

**BASICS OF M&A**

**FOR FAMILY OWNED COMPANIES**

**AN INDIAN PERSPECTIVE**

December 2008

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## **Note of the Author**

First of all , I'd like to apologize for my English and for some mistakes, but I believe I had to start somewhere and the following pages are better than not doing it, waiting for perfection.

I do believe that India and Europe can benefit from exploring new ways of working and growing together.

I do believe , today more than ever, that after November 2008 terrorist attacks in Mumbai we should increase our efforts and investments in improving relationships between Europe and India.

I do believe that the bulk of each other's richness lies in the tremendous value of all small and medium family owned companies that can get together and become more competitive.

I do believe that both European and Indian family owned companies, as well as Private Equity Funds, can benefit from this 7.6% India's economy growth as of September 2008.

Paris & Partners can help both family owned companies and private equity funds to get together and design a new strategy for survival and growth through all different market solutions.

The aim of this short and easy reading publication is to make some M&A concepts more familiar and to get closer to Indian family owned companies and show them a new path for inorganic growth.

I would strongly appreciate new comments and insights from other M&A Indian Leaders , in order to prepare new easy short publications and create a common ground with European family owned companies and contribute to both Europe and India growth.

## **Acknowledgements**

I would like to thank and acknowledge, among others, some of the best real M&A leaders in India who taught me a lot about M&A in India and Europe with very important contributions and insights of theirs for this very first tentative draft to make M&A language easy and user friendly to beginners and to all family owned companies and entrepreneurs looking at new growth strategies.

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## **Introduction of Paris & Partners**

**Paris & Partners** does focus its activity in order to re-launch the Made in Italy in India and to promote Indian business in Italy.

**Paris & Partners** is an advisory company, that has been present in India since 2005, with offices in Milan, Mumbai, New Delhi, Pune and Goa.

**Paris & Partners** is one of the Italian players in Origination and Business Development for M&A, corporate finance and international business in the segment of both Italian and Indian family owned companies and high net worth entrepreneurs willing to invest mainly in Italy and India.

Through a prestigious partners' network, **Paris & Partners** can advise both Indian companies and High Net Worth individuals willing to invest in Europe and Eastern European Countries.

**Paris & Partners** has got a generalist approach and does focus mainly on following sectors: automotive; chemical and pharmaceutical; luxury; cosmetics and hair care; ITC; fast consumer goods for commercial malls; wine and spirits; olive oil; real estate .

**Paris & Partners** is available also for managing crisis situations, distressed companies, investments liquidation and restructuring, with special focus on cost reduction and bank relationships.

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## India Emerging Partnership Enterprise

The India Partnership for Emerging Enterprise, creates and delivers market strategy and business development services, as a key-partner, to those small and medium sized clients in Europe/West, that are planning to expand their activities , related to emerging sectors, to India. India is not following any of the proven paths to success. Compared to the classic Asian strategy – exporting labor intensive, low priced manufactured goods to the west – India’s economy is driven more by consumption than investment, domestic markets more than exports, services more than industry, and high-tech more than low-skilled manufacturing. This book will assist in defining companies their own paths to success for their activities in India through process of M&A .

Small and medium sized enterprises in Europe/ West, are increasingly wishing to expand their market and business in India. By forming partnerships with such European/ Western enterprises, this book through endeavors of [PARIS&PARTNERS](http://www.parisandpartners.com) to become the Indian-extension of them. While information technology and services sectors in India have become important globally, there are many other sectors on the verge of a major boom. **We** through this book is focused on these sectors that are of major interests to its clients reader in European/ Western countries. The enterprising spirit of the Indian entrepreneurs is getting fully unleashed now. The entrepreneur is at the centre of India’s success story. **We** with such an entrepreneurial venture itself, brings this spirit to its clients readers. Economic missions based out of embassies of European/ Western countries in India, chambers of commerce in India, various leading global consulting firms already offer the first step that includes partner searches, market entry advisory and such. **We** offers services for the second and further steps.

## **Why M&A with India**

As for the second quarter of 2008 , in India M&A activities counted for US\$1.6 trillion which is 36% lower than the first half of 2007 but the cross- border deals continued to raise at 39% that shows the optimism in the Indian corporate leaders despite of the global economic conditions.

The driving forces for the M&A were and are: fast lane to innovation because Indian companies get new products and can access to latest technologies; search for leadership and consolidation both in India as well in global terms; possibility to access to new markets and pursue market liberalization; presence of new players thanks to the explosion of private equity by US\$100 billion ; search for inorganic growth as organic growth has proved to be slow as time to market.

## **Introduction to M&A and corporate restructuring**

Mergers and acquisitions (M&A) and corporate restructuring are a big part of the corporate finance world. Every day, Wall Street investment bankers arrange M&A transactions, which bring separate companies together to form larger ones. When they're not creating big companies from smaller ones, corporate finance deals do the reverse and break up companies through spin-offs, carve-outs or tracking stocks. Not surprisingly, these actions often make the news. Deals can be worth hundreds of millions, or even billions, of dollars. They can dictate the fortunes of the companies involved for years to come. For a CEO, leading an M&A can represent the highlight of a whole career. And it is no wonder we hear about so many of these transactions; they happen all the time. Next time you flip open the newspaper's business section, odds are good that at least one headline will announce some kind of M&A transaction. Sure, M&A deals grab headlines, but what does this all mean to investors? To answer this question, this tutorial discusses the forces that drive companies to buy or merge with others, or to split-off or sell parts of their own businesses. Once you know the different ways in which these deals are executed, you'll have a better idea of whether you should cheer or weep when a company you own buys another company - or is bought by one.

You will also be aware of the tax consequences for companies and for investors. Anyhow, many companies find that the best way to get ahead is to expand ownership boundaries through mergers and acquisitions. For others, separating the public ownership of a subsidiary or business segment offers more advantages. At least in theory, mergers create synergies and economies of scale, expanding operations and cutting costs. Investors can take comfort in the idea that a merger will deliver enhanced market power.

By contrast, de-merged companies often enjoy improved operating performance thanks to redesigned management incentives. Additional capital can fund growth organically or through acquisition. Meanwhile, investors benefit from the improved information flow from de-merged companies.

M&A comes in all shapes and sizes, and investors need to consider the complex issues involved in M&A. The most beneficial form of equity structure involves a complete analysis of the costs and benefits associated with the deals.

In the following parts we will highlight some basic concepts about M&A and we will try to add some working experience given some valuable insights by most important M&A players in India.

We will look at how a merger can happen when two companies decide to combine into one entity or when one company buys another, whereas an acquisition always involves the purchase of one company by another.

We will elaborate more how the functions of synergy allow for the enhanced cost efficiency of a new entity made from two smaller ones – how synergy is the logic behind mergers and acquisitions.

We will talk about how acquiring companies use various methods to value their targets. Some of these methods are based on comparative ratios - such as the P/E and P/S ratios - replacement cost or discounted cash flow analysis. And how an M&A deal can be executed by means of a cash transaction, stock-for-stock transaction or a combination of both and how a transaction struck with stock is not taxable.

We will discuss how break up or de-merger strategies can provide companies with opportunities to raise additional equity funds, unlock hidden shareholder value and sharpen management focus. De-mergers can occur by means of divestitures, carve-outs spin-offs or tracking stocks.

We will learn also from experience how mergers can fail for many reasons including a lack of management foresight, the inability to overcome practical challenges and loss of revenue momentum from a neglect of day-to-day operations.

Step by step, the M&A process will follow with main single phases. Pre-merger; planning; valuation; execution; due diligence; implementation and integration. For each of those steps we will highlight main issues and offer some hints for solutions.

## **Mergers and Acquisitions**

**The main idea** .To have a perfect M&A the aim should be to make  $1+1=3$  this equation is the special alchemy of a merger or an acquisition which can be achieved only through a cautious planning and very careful implementation process.

**The key principle** behind buying a company is to create shareholder value over and above that of the sum of the two companies. Two companies together are more valuable than two separate companies - at least, that's the reasoning behind M&A. This rationale is particularly alluring to companies when times are tough. Strong companies will act to buy other companies to create a more competitive, cost-efficient company. The companies will come together hoping to gain a greater market share or to achieve greater efficiency. Because of these potential benefits, target companies will often agree to be purchased when they know they cannot survive alone.

**One common goal**. Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create **synergy** that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on whether this synergy is achieved.

Although they are often uttered in the same breath and used as though they were synonymous, the terms merger and acquisition mean slightly different things.

**Acquisitions.** When one company takes over another and clearly established itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.

**Mergers.** In the pure sense of the term, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals." Both companies' stocks are surrendered and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created. In practice, however, actual mergers of equals don't happen very often. Usually, one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's technically an acquisition. Being bought out often carries negative connotations, therefore, by describing the deal as a merger, deal makers and top managers try to make the takeover more palatable. A purchase deal will also be called a merger when both CEOs agree that joining together is in the best interest of both of their companies. But when the deal is unfriendly - that is, when the target company does not want to be purchased - it is always regarded as an acquisition.

Whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders.

For the most part, acquiring companies nearly always pay a substantial premium on the stock market value of the companies they buy. The justification for doing so nearly always boils down to the notion of synergy; a merger benefits shareholders when a company's post-merger share price increases by the value of potential synergy. Let's face it, it would be highly unlikely for rational owners to sell if they would benefit more by not selling. That means buyers will need to pay a premium if they hope to acquire the company, regardless of what pre-merger valuation tells them. For sellers, that premium represents their company's future

prospects. For buyers, the premium represents part of the post-merger synergy they expect can be achieved.

In other words, the success of a merger is measured by whether the value of the buyer is enhanced by the action. However, the practical constraints of mergers, often prevent the expected benefits from being fully achieved.

**Advantages** . By merging, the companies hope to benefit from the following advantages:

- **Staff reductions** - As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments. Job cuts will also include the former CEO, who typically leaves with a compensation package.
- **Economies of scale** - Yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. Mergers also translate into improved purchasing power to buy equipment or office supplies - when placing larger orders, companies have a greater ability to negotiate prices with their suppliers.
- **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.
- **Improved market reach and industry visibility** - Companies buy companies to reach new markets and grow revenues and earnings. A merge may expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community: bigger firms often have an easier time raising capital than smaller ones.

**Business Structure** . From the perspective of business structures, there are different types, distinguished by the relationship between the two companies that are merging:

- **Horizontal merger** - Two companies that are in direct competition and share the same product lines and markets.
- **Vertical merger** - A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker.

- **Market-extension merger** - Two companies that sell the same products in different markets.
- **Product-extension merger** - Two companies selling different but related products in the same market.
- **Conglomeration** - Two companies that have no common business areas.

**Finance Structure** . From the perspective of how the merger is financed there are two types of mergers. Each has certain implications for the companies involved and for investors:

- **Purchase Merger** - This kind of merger occurs when one company purchases another with cash or through the issue of some kind of debt instrument. The sale is taxable. Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company.
- **Consolidation Merger** - With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another - there is no exchange of stock or consolidation as a new company. Acquisitions are often congenial, and all parties feel satisfied with the deal. Other times, acquisitions are more hostile. In an acquisition, as in some of the merger deals we discuss above, a company can buy another company with cash, stock or a combination of the two. **Asset acquisition** is common in smaller deals and it is for one company to acquire all the assets of another company. Company X buys all of Company Y's assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Of course, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

**Reverse merger** is another type of acquisition that enables a private company to get publicly-listed in a relatively short time period. A reverse merger occurs when a private

company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets. The private company reverse merges into the public company, and together they become an entirely new public corporation with tradable shares.

Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on whether this synergy is achieved.

### **Corporate restructuring methods**

As mergers capture the imagination of many investors and companies, the idea of getting smaller might seem counterintuitive. But corporate break-ups, or de-mergers, can be very attractive options for companies and their shareholders.

The rationale behind a spin-off, tracking stock or carve-out is that "the parts are greater than the whole." These corporate restructuring techniques, which involve the separation of a business unit or subsidiary from the parent, can help a company raise additional equity funds.

**A break-up** can also boost a company's valuation by providing powerful incentives to the people who work in the separating unit, and help the parent's management to focus on core operations. Most importantly, shareholders get better information about the business unit because it issues separate financial statements. This is particularly useful when a company's traditional line of business differs from the separated business unit. With separate financial disclosure, investors are better equipped to gauge the value of the parent corporation. The parent company might attract more investors and, ultimately, more capital. Also, separating a subsidiary from its parent can reduce internal competition for corporate funds. For investors, that's great news: it curbs the kind of negative internal wrangling that can compromise the unity and productivity of a company. For employees of the new separate entity, there is a publicly traded stock to motivate and reward them. Stock options in the parent often provide

little incentive to subsidiary managers, especially because their efforts are buried in the firm's overall performance.

That said, de-merged firms are likely to be substantially smaller than their parents, possibly making it harder to tap credit markets and costlier finance that may be affordable only for larger companies. And the smaller size of the firm may mean it has less representation on major indexes, making it more difficult to attract interest from institutional investors. Meanwhile, there are the extra costs that the parts of the business face if separated. When a firm divides itself into smaller units, it may be losing the synergy that it had as a larger entity. For instance, the division of expenses such as marketing, administration and research and development (R&D) into different business units may cause redundant costs without increasing overall revenues.

There are other restructuring methods: doing an outright sell-off, doing an equity carve-out, spinning off a unit to existing shareholders or issuing tracking stock. Each has advantages and disadvantages for companies and investors. All of these deals are quite complex.

**Sell-Offs** A sell-off, also known as a divestiture, is the outright sale of a company subsidiary. Normally, sell-offs are done because the subsidiary doesn't fit into the parent company's core strategy. The market may be undervaluing the combined businesses due to a lack of synergy between the parent and subsidiary. As a result, management and the board decide that the subsidiary is better off under different ownership. Besides getting rid of an unwanted subsidiary, sell-offs also raise cash, which can be used to pay off debt. In the late 1980s and early 1990s, corporate raiders would use debt to finance acquisitions. Then, after making a purchase they would sell-off its subsidiaries to raise cash to service the debt. The raiders' method certainly makes sense if the sum of the parts is greater than the whole. When it isn't, deals are unsuccessful.

**Equity Carve-Outs** More and more companies are using equity carve-outs to boost shareholder value. A parent firm makes a subsidiary public through an initial public offering (IPO) of shares, amounting to a partial sell-off. A new publicly-listed company is created, but the parent keeps a controlling stake in the newly traded subsidiary. A carve-out is a strategic avenue a parent firm may take when one of its subsidiaries is growing faster and carrying

higher valuations than other businesses owned by the parent. A carve-out generates cash because shares in the subsidiary are sold to the public, but the issue also unlocks the value of the subsidiary unit and enhances the parent's shareholder value. The new legal entity of a carve-out has a separate board, but in most carve-outs, the parent retains some control. In these cases, some portion of the parent firm's board of directors may be shared. Since the parent has a controlling stake, meaning both firms have common shareholders, the connection between the two will likely be strong. That said, sometimes companies carve-out a subsidiary not because it's doing well, but because it is a burden. Such an intention won't lead to a successful result, especially if a carved-out subsidiary is too loaded with debt, or had trouble even when it was a part of the parent and is lacking an established track record for growing revenues and profits. Carve-outs can also create unexpected friction between the parent and subsidiary. Problems can arise as managers of the carved-out company must be accountable to their public shareholders as well as the owners of the parent company. This can create divided loyalties.

**Spin-offs** A spin-off occurs when a subsidiary becomes an independent entity. The parent firm distributes shares of the subsidiary to its shareholders through a stock dividend. Since this transaction is a dividend distribution, no cash is generated. Thus, spin-offs are unlikely to be used when a firm needs to finance growth or deals. Like the carve-out, the subsidiary becomes a separate legal entity with a distinct management and board. Like carve-outs, spin-offs are usually about separating a healthy operation. In most cases, spin-offs unlock hidden shareholder value. For the parent company, it sharpens management focus. For the spin-off company, management doesn't have to compete for the parent's attention and capital. Once they are set free, managers can explore new opportunities. Investors, however, should beware of throw-away subsidiaries the parent created to separate legal liability or to off-load debt. Once spin-off shares are issued to parent company shareholders, some shareholders may be tempted to quickly dump these shares on the market, depressing the share valuation.

**Tracking Stock** - A tracking stock is a special type of stock issued by a publicly held company to track the value of one segment of that company. The stock allows the different segments of the company to be valued differently by investors. Let's say a slow-growth

company trading at a low price-earnings ratio (P/E ratio) happens to have a fast growing business unit. The company might issue a tracking stock so the market can value the new business separately from the old one and at a significantly higher P/E rating. Why would a firm issue a tracking stock rather than spinning-off or carving-out its fast growth business for shareholders? The company retains control over the subsidiary; the two businesses can continue to enjoy synergies and share marketing, administrative support functions, a headquarters and so on. Finally, and most importantly, if the tracking stock climbs in value, the parent company can use the tracking stock it owns to make acquisitions. Still, shareholders need to remember that tracking stocks are class B, meaning they don't grant shareholders the same voting rights as those of the main stock. Each share of tracking stock may have only a half or a quarter of a vote. In rare cases, holders of tracking stock have no vote at all.

### **How to win through mergers & acquisitions**

M&A is very sensitive and crucial for the business, it is not only a high value deal but also include all the levels of the acquiring organization i.e. if the target organization fails it will have a huge impact on the acquirer company, hence M&A decisions are very strategic.

**Corporate Strategic Plan.** The M&A plan should be part of a precise Corporate Strategy Plan and not with a potential target as it can deviate you from the original strategy.

**Identifying the right target .** Then you should start with identifying the right target, which is more important than the right bargain. During finding the right target you should realize the value adders and value destroyers as they can help you in finding the right company for you.

**Integration Planning .** Then comes the most important thing that is the integration planning and then finally the rigor of execution. This all are the standard method for a good M&A transaction but every industry has its own peculiarity according to which you might have to

change your approach, which makes each and every transaction unique and M&A an art instead of science.

**Various reasons for acquisitions.** M&A can be done for various reasons some being globalization, gaining new customers, entering new markets, competency acquisition and even for changing the business model. Typically the most common ones are : technology, geography, clients, and scale. Other companies look at M&A mainly to enhance profitability, to increase in market reach and economy of scale, to optimize tax and financial benefits, to pursue diversification; ultimately to increase the rate of growth of the company.

All this leads the company to enjoy some benefits like synergies, scale of operation, territorial, leveraging, competitive edge etc. which in the end are expected to increase the bottom line profits of the company.

**Synergy.** Synergy is the magic force that allows for enhanced cost efficiencies of the new business and that takes the form of revenue enhancement and cost savings. Achieving synergy is easier said than done - it is not automatically realized once two companies merge. Sure, there ought to be economies of scale when two businesses are combined, but sometimes a merger does just the opposite. Alias, the synergy promised by deal makers might just fall short. In many cases, one and one add up to less than two. Sometimes, synergy opportunities may exist only in the minds of the corporate leaders and the deal makers. Where there is no value to be created, the CEO and investment bankers - who have much to gain from a successful M&A deal - will try to create an image of enhanced value. The market, however, eventually sees through this and penalizes the company by assigning it a discounted share price.

Mergers are awfully hard to get right, so investors should look for acquiring companies with a healthy grasp of reality. An acquiring company should be targeting a company that is smaller and in businesses that the acquiring company knows intimately. Synergy is hard to create from companies in disparate business areas. Very often, companies have a bad habit of biting off more than they can chew in mergers.

The success of a merger is measured by whether the value of the buyer is enhanced by the action. However, the practical constraints of mergers, often prevent the expected benefits from being fully achieved. Alias, the synergy promised by deal makers might just fall short.

It's hard for investors to know when a deal is worthwhile. The burden of proof should fall on the acquiring company. In order to have a chance of success, investors' rule of thumb is looking a reasonable purchase price. A premium of, say, 10% above the market price seems within the bounds of level-headedness. A premium of, say, 50%, on the other hand, requires synergy of stellar proportions for the deal to make sense. Stay away from companies that participate in such contests. Should the investor pay in cash be more careful when calculating bids and target valuations closer to target. When stock is used as the currency for acquisition, discipline can go by the wayside.

### **M&A can fail**

**Unplanned M&A can fail.** It's no secret that plenty of mergers don't work. The M&A are very risky and have a high failure rate, nearly 70% of the transactions fail to reach the goals planned and in fewer deals the costs are realized within 10 years. Those who advocate mergers will argue that the merger will cut costs or boost revenues by more than enough to justify the price premium. It can sound so simple: just combine computer systems, merge a few departments, use sheer size to force down the price of supplies and the merged giant should be more profitable than its parts. In theory,  $1+1 = 3$  sounds great, but in practice, things can go awry.

Historical trends show that roughly two thirds of big mergers will disappoint on their own terms, which means they will lose value on the stock market. The motivations that drive mergers can be flawed and efficiencies from economies of scale may prove elusive. In many cases, the problems associated with trying to make merged companies work are all too concrete.

**Major reasons for failure.** Some of the major reasons for the failure are: ignored integration challenges as nearly 67% of the companies ignore them and hence creates a problem not

only for short term but also on a long term; non-existent or overestimated synergies; problems integrating management teams; due diligence failure to highlight key issues; target company was window dressed; insufficient strategic fit; carelessness and ignorance of the main activities; incompatible cultures, inability to manage the target, inability to effectively implement change, lack of anticipation of foreseeable events, a clash in management styles, excessive premium for acquisition, incompatible sales and marketing systems, unhealthy acquisition target requirement to spin off or liquidate too much. All of which can be taken care by proper planning and effective implementation and sticking to the plan.

For example, a booming stock market encourages mergers, which can spell trouble. Deals done with highly rated stock as currency are easy and cheap, but the strategic thinking behind them may be easy and cheap too. Also, mergers are often attempt to imitate: somebody else has done a big merger, which prompts other top executives to follow suit. A merger may often have more to do with glory-seeking than business strategy. The executive ego, which is boosted by buying the competition, is a major force in M&A, especially when combined with the influences from the bankers, lawyers and other assorted advisers who can earn big fees from clients engaged in mergers. Most CEOs get to where they are because they want to be the biggest and the best, and many top executives get a big bonus for merger deals, no matter what happens to the share price later. On the other side of the coin, mergers can be driven by generalized fear. Globalization, the arrival of new technological developments or a fast-changing economic landscape that makes the outlook uncertain are all factors that can create a strong incentive for defensive mergers. Sometimes the management team feels they have no choice and must acquire a rival before being acquired because the idea is that only big players will survive a more competitive world.

Coping with a merger can make top managers spread their time too thinly and neglect their core business. Too often, potential difficulties seem trivial to managers caught up in the thrill of the big deal. The chances for success are further hampered if the corporate cultures of the companies are very different. When a company is acquired, the decision is typically based on product or market synergies, but cultural differences are often ignored. It's a mistake to assume that personnel issues are easily overcome. For example, employees at a target company might be accustomed to easy access to top management, flexible work schedules or even a relaxed dress code. These aspects of a working environment may not seem significant,

but if new management removes them, the result can be resentment and shrinking productivity. Attrition can lead to hazardous results and spoil the whole deal, so during the due diligence process one should make sure what to expect from the employees and anticipate.

More insight into the failure of mergers is found in one McKinsey research. Companies often focus too intently on cutting costs following mergers, while revenues, and ultimately, profits, suffer. Merging companies can focus on integration and cost-cutting so much that they neglect day-to-day business, thereby prompting nervous customers to flee. This loss of revenue momentum is one reason so many mergers fail to create value for shareholders. But remember, not all mergers fail. Size and global reach can be advantageous, and strong managers can often squeeze greater efficiency out of badly run rivals. Nevertheless, the promises made by deal makers demand the careful scrutiny of investors. The success of mergers depends on how realistic the deal makers are and how well they can integrate two companies while maintaining day-to-day operations.

**Pre-merger stage** . Having well in mind why M&A can fail, now in order to avoid it and to achieve the optimum results the acquiring company has to get a head start which is the pre-merger stage i.e. the screening and search for the target firm then planning, which require a full-blown evaluation of the target. This stage includes all kinds of assessments to be made by the acquirer on the target firm and the target firm should also participate in this stage to realize its optimum value.

The M&A is like a marriage it is not always perfect but with proper adjustment it can work, so it requires a lot of thinking. You should start with a perfect team to handle the process, then remember you only get one shot to approach the seller don't hurry things up have a plan ready and be proactive instead of reactive.

**Planning**. The companies should go for strategic M&A which means they should have an inner felt need and a proper strategy before going for M&A this helps to set some strategic objective like- increase market share or go for diversification and some more crucial decisions.

When you have a strategic plan and you stick to it, this helps to avoid poorly structured deals. Strategy plus Selection plus Implementation add up to make an intersection called as “sweet spot” which is where all the successful deals lie and realize the perfect value from the deal. Hence the focus should be on strategy transaction integration and then finally when everything is in place there should be a proper manage and measure tools in place to guide the performance of the employees, All this should be planned well in advance so the deal is actually in the papers first and then it is implemented.

A Successful M&A lies in a excellent planning and in a few crucial factors like the due diligence and the integration both of which have a long lasting effect on the company and last but not the least the valuation of the company. Once you have a plan remember never deviate from it . The corporate strategy is crucial and hence a clear defined goals and aims should be there in the plan and also remember you are not buying only the company but the people, employees, of the company too, they at no point of time should feel out of place and ignored as they should be involved in the process.

And all this being on a big scale where a lot of money is spent and a lot of risk is involved, there should be a good amount of planning, the target company should be chosen very carefully and after a very thought after plan i.e. there should be a rationale behind the acquisition and also there should be a game plan ready which includes the team that will champion the transaction, manage and execute it, there should be a plan to finance the acquisition and then finally there should also be a pre-prepared plan for integration. Here the plan is to evaluate all your options and find the most appropriate target company i.e. if you want to narrow down on one company first chose a few suitable companies and then give right weights to the areas important to your company and then evaluate them and choose the best one out, for all this you can take help of an outside external vendor who will not only help you to find a suitable target might also help you in the further processes.

So when finding the target company one should start with a “Wide Canvas” which lets you evaluate different prospect targets, second step should be finding the Business Sponsor and keep informed your investment banker since the beginning even though he must be taken in the loop a bit later. Remember to pay extra attention to the target’s banker; to the target’s mindset; to the approach expected by the target ( formal or casual); to approach the vendor

on a “no-name” basis for secrecy; to the valuation of the target company; to a local reach by appointing a local supervisor; whether communication has to be formal or informal.

You should not reject a company just because it has a lower current performance as these are the very companies whose optimum capacity isn't exploited and giving you an opportunity. When dealing with the target company one should be very cautious and a clear decisions should be taken and only the precise information should be requested as the whole deal can be defined in the very first meet, which again reinforces that a company should have a defined corporate strategy

**Valuation.** Investors in a company that is aiming to take over another one must determine whether the purchase will be beneficial to them. In order to do so, they must ask themselves how much the company being acquired is really worth.

Naturally, both sides of an M&A deal will have different ideas about the worth of a target company: its seller will tend to value the company at as high of a price as possible, while the buyer will try to get the lowest price that he can. There are, however, many legitimate ways to value companies. The most common method is to look at comparable companies in an industry, but deal makers employ a variety of other methods and tools when assessing a target company. Here are just a few of them:

**1. Comparative Ratios** - The following are two examples of the many comparative metrics on which acquiring companies may base their offers:

- **Price-Earnings Ratio (P/E)** - an acquiring company makes a price offer that is a multiple of the earnings of the target company. Looking at the P/E for all the stocks within the same industry group will give the acquiring company good guidance for what the target's P/E multiple should be.
- **Enterprise-Value-to-Sales Ratio (EV/Sales)** - the acquiring company makes an offer as a multiple of the revenues, again, while being aware of the price-to-sales ratio of other companies in the industry.

**2. Replacement Cost** - In a few cases, acquisitions are based on the cost of replacing the target company. For simplicity's sake, suppose the value of a company is simply the sum of all its equipment and staffing costs. The acquiring company can literally order the target to sell at that price, or it will create a competitor for the same cost. Naturally, it takes a long

time to assemble good management, acquire property and get the right equipment. This method of establishing a price certainly wouldn't make much sense in a service industry where the key assets - people and ideas - are hard to value and develop.

**3. Discounted Cash Flow (DCF)** - A key valuation tool in M&A, discounted cash flow analysis determines a company's current value according to its estimated future cash flows. Forecasted free cash flows (operating profit + depreciation + amortization of goodwill – capital expenditures – cash taxes - change in working capital) are discounted to a present value using the company's weighted average costs of capital (WACC). Admittedly, DCF is tricky to get right, but few tools can rival this valuation method.

**Pre-Deal Considerations.** First before starting the deal, during the pre-deal phase you should identify and clarify the objective of the proposed deal and the term of the deal which will be your corporate plan and will serve you during the whole process. Then your very next step should be to put down your expectations from the deal and set the time frames for these outcomes and during this pre-deal stage consider the legal and geo-political and economic formalities and effects.

Then you should keep in mind which are those key aspects for a successful M&A like the seriousness of the buyer, his financial capability to be assessed properly and be shown in the beginning of the talks. When dealing with the family owned businesses a lot of emotional value is attached and must be taken care of. Post merger integration is very crucial.

**M&A in Europe.** Indian companies are pretty experienced as far as European markets are concerned as there are a few success stories which can be referred to but it is always better to ask for advise a reliable European M&A advisor or investment banker. Though there are rules to govern the investments but they are not aimed to create a control or problems but to just govern the competition and avoid monopoly and the main aim of EU is to attract foreign investment not to restrict it. Considering all this the local laws and their culture has to be paid extra attention as they are extremely crucial . You must be very serious when approaching the target company and preferably appoint a local supervisor as language can be a big obstacle in the M&A process and also the supervisor will help you with the culture of the

country and help you with the optimum way to approach the target company and finally to make the transaction smooth.

**Managing cultural differences and sensitiveness.** In the context of M&A , You must also consider that there are some cultural differences between the Indian approach and the western way of working which plays a very crucial part in the cross-border M&A. Western Countries like USA, UK, and European attitude looks more individualistic, decisions are top-down, they give top priority to shareholder interests, they are more transaction oriented, they prefer formal and structured communication, they give high importance to legal agreements, they strive for transparency, and all the approach looks to be very logical. Indian attitude apparently looks more collaborative, both management and shareholders pay attention to multiple stakeholders, they look for a consensual relationship whereas all communication is very informal, legal agreements are important but can be just indicative and not bounding, transparency is not always there and emotional aspects do play all the time.

**Negotiation Process** . The negotiation process is the stage where the company move from the thinking mode to the action mode and actually does the work in the field i.e. the board room and discusses about the deal with the target company. This being a very crucial stage it is advised to use experts for this process. Here you should focus on the legal, human capital and structural terms, obtain the stake holders agreement and do all the documentation. This is the stage where you pay for the company, hence have to do the final work for the financing of the deal.

During the whole M&A process you want to buy something at a best possible way and then realize the best possible value out of it all this is possible by through planning and a good experience in the field. Techniques like delayed tactics may work against you if not utilized properly and effectively and hence it is always advised to involve your banker and an external advisor for the M&A process.

Therefore there are some important suggestions to be kept in mind.

**Investigate.** first investigate as much as possible about market scenario, competitor analysis, company story over last years, management profiles and performances, bank references,

suppliers' references, customers' references, . Be ready to carry out a detailed due diligence, to evaluate anti-trust issues and elaborate a plan for the integration issues .

**Create and maintain good rapport** . After including Your Banker or Your Advisor in the process, please practice diplomacy, create a positive and healthy environment when you start a talk and never take position and in ways which will create problems in the future and also have an excellent relationship with the employees.

**Be open.** Being a buyer just build a tentative price offer for the selling company but remember you have to be open to the negotiations so always leave a margin for that but the margin should not be too large or too narrow.

Make an initial offer and be open for discussion you should have a proper communication plan with the seller so that you can follow up on the proposal, generate a detailed agreement during the initial proposal so that there is no conflicts and everything is documented.

**Be ready** for unexpected reactions and sabotage behaviors by the seller's team that can lose its face because several reasons among them change of roles by CEO and CFO you have to be very careful dealing with the employees because attrition is the last thing you want happening and also the important issues like the name of the company after the M&A etc should also be taken care off.

**Be clear** . In order to avoid future problems, make it clear at the beginning of the negotiation that everything must be on the table if there's going to be an eventual deal.

It helps you that during the negotiations many problems may arise, like unreasonable preconditions , for example , should the CEO of the acquired firm insists there will be no merger unless you guarantee he'll be able to run the combined firms and the demand is real and not a bluff, you risk to fail.

**Define negotiation rules.** Insist that the negotiating teams be as small as possible and obtain a commitment prior to the first meeting that the same players will be involved on both sides,

in order to protect confidentiality and in order to avoid that negotiation people change from meeting to meeting, because new people help in changing previously agreed-upon issues.

Start the negotiation with an explicit timetable agreed to by both parties in order to avoid that the seller's company could be slowing the process down purposefully, perhaps seeking to generate another bid, and pay attention to delay tactics like when key people from the seller's negotiating team are unavailable when you want to have a substantive meeting.

**Deal Execution** . Then start the M&A process by planning your business strategy and the HR strategy, identify and evaluate the target in the context of the method of functioning , manpower and infrastructure and also mandating consultants for the HR, Tax and Financial aspects.

Please remember to include or to inform your banker since the beginning . Be open to discussions and adjustments. Try and enter in the pre-emptive stage , keep the data secret

Please remember also not to ignore the seller's cultural values. Do not join the process just to get internal information. Don't approach the seller directly and stick to the original plan

**Sales Process.** There are different types of sales process any of which the target company chooses:

**1) Controlled auction:** this type of sales process creates strong competition, flexibility in timing and buyer selection, buyer is more likely to achieve the full value of the business. This also has some cons attached with it like numerous buyers refuse to take part in auctions, focus on price rather than the fit and there is no confidentiality left in the process

**2) Restrictive Sales Process:** this process is one step away from the controlled auction process here there are only few selected buyer in the sales process so the process is faster and confidentiality is maintained till the second stage but this process too has some cons is the process can be very time consuming and might miss some interested parties, so the selling company might not realize the full value of business

**3) Targeted sales:** here there is only one buyer and so the confidentiality is the highest and the process is also executed the fastest

**Start with a tender offer** . When the CEO and top managers of a company decide that they want to do a merger or acquisition, they start with a tender offer. The process typically begins with the acquiring company carefully and discretely buying up shares in the target company, or building a position. Once the acquiring company starts to purchase shares in the open market, it is restricted to buying some percentage of the total outstanding shares before it must file with the control authority. In the filing, the company must formally declare how many shares it owns and whether it intends to buy the company or keep the shares purely as an investment. Working with financial advisors and investment bankers, the acquiring company will arrive at an overall price that it's willing to pay for its target in cash, shares or both. The tender offer is then frequently advertised in the business press, stating the offer price and the deadline by which the shareholders in the target company must accept (or reject) it.

**The Target's Response** - Once the tender offer has been made, the target company can reply like this:

- **Accept the Terms of the Offer** - If the target firm's top managers and shareholders are happy with the terms of the transaction, they will accept it.
- **Attempt to Negotiate** - The tender offer price may not be high enough for the target company's shareholders to accept, or the specific terms of the deal may not be attractive. In a merger, there may be much at stake for the management of the target - their jobs, in particular. If they're not satisfied with the terms laid out in the tender offer, the target's management may try to work out more agreeable terms that let them keep their jobs or, even better, send them off with a nice, big compensation package.

Not surprisingly, highly sought-after target companies that are the object of several bidders will have greater latitude for negotiation. Furthermore, managers have more negotiating power if they can show that they are crucial to the merger's future success.

- **Execute a Poison Pill or Some Other Hostile Takeover Defense** – A poison pill scheme can be triggered by a target company when a hostile suitor acquires a predetermined percentage of company stock. To execute its defense, the target company grants all shareholders - except the acquiring company - options to buy additional stock at a dramatic

discount. This dilutes the acquiring company's share and intercepts its control of the company.

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

Mergers and acquisitions can face scrutiny from regulatory bodies. For example, if the two biggest long-distance companies in the U.S., AT&T and Sprint, wanted to merge, the deal would require approval from the Federal Communications Commission (FCC). The FCC would probably regard a merger of the two giants as the creation of a monopoly or, at the very least, a threat to competition in the industry.

**Due diligence** . Due diligence is not just a modality to be followed but it should be religiously followed and strategically used as this could be the most crucial part of the transaction as its implications goes a long way and the whole process could depend on it. There is some peculiarities to be taken care of as in some countries the companies don't divulge all information and the due diligence could become very difficult but in the end if planned properly everything could be taken care.

When a company starts negotiating it also does a due diligence which is the planning and evaluation of the target company evaluating the synergies, the culture, the HR capital, the IT integration, etc. Result is a full report on the target company which helps the acquirer to make other plans for implementation and integration. Due diligence also helps in deciding the valuation of the company which again is one of the most crucial part of the deal. Every due diligence is customized according to the industry you are in for e.g. Bank, public company or an investment firm. You also have to take care of the method of your working i.e. are you conservative or aggressive. Then comes the strategic intent of the company after which the type of transaction is important in which you define the deal size, stock purchase/asset purchase, extent of equity transacted etc. taking all this into consideration you have to formulate the due diligence process. Due diligence is not just a modality to be followed but it should be religiously followed and strategically used as this could be the most crucial part of the transaction as its implications goes a long way and the whole process could depend on it. There is some peculiarities to be taken care of as in some countries the

companies don't divulge all information and the due diligence could become very difficult but in the end if planned properly everything could be taken care. Due diligence helps in making the final decision of going ahead with the merger, valuation of the company and identifies matters to be addressed post acquisition. It identifies issues that would obstruct the proposed transaction and those which would be necessary to consider in the valuation of business/negotiation of bid price. It also helps in figuring out risks and issues which are knowingly taken over as a calculated commercial decision. Summing up, due diligence plays an important role in identifying, quantifying and reducing the risks related to an acquisition. Although it focuses on negative information, the aim is not to raise obstacles to transactions, but rather to facilitate transactions by identifying problems and risks and by devising solutions to problems or mechanisms to reduce or manage the risks involved in acquisitions.

**Financial due diligence** can be defined as an investigation into the affairs of an entity prior to its acquisition, flotation, restructuring or other similar transaction. It is a process by which information is gathered about a target company, its business and the environment in which it operates. The objective of due diligence is to ensure that prospective investors make an informed investment decision. Financial due diligence is a fact gathering exercise with focused, business oriented analysis of information.

**There are two types of Due Diligence.**

**Buy side due diligence.** Through buy side due diligence, the acquirer initiates the process by cumulating all the details and conducting a thorough analysis on the self-felt financial and strategic areas.

**Auction due diligence.** Through the auction due diligence the analysis is done for many potential acquirers and the areas analyzed are the general important areas.

**Sell side due diligence .** The sell side due diligence is commissioned by the vendor on the focus areas of interest for the potential acquirers in order to help the interested company to speed up the process and also to calculate the appropriate worth of the company that the seller could expect.

**Steps in due diligence process.** The steps in due diligence process involve an interface with management and other advisors to ensure that all aspects of the project are duly considered

and reviewed. This is a pre-requisite for a well informed decision. The process involves acquiring pre-due diligence information, focusing on areas important to the acquirer, preparing focused information check lists and questions, analyzing data and enquiry and identifying key deal breakers. Consulting, collaborating and communicating this information is an important function in the process.

**Financial due diligence** . The main focus areas for the financial due diligence are the following:

Quality of assets and the working capital in order to evaluate the real tangible worth of the company. The gross margin analysis, the quality of earnings and cash flows in order to appreciate the health of the company, its operational efficiency and its debt service capacity. Contingent liabilities which could have an effect on the company in the future and are the most difficult part of the analysis as it might happen that the target company might not reveal the actual details. Net debt that is the total liability of the company in the balance sheet and gives us the detail on the amount of money the acquiring company might have to infuse in the target company once its taken over.

**Human Resources due diligence** . The human resources (HR) due diligence plays a vital role as it defines the following: the HR elements required ; the package plans of the employees; the Severance term; Synergies etc. HR plays a central role in any organization by keeping the heart of the organization, employees, happy and making sure that they perform at the optimum level, hence an experienced HR personnel can help a lot in the M&A by removing the value destroyer while keeping the value adders in the organization. The HR due diligence can be subjective to a great extent as many things depend on the perception and as the perception is subjective. Nevertheless, in order to have a perfect M&A, one needs to have a perfect HR due diligence and to do that you can have a HR Check list about Corporate culture; Site organization history; Industrial relations framework; Compensation ; Salary administration and payroll; Career management development; Employee benefit plans and cost; Pension plans; Local work practices and employee services; Individual employee data; Employee rights – transfer of undertakings; etc. keep one thing in mind that humans are

inherently separate and they don't resemble so you will have to make the check list depending on the situation, given above are the general things that are important.

**IT Due Diligence** . In the M&A process you cant just ignore the role of IT as all the data of the Target company and the acquirer is in the computers and there may be different computer application that are used so to integrate this there has to be some plan and therefore including IT during the due diligence phase is very important .

Many firms tend to forget this part and after the transaction they realize that the IT integration is not possible which never allows the companies to integrate fully and hence increase the cost.

**Closing the Deal** . Finally, once the target company agrees to the tender offer and regulatory requirements are met, the merger deal will be executed by means of some transaction. In a merger in which one company buys another, the acquiring company will pay for the target company's shares with cash, stock or both.

A cash-for-stock transaction is fairly straightforward: target company shareholders receive a cash payment for each share purchased. This transaction is treated as a taxable sale of the shares of the target company.

If the transaction is made with stock instead of cash, then it's not taxable. There is simply an exchange of share certificates. The desire to steer clear of the tax man explains why so many M&A deals are carried out as stock-for-stock transactions. When a company is purchased with stock, new shares from the acquiring company's stock are issued directly to the target company's shareholders, or the new shares are sent to a broker who manages them for target company shareholders. The shareholders of the target company are only taxed when they sell their new shares. When the deal is closed, investors usually receive a new stock in their portfolios - the acquiring company's expanded stock. Sometimes investors will get new stock identifying a new corporate entity that is created by the M&A deal.

**Post Acquisition Phase** . One of the most difficult steps in post-acquisition phase is how deep you should go for integration that requires a preliminary planning to get an answer.

**Implementation and Integration.** Most of the M&A failures are because of the implementation is not efficient and fast.

**Degree of integration.** One of the first issues is to analyze and define the degree of integration to be achieved with respect to organizational autonomy . The higher the need for organizational autonomy versus the need for strategic interdependence you can decide to keep your acquired company fairly preserved, through holding structure, from reaching a symbiosis with the buyer, through future absorption.

The lower the need for organizational autonomy , according to your need for strategic interdependence then preservation would be the best option where the acquiring company preserves the identity of the target company. Other ways it will be better go for absorption and try to reach a good symbiosis through a good integration plan.

You should always include a third consultant for the whole process to give you inputs as its his core area and you should outsource or delegate the process / project to the experts to save the resources and leverage their expertise and focus on the acquired companies employees and communicate a lot with them , make sure the communication is 2 way and you get the feedback as soon as possible. Never rush through things or you will have to deal with it in future and by then it would have become a serious problem.

After the transaction go ahead with the implementation and if the implementation is not right rest assured the M&A would be a flop so do your home work make a plan and then stick to it.

When you finally are left with the control of the target company , you have to take all the decisions regarding the daily working of the company, so to start with you have to consider all the alternative structure for the company, then plan the difference and finally float the plan.

**Integration.** Integration is the stage where you after implementing try and increase the efficiency and give the right direction to the organization and in areas like Manufacturing, Marketing, Logistics, IT, and Policies ( HR and Functional).

Strategy plus Selection plus Implementation add up to make an intersection called as “sweet spot” which is where all the successful deals lie and realize the perfect value form the deal.

Hence the focus should be on strategy transaction integration and then finally when everything is in place there should be a proper manage and measure tools in place to guide the performance of the employees, All this should be planned well in advance so the deal is actually in the papers first and then it is implemented.

**Communication.** Finally the key for successful M&A is communication. The whole activity and the transaction of M&A is dependent on communication and if not communicated properly the M&A cant be a success. So communicate, communicate and communicate.

At the beginning, a good communication strategy will reduce rumors, which will help maintain the focus of the employees in the business instead on the changes taking place. Through communication the acquirer is expected to define their new policies and method of operations to the employees as it will help in reducing the adjustment time and also in some cases reduce attrition.

Communication is not only from the top or the directors of the company but the ground level employees are the ones those who execute the real work hence they should be included in the communication process.

The main reason for M&A is creating value and to do that you should have an insight in the line of business of the acquired firm after the transaction special attention is to be paid to the environment of the target, when going for the foreign M&A pay extra attention to the legal aspects and last but not the least tangible acquisition can be easy but the real challenge lies in acquiring the intangible assets.

### **Debt Funding options- syndicated financing for M&A.**

Indian firms are fairly optimistic and the number of M&A transaction is increasing, with decreasing use of debt and giving the transaction a more structured format, this has increased the confidence of the companies and encouraged them to go for high value deals.

The recent deals are funded more by equity share than debts hence having a more conservative structure and only a few deals have exploited the debt method of funding and

used it through a properly structured deals and in the current market conditions the lack of innovation has been blessing in disguise.

Financing trends post the sub-prime crises show that the global credit markets has tightened due to the lack of liquidity and the global LBO window have mostly closed, even the mezzanine debt has dried up which creates a lot of problems for the companies but the optimistic attitude of the Indian companies has kept the M&A vertical of the companies busy.

Financial structures mainly depend on the corporate plan and strategic factors. As far as debt or equity it depends on how much are the promoters planning to dilute their ownership. The higher the capacity of the companies to take risks the higher the debt. The financial structure also depends on the investors classes and currencies markets .

Tax, Legal & Regulatory Issues are crucial factors in deciding the structure of the firm and depend both on the target country, wherein the financial assistance rules, limitations on foreign ownership, corporate tax & securities law and on the acquirer country where here the company has to pay attention to any overseas direct investment limit.

In India, there are some financial assistance limitations as Section 77 of the Indian Companies Act severely limits financial assistance (no “whitewash” procedure; debt pushdown not feasible; upstream guarantee not possible).

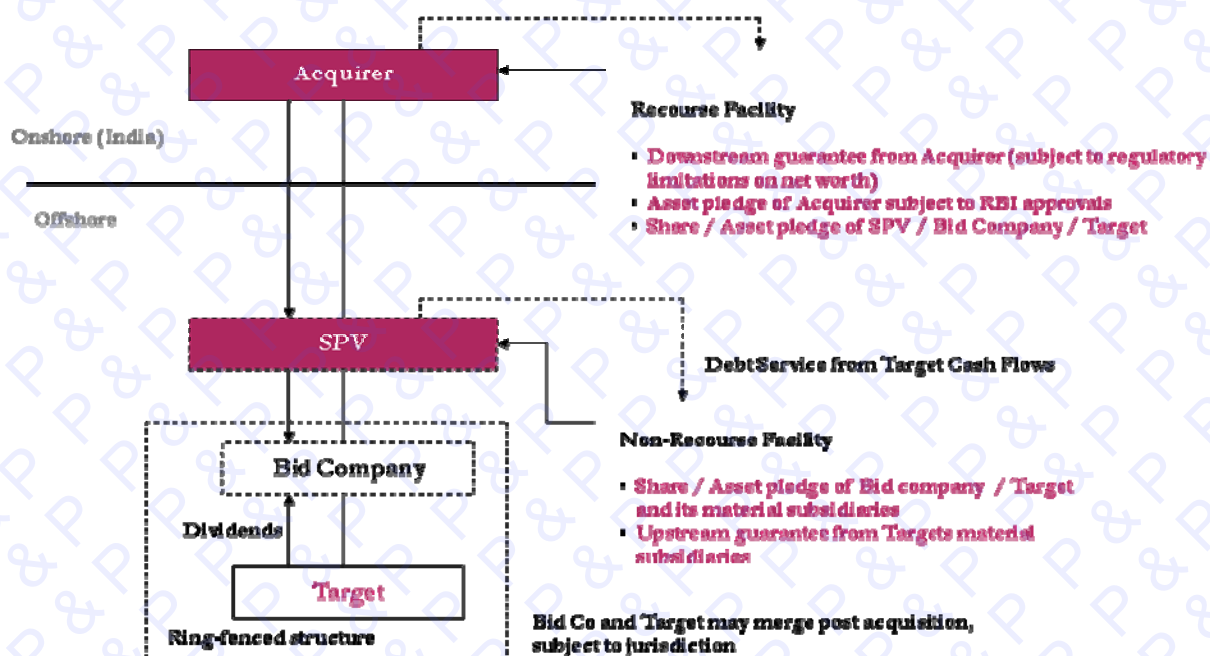
The Offshore to onshore merger is not easy. There is very little precedent in the market but such debt would need to meet ECB Guidelines. The Avenues to Service Debt are Limited to Dividends (Subject to Dividend Distribution Tax); Capital Reductions / Share Buy-backs ; Inter-company loans (Subject to ODI Guidelines)

The Rupee Borrowings for Financial Buyouts are constrained mainly by limits on Bank’s Capital Market Exposure (CME) & limited depth in Rupee Capital Markets (no “Squeeze-Out” Procedure; no tax consolidation of Indian Corporate Groups)

The M&A structure is customised for each and every transaction but there are some standard practices followed by the companies and we can observe a Standard Structure for outbound M&A, the Acquirer (onshore-India) set up an SPV ( special purpose vehicle) offshore and provide it with the capital through the equity route or the loan route, the SPV is also provided with the guarantee by the acquirer (subject to regulatory limitations on the net worth). Now the SPV provides finance for the target company by the capital provided by the acquirer.

Whenever there are dividends distributed it is distributed to the SPV, which provides tax benefits. The acquirer and the target company can be merged post acquisition or the SPV can be merged with the target company. This structure deals with the legal complications and also provides with the tax benefits, while not exposing the acquirer to all the hidden potholes of the target company, hence providing the acquiring company a safety.

The following would better explain the structure.



The ECB (FCCB) guidelines regard of the Use of Proceeds (Purpose) that are mainly limited to Capital Expenditure. It rules out possibility of any ECB for purpose of onshore acquisitions about Tenor . Minimum average maturity of 5 years for deals > US\$ 20 millions and Minimum average maturity of 7 years for deals > USD\$ 100 millions for Rupee Expenditure.

The deals tend to have back ended repayment profile to meet minimum average maturity considerations .Up to US \$ 500 million can be raised in a financial year without prior approval of RBI (“Automatic Route”) . Additional US \$ 250 million (with average maturity > 10 years) with prior RBI approval (“Approval Route”) . A pricing cap at LIBOR + 450 bps for average maturity > 7 years .

RBI approval required for extending security over immovable assets, financial securities (such as shares) in favour of overseas lenders essentially limited to International Banks /

Multilaterals, Export Credit Agencies, Foreign Equity Holders etc., are excluded hedge funds, insurance companies, other investment classes.

**Overseas Direct Investment Regulations** . Direct investment includes contribution to the capital of the overseas Joint Venture (JV) Wholly Owned Subsidiary (WOS), and guarantees issued to or on behalf of the JV / WOS . Limited Unsecured Guarantee can go up to 400% in aggregate of Net Worth of Guarantor and the deals tend to have back ended repayment profile to meet minimum average maturity considerations. A guarantee secured by collateral can see the creation of pledge over (movable as well as immovable) assets for purpose of extending Secured Guarantee to offshore lenders required prior RBI approval.

### **Equity Funding Structure**

Indian markets have outperformed foreign markets since 2006 widely because of the strong economic growth and optimistic expectation.

America's Dow Jones has grown by only 7.7%, Nasdaq by 7.4%, UK's FTSE 0.3% etc whereas Indian BSE SENSEX has grown by 54.3% and NIFTY by 53.3%, This is the growth experienced when there are only 3% of households investing in stocks whereas in developed countries the household investing in stock markets is around 60%, so the potential of the Indian market is also high.

The GDP growth of the country was around 9%, before the slow down, has shown the potential of the market to consume and also the international market is slowly realizing the Indian market capacity. Indian companies are not only family owned businesses, which was the case in the past, now mostly all the big companies are public companies whose shares are traded in the open market, this brings transparency and structure in the market, so the equity market is also growing at a fast rate.

## Equity Funding Options

**Unlisted Acquirers:** the issuance of equity shares to be listed on the domestic stock exchange through the SEBI (stock exchange board of India) approval route. They can target the investor base of the Qualified Investor Buyers or the HNI Investors, the time required would be anywhere between 16-18 weeks.

**Listed Acquirer:** FPO: Further issuance of equity shares on the domestic stock market exchange could be feasible, where in the companies can again target the QIB and the HNI Investors, the normal time required is 14-16 months.

**Rights Issue:** this kind of financing is much faster i.e. 8-10 weeks here the company could issue shares to the already invested share holders proportional to their holdings

**GDR/ADR :** any such transaction or issuance of depository receipts against underlying equity shares is to be listed at Luxemburg/Singapore/London Stock Exchange for GDR and New York for ADR. The expected time to complete the process is 9-10 weeks

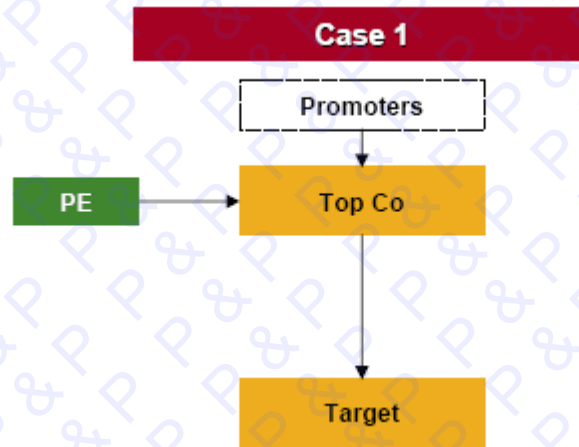
**QIP:** Issuance of the equity shares to the QIBs to be listed on domestic stock exchanges and the maximum limit of investors is 49. Time required is 6-7 weeks.

Timing and Confidentiality issues can be resolved by means of bridge financing but it would last only for 6-12 months and the interest rate would be the short- term rates to the acquirer, there is no need of collateral or security but the unsecured loan will come with recourse to the acquirer and the most important factor is the lenders want a well defined exit plan before entering into the bridge financing.

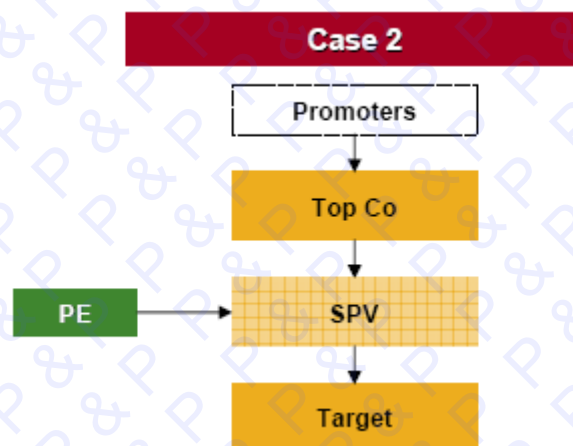
Two equity structure models follow , both with their pros and cons depending upon the transaction and the legal regulations you have to make a decision.

**First Equity Structure.** In this case the promoters have to dilute their stake in the company. The Private Equity has access to the combined entity (along with the associated synergies)

and many times help in achieving a higher valuation in the combined entity. The investor may seek representation on the board together with covenants/rights and may also seek active participation in strategic business decisions.



**Second Equity Structure.** In this case the dilution of the stake of the promoters is avoided which helps them to still have the total control of the parent company and set up an SPV (special purpose vehicle) which issues shares and deals with the acquired company. The investors may seek participation in the SPV but not in the parent company and help in the decision making process presence of a different share holding structure at the target and acquirer levels may result in sub-optimal realization of synergies and there are issues with the sharing of synergies between the top company and the target company.



**Few rules of the inbound and outbound M&A:**

**Stock Swaps – Inbound M&A**

**Considerations for the Acquirer**

**SEBI  
(Substantial  
Acquisition of  
Shares and  
Takeovers)  
Regulations,  
1997**

- Acquisition of 15% shares<sup>(1)</sup> of a listed company will trigger an 'open offer' to the other shareholders of at least 20% of the voting capital of the company
- The offer price shall be payable –
  - (a) in cash;
  - (b) by issue, exchange and, or transfer of shares (other than preference shares) of acquirer company, if the person seeking to acquire the shares is a listed body corporate; or
  - (c) by issue, exchange and, or transfer of secured instruments of acquirer company with a minimum of 'A' grade rating from a credit rating agency registered with the Board;  
Or a combination of clause (a), (b) or (c)
- Thus, in the case of an unlisted or foreign acquirer, there will be a cash outlay on account of the open offer

**Other  
Considerations**

- Shareholding in Indian target post the transaction will need to be evaluated for
  - Sector caps for foreign holding
  - The minimum public shareholding threshold of 10% - 25%, as applicable - SEBI delisting guidelines

**Considerations for the Target Shareholders**

**Foreign  
Exchange  
Management  
Act, 1999<sup>(2)</sup>**

- For Individuals, the overall cap on their investments outside India is US\$ 2,00,000
- Indian Companies can acquire shares of a foreign company upto 400% of their net worth as on the date of the last audited balance sheet

**Income Tax Act,  
1961<sup>(3)</sup>**

- In case of a stock for stock acquisition a single entity is not created, and the sale is subject to capital gains tax – either long term or short term depending on whether the holding period is one year or less

## Stock Swaps – Outbound M&A

### Considerations for the Acquirer

Foreign Exchange  
Management Act,  
1999 <sup>(1)</sup>

- Indian parties who have already made an ADR / GDR issue, may acquire under the automatic route, shares of foreign companies engaged in the same core activity in exchange of ADRs/GDRs issued to the latter; subject to:
  - ADRs/GDRs are listed on any stock exchange outside India
  - The ADR and/or GDR issue for the purpose of acquisition is backed by underlying fresh equity shares issued by the Indian Party;
  - The total holding in the Indian Party by persons resident outside India in the expanded capital base does not exceed the sectoral cap prescribed
  - Valuation of the shares of the foreign company is based on the current market cap. of the foreign company arrived at using the monthly average price on any stock exchange abroad for the 3 months preceding the month in which the acquisition is committed and over and above, the premium, if any, as suggested by the Investment Banker in its due diligence report

### Considerations for the Target Shareholders

SEBI (Substantial  
Acquisition of  
Shares and  
Takeovers)  
Regulations, 1997

- Issue of Indian company's shares to Foreign target (or its shareholders) will trigger the Indian Takeover regulations in case the shareholding of the target ( or a single shareholder of the target, as the case may be) in the Indian acquirer increases beyond 15%
  - Target or the concerned shareholder will be required to make an open offer for 20% of the expanded share capital of the Indian company; cash outlay for foreign target ( or its shareholders)

Other  
Considerations

- Issue of new shares to target ( or its shareholders) will require shareholder approval through special resolution under Section 81(1A) of the Indian Companies Act; Government of India approval required
- Shareholding in Indian company post the transaction will need to be evaluated for
  - the sector caps for foreign holding
  - the minimum public shareholding threshold of 10%-25% as applicable - SEBI delisting guidelines
- There may be some restrictions on certain classes of shareholders of the foreign target from holding Indian shares
  - Certain pension funds cannot hold shares not listed on their country's domestic exchange