An analysis of Financial Performance of Mergers and Acquisitions in India

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Abstract:

A large number of international and domestic banks all over the world are engaged in merger and acquisition activities. One of the principal objectives behind the mergers and acquisitions in the banking sector is to reap the benefits of *economies of scale*. In the recent times, there have been numerous reports in the media on the Indian Banking Industry Reports have been on a variety of topics. The topics have been ranging from issues such as user friendliness of Indian banks, preparedness of banks to meet the fast approaching Basel II deadline, increasing foray of Indian banks in the overseas markets targeting inorganic growth.

Mergers and Acquisitions is the only way of gaining *competitive advantage* domestically and internationally and as such the whole range of industries are looking for strategic acquisitions within India and abroad. In order to attain the economies of scale and also to combat the unhealthy competition within the sector besides emerging as a competitive force to reckon with in the International economy, consolidation of Indian banking sector through mergers and acquisitions on commercial considerations and business strategies – is the essential pre-requisite. Today, the banking industry is counted among the rapidly growing industries in India. It has transformed itself from a sluggish business entity to a dynamic industry. The growth rate in this sector is remarkable and therefore, it has become the most preferred banking destinations for international investors'. In the last two decade, there have been paradigm shift in Indian banking industries. The Indian banking sector is growing at an astonishing pace. A relatively new dimension in the Indian banking industry is accelerated through mergers and acquisitions. It will enable banks to achieve world class status and throw greater value to the stakeholders.

Keywords: *acquisitions, banking supervision, commercial banking, competition, India, international, mergers, motive*

Introduction

The process of mergers and acquisitions has gained substantial importance in today's corporate world. This process is extensively used for restructuring the business organizations. Mergers and acquisitions (abbreviated M&A) is an aspect of corporate strategy, dealing with the buying, selling, dividing and combining of different companies and similar entities that can help an enterprise grow rapidly in its sector or location of origin, or a new field or new location.

In India, The concept of merger and acquisition in India was not popular until the year 1988 and then government bodies initiated mergers and acquisitions. Some well known financial organizations also took the necessary initiatives to restructure the corporate sector of India by adopting the mergers and acquisitions policies.

The *Indian economic reform* since 1991 has opened up a whole lot of challenges both in the domestic and international spheres. The increased competition in the global market has prompted the Indian companies to go for mergers and acquisitions as an important strategic choice. India has emerged as one of the top countries with respect to merger and acquisition deals. In 2007, the first two months alone accounted for merger and acquisition deals worth $40 billion in India.

The trends of mergers and acquisitions in India have changed over the years. The immediate effects of the mergers and acquisitions have also been diverse across the various sectors of the Indian economy.

Objective:

This paper seeks

1. To examine the effects on financial performance due to merger
2. To study other variables affecting company's operations

Introduction

Merger is defined as combination of two or more companies into a single company where one survives and the others lose their corporate existence. The survivor acquires all the assets as well as liabilities of the merged company or companies. Generally, the surviving company is the buyer, which retains its identity, and the extinguished company is the seller. Merger is also defined as amalgamation. In other words, it is the fusion of two or more existing companies. All assets, liabilities and the stock of one company stand transferred to Transferee Company in consideration of payment in the form of:

- Equity shares in the transferee company,
- Debentures in the transferee company,
- Cash, or
- A mix of the above modes.

Merger is a financial tool that is used for enhancing long-term profitability by expanding their operations. Mergers occur when the merging companies have their mutual consent as different from acquisitions, which can take the form of a hostile takeover.

Managers are concerned with improving operations of the company, managing the affairs of the company effectively for all round gains and growth of the company which will provide them better deals in raising their status, perks and fringe benefits. If we trace back to history, it is observed that very few mergers have actually added to the share value of the acquiring company and corporate mergers may promote monopolistic practices by reducing costs, taxes etc.

Merger Types

Merger or acquisition depends upon the purpose of the offeror company it wants to achieve. Based on the offeror's objectives profile, combinations could be vertical, horizontal, circular and conglomeratic as precisely described below with reference to the purpose in view of the offeror company.

(A) Horizontal combination:

It is a merger of two competing firms which are at the same stage of industrial process. The acquiring firm belongs to the same industry as the target company. The main purpose of such mergers is to obtain economies of scale in production by eliminating duplication of facilities and the operations and broadening the product line, reduction in investment in working capital, elimination in competition concentration in product, reduction in advertising costs, increase in market segments and exercise better control on market.

(B) Vertical combination

A company would like to take over another company or seek its merger with that company to expand espousing backward integration to assimilate the resources of supply and forward integration towards market outlets. The acquiring company through merger of another unit attempts on reduction of inventories of raw material and finished goods, implements its production plans as per the objectives and economizes on working capital investments. In other words, in vertical combinations, the merging undertaking would be either a supplier or a buyer using its product as intermediary material for final production.

The following main benefits accrue from the vertical combination to the acquirer company:

1. It gains a strong position because of imperfect market of the intermediary products, scarcity of resources and purchased products;

2. Has control over products specifications.

(C) Circular combination:

Companies producing distinct products seek amalgamation to share common distribution and research facilities to obtain economies by elimination of cost on duplication and promoting market enlargement. The acquiring company obtains benefits in the form of economies of resource sharing and diversification.

(D) Conglomerate combination:

It is amalgamation of two companies engaged in unrelated industries like DCM and Modi Industries. The basic purpose of such amalgamations remains utilization of financial resources and enlarges debt capacity through re-organizing their financial structure so as to service the shareholders by increased leveraging and EPS, lowering average cost of capital and thereby raising present worth of the outstanding shares. Merger enhances the overall stability of the acquirer company and creates balance in the company’s total portfolio of diverse products and production processes.

Methods of Acquisition

An acquisition may be affected by:

(a) An agreement with the persons holding majority interest in the company management like members of the board or major shareholders commanding majority of voting power;
(b) purchase of shares in open market;
(c) making takeover offer to the general body of shareholders;
(d) purchase of new shares by private treaty;
(e) Acquisition of share capital through the following forms of considerations viz. means of cash, issuance of loan capital, or insurance of share capital.

BENEFITS OF MERGERS AND ACQUISITIONS

1. GROWTH or DIVERSIFICATION: - Companies that desire rapid growth in size or market share or diversification in the range of their products may find that a merger can be used to fulfill the objective instead of going through the tome consuming process of internal growth or diversification. The firm may achieve the same objective in a short period of time by merging with an existing firm. In addition such a strategy is often less costly than the alternative of developing the necessary production capability and capacity. If a firm that wants to expand operations in existing or new product area can find a suitable going concern. It may avoid many of risks associated with a design; manufacture the sale of addition or new products. Moreover when a firm expands or extends its product line by acquiring another firm, it also removes a potential competitor.

2. SYNERGISM: - The nature of synergism is very simple. Synergism exists whenever the value of the combination is greater than the sum of the values of its parts. In other words, synergism is "2+2=5". But identifying synergy on evaluating it may be difficult, infact sometimes its implementations may be very subtle. As broadly defined to include any incremental value resulting from business combination, synergism is the basic economic justification of merger. The incremental value may derive from increase in either operational or financial efficiency.

Operating Synergism: - Operating synergism may result from economies of scale, some degree of monopoly power or increased managerial efficiency. The value may be achieved by increasing the sales volume in relation to assts employed increasing profit margins or decreasing operating risks. Although operating synergy usually is the result of either vertical/horizontal integration some synergistic also may result from conglomerate growth. In addition, sometimes a firm may acquire another to obtain patents, copyrights, technical proficiency, marketing skills, specific fixes assets, customer relationship or managerial personnel. Operating synergism occurs when these assets, which are intangible, may be combined with the existing assets and organization of the acquiring firm to produce an incremental value. Although that value may be difficult to appraise it may be the primary motive behind the acquisition.

Financial synergism-Among these are incremental values resulting from complementary internal funds flows more efficient use of financial leverage, increase external financial capability and income tax advantages.

a) Complementary internal funds flows

Seasonal or cyclical fluctuations in funds flows sometimes may be reduced or eliminated by merger. If so, financial synergism results in reduction of working capital requirements of the combination compared to those of the firms standing alone.

b) More efficient use of Financial Leverage

Financial synergy may result from more efficient use of financial leverage. The acquisition firm may have little debt and wish to use the high debt of the acquired firm to lever earning of the combination or the acquiring firm may borrow to finance and acquisition for cash of a low debt firm thus providing additional leverage to the combination. The financial leverage advantage must be weighed against the increased financial risk.

c) Increased External Financial Capabilities

Many mergers, particular those of relatively small firms into large ones, occur when the acquired firm simply cannot finance its operation. Typical of this is the situations are the small growing firm with expending financial requirements. The firm has exhausted its bank credit and has virtually no access to long term debt or equity markets. Sometimes the small firm has encountered operating difficulty, and the bank has served notice that its loan will not be renewed? In this type of situation a large firms with sufficient cash and credit to finance the requirements of smaller one probably can obtain a good buy bee. Making a merger proposal to the small firm. The only alternative the small firm may have is to try to interest 2 or more large firms in proposing merger to introduce, competition into those bidding for acquisition. The smaller firm's situations might not be so bleak. It may not be threatened by non renewable of maturing loan. But its management may recognize that continued growth to capitalize on its market will require financing be on its means. Although its bargaining position will be better, the financial synergy of acquiring firm's strong financial capability may provide the impetus for the merger. Sometimes the acquired firm possesses the financing capability. The acquisition of a cash rich firm whose operations have matured may provide additional financing to facilitate growth of the acquiring firm. In some cases, the acquiring may be able to recover all or parts of the cost of acquiring the cash rich firm when the merger is consummated and the cash then belongs to it.

d) The Income Tax Advantages

In some cases, income tax consideration may provide the financial synergy motivating a merger, e.g. assume that a firm A has earnings before taxes of about rupees ten crores per year and firm B now break even, has a loss carry forward of rupees twenty crores accumulated from profitable operations of previous years. The merger of A and B will allow the surviving corporation to utility the loss carries forward, thereby eliminating income taxes in future periods.

Counter Synergism-Certain factors may oppose the synergistic effect contemplating from a merger. Often another layer of overhead cost and bureaucracy is added. Do the advantages outweigh disadvantages? Sometimes the acquiring firm agrees to long term employments contracts with managers of the acquiring firm. Such often are beneficial but they may be the opposite. Personality or policy conflicts may develop that either hamstring operations or acquire buying out such contracts to remove personal position of authority. Particularly in conglomerate merger, management of acquiring firm simply may not have sufficient knowledge of the business to control the acquired firm adequately. Attempts to maintain control may induce resentment by personnel of acquired firm. The resulting reduction of the efficiency may eliminate expected operating synergy or even reduce the post merger profitability of the acquired firm. The list of possible counter synergism factors could goon endlessly; the point is that the mergers do not always produce that expected results. Negative factors and the risks related to them also must be considered in appraising a prospective merger

Other motives For Merger

Merger may be motivated by two other factors that should not be classified under synergism. These are the opportunities for acquiring firm to obtain assets at bargain price and the desire of shareholders of the acquired firm to increase the liquidity of their holdings.

1. Purchase of Assets at Bargain Prices

Mergers may be explained as an opportunity to acquire assets, particularly land mineral rights, plant and equipment, at lower cost than would be incurred if they were purchased or constructed at the current market prices. If the market price of many socks have been considerably below the replacement cost of the assets they represent, expanding firm considering construction plants, developing mines or buying equipments often have found that the desired assets could be obtained where by cheaper by acquiring a firm that already owned and operated that asset. Risk could be reduced because the assets were already in place and an organization of people knew how to operate them and market their products. Many of the mergers can be financed by cash tender offers to the acquired firm's shareholders at price substantially above the current market. Even so, the assets can be acquired for less than their current casts of construction. The basic factor underlying this apparently is that inflation in construction costs not fully rejected in stock prices because of high interest rates and limited optimism by stock investors regarding future economic conditions.

2. Increased Managerial Skills or Technology

Occasionally a firm with good potential finds it unable to develop fully because of deficiencies in certain areas of management or an absence of needed product or production technology. If the firm cannot hire the management or the technology it needs, it might combine with a compatible firm that has needed managerial, personnel or technical expertise. Of course, any merger, regardless of specific motive for it, should contribute to the maximization of owner's wealth.

3. Acquiring new technology –To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can maintain or develop a competitive edge.

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Conclusion

In today s globalised economy, mergers and acquisitions (MandA) are being increasingly used the world over, for improving competitiveness of companies by gaining greater market share, broadening the portfolio and reduce business risk, for entering new markets and geographies, and capitalising on economies of scale etc. There has been significant growth in the mergers and acquisition activity in India since 1991. From a handful of mergers in the early 1990 s, the transaction volume has reached almost 1000 deals per year since 2000. The research in this area however, has been relatively less in the context of Indian industry research so far has been on examining specific cases of mergers and returns to shareholders, developing indicators to predict mergers or acquisitions, and the issues of corporate governance in acquisitions. This present research study has aimed to study the impact of mergers on the operating performance of acquiring corporates in Indian industry..

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