# UNIT 18 FINANCIAL RESTRUCTURING

**Objectives**

The objectives of this unit are to:

- provide an understanding of concept, motives and dimensions of corporate restructuring;
- explain concept, forms and motives of mergers;
- assess merger as a source of value addition;
- provide an understanding of criteria for determining exchanges rate;
- explain process entailed in formulating merger and acquisition strategy;
- throw light on divestiture and its financial assessment;
- explain leveraged buyout, leveraged recapitalization, spin-offs, carve-outs, reorganization of capital and financial reconstruction.

**Structure**


18.1 Introduction

18.2 Corporate Restructuring

18.3 Financial Restructuring

18.4 Assessing Merger as a Source of a Value Addition

18.5 Formulating Merger and Acquisition Strategy

18.6 Regulation of Mergers and Takeovers in India

18.7 Takeover Strategies – Indian Experience

18.8 Divestitures

18.9 Characteristics of and Pre-requisities to Leveraged Buyout Success

18.10 Leveraged Recapitalization

18.11 Reorganization of Capital

18.12 Financial Reconstruction

18.13 Summary

18.14 Key Words

18.15 Self-Assessment Questions

18.16 Further Readings


## 18.1 INTRODUCTION

The world has witnessed tectonic and tumultuous changes during the last two decades in terms of unification of Germany, rising economic power of Japan and NICs in the world market, dismantling of the erstwhile USSR, emergence of new trade blocks, realignment of economic forces such as the unification of the European Community, the North American Market, ASEAN, etc; formation of WTO and far reaching changes in global trading regulations prescribed by it, growing economic inter dependencies and globalization of markets, free flow of capital and knowledge, following economic liberalization, greater interactions among different financial systems of different countries, faster growth in world trade, integration of world financial markets at unprecedented reforms across the East European and South Asian Countries, and path breaking proliferation and convergence of technologies. These changes along with fast changing demographies of work force, cataclysmic change in personal, social, familial and cultural values of people and rapidly moving customers tastes have not only

increased business complexities but also rendered global business scenario much more volatile and fairly competitive. To cope with the incredible opportunities and enhance share owners' wealth, business enterprises across the globe embarked on programmes of restructuring and alliance spree Global deal volume during the historic mergers and alliance wave of 1995 to 2000 totalled more than $12trillion.

To meet competitive challenges from the foray of multinationals following liberalization, privatization and globalization and to ensure their survival Indian corporate giants such as Tatas, A V Birlas, Reliance, HLL, SBI have, of late, pursued, the strategy of restructuring their assets, products, technologies, market and manpower resulting in spate of mergers and acquisitions in recent years (Table 18.1). Indeed, 2003 has seen the biggest ever rush of Indian corporates acquiring foreign firms. A V Birla group acquired four companies. Wipro acquired Nerve Wire, Essar group acquired a 3 MT Steel Plant in Thailand, Dabur India having acquired three comanies in the UAE and Bangladesh and Mahindra & Mahindra is scouting for a tractor plant in Europe.

**Table 18.1: Mergers & Acquisitions**

| Year | No. |
|---|---|
| 1991 | 285 |
| 1992 | 842 |
| 1993 | 858 |
| 1994 | 872 |
| 1995 | 1208 |
| 1996 | 524 |
| 2000 | 447 |
| 2001 | 395 |
| 2002 | 290 |

## 18.2 CORPORATE RESTRUCTURING

### A. Concept of Restructuring

Corporate Structuring is a process of redefining the basic line of business and discovering a common thread for the firm's existence and consolidation. Thus, restructuring is a process by which a corporate enterprise seeks to alter what it owes, refocus itself to specific tasks performance. This it does after making a detailed analysis of itself at a point of time. At times restructuring would radically alter a firm's product market mix, capital structure, asset mix and organization so as to enhance the value of the firm and attain competitive edge on sustainable basis. While planning for restructuring, the management should specify what type of business the firm can do most effectively. Those business/ market areas which offer little or no potential should be removed from the basic business structure. Others having unsatisfactory earnings, poor competitive position or management incapability should also be discontinued.

### B. Motives for Restructuring

Corporate enterprises are motivated to restructure themselves in view of the following forces:

- The Government policy of liberalization, privatization and globalization spurred many Indian organizations to restructure their product mix, market,

technologies etc. so as to meet the competitive challenges in terms of cost, quality and delivery. Many organizations pursued the strategy of accessing new market and customer segment. Convertibility of rupee has encouraged many medium – sized companies to operate in the global market.

- Revolution in information technology facilitated companies to adopt new changes in the field of communication for improving corporate performance.
- Wrong diversification and divisionalization strategy has led many organizations to revamp themselves. New business embraced by companies in the past had to be dropped because of their irrelevance in the changed environment. Product divisions which do not fit into company's care business are being divested.
- Improved productivity and cost reduction have necessitated downsizing of the workforce.
- Another plausible reason for restructuring is improved management. Some companies are suffering because of inefficient management. Such companies opted for change in top management.
- At times, organizations are motivated to reorganize their financial structure for improving the financial strength and improving operating performance.

### C. Dimension of Restructuring

Corporate restructuring is a broad umbrella that covers the following:

- **Financial Restructuring:** This involves decisions pertaining to acquisition, mergers, divestitures, leveraged buyout, leveraged recapitalization, reorganization of capital, etc.
- **Technological Restructuring:** This involves decisions pertaining to redesigning the business process through revamping existing technologies.
- **Market Restructuring:** This involves decisions regarding product – market positioning to suit the changed situations.
- **Organizational Restructuring:** During the post liberalization period many Indian firms embarked on organizational restructuring programme through regrouping the existing businesses into a few compact business units, decentralization and delayering, downsizing, outsourcing non-value adding activities and subcontracting.

You may please note that a good restructuring exercise consists of a mixture of all these. These alterations have a significant impact on the firm's balance sheet or by exploiting unused financial capacity.

### Activity 1

a) List out the five primary forces that forced Indian corporates to engage in restructuring exercises.

..................................................................................................................

..................................................................................................................

..................................................................................................................

..................................................................................................................

b) Name three top business groups in India which embarked on restructuring programmes.

..................................................................................................................

..................................................................................................................

..................................................................................................................

..................................................................................................................

## 18.3 FINANCIAL RESTRUCTURING



**A. Concept of Financial Restructuring**

Financial restructuring is the process of reorganizing the company by affecting major changes in ownership pattern, asset mix, operations which are outside the ordinary course of business. Thus, financial restructuring covers many things such as the mergers and takeovers, divestitures, leveraged, recapitalization, spin-offs, curve-outs, reorganization of capital and financial re-construction. Let us dilate upon each of these aspects.

**B. Mergers and Takeovers**

**Concept**

A company intending to acquire another company may buy the assets or stock or may combine with the latter. Thus, acquisition of an organization is accomplished either through the process of merger or through the takeover route.

Merger is combination of two or more companies into a single company where one survives and the others lose their identity or a new company is formed. The survivor acquires the assets as well as liabilities of the merged company. As a result of a merger, if one company survives and others lose their independent entity, it is a case of ‘Absorption’. But if a new company comes into existence because of merger, it is a process of ‘Amalgamation’.

Takeover is the purchase by one company of a controlling interest in the share capital of another existing company. In takeover, both the companies retain their separate legal entity. A takeover is resorted to gain control over a company while companies are amalgamated to derive advantage of scale of operations, achieve rapid growth and expansion and build strong managerial and technological competence so as to ensure higher value to shareowners. Indian takeover kings are R P Goenka, Chabria, Khaitan, Kumar Mangalam Birla and London based Swaraj Paul.

**Forms**

**Horizontal Merger**

A horizontal merger is one that takes place between two firms in the same line of business. Merger of Hindustan Lever with TOMCO and Global Telecom Services Ltd. with Atlas Telecom, GEC with EEC are examples of Horizontal Merger.

**Vertical Merger**

Vertical Merger takes place when firms in successive stages of the same industry are integrated. Vertical Merger may be backward, forward or both ways. Backward merger refers moving closer to the source of raw materials in their beginning form. Merger of Renusagar Power Supply and Hindalco is a case in point. Forward merger refers to moving closer to the ultimate customer. DU Pont acquired a chain of stores that sold chemical products at the retail level for increased control and influence of its distribution.

**Conglomerate Merger**

Conglomerate Merger is a fusion in unrelated lines of business. The main reason for this type of merger is to seek diversification for the surviving company. A case in point is the merger of Brooke Bond Lipton with Hindustan Lever. While the former was mostly into foods, the latter was into detergents and personal care.

### Reverse Merger

It occurs when firms want to take advantage of tax savings under the Income Tax Act (Section 72A) so that a healthy and profitable company is allowed the benefit of carry forward losses when merged with a sick company. Godrej soaps, which merged with the loss-making Godrej Innovative Chemicals is an example of reverse merger.

Reverse merger can also occur when regulatory requirements need one to become one kind of company or another. For example, the reverse merger of ICICI into ICICI Bank.

### Motives for Mergers

- **To Avail Operating Economics**

  Firms are merged to derive operating economies in terms of elimination of duplicate facilities, reduction of cost, increased efficiency, better utilization of capacities and adoption of latest technology. Operating economies at the staff level can be achieved through centralization or combination of such departmental as personnel accounting, advertising and finance which are common to both organizations. Merger of Reliance Petrochemicals with Reliance Industries was aimed at enhancing shareholders' value by realizing significant synergies of both the companies. Similarly, amalgamation of Asea Ltd with Asea Browns Bover (ABB) was intended to avail of the benefits of rationalization and synergy effects.

- **To Achieve Accelerated Growth**

  Both horizontal and vertical combination take place to achieve growth at higher rate than the one accomplished through its normal process of internal expansion. In fact, mergers and takeovers have played pivotal role in the growth of most of the leading corporations of the world. Nearly two-thirds of the giant public corporations in the USA are the outcome of mergers and acquisitions.

- **To Take Advantage of Complementary Resources**

  It is in the vital interest of two firms to merge if they have complementary resources each has each other needs. The two firms are worth more together than apart because each acquires something it does not have and gets it cheaper than it would by acting on its own. Also the merger may open up opportunities that neither firm would pursue otherwise.

- **To Speed Up Diversification**

  Many companies join together to reduce business risk through diversification of their operations. By merging with relatively more stable enterprise, a company prone to wide cyclical swings may be able to minimize the degree of instability in its earnings and improve its performance. Similarly, a small company may be hesitant to launch a new product with a high potential market because of high risk exposure to the projects, the potential loss will not be as significant to the surviving company as to the small one. Recent alliances of Jenson and Nicholson India Ltd. with Carl Scheneek A G, and J K Corporation with Mitel of Canada are examples of acquisition based on diversification motive.

- **To Combat Competitive Threats**

  Majority of the recent mergers struck in India were motivated to thwart competitive challenges both from domestic as well as multinational comapnies and achieve competitive edge over the rivals. The fear of increasing competitive resulting from the tie up between Procter and Gamble and Godrej Soaps forced Hindustan Lever to merge with TOMCO. Recent alliance between Max India and GIST–Brocades has made to covert potential competitor into a partner.

- **To Access to Latest Technology**

  Many organizations have, of late, forged alliances with foreign firms so as to gain access to latest product technology cheaply. Tata Telecom tie up with AT&T, Maruti-Suzuki alliance, Caltex alliance with IBP were made essentially to secure latest technology.

- **To Widen Market Base**

  In recent few years large number of firms forged alliances with specific purpose of globalising the firm's products. Tie-ups between HCL and HP Ltd, Tata-IBM, Ranbaxy Laboratories and Eli Lilly, Parle and Coco-Cola, Hindustan Motors and General Motors, DCM Data and Control Data of USA, Tata Tea and Tetelay of USA and Onida and JVC have been made to exploit tremendous market opportunities of foreign countries.

- **To Strengthen Financial Position**

  Another cogent motive for the merger may be to mitigate the financial problem. A company embarking on the expansion programme may find its difficult to satisfy its requirements owing to temporary imbalance in its cash flows, capital structure or working capital position. By joining with a stable, unlevered cash rich company a firm may present a consolidated picture of the financial position that will be more appealing to potential investors. Merger of Renu Sagar Power Supply and Hindal Co and ICICI with ICICI Bank are cases in point.

- **To Avail Tax Shields**

  A firm with accumulated losses and/or unabsorbed depreciation would like to merge with a profit making company to utilize tax advantages better for a long time.

- **To Utilize Surplus Funds**

  At times, a firm in a mature industry having generated a substantial amount of cash may not find adequate profitable investment opportunities. Management of such firms may be tempted to acquire another company shares. Such firms often turn to mergers financed by cash as a way of redeploying their capital.

- **To Acquire Competent Management**

  When a firm finds that it is not a position to hire top quality management and that it has none to come up through the ranks, it may seek merger with a firm endowed with sapient and savvy management.

- **To Strengthen Controlling Power**

  Acquisition of profit making companies by Indian businessmen like Kumar Mangalam Birla, Ratan Tata, Mukesh Ambani, R P Goenka, G P Goenka, Piramals, Modis, Ruias, Khaitan, etc. took place to get hold of the controlling interest through open offer of market prices.

## 18.4 ASSESSING MERGER AS A SOURCE OF VALUE ADDITION

While taking decision whether to acquire a firm, finance manager of a firm must ensure that this step would add value to the firm. For this purpose he has to follow the procedure laid down below:

(i) Determine if there is an economic gain from the merger. There is an economic gain only if the two firms are worth more together than apart. Thus, economic gain of the merger is the difference between the present value (PV) of the combined entity (Pvxy) and the present value of the two entities if they remain separate **(Pvx + pvy).** Hence,

Gain = Pvxy – (Pvx+Pvy)

(ii) Determine the cost of acquiring firm Y. If payment is made in cash, the cost of acquiring Y is equal to the cash payment minus Y's value as a separate entity. Thus,

$$\text{Cost} = \text{Cash paid} - \text{Pvy}$$

(iii) Determine the net present value to X of a merger with Y. It is measured by the difference between the gain and cost. Thus,

$$\text{NPV} = \text{gain} - \text{cost}$$
$$= \text{W Pvxy} - (\text{Cash}-\text{Pvy})$$

If the difference is positive, it would be advisable to go ahead with the merger.

**Example 1**

Firm X has a value of Rs. 400 crore, and Y has a value of Rs. 100 crore. Merging the two would allow cost savings with a present value of Rs. 50 crore. This is the gain from the merger. Thus,

$$\text{Pvx} = \text{Rs. } 400 \text{ crore}$$
$$\text{Pvy} = \text{Rs. } 100 \text{ crore}$$
$$\text{Gain} = \text{W Pvxy} = \text{Rs. } 50 \text{ crore}$$
$$\text{Pvxy} = \text{Rs. } 550 \text{ crore}$$

Suppose that Firm Y is bought for cash, say for Rs. 130 crore. The cost of merger is:

$$\text{Cost} = \text{Cash paid} - \text{Pvy}$$
$$= \text{Rs. } 130 \text{ crore} - \text{Rs. } 100 \text{ crore} = \text{Rs. } 30 \text{ crore}$$

Note that the owners of firm Y are ahead by Rs. 30 crore. Y's gain will be X's cost. Y has captured Rs. 30 crore of Rs. 50 crore merger gain. Firm X's gain will, therefore, be:

$$\text{NPV} = \text{Rs. } 50 \text{ crore} - \text{Rs. } 30 \text{ crore} = \text{Rs. } 20 \text{ crore}$$

In other words, firm's X's worth in the beginning is Pv = Rs. 400 crore. Its worth after the merger comes to Pv = Rs. 400 crore and then it has to pay out Rs. 130 crore to Y's stockholders. Net gain of X's owners is

$$\text{NPV} = \text{Wealth with merger} - \text{Wealth without merger}$$
$$= (\text{Pvxy}-\text{cash}) - \text{Pvx}$$
$$= (\text{Rs. } 550 \text{ crore} - \text{Rs.}30 \text{ crore}) - \text{Rs. } 400 \text{ crore} = \text{Rs. } 20 \text{ crore}$$

In the above procedure, the target firm's market value (Pvy) is taken into consideration along with the changes in cash flow that would result from the merger. It should be noted that it would be incorrect to undertak emerger analysis on the basis of forecast of the target firm's furture cash flows in terms of incremental revenue or cost reductions attributable to the merger and then discount them back to the present and compare with the purchase price. This is for the fact that there are chances of large errors in valuing a business. The estimated net gain may come up positive not because the merger makes sense but simply because the analyst's cash flow forecasts are too optimistic.

**Estimating Cost When the Merger is financed by Stock**

In the preceding discussion our assumption was that the acquiring firm pays cash compensation to the acquired firm. In real life, compensation is usually paid in stock. In such a situation, cost depends on the value of the shares in new company received by the shareholders of the selling company. If the sellers receive N shares, each worth Pxy, the cost is:

$$\text{Cost} = \text{NX Pxy} - \text{Pvy}$$

Let us consider an example:

**Example 2**

Firm X is planning to acquire firm Y, the relevant financial details of the two firms prior to the merger announcement are:

| | X | Y |
|---|---|---|
| Market Price per share | Rs. 100 | Rs. 40 |
| Number of shares | Rs. 50,000 | Rs. 2,50,000 |
| Market value of the firm | Rs. 50 lakh | Rs. 10 lakh |

The merger deal is expected to bring gains which have a present value of Rs. 10 lakh. Firm X offers 125,000 shares in exchange for 250,000 shares to the shareholders of firm Y.

The apparent cost of acquiring firm Y is:

$$125,000 \text{ X } 100 - 10,000,000 = \text{Rs. } 25,00,000$$

However, the apparent cost may not be the true cost. X' stock price in Rs. 100 before the merger announcement. At the announcement it ought to go up.

The true cost, when Y's shareholders get a fraction of the share capital of the combined firm, is equal to:

$$\text{Cost} = aPvxy - Pvy$$

In the above example, the share of Y in the combined entity will be:

$$a = 12,50,000/5,00,000 + 1,25,000 = 0.2$$

**Terms of Merger**

While designing the terms of merger management of both the firms would insist on the exchange ratio that preserves the wealth of their shareholders. The acquired firm (Firm X) would, therefore, like that the price per share of the combined firm is atleast equal to the price per share of the firm X.

$$Pxy = Px \text{ ..................................... (1)}$$

The market price per share of the combined firm (XY) is denoted as the product of price earnings ratio and earnings per share:

$$Pxy = (PExy)\ (EPSxy) = Px \text{ ........ (2)}$$

The earnings per share of the combined firm is denoted as:

$$EPSxy = Ex+Ey/Sx+Sy(Erx) \text{ ......... (3)}$$

Here Erx represents the number of shares of firm X given in lieu of one share of firm Y. Accordingly, Eq. 2 may be restated as:

$$Px = (Pexy)(Ex+Ey)/Sx+Sy(Erx) \text{ ... (4)}$$

Solving Eq. 4 for Erx yields:

$$Erx = -Sx/Sy + (Ex+Ey)\ (Pexy)/PxSy$$

Let us explain the process of determination of exchange rate with the help of an example:

**Example 3**

X corporation is contemplating to acquire Y corporation. Financial information about the firms are setout below:

| | X | Y |
|---|---|---|
| Total current earnings, E | Rs. 10 lakh | Rs. 4 lakh |
| Number of outstanding shares, S | Rs. 5 lakh | Rs. 2 lakh |
| Market price per share, P | Rs. 6 | Rs. 4 |

Determine the maximum exchange ratio acceptable to the shareholders of X corporation if the P/E ratio of the combined entity is 3 and there is no synergy. What is the minimum exchange ratio acceptable to the shareholders of Y corporation if the P/E ratio of the combined entity is 2 and there is synergy benefit of 5%?

**Solution:**

(a) Maximum exchange ratio from the Point of the shareholders of X corporation

$$
\begin{aligned}
ERx &= -Sx/Sy + PExy\ (Exy)/PxSy \\
&= -5\text{ lakh}/2\text{ lakh} + 3X\ 14\text{lakh}/6X2\text{lakh} \\
&= 1.0
\end{aligned}
$$

(b) Minimum exchange ratio from the point of view of the Y shareholders:

$$
\begin{aligned}
ERy &= PySx\ /\ (Pxy)\ Exy - PySy \\
&= 4X5\text{lakh}/2X\ (14\text{lakh}X1.05) - 4X2\text{lakh} \\
&= 20\text{ lakh}/14.70\text{ lakh} - 8\text{ lakh} \\
&= 0.3
\end{aligned}
$$

**Criteria for Determining Exchange Ratio**

Commonly used criteria for establishing exchange ratio are earnings per share (EPS), market price per share and book value per share.

Earnings per share reflect, the earning power of a firm. However, it does not take into consideration the difference in the growth rate of earnings of the two firms, gains stemming out of merger and the differential risks associated with the earnings of the two firms. Further, EPS cannot be the basis if it is negative.

Market price per share can also be the basis for determining exchange ratio. This measure is very useful where the shares of the firms are actively traded. Otherwise, market prices may not be very reliable. There is also possibility of manipulation of market process by those having a vested interest.

As regards utility of book value per share as the basis for determining exchange ratio, it may be noted that book values do not reflect changes in purchasing power of money as also true economic values.

**Takeovers**

Financial restructuring via takeover generally implies the acquisition of a certain block of equity share capital of a firm which enables the acquirer to exercise control over the affairs of the company. It is not always necessary to buy more than 50% of the equity share capital to enjoy control since effective control can be exercised with a remaining portion is widely diffused among the shareholders who are scattered and ill-organized.

Some of the recent major takeovers in the Indian Corporate world are:

| | | |
|---|---|---|
| HLL | : | Modern Foods |
| HINDALCO | : | INDAL |
| Sterlite Industries | : | Hindustan Zinc |
| Chhabrias | : | Shaw Wallace |
| Tatas | : | CMC |
| Hindujas | : | Ashok Leyland |
| Goenkas | : | Calcutta Electric Supply Company |
| Wipro | : | Ner Ve Wire |
| Satyam | : | India World |
| Gujarat Ambuja | : | DLF Cement |

## 18.5 FORMULATING MERGER AND ACQUISITION STRATEGY

Mergers and acquisition should be planned carefully since they may not always be helpful to the organizations seeking expansion and consolidation and strengthening of financial position. Studies made by Mc Kinsey & Co. show that during a given 10-year period, only 23 percent of the mergers ended up recovering the costs incurred in the deal, much less shimmering synergistic heights of glory. The American Management Association examined 54 big mergers in the late 1980s and found that about half of them lead straight down hill in productivity and profits or both.

Broadly speaking, acquisition strategy should be developed along the following lines:

- **Laying down Objectives and Criteria**

A firm embarking upon a strategy of expansion through acquisition must lay down acquisition objectives and criteria. These criteria sum up the acquisition requirements including the type of organization to be acquired and the type of efforts required in the process. Laying down the corporate objectives and the acquisition criteria ensures that resources are not dissipated on an acquisition when these might more profitably be used to expand existing business activities.

- **Assessing Corporate Competence**

A detailed and dispassionate study of the firm's own capabilities should form an integral part of acquisition planning. Such a study is done to make sure that the firm possesses the necessary competence to carry out the acquisition programme successfully. Once the corporate strengths have been formulated the management should appoint an *adhoc* task force with a member of the top management team to head this body and functional executives on its members to carry out the pre-acquisition analysis, negotiate with the prospective firm and integrate the firm, perform post-acquisition tasks and monitor acquisition results.

- **Locating Companies to Acquire**

Before undertaking search process the central management should consider a number of factors which have their significant bearing on the aquisition. Some of these factors are listed below:

1. **Choice of Company:** A firm keen to takeover another company should look for companies with high growth potential and shortlist firms with large assets, low capital bases with fully depreciated assets or with large tracts of real estate or securities.
2. **Type of Diversification:** Success of acquisition also depends on form of diversification. Success has been reported mostly in horizontal acquisitions, where the company purchased belonged to the same product-market as the acquirer. Success rate in the case of vertical integrations has been relatively lower. Further, marketing-inspired diversifications appeared to offer the lowest risk, but acquisitions motivated by the desire to take advantage of a common technology had the highest failure rate of all. Pure conglomerate acquisitions, which tend to be in low technology industries, had a lower overall failure rate than all forms of acquisition except horizontal purchases.
3. **Market Share:** Another variable influencing acquisition success is the market share. Higher the market share, greater the success of acquisition move. Kitching's study reveals that acquisition with market shares of less than 5 percent for diversification moves had failure rates of over 50 percent.
4. **Size of Purchase:** The size of an acquired firm in relation to the acquirer is an important determinant of acquisition success. The possibility of success increases with increase in size of the acquisitionbecause acquisition of a large firm is likely to bring about material change in corporate performance. For large purchases, management makes a determined effort to ensure that the new acquisition achieves the results expected of it quickly.
5. **Profitability of Acquisitions:** Success of acquisition also depends upon profitability of the firm being acquired. Acquiring a loss making firm may not ensure success unless the acquiring firm is equipped with a skilled management, capable of handling such situations. It may, therefore, be in firms are not available for sale or require the payment of such a premium as to make their acquisitions unattractive. Acquisition of highly promising organizations may be resisted by the host country governments. The firm may go for low profit organizations if they are at the bottom of their business cycle or when the unprofitable assets are broken up and disposed off to return more than the purchase price or where there are tax shields of losses to be carry forward or other similar financial advantages.

Keeping in view the above factors, the acquiring firm should ascertain what the potential firm can be for the organization which it cannot do on its own, what the organization can do for the potential firm, what it cannot do itself, what direct and tangible benefits or improvements results from acquiring the potential firm and what is the intangible value of these saving to the organization. In the same way, legal procedures involved in acquisition must begin through in detail.

An enormous amount of information pertaining to the above aspects gathered over a period of time is indispensable to a firm with an active continuous acquisition programme. Commercial data are not readily available everywhere. Financial data in particular is not reliable in some countries due to varying accounting conventions and standards, local tax patterns and financial market requirements. However, this should not deter management from going ahead with its plan of acquiring overseas firms. The desired information can be gathered particularly through information service organizations such as Business International and Economic Intelligence Unit, non-competing firms and from various international publications like International Yellow Pages, the Exporter's

Encyclopaedia and Directories of manufacturers, importers and other kinds of business in world markets.



- **Evaluating the Prospective Candidtates for Acquisition**

After identifying firms according to the specification, the task force should evaluate each of the prospective candidates to pick out the one that suits most of the needs of the acquiring company. The following aspects should receive attention of the evaluator:

- **General Background of the Potential Candidates**

The background information of each of the identified companies about the nature of business, past year business performance, product range, fixed assets, sales policy, capital base, ownership, management structure, directors and principal officers and the recent changes in regard to the above should be collected and sifted in terms of the interests of the acquiring company.

It will also be useful to scan the current organizational structure and climate of the perspective firms. The focus of the study should be on strength of labour, their skills, labour unions and their relations with management. Departmentation of the firms, extent of delegation of authority, communication channels, wage and incentive structure, job evaluation etc.

- **Appraisal of Operation of the Potential Candidates**

The task force should scan the location of the plants of the company, its machines and equipments and their productivity, replacement needs, operating capacity and actual capacity being used, critical bottlenecks, volume of production by product line, production costs in relation to sale price, quality, stage in life cycle, production control, inventory management policies, stores procedures, and plant management competence. It may be helpful to appraise research and development capability of managing production lines and competence in distributing products.

It will also be useful to undertake detailed appraisal of the product purchasing organization and its competence, major suppliers and materials supplied by them, prices being charged and alternative sources. It should also be found out if there have been instances of bad buying, overstocking, large stock write offs, slow 'moving stock.'

Evaluator should assess the operations of the firm from marketing point of view. Thus, current policies of the firm pertaining to product, pricing, packaging, promotion and distribution and recent changes therein, channels of distribution, sales force and its composition, markets served in terms of the share held, nature of consumers, consumer loyalty, geographical distribution of consumers should be kept in view. Identification of major competitors and their market share are source of the critical aspects the must receive attention of the evaluator.

## 18.6 REGULATION OF MERGERS AND TAKE OVERS IN INDIA

Mergers and acquisition may lead to exploitation of minority share holders, may also stifle competition and encourage monopoly and monopolist corporate behavior. Therefore, most of the countries have their own legal frame work to regulate the merger and acquisition activities. In India, merger and acquisition are regulated through the provision of companies Act 1956, the monopolies and restrictive trade practices (MRTP) Act 1969, the Foreign exchange regulation

Act (FERA) 1973, the income tax Act 1961, and the securities and exchange board of India (SEBI) also regulates mergers and acquisition (take over).

**Legal Measures Against Takeover:**

The company's act restricts an individual or a group of people or a company in acquiring shares in public limited company to 25 percent (including the share held earlier) of the total paid up capital. However, the control group needs to be informed when ever such holding exceeds 10 percent. When ever the company, or group of individuals or individuals acquires the share of another company in excess of the limits should take the approval of the share holders and the Government.

In case of a hostile takeover bid companies have been given power to refuse to register the transfer of shares and the company should inform the transfere and transfer within 60 days. Hostile take over is said to have taken place in case if

- legal requirements relating to the transfer of share have not be complied with or
- the transfer is in contravention of law or
- the transfer is prohibited by Court order
- the transfer is not in the interests of the company and the public Protection of minority shareholders interests

The interest of all the shareholders should be protected by offering the same high price that is offered to the large share holders. Financial Institutions, banks and few individuals may get most of the benefits because of their accessibility to the process of the take-over deal market. It may be too late for small investor before he knows about the proposal. The company act provides that a purchaser can force the minority shareholders to sell their shares if.

1. The offer has been made to the shareholders of the company.
2. The offer has been approved by at least 90 percent of the shareholders when transfer is involved within four months of making the offer.

- **Guidelines for Takeovers:**

A listing agreement of the stock exchange contains the guidelines of takeovers. The salient features of the guildelines are:

1. **Notification to the Stock Exchange:** If an individual or a company acquires 5 percent or more of the voting capital of a company the stock exchange shall be notified within 2 days of such acquisition.
2. **Limit to Share Acquisition:** An individual or a company which continues acquiring the shares of another company without making any offer to share holders until the individual or the company acquires 10 percent of the voting capital.
3. **Public Offer:** If this limit is exceeded a public offer to purchase a minimum of 20 percent of the shares shall be made to the remaining shareholders.
4. **Offer Price:** The offer price should not be less than the highest price paid in the paid in the past 6 months or the negotiated price.

**Disclosure:** The offer should disclose the detailed terms of offer in details of existing holding.

**Offer Document:** The offer document should contains the offer and financial information. The companies act guidelines for take over are to ensure full disclosure about the merger and take over and to protect the interests of the share holders.

**Legal Procedures:** The following in the legal procedure for merger or acquisitions laid out in the Companies Act 1956.



**Permission for Merger:** Two or more companies can amalgamate only when amalgamation is permitted under their memorandum of association. If the memorandum of association does not contain this clause it is necessary to seek the permission of the share holders board of directors and the company law board before affecting the merger.

**Information to the Stock Exchange:** The acquiring and acquired companies should inform the stock exchange where they are listed about the merger.

**Approval of Board of Directors:** The Board of Directors of the individual companies should approve the draft proposal for merger and authorize the management to further to pursue the proposal.

**Application in the High Court:** An application for approving the draft amalgamation proposal duly approved by the board of directors of the individual companies should be made to the high court. The high court would convene the meeting of the shareholders and creditors to approve the amalgamation proposal. The notice of meeting should be sent to them at least 21 days in advance.

**Shareholders and Creditors Meetings:** The individual companies should hold corporate meetings of their shareholders and creditors for approving the merger scheme. A minimum of 75 percent of share holders and creditors in separate meetings by voting in person or by proxy must accord approval to the scheme.

**Sanction by the High Court:** After the approval of shareholders and creditors on the petitions of the companies the high court will pass order sanctioning the amalgamation scheme after it is satisfied that the scheme is fair and reasonable. It can modify the scheme if it deems fit so.

**Filling of the Court Order:** After the court order its certified true copies will have to be filled with the Registrar of companies.

**Transfer of Assets and Liabilities:** The assets and liabilities of the acquired company will exchange shares and debentures of the acquired company of accordance with the approved scheme.

**Payment by Cash or Securities:** As per the proposal the acquiring company will exchange shares and debentures and or pay cash for the shares and debentures of the acquired company. These securities will be listed on the stock exchange.

## 18.7 TAKE OVER STRATEGIES: INDIAN EXPERIENCE

The take over strategies involve successful identification and takeover of another corporation. However, it entails complex legal and financial action on the part of the acquiring firm when a firm's strategy is to seek external growth through acquisition. This is generally done by the firm's top management, legal staff, bankers and even outside consultants who specialise in recommending workable corporate unions.

As financial analyst, we must have a way to evaluate mergers and acquisitions. The evaluator of acquisition should analyse the price paid for acquisition and its impact on the share holders wealth. The shareholders' wealth is interpreted by different people in different ways. There are several methods of wealth maximisation of share holders. The tools and techniques for the evaluation of mergers are also used in support of the executive judgement and political process in corporations.

When a company wants to acquire another company, its share holders have to pay considerations to the shareholders of the company under acquisition. This consideration is the value of the shares or assets of the company under acquisition. The right kind of consideration to be paid its current market value of the firm under acquisition. However, it is found in many of the acquisitions that the current market value is minimum consideration to be offered, if the consideration price to be paid is more than the current market price is at premium. The premium may be paid because of the under valuation of the shares or as an incentive to the share holders of the company under acquisition. This would enable the acquiring company to have the controlling right of the acquired company.

In 1932 the Lever Brothers (INDIA) began its manufacturing activity in India (now Hindustan Lever Ltd) taking over North West South Co with a capacity of 2,250 tones. Over the years and till the mid fifties Lever similarly acquired sick factories at various other sites. The govt. got tough in 1969 with the MRTP Legislation making takeover virtually impossible.

In the early eighties the Government accorded high priority to the revival of sick units and enacted laws like the Industrial Reconstruction Bank of India Act and other Sick Industrial Legislation.

Lever quickly saw an opportunity in taking over and reviving a sick company viz. Stepehn Chemicals a Punjab based soaps and detergents firm. The company was not in attractive shape, its outstanding debts stood at Rs. 6 crore and its Rs. 3 crore capital had been wiped out by losses. But that did not deter Lever from 10,000 tones of detergents and 7,200 tones of soaps that Stephen had capacities for when lever started the lease. The Rs. 200 crore company today rolls out more than 50,000 tonnes of soaps and detergents. The high point of stephen's success game four years ago is in the forefront of Lever war against Nirma, "Wheel" washing power. Lever's successful answer to Nirma challenge was produced by Stephen.

The Stephen acquisition was followed by a chain of other sick units which Lever snapped up and quickly revived.

Detergent Bar Manufacturer jon. Home products and Sunrise Chemicals, a soap company in Rajakot. There is also a unique case of Shivalik cellulose a Gujarat based paper plant which was set up in seventies, but turned sick though it was a paper plant. Lever was interested. Taking Shivalik on a 24 years lease with an option to buy after five years; Lever turned the paper plant into a 30,000 tones soap plant has kicked of production recently.

In the afternoon of 9th March 1993 Tata Oil Mill company Ltd (TOMCO) informed the Bombay stock exchange about its intention to merge with the Hindustan Lever Ltd. The Board of Directors of the two companies approved the merger on 19th March, 1993, TOMCO is Rs. 4,460 million turn over (1992) company and Lever's Rs. 20,000 million.

Lever would control one-third of three million tonnes soaps and detergents markets by this merger. Some competitors of Lever think that it will eliminate

competition. The management of Lever, however, felt that the merger would result into a strategic fit in many areas such as brand positioning, manufacturing locations, geographical reach and distribution network. Tomco has four manufacturing plants and large distributive network covering 2,400 stockists and nine million outlets. It is strong in South.

Merger would have many benefits for Tomco which is reported to have incurred a loss of Rs. 66 million for the first six months of 1992-1993. It was Lever's nearest rival but lagged much beind in the eighties. A number of attempts by management to revive Tomco through diversification did not succeed. The acquisition of Tomco by the Lever to gain market leadership and dominance is seen strategically important in view of the intensifying competition following strategic alliance between Godrej soaps and the American multinational, Procter and Gamble.

Already most of Tomco's brands Hamam, Moti, the 501 range of laundry soaps range have been re-launched. Tomco take over has helped on capitalizing on new brand like Tomco hair Oil, Nihar and Tomco's eau de cologne.

With the new take over code, the Indian corporates are experiencing the wave of merger and acquisitions. The new legal frame work govering the merger and take over opened the doors to hostile take over. The market for corporate control has exploded, with merger and acquisitions being accepted as means of corporate restructuring and redirecting capital towards efficient management. The political uncertainty and the slow down of industrial production have depressed the share prices to levels where acquisition have become viable. This is an ideal opportunity to take over without the government intervention. Now the financial institutions are also ready to sell their stock at good prices. They are no more interested in protecting the existing promoters, in the recent half a dozen mergers and acquisitions. The Rs. 8,342/- crore Hindustan Lever resurfaced with the negotiated acquisition of the Rs. 59,11 crore LAKME from the Rs. 35,000 crore TATA GROUP the Rs. 1,162 crore Indian Aluminum was targeted by Rs. 1,146 Sterlite Industries by targeting 20 percent stock in the former one. Imeediately alarmed by this, Indian Aluminum targeted the Rs. 162 crore Pennar Aluminum. In Pharmaceuticals, the Rs. 400 crore wockhard targeted Rs. 200 crore Merind. The cement Industry saw a major restructuring bid as the Rs. 832 crore India Cements managed to take over the Rs. 349 crore Raasi Cements.

**Indian Cements Ltd.**

The Chennai based cements major India Cements Ltd. (ICL) has pulled off a quite coup in its bid to acquire Raasi Cement Ltd by winning over the fighting main promoter and chairman Dr. B.V. Raju ICL originally held 9.75 percent stake in RCL. Later it acquired 8.28 percent from Mr. M.K.P. Raju, 2.23 percent from APIDC and 1.14 percent from a Chennai based shar broking

**Financials 1996-97 (Rs. Crores)**

| | India Cements | Raasi Cements |
|---|---|---|
| Sales | 632.50 | 410.19 |
| Gross Profit | 126.65 | 42.20 |
| Net Profit | 82.58 | 22.83 |
| Equity | 64.34 | 16.31 |
| EPS (Rs) | 12.83 | 13.99 |

firm. The promoters of RCL sold their 32 percent equity to ICL. ICL and its associates on the verge of picking up 8 percent from a transport contractor who is also an the board of Raasi. ICL now plan to go ahead with an open offer to mop up 20 percent at the earlier offered price of Rs. 300. This will increase the total Stake in Raasi to nearly 78 percent. Dr. B. v Raju, managing Director of Raasi said the "The present take over regulation do not give protection to technocrat promoter who cannot have large stake in companies. The regulations should be modified to protect the technocrat entrepreneurs and the government should seriously consider of introducing the buy back of shares."

While the merger and acquisition may become direction less and corporate conglomerates may end up with unanticipated added costs instead of anticipated economies of scale, the benefits of a successful acquisition are powerful, offering dominant market share, the strength of sheer size and unique competitive advantage. But how does the bidder for takeover know before hand whether the acquisition he is targeting will be worth the price he has to pay?

Corporate India is in the grip of a new wave of mergers. It is take over time again if you read the pink papers. The take over bazaar is brimming over with companies waiting to be picked up. The volume of mergers & acquisitions deal in the country is no match for similar deals currently struck abroad. One International Mega deal the recently aborted one is between Glaxo and Smithkilne Beecham will dwarf the total value of deal (roughly estimated at Rs. 2000 crore by market source) struck here over past few months.

**Activity 1**

Bharat Chemicals Ltd. is planning to merge Modern Fertilizers Ltd. Bharat Chemicals has approached you to advise in this regard. Putting yourself in the position of a financial consultant:

a) What information would you like to collect from the firms?

b) How would you evaluate feasibility of the proposal?

c) What important criteria would you take into account to determine exchange rate between the two firms?

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

....................................................................................................

## 18.8 DIVESTITURES

While mergers and acquisitions lead to expansion of business in some way or the other, divestiture move involves some sort of contraction of business. Divestiture as form of corporate restructuring signifies the transfer of ownership of a unit, division or a plant to someone else. Sale of its cement division by Coromandel Fertilizers Ltd. to India Cements Ltd. is an example of divestiture.

Divestiture strategy is pursued generally by highly diversified firms who have had difficulty in managing broad diversification and have elected to divest certain of their businesses to focus their total attention and resources on a lesser number of core businesses. Divesting such businesses frees resources that can be used to reduce debt, to support expansion of the remaining busines, or to make acquisitions that materially strengthen the company's competitive position in one or more of the remaining core business. For instance, A V Birla group divested a publicly announced paper and chemicals project and a sea water magnesia unit in Visakapatnam and MRPL a petrochemicals Joint Venture with HPCL, so as to strengthen its core business.

Before taking a final decision, finance manager should assess if its is in the interest of the firm to do so.

### Financial Assessment of a Divestiture

Financial assessment of divestiture proposition involved the following steps:

- Estimate the post-tax cash flow of the selling firm with and without divestiture of the unit in question.
- Establish the discount rate for the unit on the basis of cost of capital of some firms engaged in the same line of business.
- Compute the unit's present value, using the discount rate, as determined above.
- Find the market value of the unit's specific liabilities in terms of present value of the obligations arising from the liabilities of the unit.
- Determine the value of the selling firm's ownership position in the unit by deducting market value of the unit's liabilities from the present value of its cash flow.
- Compare the value of ownership position (VOP) with the proceeds from the divestiture (PD). PD represents compensation received by the selling firm for giving up its ownership in the unit. Hence, the decision rule will be:

$$PD > VOP = \text{Sell the unit}$$

$$PD = VOP = \text{Be indifferent}$$

$$PD < VOP = \text{Retain the unit}$$

## 18.9 CHARACTERISTICS OF AND PRE-REQUISITIES TO LEVERAGED BUYOUT SUCCESS

Leveraged buyout (LBO) is an important form of financial restructuring which represents transfer of an ownership consummated heavily with debt. LBO involves an acquisition of a division of a company or sometime other sub unit. At times, it entails the acquisition of an entire company.

- **Characteristics of LBO**

1. A large proposition of the purchase price in debt financed.
2. The debt is secured by the assets of the enterprise involved.

3. The debt is not intended to be permanent. It is designed to be paid down.
4. The sale is to the management of the division being sold.
5. Leveraged buyouts are cash purchases, as opposed to stock purchases.
6. The business unit involved invariably becomes a privately held company.

**Pre-requisites to Success of LBO**

1. The company must have a several year window of opportunity where major expenditures can be deferred. Often it is a company having gone through a heavy capital expenditure programme and whose plant is modern.
2. For the first several years, cash flows must be dedicated to debt service. If the company has subsidiary assets that can be sold without adversely impacting the core business, this may be attractive because sale of such assets provides cash for debt service in the initial years.
3. The company must have stable, predictable operating cash flows.
4. The company should have adequate physical assets and/or brand names which in times of need may lead to cash flows.
5. Highly competent and experienced management is critical to the success of LBO.

**Example 5**

Modern Manufacturing Ltd. (MML) has four divisions, viz; Chemical, Cement, Fertilizers and Food. The Company desires to divest the Food Division. The assets of this division have a book value of Rs. 240 lakh. The replacement value of the assets is Rs. 340 lakh. If the division is liquidated, the assets would fetch only Rs. 190 lakh. MML has decided to sell the division if it gets Rs. 220 lakh in cash. The four top divisional executives are willing to acquire the division through a leveraged buyout. They are able to come up with only Rs. 6 lakh in personal capital among them. They approach a finance consultant for financial assistance for the project.

The Finance Consultant prepares projections for the Food division on the assumption that it will be run independently by the Four executives. The consultant works out that cash flows of the division can support debt of Rs. 200 lakh it finds a finance company that is willing to lend Rs. 170 lakh for the project. It has also located a private investor who is ready to invest Rs. 24 lakh in the equity if this project. Thus, the Food division of MML is acquired by an independent company run by the four key executives, which is funded through debt to the tune of Rs. 170 lakh and equity participation of Rs. 30 lakh.

In the above case, two forms of funds are employed:

Debt (Rs. 170 lakh) and equity (Rs. 30 lakh). Thus, LBO permits going private with only moderate equity. The assets of the acquired division are used to secure a large amount of debt. The equity holders are, of course, residual owners. If things move as per plans and the debt is serviced according to schedule, after 5 years they will own a healthy company with a moderate debt. In any LBO, the first several years are key. If the company can repay debt regularly, the interest burden declines resulting in improved operating earnings.

Two types of risks involved in LBO are: business risk – arising out of unsatisfactory performance of the company and the consequent failure to service the debt – and interest rate risk arising out of changing interest rates which may, in case of sharp rise, involve increased financial burden.

Thus, the equity owners are playing a high-risk game and the principle of leverage being a double-edged weapon becomes evident. Another potential

problem with the need to service debt is the focus on short-run profitability. This may have telling effect on the long-term survival and success of the organization.

## 18.10 LEVERAGED RECAPITALIZATION

Another kind of financial restructuring is leveraged recapitalization (LR). LR is a process of raising funds through increased leverage and using the cash so raised to distribute to equity owners, often by means of dividedn. In this transaction, management and other insiders do not participate in the payout but take additional shares instead. As a result, their proportional ownership of the company increases sharply.

LR is similar to LBO in as much as high degree of leverage is incorporated in the company and the managers are given a greater stake in the business via stock options or direct ownership of shares. However, LR allows company to remain public unlike LBO which converts public traded company into private one.

As for the potentiality of LR as a means of value addition to the company, LR has been found to have a salutary effect on management efficiency due to high leverage and a greater equity stake. Under the discipline of debt, internal organization changes may take place which may lead to improvements in operating performance.

### Spin-Offs

A spin-off, as a form of restructuring, involves creation of a new, independent company by detaching part of a parent company's assets and operations. Shares in the new company are distributed to the parent company's stockholders.

Spin-offs widen investors' choices by allowing them to invest in just one part of the business. More important, spin-offs can motivate managers to perform better. By spinning-off those businesses which do not fit the company's core competence, the management of the parent company can concentrate on its main business. If the businesses are independent, it is easier to see the value and performance of each and reward managers accordingly. Investors feel relieved from the worry that funds will be siphoned from one business to support unprofitable capital investment another.

Announcement of a spin-off is generally greeted as good news by investors who reward the focus and penalize scope, scale and diversification. Spin-off is considered as a way of protecting the Crown Jewel from a predator. In increases the competence of core business and keeps away the unwanted activities resulting in improved profitability of the parent company.

### Carve-Outs

Carve-outs are similar to spin-off with one exception that shares in the new company are sold in public instead of distributing them among existing equity owners. Carve outs result in new cash flows.

Although carve-outs share many of the virtues of spin-offs, the same depends on whether a majority stake is sold so that the new company operates independently. Sale of a minority stake leaves the parent company is control and may not reassure without the investors who worry about lack of focus or poor fit.

But at times a minority carve-out can create a market for the subsidiary shares and allows compensation schemes based on management ownership of shares or stock options.

## 18.11 REORGANIZATION OF CAPITAL

Reorganization of Capital refers to the restructuring of company by affecting change in the capital structure of the company with a view to improving its financial strength. It is an adjustment of gearing i.e. debt-equity ratio of the company so as to maximize the wealth of the share owners.

Despite careful financial planning, a firm may be constrained to bring about certain adjustments in its capital structure because of changes in business climate, fluctuation of interest rates need to avoid unwanted leverage or to eliminate a bond issue carrying prohibitively restrictive features and similar other situations.

In reorganization of capital a firm attempts to reduce total debt by reducing fixed charges through raising fresh equity share capital. But when the equity is higher, the cost of serving also tends to be higher which can be reduced by relying more on debt for financing further expansion programmes. Firm may, therefore, think of reducing fixed burden of debt financing through voluntary extinction of bonds, extinction through refunding, extinction through redemption and extinction through conversion.

- **Extinction Through Refunding**

Refunding means substituting old bonds by new bond issue. The management uses this method to take advantage of cheaper sources of financing. When interest rate in the market drops and the management believes that the firm can sell new bonds at a lower rate of interest than that being paid on outstanding debts. Sometimes, to avoid bonds carrying unfavourable terms, the management may be tempted to substitute old bonds by new ones. Also, a firm which borrowed funds in its initial years at higher cost because of its weak financial position may find subsequently when it gains strength that it can procure loans at cheaper cost and at convenient terms.

Accordingly, the firm may take recourse to refunding as a means of reducing its cost of capital. The management may also use refunding to consolidate several existing bond issues to simplify their management. Among these reasons, however, refunding is generally resorted to reduce cost of servicing debt and to improve earning per share of the firm.

Before refunding an outstanding bond the finance manager must determine whether or not refunding is profitable. Accordingly he must, as in capital budgeting decision, match the costs of refunding against receipts as a result of the refunding operation. It is only when receipts exceed costs, the management should proceed ahead with refunding operation otherwise the idea of refunding must be dropped.

- **Extinction Through Redemption**

Redemption is the actual paying of the debt. Through redemption, the firm extinguishes the bonded debt absolutely. this is possible only when bond issues contain call privilege giving the firm the option to buy back the bonds at a stated price before their maturity. The bond indenture provides the prices which the firm pay the bondholder for a bond called for redemption before their maturity. Generally, this redemption price is greater than the par value of the bond. The actual price is fixed taking into account par value of the bond plus a reasonable premium. This bonus is provided to enable the bondholder whose bond has been called for redemption to take time to find another profitable investment for his money without suffering any loss of interest.

When bonds are redeemed, the firm needs cash to take them up. There are two methods of providing the cash, viz; (i) voluntary setting aside of moneys

received from earnings in such amounts as make it possible to meet the bonds when they are to be paid and (ii) putting aside of a sinking fund to pay off the bonds. While the former is done by the management as a matter of business and financial policy and not because of any agreement with bondholders, the latter is made obligatory by the terms of the bond indenture.

- **Extinction Through Conversion**

Management may sometimes convert bonds into stocks in order to simplify capital structure and also to get rid of bonded indebtedness and the fixed interest charges associated with it. When a firm converts its bonds, it does not require cash to pay to the bondholders. When bonds are converted into stock, bondholders become owner of the firm and bonded indebtedness is wiped out.

This is possible only when bond issue is convertible. The conversion privillege is exercised almost without exception wholly at the option of the bondholders. However, the company may force conversion at a time when it is more profitable for the bondholders to convert rather than surrender the bonds and receive cash. Before deciding about conversion finance manager must examine the impact of the transaction on the market value of the stock as the decision criterion. Rate of conversion is provided in debt indenture. For example, one Rs. 1000 par value bond may be exchanged for 10 shares of the stock. Sometimes the conversion basis is expressed by stating that the bonds are convertible into stock at some specified figure, say Rs. 100 which means that the stock is being valued for conversion purposes at Rs. 100 a share.

## 18.12 FINANCIAL RECONSTRUCTION

Financial reconstruction is the recasting of firm’s capital structure to reduce the amount of fixed burden of leverage. Where firm has been suffering operating losses for several years but has potential to recover in future and its economic worth as an operating entity is greater than its liquidation value, management may think of keeping the firm alive by changing its capital structure.

The major difference between reorganization of capital and financial reconstruction is that the former is resorted to for further improving financial health of the firm but the latter is taken up when the firm is continuously suffering losses and is heading towards liquidation.

Formulation of reconstruction plan involves three steps:

(i) Determine total valuation of the company by capitalization of prospective earnings. For example, if future earnings of a company are expected to be Rs. 4 lakh, and the overall capitalization rate of similar companies average 10 percent, total value of Rs. 40 lakh would be set for the company.

(ii) Determine new capital structure for the company to reduce fixed charges so that there will be an adequate coverage margin. To reduce these fixed charges, the total debt of the firm is reduced by shifting to income, bonds, preferred stock and common stock. In addition, terms of the debt may be changed. If it appears that the reconstructed company will need new financing in the future, a more conservative ratio of debt to equity may be thought of so as to provide for future financial flexibility.

(iii) Valuation of the old securities and their exchange for new securities. In general, all senior claims on assets must be settled in full before a junior claim can be settled. In the exchange process, bondholders must receive the par value of their bonds in another security before there can be any distribution to preferred stockholders. The total valuation figure arrived at in **step 1** sets an upper limit on the amount of securities that can be issued.

The existing capital structure of a company undergoing reconstruction is given as under:

| | **Rs. in lakhs** |
|---|---|
| Debentures | 18 |
| Subordinated debentures | 6 |
| Preferred stock | 12 |
| Common stock equity (book value) | 20 |
| **Total** | **Rs. 56** |

If the total valuation of the company is to be Rs. 40 lakh, the following could be the new capital structure:

| | **Rs. in lakhs** |
|---|---|
| Debentures | 6 |
| Income bonds | 12 |
| Preferred stock | 6 |
| Common stock | 16 |
| **Total** | **Rs. 40** |

After deciding about the **'appropriate'** capital structure for the company, the new securities have got to be allocated. Thus, the debentureholders exchange their Rs. 18 lakh in debentures for Rs. 6 lakh in new debentures and Rs. 12 lakh in income bonds, that the subordinated debentureholders exchange their Rs.6 lakh in securities for preferred stock, and that preferred stock holders exchange their securities for Rs. 12 lakh of common stockholders would then be entitled to Rs. 4 lakh in stock in the reconstructed company, or 25 percent of the total common stock of the reconstructed company.

Thus, exchange claim is settled in full before a junior claim is settled. In a harsh reconstruction, debt instruments may be exchanged for common stock in the newly reconstructed company and the old common stock may be eliminated completely. Much depends on negotiation between the management and claimholders.

## 18.13 SUMMARY

In recent years majority of the Corporate Organizations across the globe including India engaged in restructuring exercises so as to cope with increased business complexities and uncertainties and improve their competitive strength. Corporate restructuring exercises were financial, technological and organizational in nature.

Mergers, acquisitions, takeovers, divestitures, spin-offs, leveraged buyouts, leveraged recapitalization and financial reconstruction, as significant forms of financial restructuring, have become a major force in the economic and financial milieu all over the world.

Mergers, which subsume both absorption and consolidation, may take the form of horizontal, vertical, conglomerate and reverse. The principle economic rule for a merger is that value of the combined entity should be greater than the sum of the independent values of the merging entities. The most cogent reasons for merger are economies of scale, higher growth, advantage of complementary resources, speedy diversification, access to latest technology, larger market base, strong financial position and so on. The net economic benefit of a merger is the difference between the present value of the combined unit and the present value of the combining entities if they remain independent.

A divestiture represents sale of division or plant or unit of one firm to another. Divestiture decisions are driven by a variety of motives such as raising capital,

curtailment of losses, strategic realignment and efficiency gain. Since divestitures have become common, management should scan their financial desirability systematically and rationally.

LBO as a form of restructuring represents transfer of an ownership consummated heavily with debt. It is a cash purchase as opposed to stock purchase. The firm going for LBO must have stable, predictable operating cash flows and should have adequate physical assets and/or brand names.

LR is a process of raising funds through increased leverage and using the cash so raised to distribute to equity owners. It is similar to LBO in as much as high degree of leverage is incorporated in the company. However, LR allows the company to remain public unlike LBO which converts public traded Company into private one.

At times, a company suffering from operating losses and financial problem may go for financial reconstruction to recast its capital structure to reduce the amount of fixed burden of leverage. Financial reconstruction process involves three main steps, viz; determination of total valuation of the company, determination of new capital structure for the company to reduce fixed charges and finally valuation of the old securities and their exchange for new structures.

## 18.14 KEY WORDS

**Absorption:** refers to a situation where a company survives and others lose their identity.

**Amalgamation:** refers to a situation where a new company comes into existence because of merger.

**Take over:** is the purchase by one company of a controlling interest in the share capital of another existing company.

**Divestiture:** signifies the transfer of ownership of a unit, division or a plant to some one else.

**Leveraged buyout:** represents transfer of an ownership consummated heavily with debt.

**Leveraged Recapitalization:** is a process of raising funds through increased leverage and using the cash so raised to distribute to equity owners.

**Spin-offs:** involve creation of a new, independent company by detaching part of a parent company's assets and operations.

## 18.15 SELF ASSESSMENT QUESTIONS

1. What is corporate restructuring? What motivates an enterprise to engage in restructuring exercise?
2. Discuss various forms of mergers. What are the driving forces for mergers & acquisitions?
3. Discuss various steps involved in a merger.
4. What are the regulatory provisions in India regarding mergers and acquisitions?
5. How would you assess merger as a source of value addition?
6. What is the cost of a merger from the point of the acquiring company?
7. How would you determine the present value of a merger from the point of view of the acquiring company?

8. What are the important bases for determining the exchange ratio?
9. What are the salient features of divestitures? How would you assess divestiture programme of a company?
10. What is leveraged buy out? How is it different from leveraged recapitalization?
11. Distinguish between spin-offs and carve-outs.
12. Under what circumstances does a firm reorganize its capital? What are the various techniques of reorganization of capital?
13. Divya Sugar Mills plans to acquire Shubhra Sugar Mills. The relevant financial information are:

| | Divya Sugar Mills | Shubhra Sugar Mills |
|---|---|---|
| Market Price per share | Rs. 140 | Rs. 64 |
| Number of outstanding shares | 40 lakh | 30 lakh |

The merger is expected to generate gains which have a present value of Rs. 400 lakh. The exchange rate agreed to is 0.5.

Compute the true cost of the merger from the view point of Divya Sugar Mills.

14. Dolly Electronics is contemplating to merge Smriti Electronics. The following data are available:

| | Dolly Electronics | Smriti Electronics |
|---|---|---|
| Total Current Earnings, E | Rs. 100 lakh | Rs. 40 lakh |
| Number of outstanding shares, S | 40 lakh | 20 lakh |
| Market Price per share, P | Rs. 30 | Rs. 20 |

(i) What is the maximum exchange ratio acceptable to the owners of Dolly Electronics if the P/E ratio of the combined entity is 12 and there is no synergy gain?

(ii) What is the minimum exchange ratio acceptable to the shareholders of Smriti Electronics if the P/E of the combined entity is 11 and there is a synergy benefit of 5 percent?

## 18.16 FURTHER READINGS


James C. Van Horne, *Financial Management Policy,* Prentice Hall of India Pvt. Ltd., New Delhi, 2002

Richard A. Brealey and Stewart C. Myers, *Principles of Corporate Finance,* Tata Mc Graw Hill Public Company Ltd., New Delhi, 2000

J.F. Weston, K.S. Chung and J.A. Siu, *Takeovers, Restructuring and Corporate Finance,* Prentice-Hall, upper saddle River, N.J. 1998

John J. Hompton, *Financial Decision Making,* Prentice Hall Publishing Company, Virginia, 1978

J. Fred Weston, Eugene F. Brigham, *Managerial Fiannce,* Dryden Press, Hinsdace, Illinois, 1978

Prasanna Chandra, *Financial Management,* Tata Mc Graw Hill Public Company Ltd., New Delhi, 2001

R.M. Srivastava, *Financial Management and Policy,* Himalaya Publishing House, Mumbai, 2003.