profit:* The basic reason for a firm to acquire another one would be an increase in its operating profit. The gross profit and net profit ratios would provide a clear picture of the profit. The G.P ratios for both SAIL and JSW steel have revealed quite a dynamic result. The gross profit and net profit margins are a percentage w.r.t the total turnover. The merger took place in 2007 and was exercised from 2008. The ratio has shown no improvement in absolute terms. If a marginal increase is considered, that is also absent in this case. Over the subsequent years, the ratio has no signs of improvement. In case of SAIL, the ratios are marginally better and the post merger era has seen a much better performance of the company. Another important observation is that over the years the gross profit ratio has remained fairly high as compared to the pre-merger era. The average increase in the year of the merger is more than 100% and has remained so over the next year. Even though the year immediate to the merger year has shown positive results, yet the subsequent years did not prove to be greatly beneficial to the merged firm. The last decade has again shown a very average gross profit within a bracket of 10% to 20% of its sales turnover *(Table I &II*). In case of net profit, the basis of calculation is similar to gross profit and the two companies have not shown any major variations from gross profit. For JSW Steel there are traces of imbalance in the relation between G.P. and N.P. ratios. The merger year witnessed a huge margin of both the operating profits. Subsequently, the years later the gross profits have not shown any quantum jump due to the merger announcement. The net profits have similar results. The net profit levels have plummeted from 14.92% to 3.23% and have never recovered in the entire study tenure *(Table II&IV).*
- Fixed Assets Turnover Ratio: This ratio is a measure of the average performance of the sales as a percentage of assets. For any firm resorting to merger as a restructuring strategy, this ratio would indicate the marginal increase in turnover due to the fresh block of assets getting pumped into the working cycle of the firm.
    - ✓ SAIL: this ratio was performing at an average of 0.9% in the pre merger years and it enjoyed a huge increase in the post-merger years with the average at 2.37%, a more than double increase in the figures.
    - ✓ JSW Steel: this company shows a more contrasting performance. The ratio has not improved much after the merger and maintained a very tight average. Even though the merger year had witnessed a very huge increase in the ratio, yet if failed to maintain the achieved level and was seen performing averagely in the subsequent years(Table *(V& VI).*
- Debt/Equity Ratio: Another very crucial ratio which plays a decisive role for managers in formulating any financial policy for an organization is the debt-equity ratio. This is a measure of the leverage of the firm in relation to its owned funds(*(Table VII & VIII).*
    - ✓ SAIL: IN this company, the ratio was very high in the event year at 5.14. In the succeeding years in the post merger era, it reduced and gained a more balanced level at 1.72. even though it was more than the optimum levels of 0-1, yet it was stronger than the merger year.

- ✓ JSW Steel: for this company, the ratio has remained at equilibrium and has not shown any signs of fluctuations. The average has been around 1. The merger year has a comparatively low D/E ratio. Post the merger date the ratio remained very much a particular range. This shows that unlike SAIL, which showed extremely positive response to the merger, this entity has not been able to reflect much improvement due to merger. Whatever growth has happened is due to formal demand function and price level changes.

- *ROCE and RONW*: ROCE reveals the overall efficiency within which the firm is operating. The formula being *Profit/ capital employed*. ROE indicates how well the firm has used the resources of the owners. The formula being *PAT/ NW.* Both the ratios have shown positive performance in the post merger years. The three-year window immediately after the merger has seen a consistent growth in the ratios.*(Table IX to XII)*
- *Operating profit margin*: It is the ratio which reveals the operating efficiency of the firm. The formula is - (Cost of goods sold+ operating expenses)/ net sales. Both the companies have shown positive results yet the performance of SAIL is much more robust as compared to JSW steel *(Table XIII & XIV).*
- *EPS:* Earnings per share may be defined as portion of a company's profit allocated to each outstanding share of common stock. It serves as an indicator of a company's profitability. The formula is – Net income-Preference Dividend/ outstanding shares. The performance of EPS in the post merger era for both companies has improved but SAIL has consistently shown better returns as compared to the other company *(Table XV & XVI).*

CONCLUSION:

The above ratios have suggested that both the companies have performed marginally well in the post merger era but the performance of SAIL has be comparatively better than that of JSW steel. The merger has proved to be profitable for SAIL but not so much for the other firm. The synergistic benefit of 2+2=5 has not been achieved in the latter case. It is observed that even though the operating performance has improved over the years yet there is not a significant change in the EPS of the companies. The shareholders have not gained out of the restructuring activity and there has been no growth due to the merger.

Further Scope of Study:

This paper can be further extended where the companies considered can be much widely distributed in the different sectors of the economy. In addition to that, the study can be extended by considering the pre and post merger statistical analysis of the firms.

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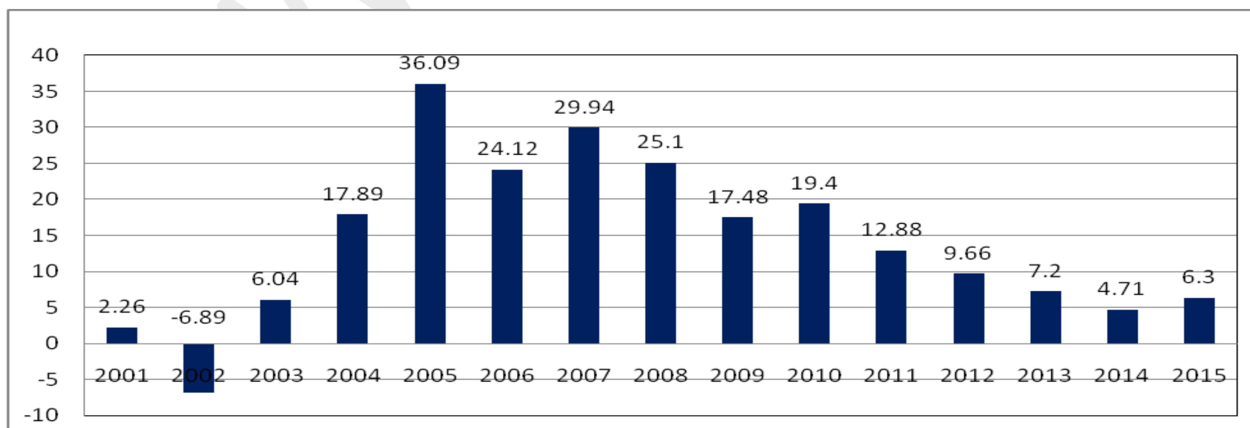

TABLE 1- SAIL Gross profit ratio

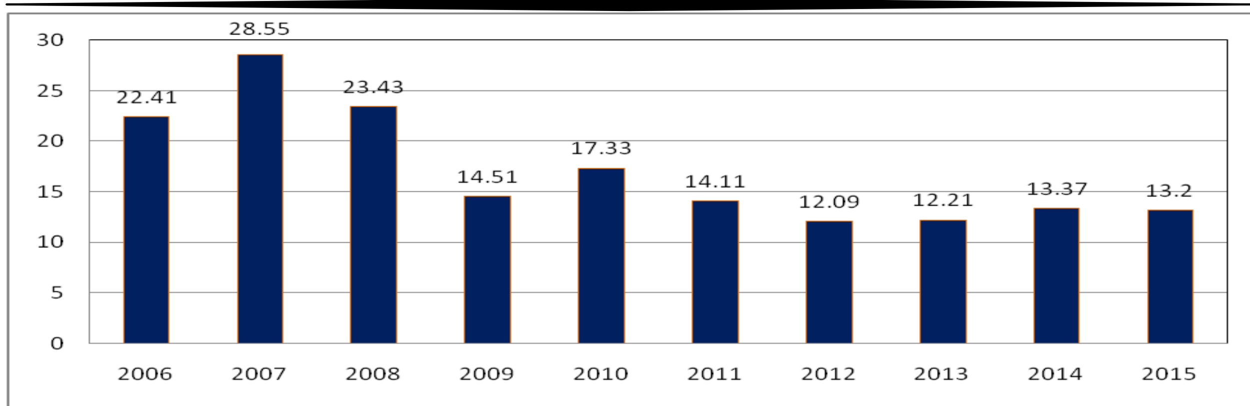

TABLE II- JSW Steel Gross profit ratio

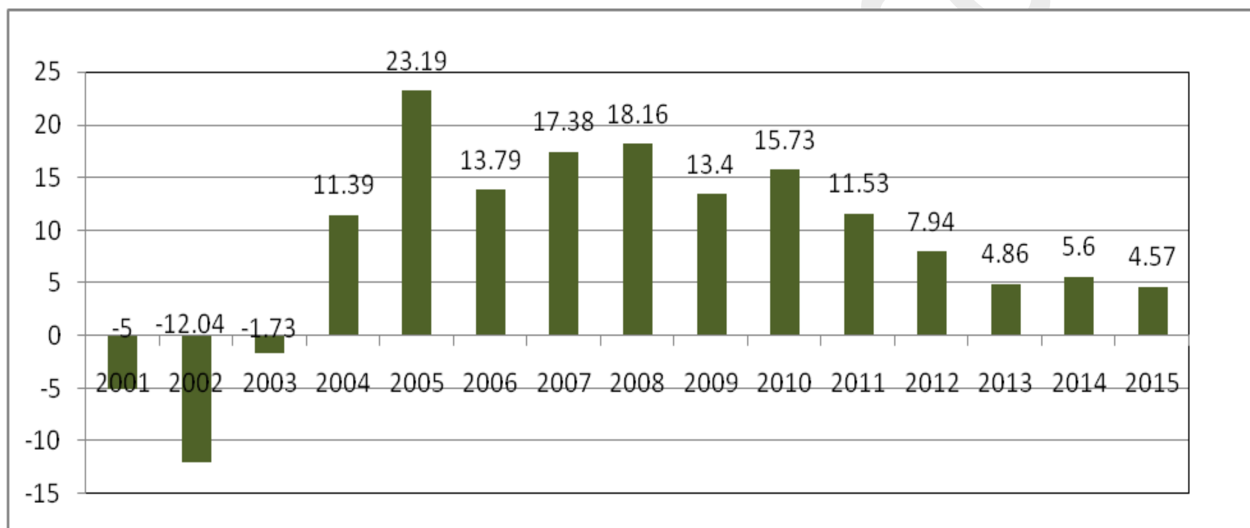

TABLE III- SAIL net profit ratio

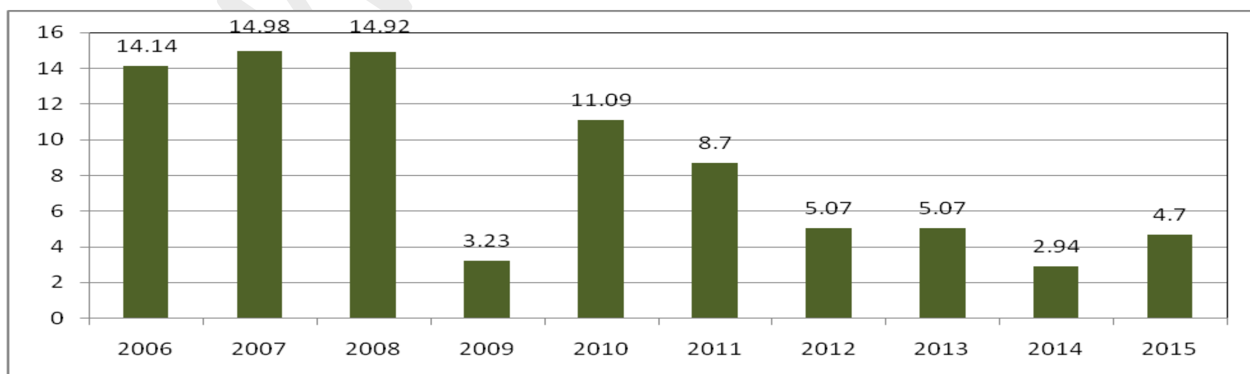

TABLE IV- JSW Steel net profit ratio

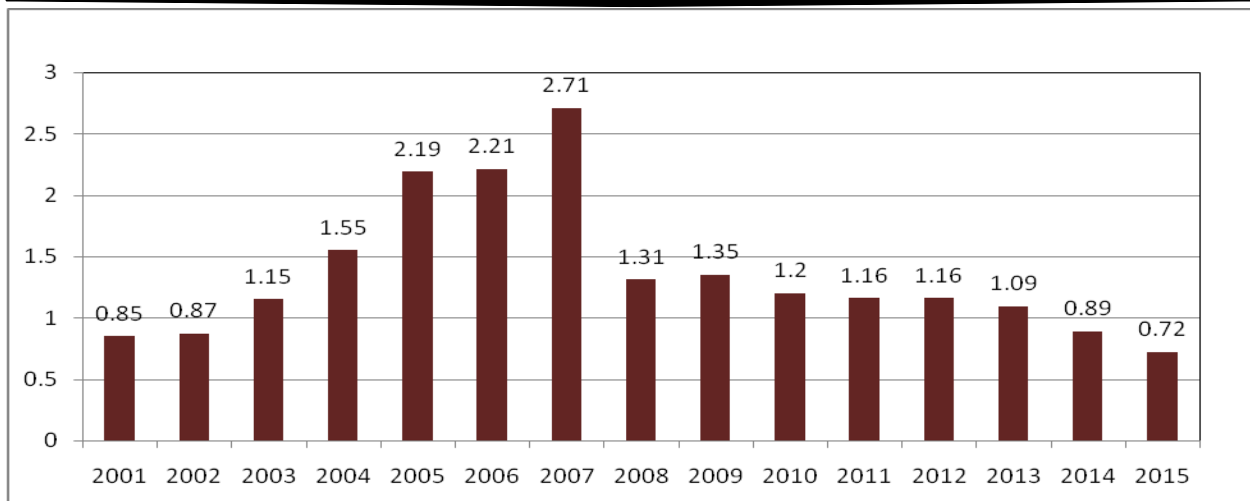

TABLE V- SAIL fixed asset turnover ratio

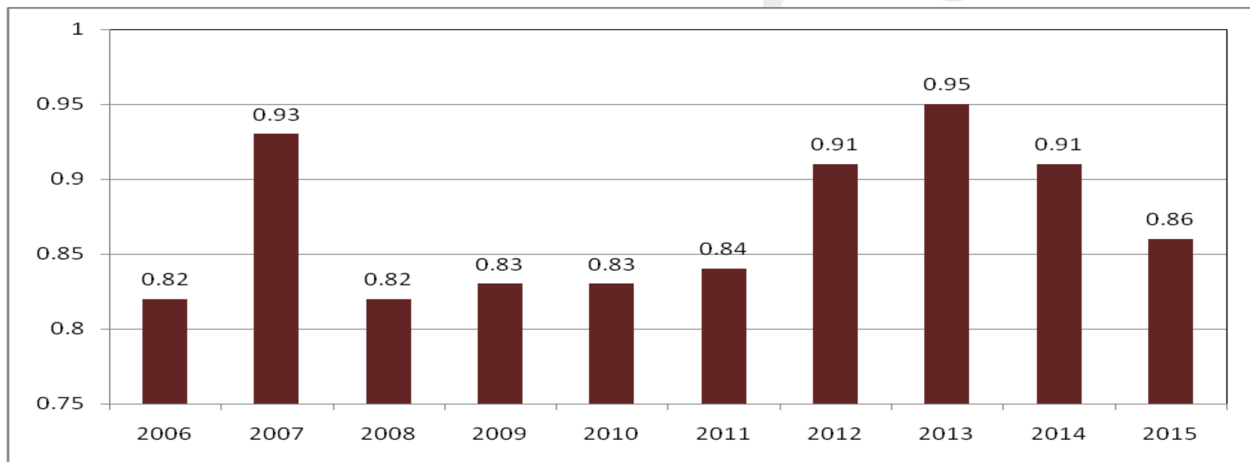

TABLE VI- JSW Steel fixed asset turnover ratio

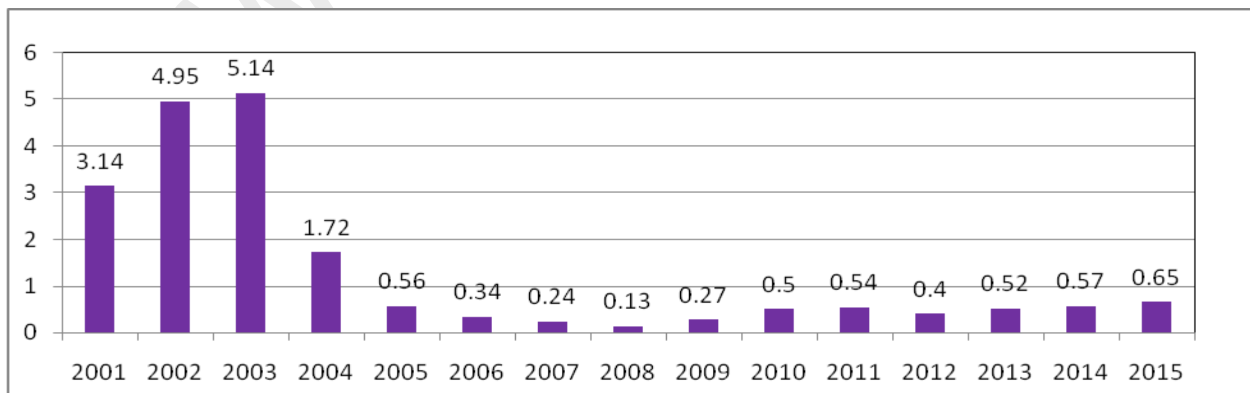

TABLE VII- SAIL debt equity ratio

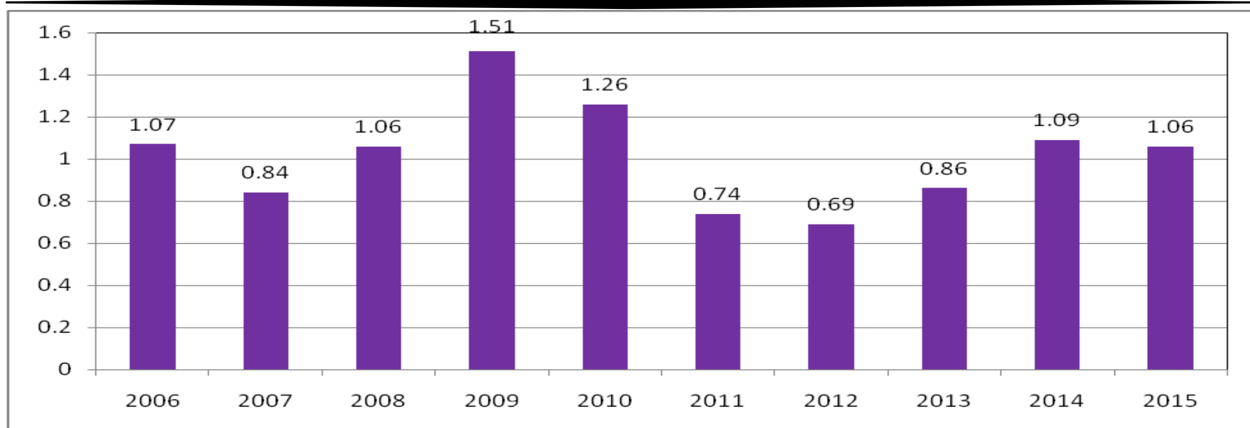

TABLE VIII- JSW Steel debt equity ratio

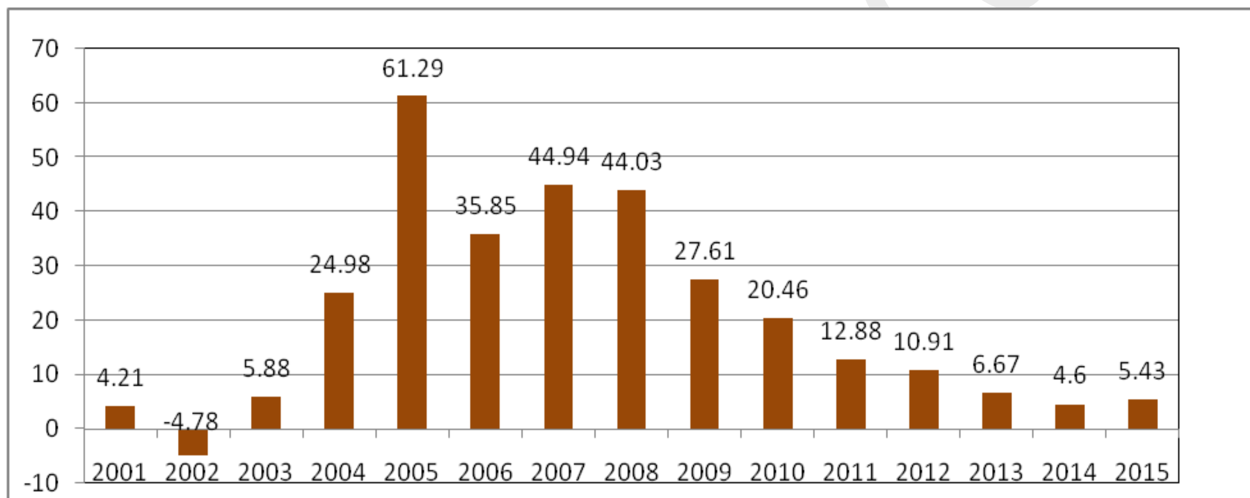

TABLE IX- SAIL ROCE

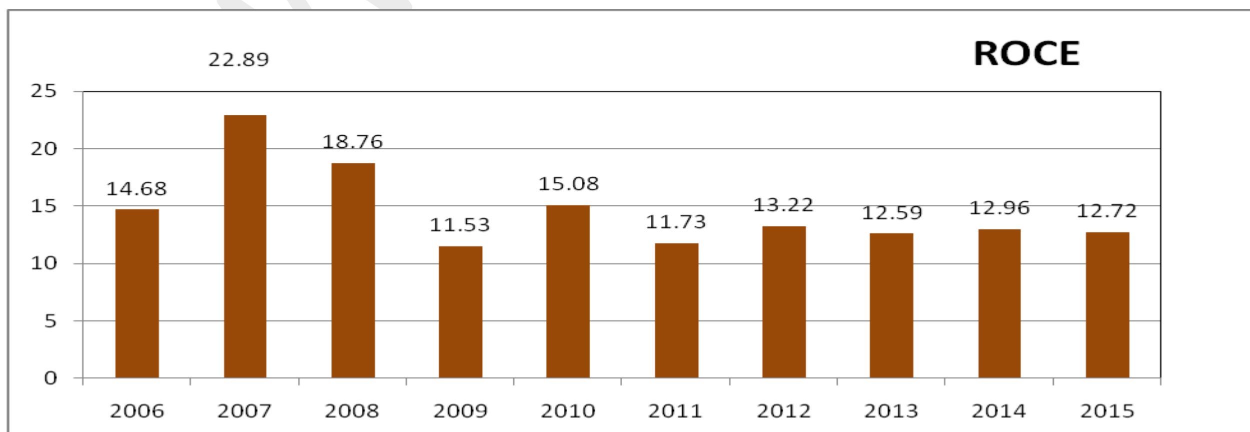

TABLE X- JSW Steel ROCE

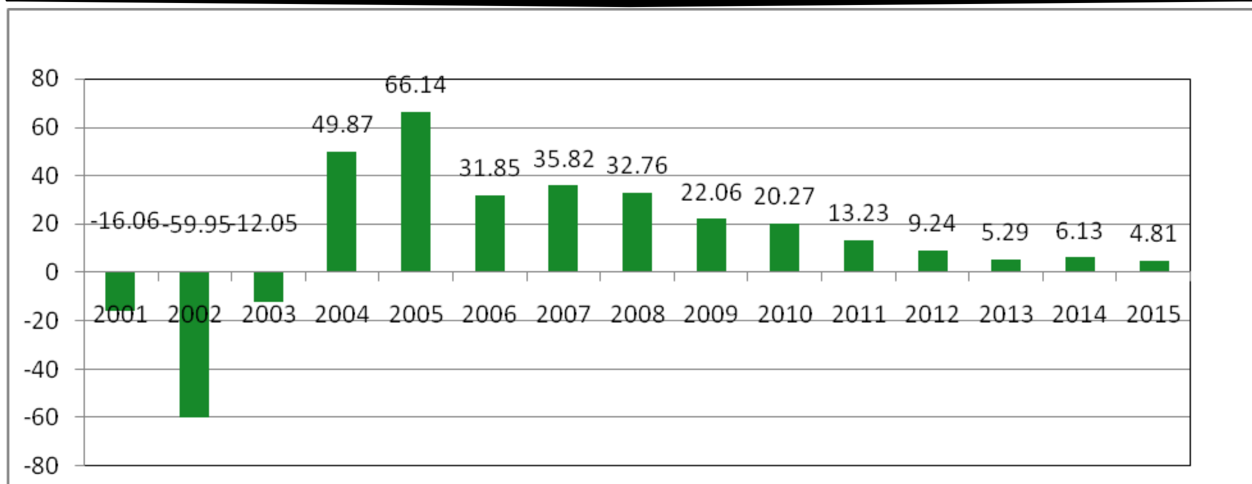

TABLE XI- SAIL RONW

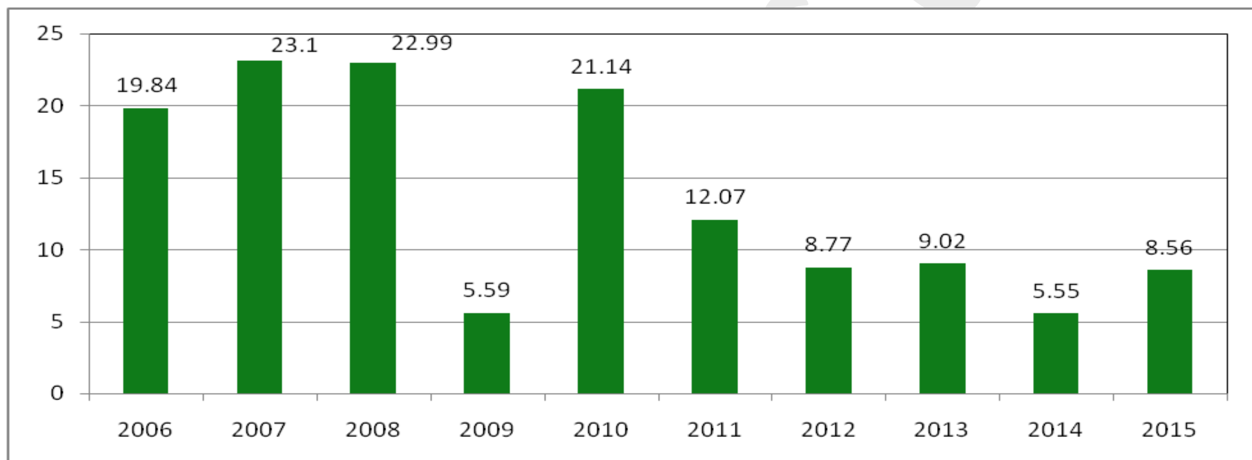

TABLE XII - JSW Steel RONW

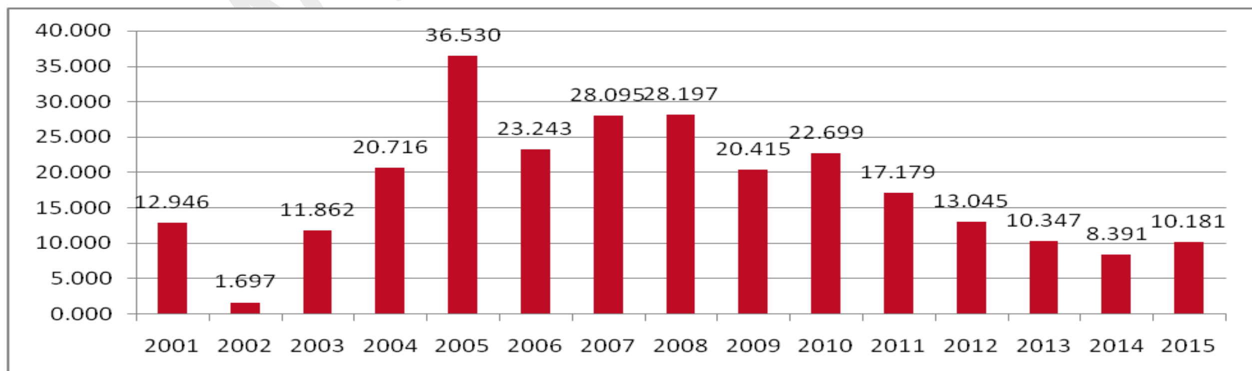

TABLE XIII- SAIL operating profit margin

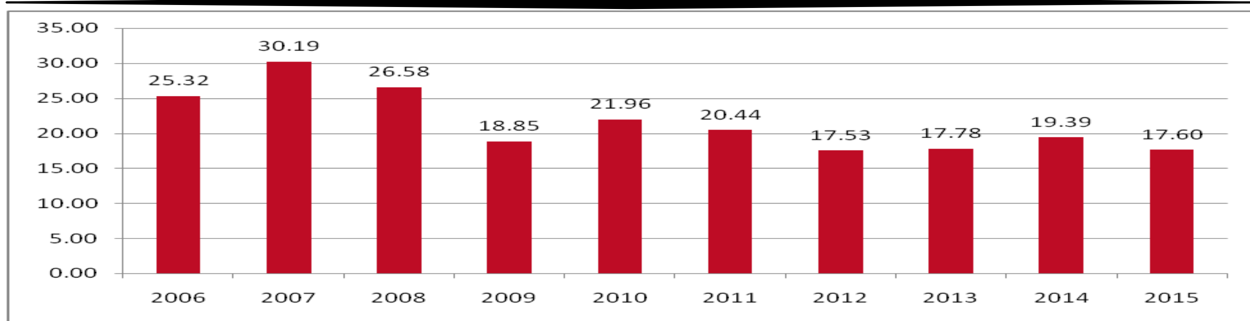

TABLE XIV - JSW Steel operating profit margin

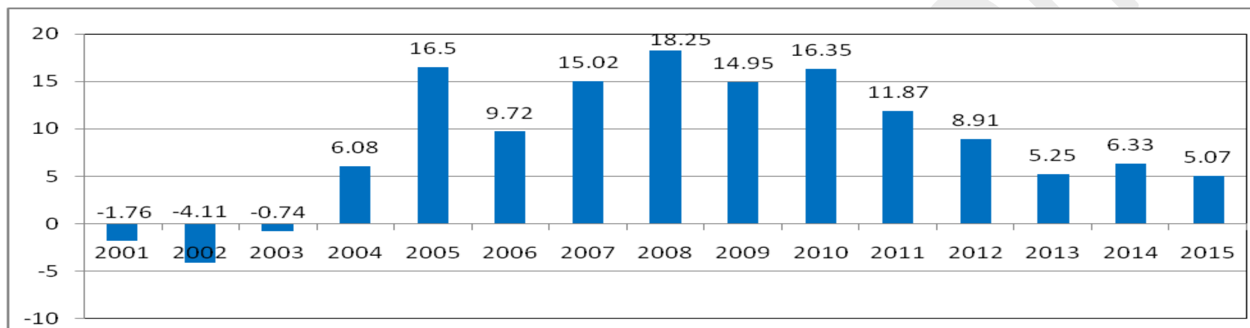

TABLE XV - SAIL EPS

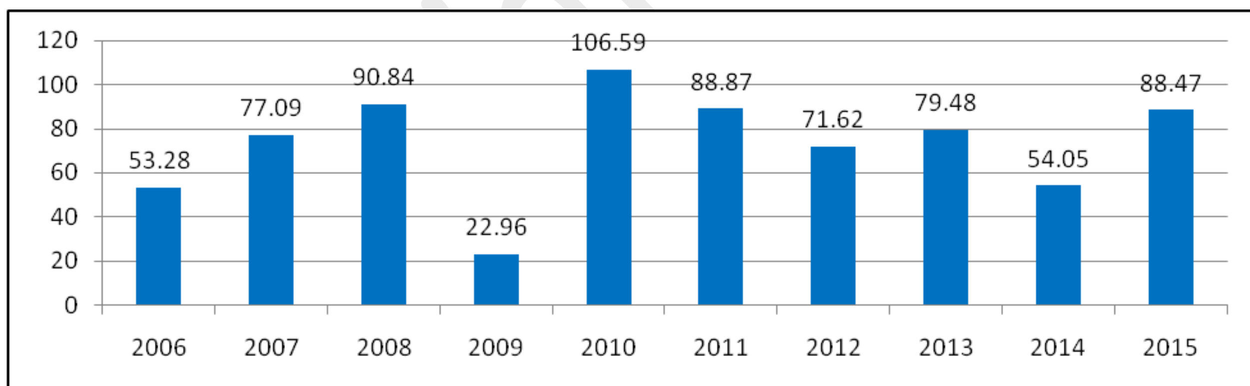

TABLE XIV - JSW Steel EPS