UNIT 10 GROWTH STRATEGIES-II

Objectives

The Objectives of this unit are to:

- acquaint you with the various diversification strategies;
- explain the reasons for pursuing diversification strategies;
- explain the various routes to diversification;
- make clear the mechanics of M&A and the basic steps involved in M&A;
- explain the rationale behind M&A;
- identify the attributes of successful and effective acquisitions; and
- provide you with a brief overview of the M&A scenario in India.

Structure

10.1 DIVERSIFICATION

Diversification involves moving into new lines of business. When an industry consolidates and becomes mature, most of the firms in that industry would have reached the limits of growth using vertical and horizontal growth strategies. If they want to continue growing any further the only option available to them is diversification by expanding their operations into a different industry. Diversification strategies also apply to the more general case of spreading market risks: adding products to the existing lines of business can be viewed as analogous to an investor who invests in multiple stocks to "spread the risks". Diversification into other lines of business can especially make sense when the firm faces uncertain conditions in its core product-market domain.

While intensification limits the growth of the firm to the existing businesses of the firm, diversification takes it beyond the confines of the current product-market domain to uncharted and unfamiliar products- market territory. In other words, this strategy steers the organization away from both its present products and its present market simultaneously. Of the various routes to expansion, diversification is definitely the most complex and risky route. Diversification approach to expansion is complex since it seeks to enter new product lines, processes, services or markets which involve different skills, processes and knowledge from those required for the current bussiness. It is risky since it involves deviating from familiar territory: familiar products and familiar markets.

Diversification of a firm can take the form of concentric and conglomerate diversification. Concentric (Related) diversification is appropriate when a firm has a strong competitive position but industry attractiveness is low. Conglomerate (unrelated) diversification is an appropriate strategy when current industry is unattractive and that the firm lacks exceptional and outstanding capabilities or skills in related products or services. Generally, related diversification strategies have been demonstrated to achieve higher value creation (profitability and stock value) than unrelated diversification strategies (conglomerates). The interpretation of this finding is that there must be some advantage achieved through shared resources, experience, competencies, technologies, or other value-creating factors. This is the so called synergy effect of diversification i.e., ‘the whole is greater than the sum of its parts’. While it is difficult to predict what is a “synergistic” match of a business to an existing corporate portfolio, the test must be that the business creates new value when it is added to a corporation’s line of existing businesses.

10.2 RELATED DIVERSIFICATION (CONCENTRIC DIVERSIFICATION)

In this alternative, a company expands into a related industry, one having synergy with the company’s existing lines of business, creating a situation in which the existing and new lines of business share and gain special advantages from commonalities such as technology, customers, distribution, location, product or manufacturing similarities, and government access. In essence, in concentric diversification, the new industry is related in some way to the current one. This is often an appropriate corporate strategy when a company has a strong competitive position and distinctive competencies, but its existing industry is not very attractive. Thus, a firm is said to have pursued concentric diversification strategy when it enters into new product or service area belonging to different industry category but the new product or service is similar to the existing one with respect to technology or production or marketing channels or customers. Such diversification may be possible in two ways: internal development through product and market expansion utilizing the existing resources and capabilities or through external acquisitions operating in the same market space. Addition of lease financing activity in India is a case of market-related concentric diversification. Another type of concentric diversification is technology related in which the firm employs similar technology to manufacture new products. Addition of tomato ketchup and sauce to the existing ‘Maggi’ brand processed items of Food Specialities Ltd. is an instance of technological-related concentric diversification.

10.3 UNRELATED DIVERSIFICATION (CONGLOMERATE DIVERSIFICATION)

Conglomerate diversification is a growth strategy in which a company seeks to grow by adding entirely unrelated products and markets to its existing business. A company that consists of a grouping of businesses from unrelated streams is called a conglomerate. In conglomerate diversification, a firm generally introduces new products using different technologies in new markets. A conglomerate consists of a number of product divisions, which sell different products, principally to their own markets rather than to each other. Conglomerates diversify their business risk through profit gained from profit centers in various lines of business. However, some may become so diversified and complicated that they are too difficult to manage efficiently. However, since their huge popularity in the 1960s to 80s, many conglomerates have reduced their business lines by restricting to a choice few. The reasons for considering this alternative are primarily to seek more attractive opportunities for growth, spread the risk across different industries, and/or to exit an existing line of business. Further, this may be an appropriate strategy when, not only the present industry is unattractive, but the company also lacks outstanding competencies that it could transfer to related products or industries. However, since it is difficult to manage and excel in unrelated business units, it is often difficult to realize the expected and anticipated results.

In India, a large number of companies diversified their operations following economic liberalization. Gujarat Narmada Valley Fertilizers Ltd. has diversified from fertilizers to personal transport, chemicals and electronic industries, while Arvind group, hitherto confined to textiles, diversified into unrelated activities such as manufacturing of agro- products, floriculture and export of fresh fruits. Likewise, BPL has decided to venture into sectors like power generators, cement, steel and agricultural inputs in a big way. Wipro is another company with wide ranging business interests encompassing vegetable oils, computer hardware, and software, medical equipment, hydraulic systems, consumer products, lighting, export of leather shoe nippers and has recently entered into financial services (*Refer to case study 1 in appendix-2*).

10. 4 RATIONALE FOR DIVERSIFICATION

Under strict assumptions of an efficient market theory, there is no convincing rationale for one company to acquire another, especially less efficient or unrelated businesses. Since the markets are imperfect and do not follow the norms of efficient market theory, companies do diversify for several reasons given below:

Economies of Scale and Scope (Synergy): The merger of two companies producing similar products should allow the combined firms to pool resources and attain lower operating costs. By making optimal use of existing marketing, investment, operating and managerial facilities of the two combining firms and eliminating redundant and overlapping activities, the combined entity can lower the operating costs and increase operational efficiency. The saving may come from reduced overheads or the ability to spread a larger amount of production over lower (consolidated) fixed costs. There may also be differential management capabilities: an efficiently managed firm may acquire a less efficient firm with the intent of bringing better management to the business. Efficiencies can also be gained through pooled financial resources or simply through pooled risk.

Widen Market Base and Enhance Market Power: Large number of collaborations and acquisitions are aimed at expanding the market for the firm's products. For instance, HCL and Hewlett Packard Ltd., Tata-IBM, Ranbaxy Laboratories and Eli Lilly Company, Hindustan Motors and General Motors and Tata Tea and Tetley of

USA, entered into tie-up arrangements mainly to exploit the market opportunities. Mergers and acquisitions can increase a firm's market share when both firms are in the same business. But, market share does not necessarily translate to higher profits or greater value for owners unless the merger substantially reduces the inter-firm rivalry in the industry.

Profit Stability: Acquisition of new business can reduce variations in corporate profits by expanding the company's lines of business. This typically occurs when the core business depends on sales that are seasonal or cyclical. A large number of organizations pursue diversification strategy just to avoid instability in sales and profits which can result from events such as cyclical and seasonal shifts in demand, changes in the life cycles and other destabilizing forces in the micro, meso and macro environment.

Improve Financial Performance: Large firms generate cash that can be invested in other ventures. The firm acts as a banker of an internal capital market. The core business sustains itself on its moneymaking ventures, and uses this cash flow to create new ventures that generate additional profits. A firm may also be tempted to exploit diversification opportunities because it has liquid resources far in excess of the total expansion needs. Sometimes a company may seek a merger with another organization with the intention of tiding over its financial problems.

Growth: Diversification is basically a way to grow. Indeed, managers often cite growth as the principle reason for diversification. The most important factor that motivates management to diversify is to achieve higher growth rate than which is possible with intensification strategy. If the management feels that the existing products and markets do not have the potential to deliver expected growth, the only alternative they have is to diversify into new territories. Unlike organic growth, which is slow, an acquisition or merger (inorganic) can deliver the results rather quickly since resources, skills, other factors essential for faster growth are immediately available.

Counter Competitive Threats: Organizations are driven at times towards external diversification through merger by competitive pressures. Such a strategic move is expected to counter the competitive threats by reducing the intensity of competition.

Access to Latest Technology: Many Indian firms enter into strategic alliances with foreign firms to gain access to the latest technologies without spending huge amount of money on R&D. For instance, Johnson and Nicholson India Ltd., a leading domestic paint manufacturer, has strengthened its position in the Indian market and also diversified into industrial electronics along with its German partner, Carl Schevek AG of Germany.

Regulatory Factors: A large number of organizations have diversified their operations geographically to exploit opportunities in different regions and countries and also to take advantage of the incentives being offered by the various governments to attract investment. Many companies enter other countries to avoid restrictions placed by the regulators in their host country.

Activity 1

Compare and contrast the strategies of Bajaj group and TVS group. Are they following concentric or conglomerate diversification?

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10.5 ALTERNATIVE ROUTES TO DIVERSIFICATION

Once a firm opts for diversification, it must select one of the options discussed below. There are three broad ways to implement diversification strategies:

Mergers and Acquisitions

A merger is a legal transaction in which two or more organizations combine operations through an exchange of stock. In a merger only one organization entity will eventually remain. An acquisition is a purchase of one organization by another. In recent years, there were quite a few acquisitions in which the target firms resisted the take-over bids. These acquisitions are referred to as hostile takeovers. It is natural for the target organization's management to try to defend against the takeover. Although they are used synonymously, there is a slight distinction between the terms 'merger' and 'acquisition'. This will be discussed more in detail in the later sections.

Strategic Partnering

Strategic partnering occurs when two or more organizations establish a relationship that combines their resources, capabilities, and core competencies to achieve some business objective. The three major types of strategic partnerships: joint ventures, long-term partnerships, and strategic alliances are discussed below:

Joint Ventures: In a joint venture, two or more organizations form a separate, independent organization for strategic purposes. Such partnerships are usually focused on accomplishing a specific market objective. They may last from a few months to a few years and often involve a cross-border relationship. One firm may purchase a percentage of the stock in the other partner, but not a controlling share. The joint ventures between various Indian and foreign companies such Hindustan Motors and General Motors, Hero Cycles with Honda Motor Company, Wipro and General Electric, etc are examples of such strategic partnering.

Long-Term Contracts: In this arrangement, two or more organizations enter a legal contract for a specific business purpose. Long-term contracts are common between a buyer and a supplier. Many strategists consider them more flexible and less inhibiting than vertical integration. It is usually easier to end an unsatisfactory long-term contract than to end a joint venture. A good example is the change in supplier relationships that Chrysler's management undertook after 1989, when it launched the LH project to create a new generation of cars. Supplier relationships are critical at Chrysler since outsourced components constitute about 70 percent of Chrysler's cars, compared to about 50 percent for GM and Ford. Japanese automakers also enter into such arrangements with their vendors frequently.

Strategic Alliances: In a strategic alliance, two or more organizations share resources, capabilities, or distinctive competencies to pursue some business purpose. Strategic alliances often transcend the narrower focus and shorter duration of joint ventures. These alliances may be aimed at world market dominance within a product category. While the partners cooperate within the boundaries of the alliance relationship, they often compete fiercely in other parts of their businesses.

10.6 MERGERS AND ACQUISITIONS (M&A)

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

A corporate merger is essentially a combination of the assets and liabilities of two firms to form a single business entity. Although they are used synonymously, there is a slight distinction between the terms 'merger' and 'acquisition'. Strictly speaking, only a corporate combination in which one of the companies survives as a legal entity is called a merger. In a merger of firms that are approximate equals, there is often an exchange of stock in which one firm issues new shares to the shareholders of the other firm at a certain ratio. In other words, a merger happens when two firms, often about the same size, agree to unite as a new single company rather than remain as separate units. This kind of action is more precisely referred to as a "merger of equals." Both companies' stocks are surrendered, and new company stock is issued in its place. When a company takes over another to become the new owner of the target company, the purchase is called an acquisition. From the legal angle, the 'target company' ceases to exist and the buyer "gulps down" the business and stock of the buyer continues to be traded.

In summary, "acquisition" is generally used when a larger firm absorbs a smaller firm and "merger" is used when the combination is portrayed to be between equals. For the sake of discussion, the firm whose shares continue to exist (possibly under a different company name) will be referred to as the acquiring firm and the firm's whose shares are being replaced by the acquiring firm will be referred to as the target firm. However, a merger of equals doesn't happen very often in practice. Frequently, a company buying another allows the acquired firm to proclaim that it is a merger of equals, even though it is technically an acquisition. This is done to overcome some legal restrictions on acquisitions.

Synergy is the main reason cited for many M&As. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit through staff reductions, economies of scale, acquisition of technology, improved market reach and industry visibility. Having said that, achieving synergy is easier said than done-synergy is not routinely realized once two companies merge. Obviously, when two businesses are combined, it should results in improved economies of scale, but sometimes it works in reverse. In many cases, one and one add up to less than two.

Excluding any synergies resulting from the merger, the total post-merger value of the two firms is equal to the pre-merger value, if the 'synergistic values' of the merger activity are not measured. However, the post-merger value of each individual firm is likely to be different from the pre-merger value because the exchange ration of the shares will not exactly reflect the firms' values compared to each other. The exchange ration is distorted because the target firm's shareholders are paid a premium for their shares. Synergy takes the form of revenue enhancement and cost savings. When two companies in the same industry merge, the revenue will decline to the extent that the businesses overlap. Hence, for the merger to make sense for the acquiring firm's shareholders, the synergies resulting from the merger must be more than the value lost initially.

Different forms of Mergers

There are a whole host of different mergers depending on the relationship between the two companies that are merging. These are:

- **Horizontal Merger:** Merger of two companies that are in direct competition in the same product categories and markets.
- **Vertical Merger:** Merger of two companies which are in different stages of the supply chain. This is also referred to as vertical integration. A company taking over its supplier's firm or a company taking control of its distribution by acquiring the business of its distributors or channel partners are examples of this type of merger.
- **Market-extension Merger:** Merger of two companies that sell the same products in different markets.
- **Product-extension Merger:** Merger of two companies selling different but related products in the same market.
- **Conglomeration:** Merger of two companies that have no common business areas.

Activity 2

Scan The Economic Times, Business Line, Business Standard or any other business daily for news on mergers. Classify the mergers you have come across during your search into various types discussed.

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From the finance standpoint, there are three types of mergers: pooling of interests, purchase mergers and consolidation mergers. Each has certain implications for the companies and investors involved:

Pooling of Interests: A pooling of interests is generally accomplished by a common stock swap at a specified ratio. This is sometimes called a tax-free merger. Such mergers are only allowed if they meet certain legal requirements. A pooling of interests is generally accomplished by a common stock swap at a specified ratio. Pooling of interests is less common than purchase acquisitions.

Purchase Mergers: As the name suggests, this kind of merger occurs when one company purchases another one. The purchase is made by cash or through the issue of some kind of debt investment, and the sale is taxable. Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be "written up" to the actual purchase price, and the difference between book value and purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company. Purchase acquisitions involve one company purchasing the common stock or assets of another company. In a purchase acquisition, one company decides to acquire another, and offers to purchase the acquisition target's stock at a given price in cash, securities or both. This offer is called a tender offer because the acquiring company offers to pay a certain price if the target's shareholders will surrender or tender their shares of stock. Typically, this tender offer is higher than the stock's current price to encourage the shareholders to tender the stock. The difference between the share price and the tender price is called the acquisition premium. These premiums can sometimes be quite high.

Consolidation Mergers: In a consolidation, the existing companies are dissolved, a new company is formed to combine the assets of the combining companies and the stock of the consolidated company is issued to the shareholders of both companies. The tax terms are the same as those of a purchase merger. The Exxon merger with Mobil Oil Company is technically a consolidation.

Acquisitions

As stated earlier, an acquisition is only slightly different from a merger. Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies, and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another—there is no exchanging of stock or consolidating as a new company. In an acquisition, a company can buy another company with cash, stock, or a combination of the two. In smaller deals, it is common for one company to acquire all the assets of another company. Another type of acquisition is a reverse merger, a deal that enables a private company to get publicly listed in a relatively short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise finance buys a publicly listed shell company, usually one with no business and limited assets. The private company reverse merges into the public company and together they become an entirely new public corporation with tradable shares. Regardless of the type of combination, all mergers and acquisitions have one thing in common: they are all meant to create synergy and the success of a merger or acquisition hinges on how well this synergy is achieved. (*Refer to case study-2 in Appendix-2*).

10.7 MERGER AND ACQUISITION STRATEGY

There are a number of reasons that mergers and acquisitions take place. These issues generally relate to business concerns such as competition, efficiency, marketing, product, resource and tax issues. They can also occur because of some very personal reasons such as retirement and family concerns. Some people are of the opinion that mergers and acquisitions also occur because of corporate greed to acquire everything. Various reasons for M&A include:

Reduce Competition: One major reason for companies to combine is to eliminate competition. Acquiring a competitor is an excellent way to improve a firm's position in the marketplace. It reduces competition and allows the acquiring firm to use the target firm's resources and expertise. However, combining for this purpose is as such not legal and under the Antitrust Acts it is considered a predatory practice. Therefore, whenever a merger is proposed, firms make an effort to explain that the merger is not anti-competitive and is being done solely to better serve the consumer. Even if the merger is not for the stated purpose of eliminating competition, regulatory agencies may conclude that a merger is anti-competitive. However, there are a number of acceptable reasons for combining firms.

Cost Efficiency: Due to technology and market conditions, firms may benefit from economies of scale. The general assumption is that larger firms are more cost-effective than are smaller firms. It is, however, not always cost effective to grow. Inspite of the stated reason that merging will improve cost efficiency, larger companies are not necessarily more efficient than smaller companies. Further, some large firms exhibit diseconomies of scale, which means that the average cost per unit increases, as total assets grow too large. Some industry analysts even suggest that the top management go in for mergers to increase its own prestige. Certainly, managing a big company is more prestigious than managing a small company.

Avoid Being a Takeover Target: This is another reason that companies merge. If a firm has a large quantity of liquid assets, it becomes an attractive takeover target because the acquiring firm can use the liquid assets to expand the business, pay off shareholders, etc. If the targeted firm invests existing funds in a takeover, it has the effect of discouraging other firms from targeting it because it is now larger in size, and will, therefore, require a larger tender offer. Thus, the company has found a use for its excess liquid assets, and made itself more difficult to acquire. Often firms will state that acquiring a company is the best investment the company can find for its excess cash. This is the reason given for many conglomerate mergers.

Improve Earnings and Reduce Sales Variability: Improving earnings and sales stability can reduce corporate risk. If a firm has earnings or sales instability, merging with another company may reduce or eliminate this provided the latter company is more stable. If companies are approximately the same size and have approximately the same revenues, then by merging, they can eliminate the seasonal instability. This is, however, not a very inefficient way of eliminating instability in strict economic terms.

Market and Product Line Issues: Often mergers occur simply because one firm is in a market that the other company wants to enter. All of the target firm's experience and resources are readily available of immediate use. This is a very common reason for acquisitions. Whatever may be the explanation offered for acquisition, the dominant reason for a merger is always quick market entry or expansion . Product line issues also exert powerful influence in merger decisions. A firm may wish to expand, balance, fill out or diversify its product lines. For example, acquisition of Modern Foods by Hindustan Lever Limited is primarily related product line.

Acquire Resources: Firms wish to purchase the resources of other firms or to combine the resources of the two firms. These may be tangible resources such as plant and equipment, or they may be intangible resources such as trade secrets, patents, copyrights, leases, management and technical skills of target company's employees, etc. This only proves that the reasons for mergers and acquisitions are quite similar to the reasons for buying any asset: to purchase an asset for its utility.

Synergy: Synergy popularly stated, as "two plus two equals five," is similar to the concept of economies of scope. Economies of scope would occur if two companies combine and the combined company was more cost efficient at both activities because each requires the same resources and competencies. Although synergy is often cited as the reason for conglomerate mergers, cost efficiencies due to synergy are difficult to document.

Tax Savings: Although tax savings is not a primary motive for a combination, it can certainly "sweeten" the deal. When a purchase of either the assets or common stock of a company takes place, the tender offer less the stock's purchase price represents a gain to the target company's shareholders. Consequently, the target firm's shareholders will usually gain tax benefits. However, the acquiring company may reap tax savings depending on the market value of the target company's assets when compared to the purchase price. Also, depending on the method of corporate combination, further tax savings may accrue to the owners of the target company.

Cashing Out: For a family-owned business, when the owners wish to retire, or otherwise leave the business and the next generation is uninterested in the business, the owners may decide to sell to another firm. For purposes of retirement or cashing out, if the deal is structured correctly, there can be significant tax savings.

To summarize, firms take the M&A route to seize the opportunities for growth, accelerate the growth of the firm, access capital and brands, gain complementary strengths, acquire new customers, expand into new product- market domains, widen their portfolios and become a one-stop-shop or end-to end solution provider of products and services.

10.8 REASONS FOR FAILURE OF MERGER AND ACQUISITION

The record of M&As world over has not been impressive. Advocates of M&As argue that they boost revenues to justify the price premium. The notion of synergy, '1+1 = 3', sounds great, but the assumptions behind this notion are too simplistic. In real life things are not that simple and rosy. Past trends show that roughly two thirds of all big mergers have not produced the desired results. Rationale behind mergers can be flawed and efficiencies from economies of scale may prove elusive. Moreover, the problems associated with trying to make merged entities work cannot be overcome easily. Reasons supporting the use of diversification have been explained in the previous section. The potential pitfalls of this strategy are explained in this section. The conclusion that one may draw from this discussion will be that "successful diversification would involve a well thought strategy in selecting a target, avoiding over-paying, creating value in the integration process."

The potential pitfalls that a firm is likely to encounter during diversification include:

Integration Difficulties: Integrating two companies following mergers and acquisition can be quite difficult. Issues such as melding two disparate corporate cultures, linking different financial and control systems, building effective financial and control systems, building effective working relationships, etc., will come to the fore and they have to be contend with.

Faulty Assumptions: A booming stock market encourages mergers, which can spell danger. Deals done with highly rated stock as currency appear easy and cheap, but underlying assumptions behind such deals is seriously flawed. Many top managers try to imitate others in attempting mergers, which can be disastrous for the company. Mergers are quite often more to do with personal glory than business growth. The executive ego plays a major in M&A decisions, which is fuelled further by bankers, lawyers and other advisers who stand to gain from the fat fees they collect from their clients engaged in mergers. Most CEOs and top executives also get a big bonus for merger deals, no matter what happens to the share price later.

Mergers are also driven by fear psychosis: fear of globalization, rapid technological developments, or a quickly changing economic scenario that increases uncertainty can all create a strong stimulus for defensive mergers. Sometimes the management feels that they have no choice but to acquire a raider before being acquired. The idea is that only big players will survive in a competitive world.

Failure to carry out effective due-diligence: The failure to complete due-diligence often results in the acquiring firm paying excessive premiums. Due diligence involves a thorough review by the acquirer of a target company's internal books and operations. Transactions are often made contingent upon the resolution of the due diligence process. An effective due-diligence process examines a large number of items in areas as diverse as those of financing the intended transaction, differences in cultures between the two firms, tax concessions of the transaction, etc.

Inordinate increase in debt: To finance acquisitions, some companies significantly raise their levels of debt. This is likely to increase the likelihood of bankruptcy leading to downgrading of firm's credit rating. Debt also precludes investment in areas that contribute to a firm's success such as R&D, human resources development and marketing.

Too much diversification: The merger route can lead to strategic competitiveness and above-average returns. On the flip-side, firm's may lose their competitive edge due to over diversification. The threshold level at which this happens varies across companies, the reason being that different companies have different capabilities and resources that are required to make the mergers work. Crossing these threshold limits can result in overstretching these capabilities and resources leading to deteriorating performance. Evidence also suggests that a large size creates efficiencies in various organizational functions when the firm is not too large. In other words, at some level the costs required to manage the larger firm exceed the benefits of efficiency created by economies of scale.

Problems in making M&A work: Mergers can distract them from their core business, spelling doom for the company. The chances for success are further hampered if the corporate cultures of the companies are very different. When a company is acquired, the decision is typically based on product or market synergies, but cultural differences are often ignored. It's a mistake to assume that these issues are easily overcome. A McKinsey study on mergers concludes that companies often focus too narrowly on cutting costs following mergers, without paying attention to revenues and profits. The exclusive cost-cutting focus can divert attention from the day-to-day business and poor customer service. This is the main reason for the failure of mergers to create value for shareholders.

However, not all mergers fail. Size and global reach can be advantageous and tough managers can often squeeze greater efficiency out of poorly run acquired companies. The success of mergers, however, depends on how realistic the managers are and how well they can integrate the two companies without losing sight of their existing businesses. Though the acquisition strategies do not consistently produce the desired results, some studies suggest certain decisions and actions that firms may follow which can increase the probability of success. The attributes leading to successful acquisition suggested by various studies are that the:

- Acquired firm has assets or resources that are complimentary to the acquiring firm's core business.
- Acquisition is friendly.
- Acquiring firm selects target firms and conducts negotiation carefully and methodically.
- Acquiring firm has adequate cash and fovourable debt position.
- Merged firms maintains low to moderate debt position.
- Acquiring firm has experience with change and is flexible and adaptable.
- Acquiring firm maintains sustained and consistent emphasis on R&D and innovation

10. 9 STEPS IN MERGER AND ACQUISITION DEALS

A firm that intends to take over another one must determine whether the purchase will be beneficial to the firm. To do so, it must evaluate the real worth of being acquired. Logically speaking, both sides of an M&A deal will have different ideas about the worth of a target company: the seller will tend to value the company as high as possible, while the buyer will try to get the lowest price possible. There are, however, many ways to assess the value of companies. The most common method is to look at comparable companies in an industry, but a variety of other methods and tools are used to value a target company. A few of them are listed below.

1) Comparative Ratios

The following are two examples of the many comparative measures on which acquirers may base their offers:

P/E (price-to-earnings) Ratio: With the use of this ratio, an acquirer makes an offer as a multiple of the earnings the target company is producing. Looking at the P/E for all the stocks within the same industry group will give the acquirer good guidance for what the target's P/E multiple should be.

EV/Sales (price-to-sales) Ratio: With this ratio, the acquiring company makes an offer as a multiple of the revenues, again, while being aware of the P/S ratio of other companies in the industry.

2) Replacement Cost

In a few cases, acquisitions are based on the cost of replacing the target company. The value of a company is simply assessed based on the sum of all its equipment and staffing costs without considering the intangible aspects such as goodwill, management skills, etc. The acquiring company can literally order the target to sell at that price, or it will create a competitor for the same cost. This method of establishing a price certainly wouldn't make much sense in a service industry where the key assets—people and ideas—are hard to value and develop.

3) Discounted Cash Flow

An important valuation tool in M&A, the discounted cash flow analysis, determines a company's current value according to its estimated future cash flows. Future cash flows are discounted to a present value using the company's weighted average cost of capital. Though this method is a little difficult to use, very few tools can rival this valuation method.

4) Synergy

Quite often, acquiring companies pay a substantial premium on the stock value of the companies they acquire. The justification for this is the synergy factor: a merger benefits shareholders when a company's post-merger share price increases by the value of potential synergy. For buyers, the premium represents part of the post-merger synergy they expect can be achieved. The following equation solves for the minimum required synergy and offers a good way to think about synergy and how to determine if a deal makes sense. In other words, the success of a merger is measured by whether the value of the buyer is enhanced by the action. The equation:

$$\frac{\text{(Pre-merger value of both firms + synergies)}}{\text{Post-merger number of shares}} = \text{Pre-merger stock price}$$

Here the pre-merger stock price refers to the price of the acquiring firm. Increase in the value of the acquiring firm is a test of success of the merger. However, the practical aspects of mergers often prevent the anticipated benefits from being fully realized and the expected synergy quite often falls short of expectations.

Some more criteria to consider for valuation include:

- A reasonable purchase price - A small premium of, say, 10% above the market price is reasonable.
- Cash transactions- Companies that pay in cash tend to be more careful when calculating bids, and valuations come closer to target. When stock is used for acquisition, discipline can be a casualty.
- Sensible appetite – An acquirer should target a company that is smaller and in a business that the acquirer knows intimately. Synergy is hard to create from disparate and unrelated businesses. And, sadly, companies have a bad habit of biting off more than they can chew in mergers.

The Basics Steps in Mergers and Acquisitions

1) Initial Offer by the Intending Buyer

When a company decides to go for a merger or an acquisition, it starts with a tender offer. Working with financial advisors and investment bankers, the acquiring company will arrive at an overall price that it's willing to pay for its target in cash, shares, or both. The tender offer is then frequently advertised in the business press, stating the offer price and the deadline by which the shareholders in the target company must accept (or reject) it.

2) Response from Target Company

Once the tender offer has been made, the target company can do one of the several things listed below:

Accept the Terms of the Offer: If the target firm's management and shareholders are happy with the terms of the transaction, they can go ahead with the deal.

Attempt to Negotiate: The tender offer price may not be high enough for the target company's shareholders to accept, or the specific terms of the deal may not be attractive. If target firm is not satisfied with the terms laid out in the tender offer, the target's management may try to work out more agreeable terms. Naturally, highly sought-after target companies that are the object of several bidders will have greater latitude for negotiation. Therefore, managers have more negotiating power if they can show that they are crucial to the merger's future success.

Execute a Poison pill or some other Hostile Takeover Defense: A target company can trigger a poison pill scheme when a hostile suitor acquires a predetermined percentage of company stock. To execute its defense, the target company grants all shareholders—except the acquirer—options to buy additional stock at a hefty discount. This dilutes the acquirer's share and stops its control of the company. It can also call in government regulators to initiate an antitrust suit.

Find a White Knight: As an alternative, the target company's management may seek out a friendly potential acquirer, or white knight. If a white knight is found, it will offer an equal or higher price for the shares than the hostile bidder.

3) Closing the Deal

Finally, once the target company agrees to the tender offer and regulatory requirements are met, the merger deal will be executed by means of some transaction. In a merger in which one company buys another, the acquirer will pay for the target company's shares with cash, stock, or both. A cash-for-stock transaction is fairly straightforward: target-company shareholders receive a cash payment for each share purchased. This transaction is treated as a taxable sale of the shares of the target company. If the transaction is made with stock instead of cash, then it's not taxable. There is simply an exchange of share certificates. The desire to steer clear of the taxman explains why so many M&A deals are carried out as cash-for-stock transactions.

When a company is purchased with stock, new shares from the acquirer's stock are issued directly to the target company's shareholders, or the new shares are sent to a broker who manages them for target-company shareholders. Only when the shareholders of the target company sell their new shares are they taxed. When the deal is closed, investors usually receive a new stock in their portfolio—the acquiring company's expanded stock. Sometimes investors will get new stock identifying a new corporate entity that is created by the M&A deal.

10.10 MERGERS AND ACQUISITIONS: THE INDIAN SCENARIO

M&A activity had a slow take-off in India. Traditionally, Indian promoters have been very reluctant to sell out their businesses since it was synonymous with failure and was never viewed as a sensible move. This scenario changed dramatically in the 90s with the Tatas selling TOMCO and Lakme. Suddenly selling out had become a sensible option. The second major reason for the slow take-off of M&A activity was due to the fact that even while the companies continued to decline, the banks and financial institutions, normally the biggest stakeholders in most Indian companies were reluctant to change the managements. Fortunately this situation has changed for the better. Worried about the spectre burgeoning NPAs, these institutions are now willing to force the promoters to sell out. The FIs and banks are flushed with funds and they are willing to assist big companies in acquiring new companies.

Indian cement industry was trendsetter in M&A in India. The cement industry was ripe for consolidation in many ways. The industry comprised of four or five dominant players in addition to a number of small players having economically viable capacities, but with very small market shares. Rapid expansion by the bigger players in a capital-intensive industry meant that these small players would naturally be marginalized. Moreover, the excess capacity due to rapid expansion of big players meant that the smaller players would lose money. This situation naturally spurred the merger activity in the cement industry.

The past few years have been record years for M&A globally with mega deals dwarfing the previous records. M&A has also become a buzzword among Indian companies as well. HDFC-Times Bank, Gujarat Ambuja-DLF and ICICI Bank-Centurion Bank mergers have all been in the news recently for this reason. The merger wave in the country was catalyzed by economic liberalization in 1991. M&A activity is on the rise and the Indian industry has witnessed a spate of mergers and acquisitions in the past few years. Mergers and acquisitions are here to stay and more are expected to follow in the near future.

Mergers and acquisitions in India, just as in other parts of the world, are primarily aimed at expanding a company's business and profits. Acquisitions bring in more customers and business, which in turn brings in more money for the companies thus helping in its overall expansion and growth. More and more companies are, therefore, moving towards acquisitions for a fast-paced growth. Consolidation has become a compelling necessity to counter the effects of increasing globalization of businesses, declining tariff barriers, price decontrols and to please the ever demanding and discerning customers. And these pressures are expected to intensify and relentlessly batter every business in the future. The M&A activity is helping the companies restructure, gain market share or access to markets, rationalize costs and acquire brands to counter these threats. The shareholders of many companies are also supporting these moves and sharp increase in share prices is an indication of this support.

Since size and focus are factors that matter for surviving the onslaught of competition, mergers and acquisitions have emerged as key growth drivers of Indian business. Tax benefits were the sole reason to justify mergers in the past but for many Indian promoters, that is no longer an incentive. Indian companies have taken to M&A many reasons. Experts feel that Indian companies look at M&As due to the size factor, the niche factor or for expanding their market reach. They are also of the opinion that acquisitions help in the inorganic (and quicker) growth of the business of a company. Besides these factors, the pricing pressures and consolidation of global companies by building offshore capabilities have made M&A relevant for Indian enterprises.

Many Indian companies have also followed the M&A route to grow in size by adding manpower and to facilitate overall expansion by moving into new market space. Another reason behind M&A has been to gain new customers. For instance, vMoksha, an IT firm, saw a rise in the number of its customers due to acquisitions as it expanded considerably in the US market and leveraged on the existing customer base. Similarly, Mphasis added new customers in the Japanese and Chinese markets after the acquisition of Navion. The need for skill enhancement seems to be another major reason for companies to merge and make new acquisitions. The Polaris-OrbiTech merger helped in combining skill sets of both companies, which consequently led to growth and expansion of the merged entity. Likewise, Wipro acquired GE Medical Systems Information Techno-logy (India) to leverage its expertise in the health science domain. (*Refer to case study-3 in Appendix-2*).

10.11 SUMMARY

Diversification involves moving into new lines of business. Of the various routes to expansion, diversification is definitely the most complex and risky route. Diversification of a firm can take the form of concentric and conglomerate diversification. A firm is said to pursue concentric diversification strategy when it enters into new product or service areas belonging to different industry category but the new product or service is similar to the existing one in many respects.

The two major routes to diversification are mergers and acquisitions and strategic partnering. One plus one makes three: this equation is the special alchemy of a merger or acquisition. Although they are used synonymously, there is a slight distinction between the terms 'merger' and 'acquisition'. The term acquisition is generally used when a larger firm absorbs a smaller firm and merger is used when the combination is portrayed to be between equals.

Firms take the M&A route mainly to seize the opportunities for growth, accelerate the growth of the firm, access capital and brands, gain complementary strengths, acquire new customers, expand into new product-market domains, wident their portfolios and become a one-stop-shop or end-to-end solution provider of products and services. The three basic steps in the merger process are—offer by the acquiring firm, response by the target firm and closing the deal.

M and A activity had a slow take-off in India. However, M&A has become a buzzword among Indian companies after the economic liberalization in 1991. M&A activity is on the rise and the Indian industry has witnessed a spate of mergers and acquisitions in the past few years.

10.12 KEY WORDS

Acquisitions: A company taking over controlling interest in another company.

Concentric Diversification: A firm is said to have pursued concentric diversification strategy when it enters into new product or service area belonging to different industry but the new product or service is similar to the existing one with respect to technology or production or marketing channels or customers.

Conglomerate Diversification: Conglomerate diversification is a growth strategy in which a company seeks to grow by adding entirely unrelated products and markets to its existing business.

Diversification: Diversification involves moving into new lines of business.

Joint Ventures: Two or more organizations form a separate, independent organization for strategic purposes.

Mergers: The conpination of two or more companies.

Strategic Alliances: Two or more organizations share resources, capabilities, or distinctive competencies to pursue some business purpose.

Strategic Partnering: Two or more organizations establish a relationship that combines their resources, capabilities, and core competencies to achieve some business objective.

10.13 SELF-ASSESSMENT QUESTIONS

1) What is meant by diversification? What are the pros and cons of a diversification strategy?
2) Explain the mechanics of mergers and acquisitions. What motivates the top management to go in for M&A?
3) What are the pitfalls that a management should take into consideration while going for M&A?
4) Explain the basic steps involved in the M&A process.
5) Scan the business newspapers in the past few months and explain the M&A trends in Indian business scenario and list out the various reasons why Indian companies plan to follow M&A strategy.

10.14 REFERENCES AND FURTHER READINGS

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Appendix-2

Case Study-1

Aditya V Birla Group: A Case of a Highly Diversified Group

The Aditya V Birla group is one of the fastest growing industrial houses in the country. Grasim, a group company, was incorporated as Gwalior Rayon Silk Manufacturing (Weaving) Co Ltd in 1947. It started as a textile manufacturing mill and integrated backward in 1954, to produce VSF (Viscose Staple Fiber) used in textiles. It expanded its capacity further through backward integration into manufacture of rayon grade wood pulp, caustic soda and manufacturing equipment to become a low cost producer. Grasim diversified into cement when industry was decontrolled. It also diversified into production of sponge iron in 1993. Grasim has presence in exports and computer software as well. It holds significant equity in several other Birla group companies.

The manufacturing facilities of Grasim are spread all across the country. Grasim's sponge iron plant is located at Raigarh near Mumbai, while its cement plants are located at Jawad, Shambhupura in Rajasthan and Raipur in MP. The VSF plants are located at Mavoor and Harihar in Karnataka and Nagda in MP and it has recently set up a new VSF plant at Surat, Gujarat. It has pulping facilities at Nagda, Harihar and Mavoor. Grasim's textile mills are located at Gwalior and Bhiwani near Delhi.

The Aditya Birla Group's strategy has been to diversify into capital-intensive businesses and become a cost-leader by leveraging on its various strengths. Apart from Grasim, major companies in the group include Hindalco Industries Ltd (aluminium), Indian Rayon (Cement, VFY, carbon black, insulators etc), Indo-Gulf Fertilizer (Fertilizer - Urea), Tanfac Industries (Chemicals for aluminum), Bihar Caustic & Chemicals Ltd (Caustic Soda/ chlorine), Hindustan Gas Industries (gas producer), Birla Growth Fund (financial services), Mangalore Refinery (oil refinery). Grasim holds a 58.6% stake in Kerala Spinners Ltd, which manufactures synthetic/ blended yarn. Grasim's fully owned subsidiaries, Sun God Trading and Investments Ltd and Samruddhi Swastik Trading and Investments Ltd, are into asset based financing. The group also owns several companies in Thailand, Indonesia and Malaysia manufacturing textiles, synthetic/ acrylic yarn, rayon, carbon black and other chemicals.

Case Study-2

Ispat International: Building a Muscle of Steel

Steel magnate Lakhmi N. Mittal's Ispat International announced the acquisition of LNM Holdings and a merger with the US based International Steel Group Inc (ISG) in a deal worth $ 17.8 billion to form the world's largest steel firm, Mittal Steel Co. Mittal Steel, with operations in 14 countries in Europe, Africa, Asia and the United States and 165,000 employees will have pro forma revenues of $30 billion in 2004 and an annual production capacity of 70 million tones, according to a statement from Ispat International. The Netherlands-based Ispat International, 77-percent owned by Mr.Mittal, will issue 525 million new shares, valued at $ 13.3 billion to the shareholder of LNM Holdings. The Mittal Steel Co. will then pay $42 a share in cash and stock-or about $4.5 billion- depending on Mr.Mittal's share price, to the ISG shareholders.

These transactions dramatically change the landscape of the global steel industry. The coming together of Ispat International, LNM Holdings and ISG, one of the largest steel producers in America, will create global powerhouse. This combination also provides Mittal Steel with a more significant presence in important industrialized economies such as those in North America and Europe and in economies that are expected to experience above average in steel consumption, including Asia and Africa. According to Mr.Aditya Mittal, President and CEO of the new combined entity, Mittal Steel will be a leader not only in terms of its global reach and operational excellence but also among the most profitable steel producers in the world. LNM Holdings earned $ 9.9 billion revenue and had an operating income of $3.2 billion in the first nine months of 2004, and was also one of the largest steel companies. (*Source*: The Hindu, October 26, 2004)

Case Study-3

Nicholas Piramal India Ltd: Profiting from M and A

Nicholas Piramal India Ltd (NPIL), best known for its growth by mergers and acquisitions, is among the top ten companies in the domestic formulations market with a major presence in anti-bacterial, CNS & CVS-Diabetic. NPIL has expanded aggressively after the Nicholas group took over Nicholas Laboratories in 1986. The turnover and net profit have grown at a healthy compounded annual growth (CAGR) of 33% and 45% respectively in the past decade. With more than a dozen joint ventures with pharmaceutical companies in different healthcare segments, NPIL has mastered the art of forging JVs and running them successfully.

Prices of over 60% of the drugs and formulations are controlled by the government through DPCO in the Rs130 billion Indian pharmaceutical market. In the domestic bulk drugs market, low entry barriers have resulted in overcapacity and price wars. Major domestic players are, therefore, focusing on formulations, where brand image and distribution network act as entry barriers. They are increasing their overseas marketing and manufacturing network to enhance their exports (under patent drugs to third world countries and generics to developed nations). In anticipation of WTO regime, multinational corporations are strengthening their operations in India by setting up 100% subsidiaries or through marketing tie-ups with major domestic players. The big local players are also strengthening their operations through brand acquisitions, co-marketing and contract manufacturing tie-ups with MNCs.

Following this trend, NPIL is focusing on strengthening its R&D to gear up for the patents regime. The company's R&D facility with more than 100 scientists (acquired from Hoechst Marion in 1999, renamed as Quest science Institute) is one of the best R&D centers in India. NPIL has hived off its Falconnage (glass) and bulk drug division into separate entities to improve efficiencies. It is working on seven new chemical entities (NCE). The first one, an anti-malarial drug, is already commercialized. NPIL has set a growth target of more than 30% through aggressive product launches as well as mergers and acquisitions of brands and companies in the therapeutic segment of anti-bacterial, CVS-diabetes, Nutrition and GI tract and Central Nervous System (CNS).