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Strategic Financial Management

MCH202

CENTRE FOR DISTANCE AND ONLINE EDUCATION

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STRATEGIC FINANCIAL MANAGEMENT
(MCH202)

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EDITION : 2024 (Restricted Circulation)
PUBLISHED BY : Teerthanker Mahaveer University, Moradabad

M.Com II Semester

STRATEGIC FINANCIAL MANAGEMENT

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Financial Innovations, Financial Innovations in India etc, finally **unit 4** includes Tobin's Q Ratio, Demerits of Financial Engineering, Demerits of Financial Engineering etc.

Module 2:- gives information about Private Equity and Venture Capital, where first unit, **unit 5** includes information regarding features if venture capital investments, vision of venture capital, methods of venture capital financing etc, next unit, **unit 6** includes information regarding stages of venture capital financing, the funding process etc further **unit-7** includes information regarding structure of venture capital firms, venture capital industry etc, finally **unit 8** includes information relating to The Role of Staging and VC Monitoring in Resolving Principal – Agent Conflicts , information regarding principal-agent issues within PE/VC settings etc.

Module 3:- includes the information of Financial Distress and Restructuring where **unit 9** includes Process of Merger and Acquisition, Characteristics of M&A Transactions, Steps to Make Mergers and Acquisitions More Successful, futher **unit 10** includes information regarding Concept of Acquisition, Types of acquisition, Difference between Mergers and Acquisitions etc. **unit 11** includes Hostile Takeover and Poison Pill Defense, Buyouts/ Leverage Buyouts, Business alliance / Strategic alliance etc. further **unit 12** includes Legal Aspects of Takeover, Tax Implications Cross Border Acquisitions and International Acquisitions, Provisions of the Companies Act 1956 etc.

Module 4:- includes the information about financial distress and restructuring, where the first unit, **unit 13** includes information regarding causes of financial distress, operational cutbacks: causes and effects etc, further **unit 14** covers information regarding financial restructuring, forms of corporate restructuring etc. next unit, **unit 15** covers information such as process of corporate restructuring, strategy for corporate and distress restructuring etc**.** The last unit, **unit 16** encompasses information such as reasons for strategic failures in mergers and acquisitions.

Module 5:- includes the information about Debt Restructuring, Bankruptcy, re-organization and Liquidation further the **unit 17** covers information regarding winding up, companies in distress etc, next unit, **unit 18** includes information regarding turnaround strategies, prepackaged bankruptcy etc, next **unit 19** encompasses information regarding debt restructuring, leveraged buyouts, strategic alliance etc. The last unit, **unit 20** includes information regarding categories of takeover defense, active antitakeover defenses etc.

SRATEGIC FINANCIAL MANAGEMENT

Today most business enterprises engage in strategic planning, although the degrees of sophistication and formality vary considerably. Conceptually, strategic planning is deceptively simple: Analyze the current and expected future situation, determine the direction of the firm, and develop means for achieving the mission. In reality, this is an extremely complex process which demands a systematic approach for identifying and analyzing factors external to the organization and matching them with the firm's capabilities. Planning is done in an environment of risk and uncertainty. Managements cannot be sure what the external as well as the internal environment will be even next week, much less several years from now: Therefore, management make assumptions or forecasts known as planning premises about the anticipated environment. Some of the forecasts become assumptions for other plans. For example, the gross national product forecast becomes the assumption for sales forecast, which in turn becomes the basis for production planning and so on. Strategies and policies are closely related. Both give direction, both are the frame works for plans, both are the basis of operational plans, and both affect all areas of managing.

MODULE – 1: Strategic Financial Decisions

MODULE – 2: Private Equity and Venture Capital

MODULE – 3: Mergers, Acquisition, Takeovers and buyouts

MODULE – 4: Financial Distress and Restructuring

MODULE – 5: Bankruptcy, reorganization, and Emergence, the Liquidation Alternatives

MODULE - 1

STRATEGIC FINANCIAL DECISIONS

UNIT -1 : INTRODUCTION TO STRATEGIC FINANCIAL MANAGEMENT

Structure :

1.0 Objectives

1.1 Introduction

1.2 Strategic Financial Management Decisions

1.3 Other Aspects of Strategic Financial Management

1.4 Strategy and the Strategist

1.5 Strategic Decisions

1.6 The 'Nine References' For Strategic Financial Management

1.7 Case Study

1.8 Notes

1.9 Summary

1.10 Key words

1.11 Self Assessment Questions

1.12 References

1.0 OBJECTIVES

After studying this unit, you will be able to;

- Give the meaning Strategic Financial Management Decisions
- Describe the Strategy and the Strategist
- Analyze the various Aspects Strategic Financial Management
- Highlight the Strategic Decisions

1.1 INTRODUCTION

A business involves the interests of various stakeholders who either support it or contradict it. The shareholders in the process of maximizing their wealth, try to get a leverage on every possible front by rewarding the other 'interest groups' such as the vendors and suppliers, lenders, employees, contractors, dealers and customers and also the government. Each 'interest group' tries its level-best to grab maximum possible returns from the business that they try to sustain together. At best, such 'individualistic leveraging games' are played with more sophistication, less controversies and with a sustainable urge for long-term growth, so that all the stakeholders continue to benefit with more or less the same proportions and within tolerable limits. A win-win situation cannot be expected to turn up every time although attempts are made to bring such a situation about all the time.

The changing definitions of competitive advantage, product profiles, product life cycles, productivity and employability, markets and market variables have made the 'financial management' of a business enterprise more complex. You cannot take a conservative view on wage management, for long-term flexibility has to be achieved in wage policy if employees are to enjoy extra wages after they make extra profits. Vendors cannot be asked to give huge discounts and liberal credit terms, if they really want to manage their supply-chain smoothly. Dealers have to share an equal amount of business accountability and they must generate higher, more sustainable incremental profits before they ask for an increment in commission. Lenders have to think innovatively about various 'lending variables' so that the borrowing company and they share the prosperity together in a reasonable ratio, without disturbing the liquidity or balance of their portfolios. Managers have to look at costs strategically, so that a profit made today does not turn out to be a heavy loss tomorrow. Having a very conservative approach to cost-control leads to the loss of a good opportunity for making future profits. Indirect taxes are of prime concern when planning the tax layout. Unfortunately a disproportionately high

emphasis is placed upon the planning of 'direct taxes'. Shareholders have to sacrifice 'cash dividends' if a timely diversification, renovation or expansion is to be financed. Promoters or owners must think strategically when it comes to equity dilution or for forming alliances for joint ventures. With globalization and networking skills, companies must spend a lot on 'brand-building' and on innovative concepts in retaining the customer. Marketing executives have to aggressively incur promotional and distribution costs in order to persuade the production executives to bear the ultimate pinch in the form of a back-loaded burden of the extra cost in the value-chain.

Everyday the organization will have to use tactics in the short-run and strategies in the long-run to manage its finances if the ultimate result is to be favourable. For this, costs and benefits from every corner must be looked into, strategically, so that a due amount of transparency is achieved in cost-control efforts at every stage of the value-chain of the organization. Finances must be managed strategically if profits are to increase at a sustainable growth rate. Strategic Financial Management refers to both the financial implications and aspects of various business strategies and the strategic management of finances. If a company wants to be a blue-chip enterprise or a great enterprise for an all-time investment, it will have to adopt strategic approach to cost management, sales and revenue management, fund-raising and fund-deployment and cost-benefits analysis of every prime decision of expansion, diversification, downs-zing and renovation.

Costs and Benefits rotate around three major ingredients essential for corporate success – viz, people, technology and capital. A company aiming for recognition will always try to maintain equilibrium between these three ingredients.

1.2 STRATEGIC FINANCIAL MANAGEMENT DECISIONS

Investment Decisions: One of the tasks in corporate finance is to make capital investments, and the corporate finance department is responsible for the deployment of a company's long-term capital. The decision process of making capital investments is mainly concerned with capital budgeting, a key corporate finance procedure. Through capital budgeting, a company identifies capital expenditures, estimates future cash flows from proposed capital projects, compares planned investments with potential proceeds, and decides which projects to include in its capital budget.

Companies make conscious decisions about what kind of capital investment and how much of it they should have over time. This spells out the funding requirements and therefore affects the choice of financing sources. The first funding option is always a

company's own operating cash flow, which sometimes may not be enough to satisfy the amount of capital expenditures required. It is more likely than not that companies will resort to outside financing, debt or/and equity to make up for any internal cash flow shortfall. Capital investment is meant to benefit a company in the long run, but it nonetheless has some short-term downsides. Intensive, ongoing capital investment tends to reduce earnings in the interim, strain on liquidity from payment demand on interest and maturing principals, and dilute earnings and ownership if new equity is used.

Financing Decisions: is yet another crucial decision made by the financial manager relating to the financing-mix of an organization. It is concerned with the borrowing and allocation of funds required for the investment decisions.

The financing decision involves two sources from where the funds can be raised: using a company's own money, such as share capital, retained earnings or borrowing funds from the outside in the form debenture, loan, bond, etc. The objective of financial decision is to maintain an **optimum capital structure,** i.e. a proper mix of debt and equity, to ensure the trade-off between the risk and return to the shareholders.

The **Debt-Equity Ratio** helps in determining the effectiveness of the financing decision made by the company. While taking the financial decisions, the finance manager has to take the following points into consideration:

- The **Risk** involved in raising the funds. The risk is higher in the case of debt as compared to the equity.
- The **Cost** involved in raising the funds. The manager chose the source with minimum cost.
- The **Level of Control**, the shareholders, want in the organization also determines the composition of capital structure. They usually prefer the borrowed funds since it does not dilute the ownership.
- The **Cash Flow** from the operations of the business also determines the source from where the funds shall be raised. High cash flow enables to borrow debt as interest can be easily paid.
- The **Floatation Cost** such as broker's commission, underwriter's fee, involved in raising the securities also determines the source of fund. Thus, securities with minimum cost must be chosen.

Thus, a company should make a judicious decision regarding from where, when, how the funds shall be raised, since, more use of equity will result in the dilution of

ownership and whereas, higher debt results in higher risk, as fixed cost in the form of interest is to be paid on the borrowed funds.

Liquidity Decisions: It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm's profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a tradeoff between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not earn anything for business therefore a proper calculation must be done before investing in current assets.

Current assets should properly be valued and disposed of from time to time once they become non profitable. Currents assets must be used in times of liquidity problems and times of insolvency.

Liquidity describes the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price. Market *liquidity* refers to the extent to which a market, such as a country's stock market or a city's real estate market, allows assets to be bought and sold at stable prices.

Dividend Decisions: Dividend decision refers to the policy that the management formulates in regard to earnings for distribution as dividends among shareholders. Dividend decision determines the division of earnings between payments to shareholders and retained earnings .

The Dividend Decision, in corporate finance, is a decision made by the directors of a company about the amount and timing of any cash payments made to the company's stockholders. The Dividend Decision is an important part of the present day corporate world.

The Dividend decision is an important one for the firm as it may influence its capital structure and stock price. In addition, the Dividend decision may determine the amount of taxation that stockholders pay.

Following are the different forms of Dividend:

Scrip Dividend– An unusual type of dividend involving the distribution of promissory notes that calls for some type of payment at a future date.

Bond Dividend– A type of liability dividend paid in the dividend payer's bonds.

Property Dividend– A stockholder dividend paid in a form other than cash, scrip, or the firm's own stock.

Cash Dividend– A dividend paid in cash to a company's shareholders, normally out of its current earnings or accumulated profits.

Optional Dividend– It is the dividend which the shareholder can choose to take as either cash or stock.

Profitability Decisions: Profitability is the primary goal of all business ventures. Without profitability the business will not survive in the long run. So measuring current and past profitability and projecting future profitability is very important. Profitability is measured with income and expenses. Income is money generated from the activities of the business. For example, if crops and livestock are produced and sold, income is generated. However, money coming into the business from activities like borrowing money do not create income. This is simply a cash transaction between the business and the lender to generate cash for operating the business or buying assets.

Expenses are the cost of resources used up or consumed by the activities of the business. For example, seed corn is an expense of a farm business because it is used up in the production process. Resources such as a machine whose useful life is more than one year is used up over a period of years. Repayment of a loan is not an expense; it is merely a cash transfer between the business and the lender. Profitability is measured with an "income statement". This is essentially a listing of income and expenses during a period of time (usually a year) for the entire business. Information File Your Net worth Statement includes - a simple income statement analysis. An Income Statement is traditionally used to measure profitability of the business for the past accounting period. However, a "pro forma income statement" measures projected profitability of the business for the upcoming accounting period. A budget may be used when you want to project profitability for a particular project or a portion of a business.

1.3 OTHER ASPECTS OF STRATEGIC FINANCIAL MANAGEMENT

In addition to the above Strategic Financial Management Decisions, Strategic Financial Management also deals with the below given points.

- Valuation of the Firm
- Strategic risk Management
- Strategic investment analysis and capital budgeting
- Corporate restructuring and financial aspects

- Strategic financial evaluation
- Strategic capital restructuring
- Strategic international financial management
- Strategic financial engineering and architecture
- Strategic market expansion and planning
- Strategic compensation planning
- Strategic innovation expenditure
- And other business challenges

1.4 STRATEGY AND THE STRATEGIST

The words 'Strategy' and 'Strategic Management' became popular words after 1960. Many theories were developed on and around the concept of 'strategy'. Among the main questions that arise about strategy is it a 'game plan', a 'policy', an 'action plan' or a 'tactic'? Is it long-term or short-term? Is it quantitative or qualitative? Is it visible or invisible? Is it to be decided upon only by seniors? Is it a piece of advice given by a 'staff executive' to the 'line executive'? Ultimately, what is it?

'**Strategy' is:** 'A flexible approach for achieving the desired results, with sustainable successes.

'Strategy' then is basically – (1) an approach, which should (2) flexible should (3) achieve the desired result sand very important, (4) that such a success in achieving results should be sustainable. Strategy is normally long-term or medium-term. It would be a 'tactic', if it is effective only for a very short-term. Strategy hence is an 'action-plan' and also an approach to implement such an action plan. 'Policy' is the long-term, macro-level 'discipline' that must be observed by everybody in the organization (e.g. – work policy, wage policy, promotion policy, pricing policy etc.). 'Strategy' is a tactical, flexible way of solving routine and non-routine problems, implementing the policy smoothly and launching every possible threat to the competition or to anybody who creates problems (so you have to have strategies to handle competitors, employees, vendors, dealers, government bureaucrats, etc.) 'Strategy' is the very soul of any action and activity; which is also omnipresent and therefore every executive and owner needs to be a 'strategist'.

Strategic Financial Management demands that every executive (or stakeholder) be a 'Strategist' in the real sense. A strategist should observe financial management from a long-term point of view for sustainable success based on short-term, flexible tactics. He should equally be, both a 'generalist' and a 'specialist'. He must be able to combine, with versatility, quick, correct and analytical financial techniques along with a qualitative judgment about each and every decision or situation. A strategist must make use of a fine mix of various quantitative techniques and shrewd analytical skills when handling financial decisions or when deciding upon certain solutions or action plans to arrive at a quick and appropriate judgement. The final decision or choice will inevitable require a detailed analysis based on reliable, adequate and essential data. A strategist will come to a micro-level conclusion keeping in mind macro-level implications so that he may emerge the ultimate winner. He should always try to ensure that the 'conventional game theory' gives desirable results for all players and not result in a 'win-lose' situation. Strategic Financial Management' is not subject or an area of knowledge that contains all-time definite answers to business problems. Rather it is a subjective, mature, versatile and flexible source of solutions to complex business predicaments. It demands that the decision-maker be as quick and as flexible as an atom shaping up differently for different situations with extraordinary creative power for answers. During a financial depression, one cannot afford to displease ones dealers. One must please them with 'extra advantages' in spite of the 'cost of credit'. Same dealers may be disciplines during the time of boom even as vendors and contractors. Even the employees may have to be convinced about stagnant wages when the whole market is frustrating. Employees would most probably stay loyal to the company if they are assured that the 'comfortable days ahead' will be shared equally between the employees and themselves.

In difficult situations Strategic Financial Management may offer different solutions to a single problem leaving the ultimate conclusive choice to the strategist. One can compare this management or use of strategy to a very fine game of chess where every move is played with the anticipation of a possible repercussion. The game of chess proves either one player as a winner and the other as a loser or the game is a draw. The chess of Strategic Financial Management differs to some extent in the sense that it attempts to make both players the ultimate winners, with the possibility that there are more than just two players every time.

A strategist has to keep thinking innovatively as an old strategy would be very well known to a competitor. He will have to keep on formulating business. Formulate, be

they entirely new or old ones with moderate variations. A versatile picture of ultimate analysis and conclusion depends upon interesting combinations of such innovative ideas.

To illustrate this point, we can see how a strategist may think of the following innovative concepts or formulations as given below:

1. Incremental Cost-Benefit Anlaysis of every marginal change in decisions or situations.
2. Life Cycle costing of products, brands, employees and the enterprise, for long-term strategy formulations.
3. Leveraging 'sunk costs' by innovately using such costs or commitments in future negotiations.
4. To arrange for the Discounted Cash Flow Analysis of alternate projects to be supported by 'multi-angle performance parameters' so that a comprehensive assessment of the decision is possible.
5. Enterprise Resource Management (and not just Planning) would be possible if 'internal benchmarking of costs performance' is built up (especially when external benchmarks are not very relevant).
6. To make 'Notional Costing' for a true application of 'profit Centre Concept is a must.
7. Combining 'Value Chain Analysis' with 'Segmental ROI' and 'Enterprise Portfolio Mix' theories.
8. Forming a 'U' Curve relationship with both the vendors and dealers to create a strategic base for a long-term, sustainable and profitable partnership.
9. Making 'Economic Value Added' more meaningful by internally developing reliable benchmarks of achievable rates of return.
10. Achieving long-term wealth maximization through financial engineering by attempting 'innovative networth mix'.

The above innovative concepts and formulations are discussed in the chapters of this book, with real-life cases as illustrations. Innovations always create a scope for either new or more comfortable solutions to problems. They also make and mark the difference between a great enterprise and a blue-chip enterprise. 'Innovative thinking' is the very beginning and process of strategic financial thinking.

1.5 STRATEGIC DECISIONS

Strategic decisions are the decisions that are concerned with whole environment in which the firm operates the entire resources and the people who form the company and the interface between the two.

Characteristics/Features of Strategic Decisions

a. Strategic decisions have major resource propositions for an organization. These decisions may be concerned with possessing new resources, organizing others or reallocating others.

b. Strategic decisions deal with harmonizing organizational resource capabilities with the threats and opportunities.

c. Strategic decisions deal with the range of organizational activities. It is all about what they want the organization to be like and to be about.

d. Strategic decisions involve a change of major kind since an organization operates in ever-changing environment.

e. Strategic decisions are complex in nature.

f. Strategic decisions are at the top most level, are uncertain as they deal with the future, and involve a lot of risk.

g. Strategic decisions are different from administrative and operational decisions. Administrative decisions are routine decisions which help or rather facilitate strategic decisions or operational decisions. Operational decisions are technical decisions which help execution of strategic decisions. To reduce cost is a strategic decision which is achieved through operational decision of reducing the number of employees and how we carry out these reductions will be administrative decision.

The differences between Strategic, Administrative and Operational decisions can be summarized as follows:

Strategic Decisions	Administrative Decisions	Operational Decisions
Strategic decisions are long-term decisions.	Administrative decisions are taken daily.	Operational decisions are not frequently taken.
These are considered where The future planning is concerned.	These are short-term based Decisions.	These are medium-period based decisions.
Strategic decisions are taken in Accordance with organizational mission and vision.	These are taken according to strategic and operational Decisions.	These are taken in accordance with strategic and administrative decision.
These are related to overall Counter planning of all Organization.	These are related to working of employees in an Organization.	These are related to production.
These deal with organizational Growth.	These are in welfare of employees working in an organization.	These are related to production and factory growth.

Exhibit: 1.1

1.6 THE 'NINE REFERENCES' FOR STRATEGIC FINANCIAL MANAGEMENT

A real strategist will always try to look at various decisions and situations, with utmost versatility. Such versatility comes from an overall understanding of the most important factors deciding what is known as sustainable success. These important factors are the prime references for the strategist to design his financial game plans.

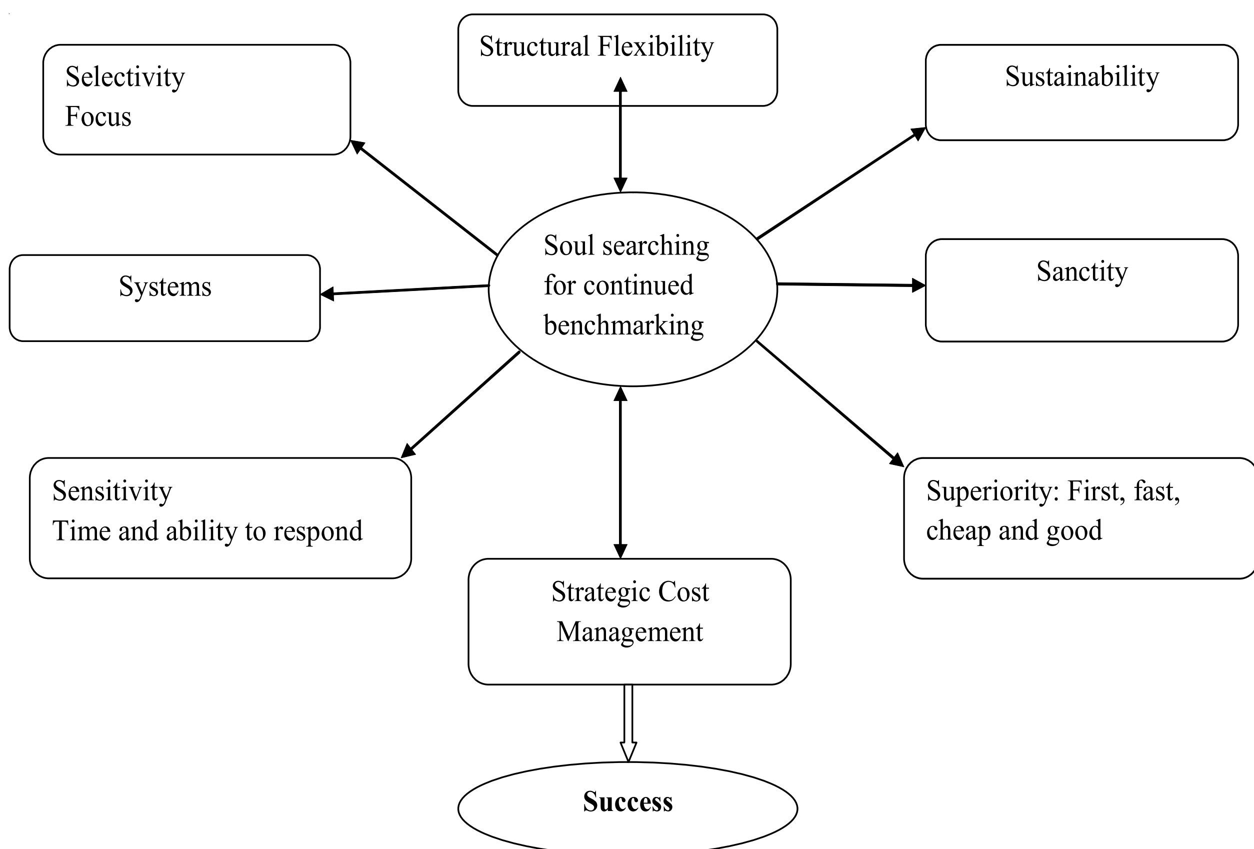

Exhibit 1.2: The Horoscope of Success. (Nine References of Strategic Financial Management. we may even call this as the Nine 'S' Model)

Prof. Potter, on the concept of 'Sustained Competitive Advantage' has discussed five elements of competitive advantage. Here, I have given a more comprehensive model based on an all-round exercise of analyzing the 'success variables' of an enterprise. I call it the 'horoscope of success', these variables shall in a horoscope would either

support each other if they are strategically mixed or would contradict each other. The nine planets of the horoscope are the nine references for strategic financial management. These references altogether give a complete ‘umbrella view’ of both the short-term and long-term profit and growth management of an enterprise that is aiming to be an all time great. A diagrammatic expression of the horoscope is as follows:

The Nine ‘S’ Model combines the quantitative and qualitative skills of a strategist. For example, ‘Sanctity’ refers to the ‘ethical economics’ of business offers a long-term, sustainable ‘brand-equity’ to the enterprise which ultimately reduces every cost at every stage of a product’s life cycle. You do not have to incur much ‘promotional cost’ when launching a new product because your credibility has already been established. The ‘Cost of Ethics’ may be initially high in the performance curve of an enterprise but the same would definitely lead to a sharp rise in revenues after the break-even is achieved. Ethical Economics of business has been discussed separately in this book, with real case-studies for illustration.

‘Selectivity’ refers to the most appropriate business choices based on an enterprise’s core competence. Strategic Financial Management (‘SFM’) should concentrate on building up a most flexible core competence together with strategic cost management. an enterprise’s core competence need not restrict the scope for its more profitable diversification even if it demands a change in its very nature. A real strategist knows the benefits of achieving a certain level of competence that must come from the stretching of an enterprise ‘core competence’. Many great enterprises have carried out this stretching exercise keeping a strict eye on pragmatic cost management.

The term ‘Systems’ emphasis the need for a supportive mechanism to make ‘SFM’ a continued success. Hence, ‘Systems’ refers to the technological, accounting, information and operational systems of an enterprise. Systems are to make SFM an automatic process both inside and outside an enterprise. To make an ‘accounting system,’ a strategic device would have to construct a four-tier structure of the system. The first-tier will serve the formal accounting requirements of external and statutory reporting. The second-tier will serve the purpose of ‘responsibility accounting’ or ‘accounting for profit-centre applications’. The third-tier will provide significant data to key executives for their decision-making processes. The second and third tier accounting packages or systems necessarily depend upon ‘notional costing assumptions’. The last or the fourth tier of accounting assists the owners or the promoters in taking strategic decisions. A separate case-study of a pharmaceutical company has been presented in this book to illustrate these four different tiers of an accounting system.

'Strategic Cost Management' refers to the micro-level strategic analysis of various cost-structures and cost-implications. This area of SFM broadly attempts to indicate the cost-molecules that are of strategic importance. A few theories have already been developed to facilitate the strategic management of cost-e.g., Activity Based Costing (I attempt to add here, Objective Based Costing-OBC!), Life Cycle Costing, Notional Cost-Benefit Analysis, Cost-Analysis for establishing the validity of a certain value-chain of an enterprise, etc.

'Sensitivity' is all about 'Strategic Information Management'. An analyst under SFM must know the strategic use of every piece of information flowing in and out. The highest degree of sensitivity comes from the most efficient use of strategically important information. Sensitivity also depends upon the ability to transform 'x' information into 'y', in the minimum possible amount of cost and time, so that quick exercises of 'cost-benefit possible amount of cost and time, so that quick exercises of 'cost-benefit analysis' are possible. A true strategist (as stated earlier) must have the capacity of a 'generalist' to convert technical data into commercial data. It is important to not that the convert technical data into commercial data. It is important to note that the commercial data may be more approximate and more macro in nature while, the base for conversion is the technical data, to explain Productivity Improvement, may technically reduce certain overheads or/and improve the quality of a product or process. The commercial conversion of such an 'improvement' may not be so exact or visible. Hence, many productivity-linked wage models become obsolete, as soon as the productivity variable undergoes a considerable change.

'Sustainability' of performance is a matter of long-term strategic planning. An enterprise achieving a high ROI (Return on Investment) during the time of boom will have to plan for a 'Break-Even ROI' during the time of recession. This low ROI should be supported by 'low cost investment' from the same depressed market. Such a strategic game-plan requires a very careful combination of 'business strategy' and 'business funding strategy'. Sustainability also means 'managing new competitors' with 'extra cost on sustenance'. You have to design a shrewd strategy for a time-bound action-plan, to retaliate every move of the competitor. Such an action-plan will have to assure a long-term safety for your core competence. This is natural since one has to pay for a 'sustained competitive advantage', keeping in mind that such a payment does not exceed the ultimate advantage of such sustenance. The theory of a long-term, average, achievable ROI has to be benchmarked, considered (or discounting) the economy-level, industry-level and enterprise-level advantages and disadvantage. The term 'Sustained Average ROI' implies

the war against all odds, including inflationary pressures, new entrants, obsolescence of markets-products-technology-people, the intrinsic problems of business processes and many more.

'Superiority' refers to the position of 'Leadership' that an enterprise mast attain in the market. Sustaining leadership is a very expensive exercise. A strategic plan has to offer the financial difference between the 'cost of leadership' and the 'cost of following others'. SFM should aim at maintaining both positions in the same market although this may look a little paradoxical. The most important portion of an enterprise's value-chain will give you the leadership position. You have to continuously work on it to see to it that your competitors do not make you 'dispensable'. In other words, the most indispensable part of your value-chain is your identity. One must retain one's identity at any cost in a competitive market. Strategically, it would be wise to follow the 'big-sizers' for the dispensible portions of one's value-chain, as they should certainly offer you the economy of scale.

The **'Structural Flexibility'** of an enterprise is approximately the sum total of the qualitative and the quantitative adaptability and adjustability of an organization. Sunk costs, Committed Costs, Engineered costs, Capacity Costs, Burden Costs and Corrective Costs could be huge if an adequate structural flexibility is absent. All great organizations have shown a tremendous amount of such flexibility especially when facing tough market conditions. Human flexibility, technical and systems flexibility, financial flexibility and entrepreneurial flexibility are a must if a dynamic organization is to achieve strategic advantages. Structural flexibility gives to an enterprise the required strength to reincarnate its product and to reinforce its human resources. It enables the organization to covert threats into opportunities and losses into profits. Structural flexibility is achieved through long-terms efforts and by incurring intangible costs (costs not visible in the short run). Enterprises very often do not take such costs seriously; therefore the ultimate yield may not turn to be a very satisfactory flexibility.

'Soul Searching' that is based on continuous bench-marking, requires a tremendous amount of financial alertness, innovation and a total exposure to new variables and parameters. One cannot pursue formulating strategies only with old strengths and assumptions because one cannot risk under evaluating one's competitors and the threat they offer to one's sustained competitive advantage. An enterprise, therefore, requires an automatic, self-regulated and self-motivated system of developing new operational and financial benchmarks. The exercises of 'Strategy Audit', 'Policy Audit' and 'Management Audit' could be very useful for appraising the validity of these benchmarks.

A qualitative exercise of 'organisational diagnosis' is also possible if a flexible model is built up using such benchmarks.

Sould searching also refers to establishing new heights of achievement and newer core-competencies. Hence, a very versatile structure is make available to the organization, giving it perpetual opportunities to realize win-win situations. The financial expression of qualitative benchmarks is a must, as this alone offers total objectivity in strategic planning. A strategic plan without the necessary financial visibility could become an abstract statement of mission with lot of scope for self-contentment when desired benchmarks are not achieved. However, financial visibility in a strategic plan could be 'approximate' sometimes. It definitely serves the purpose of creating a self-imposed accountability for achieving pre-determined benchmarks.

An enterprise is very often required to discount many positive variables on account of some intrinsic limitations of its business processes. Such discounting is objective and precise if financial expression of the variables is attempted. 'Wealth Acceleration Attempts' requires the utmost understanding of the complex relationship between 'asset utilization efficiency' and 'market handling efficiency' between the 'cost in the product' and the 'cost on the product' and between 'system-oriented costs' and 'costs of flexibility'. An ambitious entrepreneur would attempt to combine or network various strengths of value-contributors and thus maximize the networth of the enterprise. So you find the world over, the increasing dominance of 'networking corporates', that are engaged in accelerating their wealth by enlarging their presence in every possible market even while their retain the indespensible portions of their value-chain.

These nine references of Strategic Financial Management ultimately aim for "Wealth Maximization through the Accelerating Effect" and obviously wealth for every stake holder in the organization. A practical approach to wealth maximization may be tried through various permutations and combinations of 'value chain contributors'. One such combination may be presented as follows:-

Wealth maximization depends upon a constant rate and volume of growth. Growth need not be auomatic. Rather, a sustainable and all round spread of growth (keeping the Business Portfolio Risk intact) depends upon an equilibrium among various avenues of growth as follows.

Growth need not depend only on the philosophy of restricting an enterprise's core competence'. Instead, an enterprise would do well to keep on developing the competence of stretching or changing or electrifying its 'traditional core competence'. As stated earlier, enlarging a company's core competence could be the very mechanism

to speedup its net working. Well-diversified industrial groups across the globe have proved this theory of "competence of stretch competence."

As many companies have faced financial distress in recent years, managers now seem to assign greater importance to capital structure and distribution (by way of dividends and share buybacks) decisions which may be referred to as strategic financing decisions. It may be noted that carefully crafted strategic financing decisions do more to prevent value erosion that to enhance value.

At the outset, it must be emphasized that value-conscious companies seek to: (a) choose a capital structure that reduces the cost of capital for the firm, while preserving adequate financial flexibility, and (b) return cash to shareholders by way of dividends and share buybacks when the firm lacks credible value-creating opportunities to invest in business.

So far we concentrated mainly on the investment side of the balance sheet. Now we turn attention to the financing side of the business. The vocabulary of financing is confusing and the number of complex and exotic financing instruments is expanding. Yet, at a fundamental level, financing decisions, compared to investment decisions, are relatively easier to make and have a lesser impact on firm value, thanks to the following differences:

Exhibit: 1.3

Financing Decisions	**Investment Decisions**
• Financing decisions take place in capital markets which are approximately perfect.	• Investment decisions take place in real markets which tend to be imperfect.
• While making financial decisions, you can observe the value of similar financial assets.	• While make investment decisions, you have to estimate the value of the capital projects.
• There are very few opportunities in the realm of financing that have an NPV that is significantly different from zero.	• There are many opportunities in the realm of capital budgeting that have an NPV that is significantly different from zero.

1.7 CASE STUDY

The Gucci - LVMH Battle

In March 1999, a $ 3 billion stock deal was announced between luxury goods major Gucci N V and the Pinault-Printemps-Redoute (PPR) group of France.

The news of PPR acquiring a 40% stake in Gucci came as a surprise for Bernard Arnault (Arnault), Chairman of the Moet Hennessy Louis Vuitton (LVMH) group, who had been trying to acquire Gucci through open market stock acquisitions. Gucci announced that it would issue more shares if LVMH tried to further increase its stake in the group. Gucci President Domenico De Sole (De Sole) said that he had the support of Gucci staff, suppliers and independent shareholders to keep LVMH off the board. Earlier, Gucci had approved an employee stock option scheme (ESOP) to counter LVMH's acquisition tactics. Not only did LVMH remain powerless in Gucci despite spending $ 1.4 billion, but its share prices also began sliding on the Paris stock market.

LVMH charged that the sole purpose of Gucci's move was to deprive LVMH of its voting rights. The same day PPR announced its deal with Gucci, it paid $ 1 billion for Sanofi Beaute, the French owner of brands like Yves Saint Laurent cosmetics and perfumes. This was another setback for LVMH as Arnault had been trying to acquire Sanofi.

As a result of these deals, overnight the Gucci/PPR combination became a major competitor for LVMH. LVMH now made a full takeover bid for Gucci at $ 81 a share, $ 6 more than what PPR had paid. At the same time, it dragged Gucci to the court to annul the deal with PPR and replace its board with an independent overseer. The Gucci-LVMH battle took the global fashion industry by surprise. More so, because in 1994, it was Arnault himself, who had turned down an offer to buy Gucci for $ 400 million. However, in just five years the same man had spent $ 1.4 billion in building up a 34% stake in Gucci. A media report said, "How a $ 400 million reject became a highly desirable $ 8 billion company is one of the greatest comeback stories in the fashion business."

Gucci's history goes back to 1923, when Gucci Guccio started selling expensive leather goods in Florence, Italy. By 2001, the Gucci Group had emerged as one of the world's leading multi-brand luxury goods companies.

The company designed, produced and distributed high-quality personal luxury goods, including ready to wear garments, handbags, luggage, small leather goods, shoes,

timepieces, jewellery, ties and scarves, perfume, cosmetics and skincare products. Some of its important brands were Gucci, Yves Saint Laurent, Sergio Rossi and Boucheron The group directly operated stores in major markets throughout the world and also sold their products through franchise stores, duty-free boutiques and leading department and specialty stores. De Sole had joined Gucci in 1982 and quickly moved up the ranks, becoming the President of Gucci US. In the early 1980s, around 50% of the company's stock was owned by an Arab company, Investcorp.

During the 1970s and 1980s, the Gucci label was seen on almost every imaginable product: scotch, leatherwear, key chains, watches, T-shirts, etc. Also, the company was spending more than $ 4 million a year to combat a flood of fake Gucci merchandise.

In 1990, Gucci hired Tom Ford (Ford), an actor-model with a degree in interior architecture and some experience in fashion design for its designing needs. By 1993, Gucci was on the verge of bankruptcy. In 1994, it was reported that the company was offered to Arnault for $ 400 million, but he backed off at the last minute. Investcorp then bought the remaining 50% stake in a desperate effort to recoup its investment. De Sole and Ford then began working towards canceling Gucci's numerous licensing agreements and went on to build its image as a premier luxury brand. Though initially De Sole had reservations regarding Ford's competence, over the years, Ford emerged as the single most important factor behind Gucci's success..

LVMH had begun stalking Gucci since the beginning of January 1999 by acquiring more than 5% of its shares. By the end of January 1999, LVMH's stake in Gucci had increased to 34%.

On January 27th, 1999, Arnault arranged a meeting with De Sole, at which he proposed that, since he was now one of Gucci's largest shareholders, he be allowed to name a director to its board. De Sole however believed that Arnault's people should not be put on the Gucci board, since they were from the rival fashion house Louis Vuitton.

De Sole could not afford to let them have access to inside information regarding store space, publicity, and designers. De Sole alleged that Arnault was plotting a 'creeping takeover' by gradually buying enough shares to dominate Gucci's board. De Sole then asked Arnault to buy the remaining shares.

In July 2001, followers of the Gucci-LVMH tussle were surprised to see media reports that claimed that the battle was over. LVMH had agreed to sell its 20% stake in Gucci to PPR for $ 2 billion under a condition that PPR forfeit voting rights on this stake.

PPR bought the LVMH stake at $ 94 per share, raising its stake in Gucci to 53.2%. As a first step, PPR was to buy half of LVMH's 20% stake for $ 975 million. Then,

Gucci was to pay a special dividend of $ 7 per share to all shareholders except PPR in November 2001. Next, PPR was to launch a full public offer for all Gucci shares at $ 101.50 per share in March 2004.

PPR, Gucci and LVMH also agreed to release all outstanding claims and withdraw all pending litigation. PPR was planning to finance the deal by issuing equity and convertible bonds. Media reports revealed that the deal was struck at the behest of Dutch investigators, who urged the three parties to reach an agreement without seeking legal intervention.

Questions:

1. Was voting right concept is justiciable from the point of LVMH?
2. Was LVMH stake in Gucci was the game changer?
3. What was the role of PPR in this battle?

1.8 NOTES

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1.9 SUMMARY

Strategic financial management is essentially another term for financial management. It involves employing a number of strategic financial theories designed to operate in a company's best financial interests. Parts of strategic financial management include creating a budget and managing risks and assets. Each area of strategic financial management is designed to address a different part of company financial operations to reduce financial leaks and make the most of the available financial resources. In general, this practice seeks to understand and control the use of money to get its maximum benefit for a business.

Budgeting is important in strategic financial management. Without budgeting, a company cannot be sure how much money is going into and out of the organization, or whether important parts of the business are getting proper funding. Before a business engages in any other type of strategic financial management, it usually starts by gathering information about the company's financial resources and defining a budget to gain control over the money in the business. Keen budgeting helps a company run at its best, and also helps expose departments or individuals within an organization with unusually high operating costs.

1.10 KEY WORDS

Budgeting: It is the process of creating a plan to spend your money. This spending plan is called a budget. Creating this spending plan allows you to determine in advance whether you will have enough money to do the things you need to do or would like to do. Budgeting is simply balancing your expenses with your income.

Strategy: It is the direction and scope of an organisation over the long-term: which achieves advantage for the organisation through its configuration of resources within a challenging environment, to meet the needs of markets and to fulfill stakeholder expectations.

Globalization: is a process of interaction and integration among the people, companies, and governments of different nations, a process driven by international trade and investment and aided by information technology. ... Likewise, for centuries, people and corporations have invested in enterprises in other countries.

Financial Distress: Financial distress is a condition where a company cannot meet, or has difficulty paying off, its financial obligations to its creditors, typically due to high fixed costs, illiquid assets or revenues sensitive to economic downturns.

1.11 SELF ASSESSMENT QUESTIONS

1. What do you mean by Financial Management?
2. Define the scope of Financial Management.
3. Relate the Financial Management with the other areas of study.
4. Discuss the principles of Financial Management.

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UNIT-2 FINANCIAL PLANNING AND ANALYSIS

Structure:

2.0 Objectives

2.1 Introduction

2.2 Scope of Strategic Financial Planning

2.3 Decisions in strategic Financial Management

2.4 Strategic Investment from the Viewpoint of the Investor and the Employee

2.5 Strategic financial planning

2.6 Financial Performance Analysis

2.7 Models of Financial Planning

2.8 Notes

2.9 Summary

2.10 Key words

2.11 Self Assesment questions

2.12 References

2.0 OBJECTIVES

After studying this unit, you will be able to ;

- Give the Scope of Strategic Financial Planning
- Explain Decisions in strategic Financial Management
- Describe the Strategic financial planning
- Identify the concept Financial Performance Analysis
- Highlight the models of financial planning

2.1 INTRODUCTION

Financial Planning & Analysis (FP&A) outsourcing is increasingly being used by leading global firms to provide a competitive advantage while others are using the opportunity to uncover additional savings by leveraging a wide range of service delivery options and process improvements to reduce costs and generate additional value.

Financial planning is a continual cycle of identifying financial goals, prioritizing these goals and planning for how to achieve them. Although differences in age, lifestyle and financial resources may cause a financial plan to change over time, the financial planning process remains basically the same. Analysis and decision-making are integral parts of the financial planning cycle and take place in nearly every step. The lifetime total of all planning and analysis activities in each turn of the financial cycle is what ultimately creates personal financial success.

Financial planning and analysis (FP&A) is the process of compiling and analyzing an organization's long-term financial strategy. In addition to creating an organization's extended financial plan, FP&A departments also generate management reports, analyze financial trends, calculate the monetary effects of potential business decisions and advise company leaders.

Even with the cloud's rising popularity, some finance executives still question the feasibility and practically of cloud-based financial software. In this 3-part guide, get more comfortable with the cloud and gain an expert's point-of-view on hot financial technologies.

FP&A departments use a variety of tools to do their jobs. These include corporate performance management software, budgeting, planning and forecasting software, core financial management systems and ERP platforms. FP&A employees usually report to the chief financial officer.

2.2 SCOPE OF STRATEGIC FINANCIAL PLANNING

The scope of strategic financial planning is vast and relates to the following areas:

Financial planning and analysis

The financial position of the company is known by the financial statements of the company. The financial statements of the company depict the position of the company. Planning is an act of thinking ahead and framing actions for achieving the organizational goals. After the planning stage, the organization strives to work towards it. The results of the company are shown in the performance of the company, and to be precise, are depicted by the numbers in the financial statements. Analysis of the financial statements through ratio analysis gives a better understanding and comparison of performance.

Managing the cash

Cash Management plays a vital role in a company. The cash in a company is determined by the operating cycle of the company, the time lag between money received by the company and the money spent by the company. Operating cycle is a short-term financial decision-making process, which governs the day-to-day financial operations of the company.

Financial decision making

Decision making in any organization is a process whereby the best alternative to the problem is taken to arrive at a solution. Every decision-making process chooses the best alternative to move towards the organizational goal. Financial decision making is of two types, long term and short term. Long-term decision making relates to the strategic decision like how to finance the company, through debt, through equity, and so on. Short-term decision making in finance relates to the day-to-day operations of the company, which is again related to the operating cycle of the company. Hence, decisions can be long term or short term, but analyzing each course of action requires a strong financial planning.

Financial control and implementing the same

Control mechanism means the measurement of the actual performance as compared to the planned performance. The variance is identified and corrective action taken to rectify the variance. For example, in measuring the financial performance, the industry standards and bench marks are taken and compared with the actual standards. Decisions of improvising will be based on the comparison only.

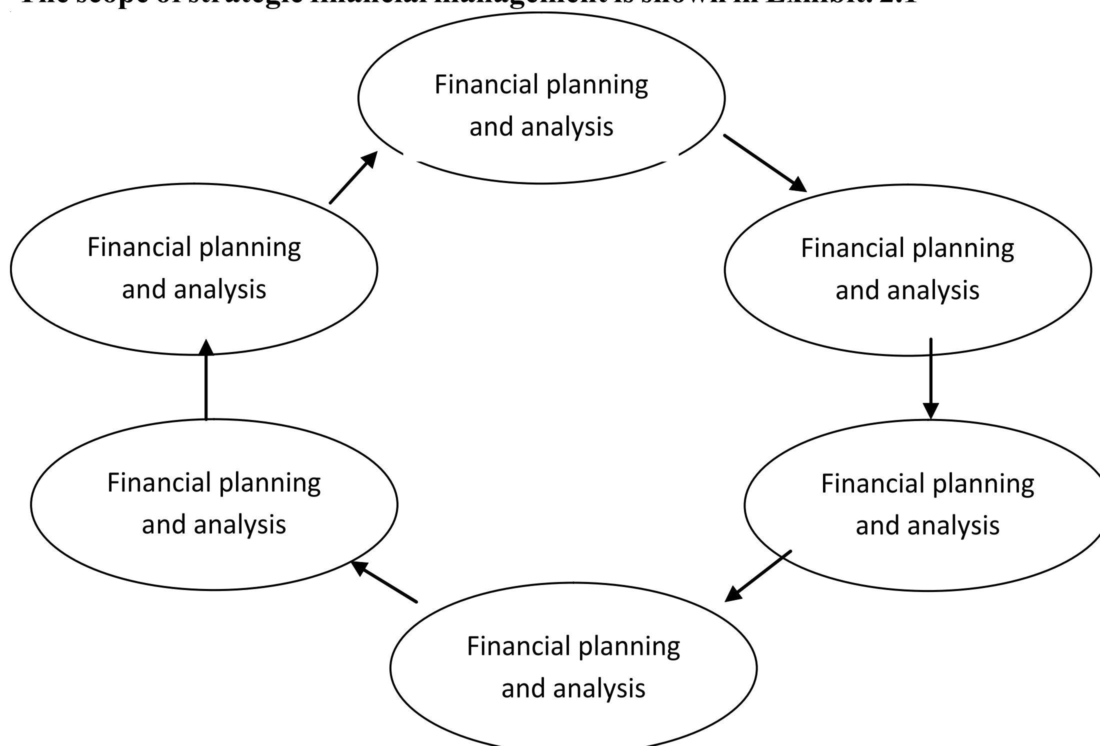
Effective utilization of the cash surplus

Once the company's performance is monitored and controlled, the company starts improving in its financial performance and the results achieved are the best. Making profits implies more cash accumulation in the company. Once the company is cash-rich, the company has a huge benefit with respect to financial independence. This can lead to the company achieving its desired results as cash position of the company is strong. Once cash-rich the company can also go in for making decisions relating to restructuring of the company. Restructuring of the company is a strategic decision. The cash generated into the company has to be used for the best performance of the company.

Restructuring of the company

Mergers and acquisitions and corporate restructuring are the decisions that the company takes for furtherance of its growth. For example, when company A acquires or merges wit6h company B, there are some synergies that are shared between both the companies and this can lead to a better outcome for the company. This happens because of both the companies optimizing their resources in a structured way to reach the maximum results and efficiency. Similarly, in case of companies, employees are given shares known as employee stock option plan (ESOP) so that they feel that they are also co-owners of the company and perform to the best of their ability in reaching the company's goals.

The scope of strategic financial management is shown in Exhibit. 2.1



2.3 DECISIONS IN STRATEGIC FINANCIAL MANAGEMENT

Now that we have understood what strategic financial management is, let us look into how it is used by managers across organizations to take decisions. Apparently, there are three types of decisions that are usually taken by managers. These are discussed in the following paragraphs. Refer to Exhibit. 2.2

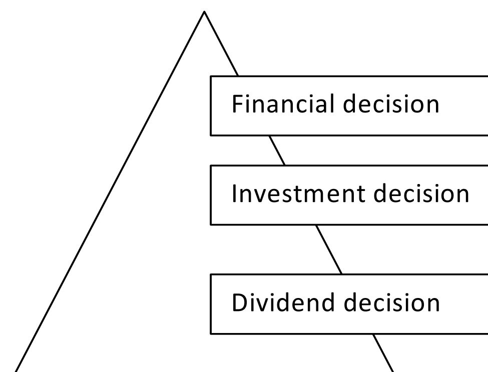


Exhibit. 2.2 Types of decisions

Financial decision

Financial decisions are referred to any type of decisions taken by a company that involves capital structure. Financial decision relates to the equity theory and capital structure of the company. Capital structure refers to the ratio in which a company finances its assets through combination of equity, debt, or hybrid securities; in other words, the way in which the capital is structured.

The company decides on the mix of debt and equity to maximize the market value of the company. This is important as debt infusion in the company helps the company get a leveraging effect. The cost of debt gets proportionally reduced due to the tax effect on the debt. Optimization of the capital structure for the maximization of the market value of the company is a financial decision.

Investment decision

Management of cash and its utilization in the company on capital projects is called investment decision. Capital projects relate to projects involving capital budgeting decisions.

To maximize the market value of the company, the company uses techniques of capital budgeting to arrive at the best investment decision that would give the expected return with the risk appetite that the company can afford.

Dividend decision

Dividends are the small proportion of profit that gets distributed to the shareholders based on the number of shares that they hold. This amount is an apportionment profit of the company, i.e., after all expenses and taxes are paid, the surplus is distributed on a percentage basis to the shareholders and the balance is carried forward to the retained earnings, which along with share capital forms the net worth of the company. The more the retained earnings, the more is the net worth of the company. The company, therefore, has to decide on the percentage of profits that will be distributed to the shareholders and the amount to be carried forward to the retained earnings. This is called the dividend decision.

In this way, strategic financial management is concerned with the maximization of the market value of the company by maximizing the wealth of the shareholders and ensures the best performance of the company by making the maximum utilization of the company's resources.

2.4 STRATEGIC INVESTMENT FROM THE VIEWPOINT OF THE INVESTOR AND THE EMPLOYEE

An investor is a person who infuses money into the company and makes the finance available to the company, whereas the employees are the backbone of the company as without them the company cannot produce or provide services. Both the parties are equally important to the company's performance. Any company cannot function without money and manpower. In fact, both play a vital role when it comes to decision making also.

As already discussed, in strategic decision making, decision are of three types, financial decision, investment decision, and the dividend decision. The analysis of each of the decisions from both the view points is given in Table 1 as follows:

To sum up, taking careful and cautious decisions helps the company achieve its desired results. Strategic financial management is very important for a company's performance as it helps in putting a check on good governance and making sound decisions so that the company can reap success.

Decision	Investor	Employee
Financial	Will think how much to invest, on what to invest, what is the returns, what is the payback period, how much is the risk involved, etc.	Will the new investment affect our current work culture? Will there be any structural changes in reporting? Will there be any locational changes? How much say will the current management have when the new investor invests? Etc.
Investment	What is the net present value of the project? How much is the internal rate of return? What is return on capital employed? What is the assured return? What is the probability of success? Etc.	What learning will I get from the new project? What kind of work will be involved? How is it going to be different from the current work? Will I be adequately compensated? Etc.
Dividend	What is the percentage to be distributed? What is the amount that needs to be carried forward to the retaining earnings? What tax benefits will the company get? How will this affect the performance of the company in stock market?	Only if the employee holds the employee stock option plan/shares of the company, will dividend decision make an impact on him/her, else no impact?

EXHIBIT 2.3 Analysis of types of decisions

2.5 STRATEGIC FINANCIAL PLANNING

Strategic financial planning refers to designing a financial framework of a company with a view to maximize its profits, keeping in mind the company's long-term goal, purpose for which the company is formed.

Strategic financial management can be depicted in short as shown in Fig. 2.3

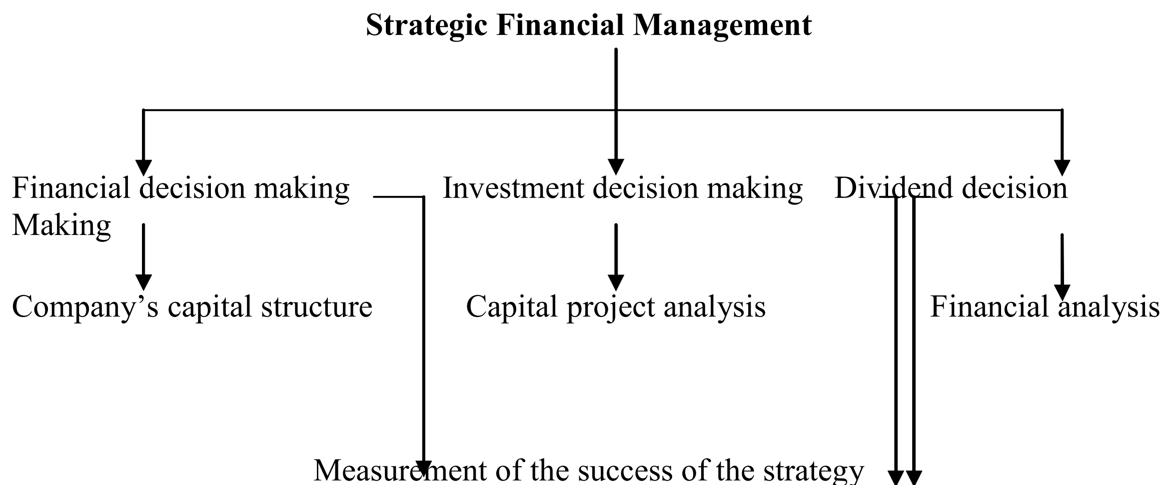


EXHIBIT 2.4

We earn to spend and we spend to live with comfort. Comfort comes through planning, as it usually happens that we think before we spend. In student life, the expenses do not and cannot exceed pocket money that a person receives, and the money received needs to be rightly planned for spending. Similarly, in a family, the expenses are planned based on the family's income. The expenses may be grocery bills, telephone bill, electricity and water bills, regular maintenance bills, newspaper, maid's payment, children's fees, medicine expenses, and so on. This apart, there are also decisions that are one time in nature where the amount involved is huge.

Planning is involved in each and every stage. Any planning involving money is called financial planning. Financial planning involves many stages. It starts from decision making and goes on till end-purposes. A financial plan involves primary statements: the profit and loss (P & I) account, the balance sheet, and the cash flow.

The P & L account also known as income statement shows details of income versus the expenditure. The balance sheet shows the financial position of assets and liabilities on a given date. The cash flow statement shows the movement of cash in an organization with opening and closing balances of cash. These statements do not use non-cash items. Since cash in hand and liquidity position is more important for a business, every in hand and liquidity position is more important for a business, every company prepares a cash flow statement and analyses the cash position.

There is another type of statement, called the fund flow statement, which shows the movement in working capital and deals with non-cash items also.

Long-term Financial Planning

Every planning starts with a budget. A budget is a statement that revolves around the revenue and cost of the company. Depending on the functionality, these are prepared by companies. They are usually prepared on a monthly basis and are classified according to their nature.

Budgets prepared in a company are linked with each other. For example, revenue budget has details of sales budget also. Sales budget is linked to the production budget and shows units and amount of sales product-wise. A sales budget is drawn based on the confirmed orders that are received by the company. It is often linked to the order book also. Order book refers to the confirmed orders that are received from customers. These vary over a period of say six to nine months and are very useful for making accurate prediction. In fact, short-term sales budget is based on confirmed orders. Long-term sales budget is based on company goals.

Long-term financial planning is a process that not only drives a company to plan for the future but also emphasizes the importance of facing any challenge that an organization may face in the future. This is used as a tool to arrive at a logical conclusion for a longer period of time in advance. Long-term financial planning deals with the vision of the future, its planning based on the projected revenue and the projected expenses vis-à-vis the financial position of the company.

Before we analyze different types of budgets used in long-term financial planning, we will identify the process that goes into financial planning. Refer to Fig. 1.1. The financial planning process includes the following:

a) **Understanding the goals of the company and the target:** The target of a company refers to what a company is formed for. Normally, all activities of an organization are focused towards achieving the end-objectives of the company. For instance, sales are the revenue generator in any company, be it service-oriented or product-oriented. Suppose a company is into manufacturing of automobile parts, the objective of the company is to supply the parts and be a market leader in capturing the demand in the market. To scale up to that, the micro-level factor is that the company has to achieve sales numbers. This is again dependent on the marketing function of the company. These come at a cost and funds that are available to a company.

b) **Preparation of the budgets:** Preparation of budgets are essential as it further drills down each and every function of the company, and the number crunching leads and guides the results. A budget is a forecast for the following period about the available source of funds vis-à-vis the cost associated with it. It is in numerical form and depicts the future position of the company in relation to the performance of the company. Once the budgets are made, the actual operations begin, which have a direction towards which the entire organization strives. The difference between the actual and budgets is the variance, which has an impact on the future forecast of the company.

c) **Preparation of the projected cash flow statement:** Projected cash flow shows the inflow and outflow of cash. This is usually prepared on a monthly basis. It shows the availability of cash after all the expenses are met. Expenses such as depreciation, amortization, and preliminary expenses write-off do not figure in this as they figure in the P & L account. The inflows show the money that comes into the operating system and the outflows show the money that comes into the operating system and the outflows show the money that flows out of the system. It is important to be prepared as it gives a clear idea of how and where the money is spent.

d) **Preparation of the projected P & L account:** Once the project cash flow statement is prepared, the projected P & L account needs to be made. This has all the numbers projected with respect to sales, other income, cost of goods sold, general and administration expenses, selling and distribution expenses, and so on. This also has non-cash items such as deferred expenses written off, depreciation, and amortizations. However, each number that is identified is related to a separate budget. This means that sales will be related to sales and production budget, cost will be related to the expenses budget, inventory will be based on the demand and supply factors and the time lag in supplying the same, and so on.

e) **Preparation of the projected balance sheet:** Balance sheet is the outcome of a complete cash flow and income (P & L) statement. It represents the assets and liabilities of an organization or a company as on a particular date.

Long-term financial planning involves ascertaining long-term sources with long-term expenses. Long-term sources include long-term borrowings and long-term expenses include the capital expenditure and investments that the company makes, keeping in mind its long-term strategy.

Like any financial planning, this too involves a complex process of ascertaining the future. It may not be possible to ascertain the future in its entirety and accuracy, but a projection made should be real so that the same is achievable.

It is also important to remember that planning and decision making can also go wrong. Not all that is planned for is correct. Financial planning with well laid out plans and investments also can go wrong.

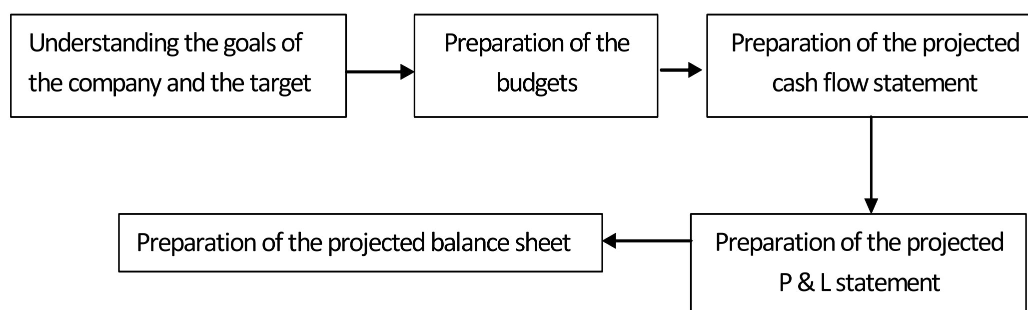


EXHIBIT 2.5 Process of long-term financial planning

Long-term financial planning provides direction to short-term financial planning.

The basic difference between long-term and short-term financial planning are as follows:

a) Long-term financial planning is for a period that exceeds more than a year, whereas short-term financial planning is maximum for one year.

b) Long-term financial planning is a strategic decision-making process, whereas short-term planning is a day-to-day operations-level decision.

c) Long-term planning involves decisions relating to the company at large, which is raising of funds, investment in some companies, hive-off decision, and so on, whereas short-term decision making refers to operating cycle decisions.

d) Long-term financial planning is goal oriented, whereas short-term financial planning is more focused on the operations level.

e) Long-term planning includes short-term financial planning, whereas the reverse is not true.

Uses of Financial Planning

Financial planning can be useful in various ways. Some of these are as follows:

a) It helps in analyzing whether funds are available for inflow or outflow.

b) It helps in ascertaining whether to go in for expansion or investment.

c) A good financial plan helps reduce uncertainties of the companies for the long-term existence of the company.

d) It helps to think and identify obstacles that can hinder the development of the company.

e) It helps to take decisions for borrowing or lending.

f) It helps to identify and take steps for maximizing the returns for the company.

2.6 FINANCIAL PERFORMANCE ANALYSIS

In any company, financial statements need to be analyzed. This is an important step that helps in taking the correct decision for the organization. A financial statement includes the analyses of balance sheet, P & L account, and the cash flow statement. Just as accounting is based on a double-entry system, a financial transaction also has two-fold effects/impact.

For example, an increase in cash sales has an impact on cash/bank balance of the company, and an increase in credit sales has an impact on debtors of the company.

These statements are analyzed using certain ratios. A ratio is a comparison of two numbers, the numerator and the denominator, that are represented in percentages or times basis. Ratio analysis is an important tool in analysis and the following are the types of ratio that are used to measure the financial performance analysis.

These ratios are classified basically on the following basis:

a) Profitability ratios
b) Liquidity ratios
c) Activity / efficiency ratios
d) Debt ratios/leveraging ratios
e) Market ratios

Why should a Company Perform Ratio Analysis?

A company should perform ratio analysis for the following reasons:

a) Financial ratios are performed by a company for understanding the results in a better way.
b) Ratios depict the relationship between two or more financial items.
c) Analysis becomes easier when two numbers are compared, which leads to better understanding.
d) Ratios help the company do inter-firm and intra firm comparisons.
e) Ratio analysis helps companies take sound managerial decisions.

Now, we will discuss the types of ratios one by one.

Profitability ratios

Profitability ratios help in measuring the profitability of the company. The profits of the company depend on the expenses and income, which are generated from the utilization of the assets of the company. All these factors are used to arrive at an understanding if the business would generate more earnings as compared to its expenses.

Examples of this type of ratio are as follows:

a) Gross margin ratio = gross profit/net sales: Gross profit ratio signifies what the gross profit percentage is that the company earns as a percentage of sales. The gross profit ratio shows the company the adjustment in sales price. The sales price can be increased or decreased based on the desired level of gross profit.

b) Operating margin ratio = operating income/net sales: This signifies the income generated out of operations before the non-operating costs. Operating margin signifies the health of the business operations.

c) **Profit margin ratio** = net profit / net sales : This signifies the percentage left after all expenses to the shareholders for appropriation and for the internal accruals have been made.

d) **Return on equity** = net income/equity: This shows what percentage of money is reaped from the business on the amount invested into the company. This signifies a company's ability to pay for dividends and so on. It is of most importance to shareholders/investors.

e) **Return on assets** = net income/total assets: This shows the ratio between the profit that the company is able to generate from the net assets and total assets.

f) **Return on assets** = net income/total assets. This shows the ratio between the profit that the company is able to generate from the net assets and total assets.

g) **Return on net assets** = net income (fixed assets + working capital). The signifies the return on total assets, fixed and current. This considers profit after tax (PAT) as a percentage of total assets of the company.

h) **Return on capital**=earnings before income and taxes * (1-taxation rate) / invested capital. This differs from return on equity as the earnings before income and taxes (EBIT) is used. The earnings before interest (post tax) is considered, as this will signify to the investors the profits as a percentage of invested capital before the interest is paid. Had the external funds not been borrowed, what is the return that the shareholders will get?

i) **Risk-adjusted return on capital** = expected return/economic capital. This is more important in situations where the company is a start-up. This ratio brings out the relationship between the expected return of the investors with the maximum capital that they will have to infuse in the worst-case scenario. The worst-case scenario is where the company does not perform as expected and the buffer that is required to keep the business running is not there. If there are no significant capital regulations, then this helps in calculating the capital that the company will infuse.

j) **Return on capital employed** = EBIT /capital employed. This shows what is the return that the company gets on the capital employed. Capital employed is the total net assets of the company. On the liability side, the capital employed is equity plus loans.

All the above ratios are used when measuring the profitability of a company.

Liquidity ratios

These ratios show the liquidity position of the company. Liquidity position of a company refers to the amount of cash, bank balance, and those assets that can be converted into cash as and when required by the firm which is owned by the firm currently. This is an important aspect for a company to know to take decisions regarding some of its plans. Some of the ratios that are used to measure this are as follows:

(a) **Current ratio** = current assets / current liabilities. This signifies the liquidity position of the company. The ratio of 2:1 is usually considered good.

(b) **Acid test ratio** = (current assets – inventories – prepaid expenses) / current liabilities. This is also known as quick ratio. This shows the quick cash available with the company, a further derivation of current ratio.

(c) **Operation cash flow ratio** = operating cash flow / total debts. This gives importance to the operating cash flow as it goes in repayment of debts.

(d) **Cash ratio**=cash and marketable securities / current liabilities. This is essential as it shows the relationship between the cash and level of current liabilities. This helps to analyze how much cash there is in the books that can meet the current liability.

All these ratios show the liquidity position of the company, analysis of which shows the changes that the company needs to make in its working capital cycle to enhance its liquidity.

Activity ratios

These ratios are used to measure the effective utilization of resources available to the company. In other words, it measures how efficiently a company operates. This is again an important aspect to be considered as it leads to affecting the end-result also (adding up the expenses).

Some of the ratios that are used to measure this are as follows:

(a) Debtors turnover ratio/average collection period (in days) = debtors / (average credit sales/ 365); if it has to be calculated in months, then it is divided by 12.

(b) Creditors turnover ratio average payment period (in days) = creditors/ (average credit purchases/ 365); if it has to be calculated in months, then it is divided by 12.

(c) Inventory turnover ratio/inventory conversion period (in days) = inventory / (cost of goods sold/365); if it has to be calculated in months, then it is divided by 12.

(d) Asset turnover ratio = net sales / total assets.

(e) Working capital cycle = average collection period – inventory conversion period – average payment period.

Debt ratios

It is the ratio that indicates the proportion between a company's debt and its total assets, that is, how much are they dependent on their debts as compared to their assets. The higher the ratio, the greater is the risk associated with the firm's operation. A low debt ratio indicates conservative financing with an opportunity to borrow in the future at no significant risk. It shows the ability to service debts of the company.

(a) **Debt equity ratio** = debt/equity. This shows how leveraged a firm is. A higher debt equity ratio shows that the company is highly leveraged and uses the taxation benefit. However, the ideal debt equity ratio is 2:1.

(b) **Interest coverage ratio** = EBIT /interest expenses. This ratio shows to what extent can the interest be covered by the profit generated by the business. This is important as this allows the company to take decisions for further intake of debt.

Market ratios

Market ratios help in evaluating the current market price of a share of a common stock versus an indicator of the company's ability to generate profits or assets held by the company. This is useful since it gives an idea to the organization about its value and status in the market. Accordingly, it can make its future plans.

(a) Earnings per share = net income/number of shares.

(b) Dividend payout ratio = dividend paid / net earnings before dividend payment.

(c) Price earnings ratio = market price per share / earning per share.

(d) Dividend yield ratio = dividend / market price per share.

(e) Price to book value ratio = market price per share / book price per share.

(f) Price earnings growth ratio = price per earnings / annual earnings per share growth.

2.7 MODELS OF FINANCIAL PLANNING

Models of financial planning are based on the end-objective. Financial planning for the normal course of action differs from the financial model for diversification or expansion. The objective needs to be identified and accordingly the obstacles need to be looked into. The best possible alternative has to be researched and implemented. Constant variance analysis needs to be performed, comparing the actual and the budgets. The budgeted figures need to be reviewed or revised based on the current trend considering the macro-level factors. The micro level (within the organization) can be controlled but the macro-level factors, generally, are uncontrollable. For example, increase in prices of raw materials and dip in sales due to

recession. All these factors must be considered by a manger before finalizing any plan or strategy to be used.

However, an experienced professional who has an industry perspective and a foresight, should be able to predict reasonably. This requires the person to be alert and have a constant touch with the latest happening in the industry.

There are no specific types of models and they vary from person to person and company to company. These are basically financial statements prepared in excel.

Chief Financial Officer and His Role

A chief financial officer (CEO) is expected to have a thorough knowledge of what is happening in the market. He mainly performs the number crunching activity and reports the key issues to the board. He also needs to not only have a thorough knowledge of the concepts but also be aware of all the issues related to the industry. The issues can be classified into macro level and micro level.

At macro level, the factors include the following:

(a) View of the government on the industry: The government is the architect of rules and statues. Issues relating to allowance of investment, taxation, industry, lobbying capacity of the industry leaders, and regulation by statutory bodies are the key factors that the CFO has to be abreast of. Any changes in any statute will have an impact on the industry and hence on the company. For example, when the rates of income tax change with the budget, the same needs to be incorporated in the budget of the company.

(b) Trend that the industry is heading towards: The growth rate that the industry is heading at, the stage of development, for example, the growth/decline stage, has to be factored into, and whether the industry is poised towards mergers and acquisitions has to be ascertained. These factors play a key role in pricing and the sales quantity.

(c) Growth of the economy: India is a growing economy and the GDP growth rate fluctuates between six per cent and eight per cent. In developed countries the rates of growth are relatively very low compared with the developing nations. For example, post-liberalization period has marked a massive expansion and growth in India and has also opened doors towards more foreign investment. A CFO has to be aware conceptually to factor-in-these into his projections and make a reasonable projection.

Micro-level factors include the following:

(a) Company's plan for the future This may include plans such as expansion, diversification, or disinvestment. In case the company is planning to sell off one particular division of the business, the financial plan should incorporate that.

(b) *Company's terms and conditions with suppliers and customers* The credit terms with suppliers, cash discounts, trade discounts, and promotional offers/schemes should be considered into the financial plan.

(c) *Statutory requirements* The statutory requirements such as deduction of the sales tax or the service tax have to be incorporated to show the sales at the net value.

(d) *Production* The production quantity has to be considered based on the installed capacity. Production cannot exceed the installed capacity. Similarly, in case the factory is working in three shifts, the maintenance cost will be higher, and this needs to be incorporated in the financial plan.

(e) *Sales budget has to be prepared based on the production budget and the customer orders in hand and in pipeline.* The sales Cycle needs to be considered (the time involved in materializing the sale has to be factored into the plan). The customer's credibility should be considered with realization of the sales.

(f) *Expense budget should be prepared based on what is the target bottom line the company wants to achieve* Knowing this is very useful in the long run for the organization to succeed and grow.

In total, the CFO has to make a very careful and precise judgement so that the budget is actually the mirror of what the company can achieve. It cannot be just a hypothetical number that cannot be achieved in the normal course of activity. Detailed analysis for each activity should be done before finalizing the plan. A constant review process of the same ensures lesser variance.

Projections

Projections are the forecast for future. Forecasting involves certain factors that have not yet occurred. The forecast depends on various factors. These factors can be classified into micro and macro factors refer to Fig. 1.3. Micro factors are factors that are within the control of the organization, whereas macro level factors are not within the control of any organization.

More often than not, one may wonder, that projection is more like speculation. However, the same is not true. Projections are more based on facts and statistics. Speculations is a wild financial guess and does not guarantee any security. It is risky. A projection is forecasting based on past performance and known future trends.

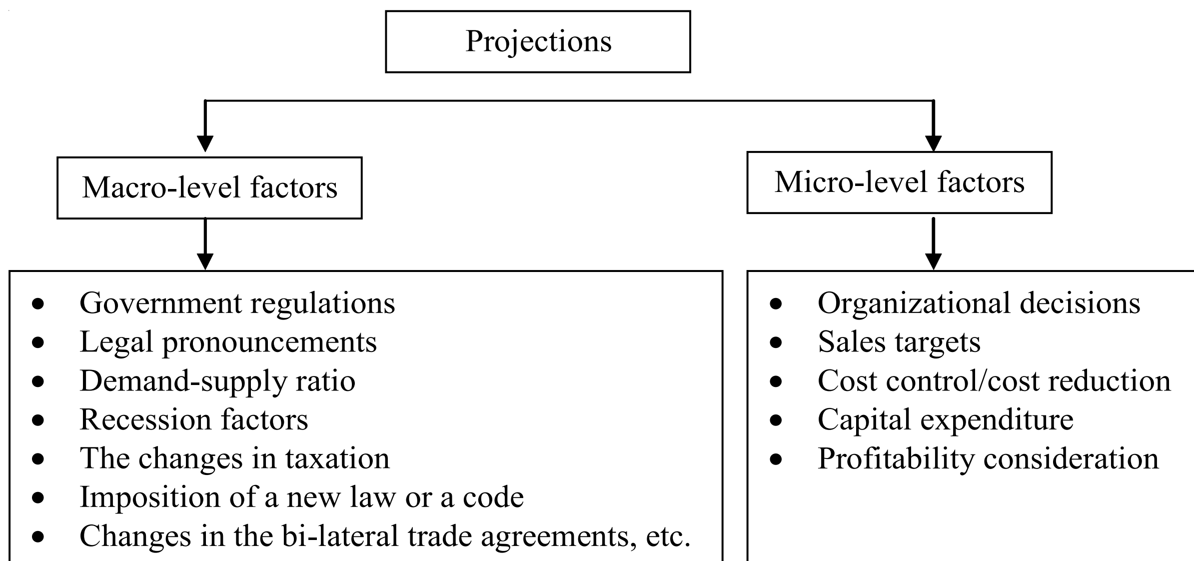


EXHIBIT 2.5 Classification of macro and micro factors used for projections

Micro- level factors are factors that are related to a particular organization, which are small when compared to the external factors. A few micro factors in relation to the projections are as follows:

(a) ***Organizational changes/ decisions*** Organizations undergo changes quite often. These changes can be structural or non-structural. Structural changes relate to the change in the structure. Change in the structure includes changes in the hierarchy level in an organization. Change in the management, the people, brings in changes in thought processes and the work procedure of the organization. Decision-making changes bring about changes in the operational workflow of the organization. Again, this can relate to the changes in the suppliers or the vendors.

For example, if an organization is selling 10,000 units to Mr. A (total production being 20,000), and the margins are very thin, whereas the margins from some others are high, the decision of the management can be to not supply to Mr A.On the other hand, if the management decides to go in for a volume game, then Mr. A will be the preferred choice as he is ordering a huge quantity and more of the same kinds may be sought.

(b) ***Sales targets*** Sales targets are the focus of revenue generation. The targets are decided based on the demand-supply ratio and also the logistics that the company can afford. For example, the company can decide to spread its scales to a different geography. Then the sales numbers may vary as demand may not be the same as the demand in domestic market.

For example, a manufacturer of cars customizes certain features for India and certain others for foreign nations. The demand for small cars may be higher in India as compared to bigger cars because of the mileage specified and the cost of fuel. Again,

as the nation grows richer and generates more wealth, the demand for luxury items increases. Here, the demand is a macro-level factor but exporting the product is a micro-level factor.

(c) ***Cost reduction/cost control*** all companies strive to achieve maximum returns. An important measure for this is controlling the costs. Controlling the costs is an internal decision. However, this decision gets affected by the price increases in the industry. For example, increase in cotton prices increases the costs of production of textiles and this in turn will reduce the margins. Increase in price of raw material is not under the control of management; however, if the management decides that the new machines may be bought, which will require less laborers and reduce costs, it is a micro-level decision.

(d) ***Capital expenditure requirements*** Capital expenditure is an expenditure that does not occur often. It is generally incurred to enhance the revenue or alternatively reduce the costs. Investing in a fixed asset to increase the production capacity is a capital expenditure that enhances the revenue as more the items produced, the more is the sales.

(e) ***Profitability considerations*** Finance is the life line of any organization and profit is the crux for finance. When the internal generation of funds is higher, the profits of the company are higher. Hence, the management will always want to increase its profits.

As can be inferred, micro-level decisions are related to macro-level factors as well. They go hand in hand, and a company cannot survive based on any one set of factors. The micro-level decisions are driven by macro-level factors.

Macro factors include the overall decision making from the outside perspective of an investor with respect to the government regulations, legal pronouncements, demand-supply ratio, recession factors, the changes in taxation, imposition of a new law or a code, changes in the bi-lateral trade agreements, and so on.

2.8 NOTES

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2.9 SUMMARY

Financial analysis and planning are one of the fundamental activities and responsibility for the finance department. Financial analysis and planning help an organization in achieving strategic tasks and objective within available resources. The key responsibility of financial analysis and planning team is to facilitate management in formulating short and long-term objectives, carrying out cost-benefit analysis and ensuring targets are met through periodic reviews. Another responsibility is to ensure that management's actions create profitability for organization by providing relevant financial information. Financial analysis and planning are essential divided into four parts forecasting, budgeting, reporting and analysis.

2.10 KEY WORDS

SWM: Share Holder Wealth Maximization

Value Creation:

- It is the sum of all strategic decisions that affect the firm's ability to efficiently increase the amount of free cash flow over time.
- Making wise investments and generating a healthy return on invested capital are two main drivers of shareholder value.

Agency Problem: The agency problem usually refers to a conflict of interest between a company's management and the company's stockholders.

2.11 SELF ASSESSMENT QUESTIONS

1. Mention some objections to agency problems.

2. Discuss about maximization of shareholders value.

3. Briefly describe an overview of Financial Management.

4. Discuss managers versus shareholders goal.

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UNIT-3: CAPITAL STRUCTURE, DIVIDEND POLICY AND FINANCIAL INNOVATIONS

Strucutre

3.0 Objectives

3.1 Capital Structure and Value in a Perfect World

3.2 Dividend Policy

3.3 Different types of dividend policies

3.4 Determinants of Dividend Policy

3.5 Financial Innovations

3.6 Types of Financial Innovations

3.7 Financial Innovations in India

3.8 Notes

3.9 Case Study

3.10 Summary

3.11 Key words

3.12 Self Assessment Questions

3.13 References

3.0 OBJECTIVES

After studying this unit, you will be able to ;

- Understand the concept of capital structure
- Explain the dividend policy
- Analyze the determinants of dividend policy
- Identify the financial innovations in India
- Highlight the financial innovations

3.1 CAPITAL STRUCTURE AND VALUE IN A PERFRECT WORLD

While the diversity of financing instruments has increased dramatically, the central question in designing the capital structure is simply the choice between debt (which represents a fixed claim) and equity (which represents a residual claim).

Since the objective of financial management is to maximize shareholder wealth, the key issue in the capital structure decision is: What is the relationship between capital structure and firm value? Alternatively, what is the relationship between capital structure and cost of capital? Remember that valuation and cost of capital are inversely related. Given a certain level of earnings, the value of the firm is maximized when the cost of capital is minimized and vice versa.

In their celebrated 1958 paper, Modigliani and Miller (MM, hereafter) have restated and amplified the net operating income position. Before discussion their propositions, let us look at the assumptions underlying their analysis:

- Capital markets are perfect. Information is freely available and transactions are costless; securities are infinitely divisible.
- Investors are rational. Investors are well-informed and choose a combination of risk and return that is most advantageous to them.
- Investors have homogeneous expectations. Investors hold identical subjective probability distributions about futures operating earnings.
- Firms can be grouped into 'equivalent risk classes' on the basis of their business risk.
- There is no corporate income tax.

Basic Propositions

Based on the above assumptions, MM derived the following propositions.

Proposition I: The total market value of firm is equal to its expected operating income divided by the discount rate appropriate to its risk class. It is independent of the degree of leverage.

Market value of firm (V) = Market value of equity (E) + Market value of debt (D)

$$= \frac{\text{Expected operating income (O)}}{\text{Discount rate applicable to the risk class To which the firm belongs } (r_o)}$$

Proposition I The expected yield on equity, r_e, is equal to r_o plus premium. This premium is equal to the debt-equity ratio (D/E) times t he difference between r_o and the yield on debt, r_d.

Arbitrage Mechanism

According to MM, if tow firms, say X and Y, are in the same risk class and have the same expected operating income they will have the same value in the market place, irrespective of differences in their capital structure. If their values diverge, investors will resort to arbitrage. They will sell the securities of the firm which has a higher value and buy the securities of the firm which has a lower value. The arbitrage actions of investors will bring about equality in the value of the two firms.

To show how the arbitrage mechanism works, a numerical illustration may be given. Take two firms, X and Y, similar in all respects except in their capital structure. Firm X is financed by equity only; firm Y is financed by a mixture of equity and debt. Relevant financial particulars of the two firms are as shown in Exhibit 6.1.

According to Exhibit 6.1, the value of the levered firm Y is higher than that of the unlevered firm. Such a situation, argue MM, cannot persist because equity investors would do well to sell their equity investment in firm Y and invest in the equity of firm X with personal leverage. For example, an equity investor who owns 1 per cent equity in firm Y would do well to:

1. Sell his equity in firm Y for 6,667;
2. Borrow 4,000 at 5 percent interest on personal account; and
3. Buy 1.0667 per cent of the equity of firm X with the amount of 10,667 that he has.

Such an action will result in the following income;

Income on investment in firm X	1,066.7
Less interest (4000x0.05)	200.0
Net income	866.7

Exhibit 3.1 Financial Particulars of Firms X and Y:

	X	**Y**
Total Capital Employed	1,000,000	1,000,000
Equity Capital	1,000,000	600,000
Debt	0	400,000
Net Operating Income	100,000	100,000
Debt interest	0	20,000
Market Value of Debt	0	400,000
Debt Capitalisation Rate		5%
Equity Earnings	100,000	80,000
Equity Capitalisation Rate	10%	12%
Market Value of Equity	1,000,000	666,667
Total Market Value of the Firm	1,000,000	1,066,667
Average Cost of Capital	10%	9.37%

This net income of 866.7 is higher than a net income of 800.0 foregone by selling 1 per cent equity of firm Y and the leverage ratio is the same in both the cases. (In the case of investment in firm X with personal borrowing we have personal leverage; in the case of investment in firm Y we have corporate leverage.)

When investors sell their equity in firm Y and buy the equity in firm X with personal leverage, the market value of equity of firm Y tends to decline and the market value of equity of firm X tends to rise. This process continues until the market values of both the firms become equal because only then the possibility of earning a higher income for a given level

of investment and leverage by arbitraging is eliminated. As a result, the cost of capital for both the firms is t he same.

In the preceding discussion we explained that due to the arbitrage mechanism the value of a levered firm cannot be higher than that of an unlevered firm, other things being equal. A similar explanation, with arbitrage in the opposite direction, may be offered to prove that the value of an unlevered firm cannot be higher than that of a levered firm, other things being equal.

Assume that the valuation of the two firms X and Y is as follows:

	Firm X	Firm Y
Debt Interest	0	20,000
Market Value of Debt	0	400,000
Debt Capitalisation Rate		5%
Equity Earnings	100.000	80,000
Equity Capitalisation Rate	8%	12%
Market value of Equity	1,250.000	666,667
Total Market Value	1,250,000	1,066,667

If a situation like this obtains, equity investors in firm X would do well to sell the equity in firm X and use the proceeds partly for investment in the equity of firm Y and partly for investment in the debt of firm Y. For example, an equity investor who owns 1 per cent equity in firm X would do well to:

1. Sell his 1 per cent equity in firm X for 12,500 and
2. Buy $1^{11/64}$ per cent of equity and debt in firm Y involving an outlay of 12,500. (The total market value of Y is 1,066,667. $1^{11/64}$ per cent of this is 12,500.)

Such an action will result in an increase of income by 172 without changing the risk shouldered by the investor. When investors resort to such a change, the market value of the equity of firm X tends to decline and the market value of the equity of firm Y tends to rise. This process continues until the total market values of both the firms become equal.

3.1 DIVIDEND POLICY

A dividend policy is the policy a company uses to decide how much it will pay out to shareholders in the form of dividends. Some research and economic logic suggests that dividend policy may be irrelevant (in theory), but many investors rely on dividends as a vital source of income. Because dividends represent a form of income for investors, a company's dividend policy is an important consideration for some investors. As such, it is an important consideration for company leadership, especially because company leaders are often the largest shareholders and have the most to gain from a generous dividend policy. Most companies view a dividend policy as an integral part of the corporate strategy. Management must decide on the dividend amount, timing and various other factors that influence dividend payments over time.

3.3 DIFFERENT TYPES OF DIVIDEND POLICIES:

There are three types of dividend policies: a stable dividend policy, a constant dividend policy and a residual dividend policy which is as explained below:

Stable Dividend Policy: The stable dividend policy is the easiest and most commonly used policy. The goal of the policy is to aim for steady and predictable dividend payouts every year, which is what most investors are seeking. When earnings are up, investors receive a dividend. When earnings are down, investors receive a dividend. The goal is to align the dividend policy with the long-term growth of the company rather than with quarterly earnings volatility. This approach allows the shareholder to have more certainty around the amount and timing of the dividend.

Constant Dividend Policy: The primary drawback of the stable dividend policy is that, in booming years, investors may not see a dividend increase. By contrast, under the constant dividend policy, a percentage of the company's earnings are paid every year. In this way, investors experience the full volatility of company earnings. If earnings are up, investors get a larger dividend; if earnings are down, investors may not receive a dividend. The primary

drawback to the method is the volatility of earnings and dividends. It is difficult to plan when dividend income is highly volatile.

Residual Dividend Policy:A residual dividend policy is also highly volatile, but for some investors, it is the only acceptable dividend policy that a company should have. In a residual dividend policy the company pays out what's left after it pays for capital expenditures and working capital needs. This approach is volatile, but it makes the most sense in terms of business operations. Investors don't want to invest in a company that justifies its increased debt with the need to pay dividends.

3.4 DETERMINANTS OF DIVIDEND POLICY

The payment of dividend involves some legal as well as financial considerations. It is difficult to determine a general dividend policy which can be followed by different firms at different times because dividend decision has to be taken considering the special circumstances of an individual case. The following are important factors which determine dividend policy of a firm:

Legal Restrictions: Legal Provisions relating to dividends as laid down in section, 205, 205A, 206 and 207 of companies Act, 1956 are significant because they lay down a framework within which dividend policy is formulated. These provisions require that dividend can be paid only out of current profit or past profits after providing for depreciation. The companies (Transfer of Profits to Reserves) Rules, 1975 require a company providing more than 10% dividend to transfer certain percentage of current year's profit to Reserves.

When Dividend Proposed	***Amount to be transferred to Reserves most not be less than***
Exceeds 10% but not 12.5% of paid up capital	2.5% of current year profit
Exceeds 12.5% but not 15% of paid up capital	5% of current year profit
Exceeds 15% but not 20% of paid up capital	7.5% of current year profits
Exceeds 20% of paid up capital	10% of current year profits.

Companies Act, further provides that dividend cannot be paid out of capital, because it will amount to reduction of capital adversely affecting the security of creditors.

Desire and Type of Shareholders: Although, legally, the direction as to whether to declare dividend or not has been left with BOD, the directors should give importance to desires of shareholders in declaration of dividends as they are representatives of shareholders. Investors such as retired persons, widows, and other economically weaker persons view dividends as source of funds to meet their day-to-day living expenses. To benefit such investors, the companies should pay regular dividends. On other hand, a wealthy investor in a high income tax bracket may not benefit by high current dividend incomes. Such an investor may be interested in lower current dividend and high capital gains.

Nature of Industry: Nature of Industry to which company is engaged also considerably affects dividend policy. Certain industries have comparatively steady and stable demand irrespective of prevailing economic conditions. For example, people used to drink liquor both in boom as well as in recession. Such firms expect regular earnings and hence follow consistent dividend policy. On the other hand, if earnings are uncertain, as in the case of luxury goods conservative policy should be followed. Such firms should retain a substantial part of their current earnings during boom period in order to provide funds to pay adequate dividends in the recession periods. Thus, industries with steady demand of their products can follow a higher dividend payout ratio while cyclical industries should follow a lower payout ratio.

Age of Company: It also influences dividend decision of company. A nearly established concern has to limit payment of dividend and retain substantial part of earnings for financing its future growth while older companies which have established sufficient reserves can afford to pay liberal dividends.

Future Financial Requirements: If a company has highly profitable investment opportunities it can convince the shareholders of need for limitation of dividend to increase future earnings and stabilize its financial position. But when profitable investment appointments do not exist then company may not be justified in retaining substantial part of its current earnings. Thus, a concern having few internal investment opportunities should follow high payout ratio as compared to one having more profitable investment opportunities.

Liquid Resources: The dividend policy of a firm is also influenced by availability of liquid resources. Although, a firm may have sufficient available profit to declare dividends, yet it may not be desirable to pay dividend if it does not have sufficient liquid resources. Hence liquidity position of company is an important consideration in paying dividends. If

company does not have liquid resources, it is better to declare *stock dividend* i.e. issue of bonus shares to existing shareholders.

Requirements of Institutional Investors: Dividend policy of a company can be affected by requirements of institutional investors such as financial institutions, banks, insurance corporations etc. These investors usually favour a policy of regular payment of cash dividends and stipulate their own terms with regard to payment of dividend on equity shares.

Stability of Dividends: Stability of dividend refers to payment of dividend regularly and shareholders generally, prefer payment of such regular dividends. Some companies follow a policy of constant dividend per share while others follow a policy of constant payout ratio and while there are some other who follows a policy of constant low dividend per share plus an extra dividend in years of high profits. A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over a number of years or those who have built up sufficient reserves to pay dividends in years of low profits. The policy of constant payout ratio i.e. paying a fixed percentage of net earnings every year may be supported by firm because it is related to firm's ability to pay dividends. The policy of constant low dividend per share plus some extra dividend in years of high profits is suitable to firms having fluctuating earnings from year to year.

Magnitude and Trend of Earnings: The amount and trend of earnings is an important aspect of dividend policy. It is rather the starting point of the dividend policy. As dividends can be paid only out of present or past's years profits, earnings of a company fix the upper limits on dividends. The dividends should nearly be paid out of current year's earnings only as retained earnings of the previous years become more or less a part of permanent investment in the business to earn current profits. The past trend of the company's earnings should also be kept in consideration while making dividend decision.

Control objectives: When a company pays high dividends out of its earnings, it may result in dilution of both control and earnings for existing shareholders. As in case of high dividend payout ratio the retained earnings are insignificant and company will have to issue new shares to raise funds to finance its future requirements. The control of the existing shareholders will be diluted if they cannot buy additional shares issued by the company. Similarly issue of new shares shall cause increase in number of equity shares and ultimately cause a lower earnings per share and their price in the market. Thus under these circumstances to maintain control of the existing shareholders, it may be desirable to declare lower dividends and retain earnings to finance the firm's future requirements.

3.5 FINANCIAL INNOVATIONS

From the early 1970s there has been an explosive growth in financial innovations. Here is a partial list of important novelties:

• Eurodollar accounts	• Forward rate agreements
• Zero coupon bonds	• Commodity bonds
• Negotiable certificates of Deposits	• Puttable and callable bonds
• NOW accounts	• Indexed linked gilts
• Variable life insurance	• Interest rate swaps
• Money market mutual funds	• Currency swaps
• Index funds	• Shelf registration process
• Options	• Electronic funds transfer system
• Financial futures	• Screen based trading
• Options on futures	• Leveraged buyouts
• Options on indexes	

This appendix explores various aspects of financial innovations. It is divided into four sections:

- What and why of financial innovations
- Types of financial innovations
- Financial innovations in India
- Excesses

What and Why of Financial Innovations

Miller, Silber, and Van Horne characterize and analyse financial innovations somewhat differently. Miller describes financial innovations as unanticipated improvements in the array

of financial products and instruments that are stimulated by unexpected tax or regulatory impulses. He cites the following examples.

- The Eurobond market emerged in response to a 30 percent withholding tax imposed by the US Government on interest payments on bonds sold in the US to overseas investors.
- Zero coupon bonds were offered to exploit a mistake of the internal Revenue service in the US which permitted deduction of the same amount each year for tax purposes. (Put differently, the Internal Revenue Service employed simple interest, not compound interest.)
- Financial futures came into being when the Bretton Woods system of fixed exchange rates was abandoned in the early 1970s.
- Paper currency, in a sense the most fundamental financial instrument, was invented when the British Government prohibited the minting of coins by the colonial North America.
- The Eurodollar market developed in response to Regulation Q in the US that imposed aceiling on the interest rate payable on time deposits with commercial banks.
- Financial swaps emerged initially in response to a restriction imposed by the British Government on dollar financing by British firms and sterling financing by non-British firms.

Since taxes and regulation have triggered a number of major financial innovations, Miller likens them to the grains of sand that irritate the oyster to produce the pearls of financial innovation.

Silber looks at financial innovations differently from Miller. He considers innovative financial instruments and processes as devices used by companies to reduce the financial constraints faced by them. Firms, he argues, maximize utility under certain constraints, some dictated by governmental regulation, some defined by the market place, and some self-imposed. Financial innovations seek to reduce the cost of complying with these constraints. Here are two examples.

- A lot of effort has gone into the designing of capital notes, which are essentially debt instruments but are treated as ‘capital’ for the purposes of bank regulation.
- Highly volatile interest rates enhanced the cost of following a policy of investing in fixed dividend rate preferred stock. This stimulated the development of various forms of adjustable rate preferred stock.

Silber's constraint-induced model of innovation explains well a large proportion of commercial bank products. Yet it offers only a partial view of financial innovation as its focus is almost wholly on the issuers of securities, not the investors in securities.

Van Horne views a new financial instrument or process as innovative, if it makes the financial markets more efficient and/or complete. A financial innovation makes the market more efficient if it reduces transaction costs or lowers differential taxes or diminishes 'deadweight' losses. A financial innovation makes the market more complete if its after-tax market is one where every contingency in the world is matched by a distinct marketable security. The sheer number of securities required to span every possible contingency suggests that the market is bound to be incomplete in some way or the other. In such a market, there are unfulfilled investor needs. Hence, there is scope for designing securities to satisfy investor desires with respect to maturity, interest rate, protection, cash flow characteristics, put feature, or some other attribute.

According to Van Horne the following factors prompt financial innovation; volatile inflation and interest rates, regulatory changes, tax changes, technological advances, the level of economic activity, and academic work on market efficiency and inefficiency. Collectively, the Miller, Silber and Van Home papers suggest that the following factors drive financial innovations.

- Tax asymmetry
- Regulatory or legislative changes
- Volatility of financial prices
- Transaction costs
- Agency costs
- Opportunities to reduce some form of risk or reallocate risk
- Opportunities to increase an asset's liquidity
- Academic work
- Accounting benefit
- Technological advances
- Level of economic activity

3.6 TYPES OF FINANCIAL INNOVATIONS

Financial innovations may be divided into the following categories:

Category	Example
A. Consumer-type instruments	• Variable life insurance policy
	• Money market mutual fund
B. Securities	• Zero coupon bond
	• Indexed-linked gilts
C. Derivative securities	• Options
	• Futures
D. Process	• Shelf registration process
	• Screen-based trading
E. Creative solution to a financial problem	• Project financing
	• Leveraged buyout

Since categories A, B and C represent financial products, we may broadly define a financial innovation as a new product or a new process or a creative solution to a financial problem..

3.7 FINANCIAL INNOVATIONS IN INDIA

Till the mid-1980s, the Indian financial system did not see much innovation. In the last three decades, financial innovation in India has picked up and it is expected to grow in the years to come, as a more liberalized environment affords greater scope for financial innovation.

The important financial innovations that have taken place in India are listed below along with the principal factor which motivated it or fuelled its growth.

Innovation	**Principal Motivating Factor**
• Debt-oriented schemes of mutual funds	• Tax benefit
• **Partially convertible debentures and fully convertible debentures**	• **Pricing and interest rate regulation obtaining under the Capital Issues Control Act**
• Puttable and callable bonds	• Perceived volatility of interest rates
• Stock index futures	• Volatility of equity prices
• Badla transactions	• Restriction on forward trading
• Ready forwards	• Restrictions under the portfolio management scheme
• Havala transactions	• RBI restrictions
• Interest rate caps/floors/collars	• Volatility of interest rates
• Interest rate swaps	• Volatility of interest rates
• Currency swaps	• Volatility of foreign exchange rates
• Forward rate agreements	• Volatility of interest rates
• Automated teller machines	• Technology
• Screen-based trading	• Technology
• Floating rate bonds	• Volatility of interest rates
• Electronic funds transfer	• Technology
• Money market mutual funds	• Volatility of interest rates
• Specialized mutual funds	• Investor preferences
• Exchange-traded options	• Volatility of stock prices
• Project finance	• Risk sharing

Excesses

The frenetic pace of financial innovations, particularly in the US, has been viewed by some with skepticism. Michael Keenan has articulated this concern very well.

"Some are beginning to believe that the late half of the 1980s will be known in the securities industry as the period when professionals lost track of what they were trying to sell. There have been literally thousands of new instruments created in recent years from the basic spectrum of stocks-bonds-insurance features-options-futures-indexes of all these instruments; No one knows the risk-return characteristics of many of these instruments; no one has studied the portfolio interrelationships of them all; no one has studied how many of these derivative instruments should be valued relative to the base instrument, or how it might be affecting the base instrument (Example: How would an option on a futures guaranteed mortgage package relate to the writing of current mortgage?"

An allied view has been voiced by Van Horne.

"Understandably the promoter wishes to make a profit regardless of whether an idea has substance. As long as people believe the proposal is a panacea for certain ills, promoters will exploit the opportunity. However, I find disturbing the case being made for such things as: defeasance; certain interest-rate swaps; schemes to dedicate bond portfolio in such a way as to make money out of defined benefit pension plan; financial institutions issuing put options against new and existing bonds in order to alter accounting income; equity-for-debt swaps; the sale of high-yield (junk) bonds to savings and loans association; and LBOs whether financed with loans or junk bonds. Many are designed to produce accounting profits with little or economic gains".

In essence, Keenan and Van Horne suggest that the enthusiasm for financial innovation seems to have resulted in excesses. Are these excess in the nature of bubbles or balloons? Van Home thinks that they are in nature of balloons. This is what he says: "A balloon might be a better metaphor for certain financial promotions. It is blown up to be sure, but not to be the extent it pops. The eventual deflation is less abrupt".

Clearly there can be excesses which tend to be costly. The costs may be in the nature of out of-pocket expense paid to promoters and investment bankers. More important, they are in the nature of misallocation of resources.

In an ideal world of completely rational expectations, there is no scope for financial excesses. However, the real world is characterized by irrationality which permits such excesses to occur.

How can such excesses be checked? It is naïve to think that the promoters of new financial products will exercise self-restraint. After all, they are driven primarily by the profit

motive. Policing by a regulatory body, too, is not a solution, as it is likely to stifle worthwhile innovation and breed corruption. The ultimate discipline has to come from the market-an informed market which responds sensibly to the torrent of financial innovation.

3.8 NOTES

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3.9 CASE STUDY:

ORACLE'S ACQUISITON OF PEOPLESOFT: On January 07, 2005, Oracle Corporation, the second largest software company in the world, announced that it would acquire PeopleSoft Inc.3 at $10.3 bn.

The announcement followed a tender offer in which more than 97 percent of PeopleSoft's shareholders tendered their stock. Post-merger, Oracle would emerge as the second largest manufacturer of business application software in the world.

Oracle first made its hostile bid to acquire PeopleSoft on June 06, 2003. Meanwhile, in July 2003, PeopleSoft acquired JD Edwards. Oracle's acquisition of PeopleSoft finally

materialized after an 18-month struggle between the two companies that involved multiple litigations and bitter exchanges between Oracle's Larry Ellison (Ellison) and the then PeopleSoft's CEO Craig Conway (Conway).

The acquisition was unique in many ways. It raised corporate governance issues when PeopleSoft's shareholders opposed the use of poison pills by the company's management. It also led to debates regarding the use of poison pills and whether prevailing regulations required a review. It brought defeat to the US Department of Justice (DOJ) in an antitrust case, thus encouraging bigger consolidations in the software industry, in future.

It was also one of the most widely analyzed acquisitions due to the hostility involved, its huge scale, multiple litigations, and the deal price.

Oracle had initially announced that it would discontinue PeopleSoft's products. Later, the company changed its stand and stated that it would support the products and would not drop them immediately. Most analysts expressed doubts on the success of the merger.

However, Ellison was confident that it would work, "This merger works because we will have more customers, which increases our ability to invest more in applications development and support."

On June 06, 2003, Oracle announced its bid to acquire PeopleSoft for $16 per share or approximately $5.1 billion in cash. The offer was made just four days after PeopleSoft had announced its decision to buy JD Edwards for $1.7 billion in stock.

On June 12, PeopleSoft rejected Oracle's offer. It filed a suit in a Californian state court, accusing Oracle of damaging its business and sought $1 billion in damages. It also charged Oracle with disrupting its ongoing acquisition of JD Edwards. PeopleSoft attributed Oracle's move to the fact that it had been continuously registering market share gains against Oracle in the previous couple of years. On June 18, Oracle raised its bid to $19.50 per share or about $6.2 billion. Two days later, PeopleSoft again rejected the offer. On June 30, the US DOJ began investigations into the Oracle offer. Meanwhile, on July 18, PeopleSoft completed its acquisition of JD Edwards. Oracle later increased the acquisition bid to about $7.5 billion.

In the late 1990s, the technology boom led to the rapid growth of the global software industry, which witnessed a mushrooming of numerous specialized business-software developers. With the industry facing a recession in the early 2000s, there were too many software vendors but not enough paying customers..

On June 30, 2003, the DOJ started its investigations into Oracle's acquisition bid. It filed a suit on February 26, 2004, to challenge the proposed merger pursuant to Section 7 of the Clayton Act. The trial began in June 2004. From the DOJ's viewpoint, Oracle's bid was an attempt to eliminate its major competitor. The DOJ expressed concern that Oracle could raise prices of its software while spending less money on product improvements. Oracle, on its part, supported its bid as an important measure to compete with archrivals -Microsoft and IBM..

After EC's approval, the hurdles that still remained for Oracle were PeopleSoft's poison pill and the company's Customer Assurance Plan. PeopleSoft had instituted its poison pill defense in 1995. The defense allowed the company's existing shareholders to purchase the company's stock at half price in an event of a hostile takeover bid in which the acquirer had acquired 20 percent of the company's stock. The Customer Assurance Plan (CAP) was adopted in June 2003 after Oracle had made its first takeover bid. The provisions under CAP guaranteed pay back to PeopleSoft's customers between two and five times the software licensing fees if the company was taken over within two years or if the product support declined within four years.

Once the deal was finalized, industry experts started reviewing it to evaluate whether Oracle had taken the right decision. They pointed out that PeopleSoft's software licensing revenues had fallen by 18% in 2003 from the previous year's figure. Moreover, for a revenue of every $100 through software sales, PeopleSoft spent $136 in sales and marketing.

According to AMR Research, the estimated financial revenues in the fiscal 2004 for the merged entity's applications business would be $5.5 billion, commanding a 12% market share of the worldwide enterprise applications market.

Analysts pointed to several integration challenges for Oracle's management, given the scale of the merger. The fact that PeopleSoft was not able to successfully integrate JD Edwards added to the complexity of this acquisition..

Questions of case study:

1. Was the acquisition of JD Edwards by people soft changed anything in this business between people soft and Oracle?
2. Why people soft rejected oracle offer?
3. Was oracle justification on people soft was justifiable?
4. The antitrust strategy which was played here was a game changer. Explain

3.10 SUMMARY

Financial innovation enhances sustainability of institutions and their outreach to the poor. A useful distinction between different types of financial innovations includes:

a. **Financial system/institutional innovations:** Such innovations can effect the financial sector as a whole, relate to changes in business structures, to the establishment of new types of financial intermediaries, or to changes in the legal and supervisory framework. Important examples include the use of the group mechanism to retail financial services, formalizing informal finance sysems, reducing the access barriers for women, or setting up a completely new service structure.

b. **Process innovations:** Such innovations cover the introduction of new business processes leading to increased efficiency, market expansion, etc. Examples include office automation and use of computers with accounting and client data management software.

c. **Product innovations:** Such innovations include the introduction of new credit, deposit, insurance, leasing, hire purchase, and other financial products. Product innovations are introduced to respond better to changes in market demand or to improve the efficiency of

The *capital structure* is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. A firm's capital structure can be a mixture of long-term debt, short-term debt, common equity and preferred equity. A company's proportion of short- and long-term debt is considered when analyzing capital structure. When analysts refer to capital structure, they are most likely referring to a firm's debt-to-equity (D/E) ratio, which provides insight into how risky a company is. Usually, a company that is heavily financed by debt has a more aggressive capital structure and therefore poses greater risk to investors. This risk, however, may be the primary source of the firm's growth.

3.11 KEY WORDS:

Dividend policy: is the set of guidelines a company uses to decide how much of its earnings it will pay out to shareholders. Some evidence suggests that investors are not concerned with a company's dividend policy since they can sell a portion of their portfolio of equities if they want cash.

Capital Structure: Capital structure is the mix of the long-term sources of funds used by a firm. It is made up of debt and equity securities and refers to permanent financing of a firm.

It is composed of long-term debt, preference share capital and shareholders' funds.

Market Value: The price an asset would fetch in the marketplace. *Market value* is also commonly used to refer to the *market* capitalization of a publicly-traded company, and is obtained by multiplying the number of its outstanding shares by the current share price.

Financial innovation: can be *defined* as the act of creating and then popularising new *financial* instruments as well as new *financial* technologies, institutions and markets. It includes institutional, product and process *innovation*.

3.12 SELF ASSESSMENT QUESTIONS.

1. Define dividend policy.

2. Discuss the concept of capital structure.

3. Define the term financial innovations.

4. Explain the financial innovations in India.

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UNIT- 4 : FINANCIAL ENGINEERING AND CHALLENGES IN STRATEGIC FINANCIAL MANAGEMENT

Structure:

4.0 OBJECTIVES

4.1 Introduction

4.2 Challenges in Strategic Financial Management

4.3 Tobin's Q Ratio

4.4 Financial Management in Sick Units

4.5 Overview and scope of Financial Engineering

4.6 Demerits of Financial Engineering

4.7 Corporate Governance Challenges in Strategic Financial Management

4.8 Regulatory challenges in Strategic Financial Management

4.9 Notes

4.10 Summary

4.11 Key words

4.12 Self Assessment Questions

4.13 References

4.0 OBJECTIVES

After studying this unit, you will be able to:

- Give the meaning Financial Engineering
- Describe the scope of Financial Management
- Analyze the Challenges in Strategic Financial Management
- Identify the Demerits of Financial Engineering
- Highlight the Tobin's Q Ratio

4.1 INTRODUCTION

Financial engineering is the use of mathematical techniques to solve financial problems. Financial engineering uses tools and knowledge from the fields of computer science, statistics, economics and applied mathematics to address current financial issues as well as to devise new and innovative financial products. Financial engineering is sometimes referred to as quantitative analysis and is used by regular commercial banks, investment banks, insurance agencies and hedge funds. Financial engineering has led to the explosion of derivative trading that we see today. Since the Chicago Board Options Exchange was formed in 1973 and two of the first financial engineers, Fischer Black and Myron Scholes, published their option pricing model, trading in options and other derivatives has grown dramatically.

Financial engineering is the application of mathematical methods to the solution of problems in finance. It is also known as financial mathematics, mathematical finance, and computational finance. Financial engineering draws on tools from applied mathematics, computer science, statistics, and economic theory. Investment banks, commercial banks, hedge funds, insurance companies, corporate treasuries, and regulatory agencies employ financial engineers. These businesses apply the methods of financial engineering to such problems as new product development, derivative securities valuation, portfolio structuring, risk management, and scenario simulation. Quantitative analysis has brought innovation, efficiency and rigor to financial markets and to the investment process. As the pace of financial innovation accelerates, the need for highly qualified people with specific training in financial engineering continues to grow in all marketenvironments.

Financial engineers design, create and implement new financial instruments, models and processes to solve problems in finance and take advantage of new financial opportunities. A great deal of research goes into these models and theories and they rely on in-depth data analysis, stochastics, simulations, and risk analysis. Financial engineers apply their knowledge in several academic fields, including corporate finance, economics and statistics. Financial engineers work in the securities, banking, financial management and consulting industries.

Financial engineering sometimes also refers to the strategies companies use to maximize profits or other important performance metrics. Examples include creating derivatives that address unusual risks faced by a party to a transaction, structuring a purchase or sale in a way that better addresses the interests of the buyer and the seller, and using new methods to compute the fair market value of new or existing financial instruments. Many financial engineers say that financial engineering involves as much creativity as is does technical knowledge, because the field is a pioneering, innovative one. The evolution of cheaper, faster computers has greatly expanded the financial engineering field.Financial engineering is somewhat controversial, and some believe that it increases any economy's systemic risk instead of decreasing it. For example, financial engineering is largely responsible for the development and use of derivatives like credit-default swaps and mortgage-backed securities that were blamed for the near financial meltdown in 2007-2008.

4.2 CHALLENGES IN STRATEGIC FINANCIAL MANAGEMENT

There is a difference between managing daily finance and managing strategic finance. The strategic financial management can work very smoothly if the finance and economy are moving on the predicted path. But in the contemporary world, it is not necessary that the world should move on the predicted path always and hence there are chances that one may have to make some changes in the strategic planning.

So, if we read the entire book on strategic financial management and finally read this chapter that focuses on the condition that it is not necessary a business should grow on the predicted path, then the purpose of strategic financial management gets defeated. In other words, why should one strategize and make plans when the future is not sure and may require tactical changes then and there?

There is an adage that states. Plans are nothing, planning is everything'. Every company makes specific plans to manage their finance for their short- and long-term basis, but what is more important is how well do they plan keeping various constraints and opportunities in

mind and what tactics do they follow for every type of constraints and opportunities that they may come across. This is the key for strategic financial management.

It is seen that strategic financial management can face challenges due to the five Es. These are economy, existence, earnings, enterprising, and execution. We will look at these factors one by one.

Economy

Economy is a major factor in any strategic financial management. About two decades back, nobody would have thought about the increased role of information technology (IT) applications in the world. Today, the increase in computerization has led to higher automation and lower manual intervention thereby making significant impact on the semi-skilled and unskilled labour force. It is seen these days that the IT budgets are allocated more than personnel budget in many of the companies, which was not the scene in many companies a decade back.

Till very recently, some of the big companies in USA have been working towards re-shoring to bring back the production facilities to increase employment for the us citizens. lic and government from the concept of the organization entity, suppliers, customers, and so on. In this world, leadership has become questionable on the strategic basis. About 50 years back, Tata and Birla were the two major entities in the minds of the public that posed leadership in the private sector. However, today new entities have sprung up in several sectors, which have been growing at a fast rate and are creating new names in those sectors. Examples of these new organizations are Reliance in various sectors, Infosys and Wipro in the IT sector, and so on. Existence of these companies holds a lot of importance.

Earnings

Every company requires funds to execute their strategies and future plans. A company may start using debts, equities, or assets, but in the long run, it is important for it to earn substantially to be able to execute its strategies,

Enterprising

Companies should be enterprising and have a lot of innovation in their course of activities. In a knowledge-based economy, patents and intellectual property rights have played a major role in changing the fate of various companies in the world. For example, in the 1980s Microsoft was known only by a few people and now only a few people might not be aware of the company. This happened because of the successful enterprising nature of the

company. In fact, Microsoft is being challenged by other operating systems such as Android and Linux, which has significant impact over the strategic financial planning of the company.

Execution

Once planning of the strategy a company might want to follow is decided, it is important to see that people who execute the plan are well trained. There may be a number of people who work together to make a plan, as the name bears 'strategic'. There could be chances that with many people in the team, the plan might get influenced or some bias might lead to making changes in the strategy. There could also be some other factors such as changes in the technology and working pattern, which could bring about changes in the process and influence the execution of the strategic financial plans.

This unit focus on understanding the challenges that strategic financial management might face in specific instances, for example, in knowledge-intensive companies, sick units, and public sector.

Financial Management in Knowledge-intensive Companies From goods-based economy, the world has moved towards knowledge-based economy. This has led to the valuation of companies on the basis of intangible assets. For example, Microsoft may be close to worth $250 billion today, but the tangible assets are worth only a few billion dollars. The major chunk of the assets is intangible, which leads to the importance of intellectual capital in the knowledge-intensive companies in the world today. Intellectual capital refers to the knowledge that can be value. The scope of this capital includes new inventions, ideas.

Know-how, design approaches, process management, and various publications. Intellectual capital also comprises human capital, structural and customer capital. Some companies still argue that it is difficult to adopt financial planning in the knowledge-intensive companies as they think it is non-strategic, passive, and decentralized, and encourages only non-core innovations.

However, companies are also seen to realize the key values of retaining the key employees and the replacement cost in the competitive environment. Hence, intellectual capital (especially human capital), is gaining value, and more and more companies are seen to be moving to this sector.

4.3 TOBIN'S Q RATIO

At this juncture, it is important to know about the Tobin's Q Ratio developed by Nobel Prize winning economist James Tobin. This ratio compares the market value of an asset with its replacement cost.

If 'q' is less than 1, that is, if an asset is worth less than the cost of replacing it then it is unlikely that a company will buy more assets of that kind; companies are likely to invest more if similar assets are greater than their replacement cost.

This is the reason many companies pay high salary and performance incentives to the key people in order to retain them.

Human capital at the organization level has become more important today and the HR managers work closely with financial management in creating the required intellectual assets for the company. The companies even announce rewards for innovations. Organizations think that a piece of extra knowledge over their competitors could make them win and, hence, depend upon their employees to pool relevant knowledge that is hidden. Unfortunately, most of the employees also feel that a piece of extra knowledge over their counterparts could make them win and so they purposefully hide such information sometimes. It is seen that nowadays people are sincere not only towards the companies that employ them but also towards their professions.

Let us look at some ways the management might try to retain people in an organization.

Organizations should continuously perform employee engagement to create loyalty.

- Incentives must be given for pooling relevant knowledge for the competitive edge.
- Due value must be assigned to the employees and the employers for the work done. This motivates and encourages them. Gap analysis should also be done to understand values created and targeted.
- Companies can form intellectual capital management group whereby the profile systems can be analyzed and suggest what the employees can expect from the company and vice versa.

Apart from companies and the management keeping a check on retaining their intellectual capital, there are also ways in which it can be measured if the capital needs to be retained by the management. Some of these ways are as follows:

Human capital measures

Though industries are embracing automation, there is no dearth for the requirement of the human capital. Skilled human resources are always much in demand. Companies try to accommodate skilled personnel at any cost with a hope of taking the company to new heights. It is true that skilled human resources will join and continue in any company that has a

conducive environment and where managers encourage employees to grow work more efficiently, provide job satisfactory and so on.

The following are the indicators for the human capital:

- Are there innovations happening in the company?
- What is the employee attitude overall?
- Are people happy about working for the company?
- Are there more people leaving the company? If so, what reasons do they quote?
- What is the average age of the company employees? Is it a young force?
- What are the career-related educational courses they undertake?
- What is the replacement cost for the employee?
- What is the average tenure of the people working in various cadres?
- Are competitors keen on hiring our company employees?
- Where does our company stand in the eyes of recruitment agencies?
- That is, what rating do they get?

Structural capital measures

Structural capital relates to the value that an organization creates and holds on the basis of the knowledge, processes, and supportive infrastructure it possesses. It enables and supports the other capital to work, and remains with the organization even when people leave. It can include the following:

- Trade secrets, formulae, proprietary and test results, and so on.
- Copyrights, trademark, package design, warranties, and logos.
- Database, manuals, process standards, security systems, and information systems.

Customer capital measures

Customer capital is one of the key factors for the success of any company. It refers to the value that is held by the relationship that an organization shares with its customers to the extent that it affects its market share. It should be measured in terms of retention, increase in business (cross-selling and up-selling) and new acquisitions capability of the company, and price tolerance level up to which the existing customers will not move out. It is believed that maximum customers can be retained through personal interaction and servicing. Hence, if the human capital is doing a good job, it has to be retained.

In most cases, if the earlier-mentioned three measures and factors are in compliance with the management, in other words, all the capital measures are working in favour of the organization, the company works to retain its human capital.

4.4 FINANCIAL MANAGEMENT IN SICK UNITS

A unit is declared sick when the market value of the unit is eroded very significantly. When such erosion happens, the company is considered to be nearly dead. This is because it would have failed in several counts such as employee issues, mounting credits, and lack of production. Many a times, the sick units will try to revive either by mortgaging _some of its well-performing assets or knock at the doors of the banks.

But the success ratio of the sick units reviving their assets despite financing by the banks is less than two per cent. Many of these firms are small or medium-scale enterprises, and this leads to increase of non-performing assets for the banks. As on December 2011, RBI data stated that the total outstanding to medium and small enterprises wasT4,82,54O crore, a growth of 11 per cent over the last year, while credit to medium enterprises grew 25 per cent to <1,98,570 crore in the same period.

Small and medium enterprises also lack the required skills support to tackle the financial crisis. It is also because of the fact of having unaffordable factors for paying high-skilled employees. Many a times, small and medium-scale enterprises meet the working capital crunch because of the longer pay back period by the purchasers (creditors). To provide the required assistance, the government passed the Factoring Bill' Factoring can be defined as the financial transaction whereby a business sells its accounts receivable (i.e., invoices) to a third Parry (called a factor) at a discount. For example, if a company has to receive <1000 in the next 10 days from XYZ, it can approach a factoring company today and discount the rate on the basis of the invoice at 80 to 90 per cent of the invoice value and take the cash. The factoring company, in turn encashes the invoice upon maturity. This is different from the banking loan by the way of non-requirement of any mortgages or hypothecation required from the client. The factoring company honours the invoice based on the credit worthiness of the client, creditor entity of the client, and so on.

Industrial Sickness

Sickness could happen due to various reasons that also include challenges arising out of external environment. To overcome these challenges, increase the growth, create employment, and promote entrepreneurship, the Government of India established Board for Industrial Finance and Reconstruction (BIFR) in 1987. Alter 1991, the scope of the BIFR

includes public sector units as well. Sick Industrial Company Act (SICA) defines 'Sick industrial unit as a unit or a company (having been in existence for not less than five years) which is found at the end of any financial year to have incurred accumulated losses equal to or exceeding its entire net worth.

The net worth is the resultant of sum total of paid-up capital and free reserves of a company after deducting the provisions and expenses. An industrial unit is also regarded as potentially sick or weak if at the end of any financial year, it has accumulated losses equal to or exceeding 50 per cent of its average net worth in the immediately preceding four financial years and has failed to repay debts to its creditor(s) in three consecutive quarters on demand made in writing for such

repayment. One may notice that some companies that were very big in the past have been closed down or acquired by others. For example, there were big television brands in India such as Solidaire and Dyanora during the 80s, of which advertisements were broadcasted very frequently on television and radio. But in due course, they were overtaken by foreign companies such as Samsung, Sony, and Panasonic. There are various other examples of such companies.

In general, sickness starts because of various issues such as companies not in sync with the upcoming technology. For example, a CD company may not foresee the growth of USB (pen drive) market, and may expand too much not in proportion with its market growth such as opening a lot of branch offices but without much business, be unable to manage people, and not manage the creditors and debtors properly. Some of the factors that lead to sickness of an organization are listed as follows.

- Mismanagement
- Logistical and location issues
- Errors in estimation of business planning
- Wrong dividend policies
- Poor implementation of projects
- Cultural mismatch among the employees
- Lack of objective of the shareholders
- Unwarranted expansions
- Delay in closure of units not creating profits
- Political issues affecting the policies of the government
- International pressures or circumstances

- Failure to upkeep the company in the wake of disruptive innovations
- Lack of supply chain management
- Credit issues
- Challenges due to accounts payable and receivables

The growing industrial sickness in the country has led to a great concern The government has been trying hard to overcome some of these consequences. The impacts of industrial sickness are as follows.

- If a company is working, it generates revenues, provides employment and pays salary and, hence, taxes are paid by the company and its employees. If the company is closed down and not working, then the government loses revenue in the form of tax and so on.
- Most of the companies would have already invested in infrastructure and machinery and if the company is closed, then the infrastructure will be idle and it may lead to loss of interest by the banks and other financial institutions who would have lent money to the company; that is, banks and other financial institutions may see an increase of non-performing assets leading to losses.
- Because of the closing down of an organization, a lot of people lose their jobs also. The infrastructure becomes smaller to absorb everyone in the country or rather give a job. In other words, this creates more unemployment in the country.
- Labour unrest creates ripple effects in the surroundings of the company creating sociological problems such as migration and redeployment challenges.
- It also affects the overall confidence of the investors in the structure of the organized sector in the country.

4.5 OVERVIEW AND SCOPE OF FINANCIAL ENGINEERING

In the wake of economic turmoil faced by the world, it has become very important to analyze the data to fit the strategies accordingly. Finance being one of the critical aspects for running any organisation, it is important to handle the financial analysis of the data very carefully.

In any organisation, any department has specific goals to achieve and often the budgetary challenges deter them from achieving the same. Budgets are derived from the financial strengths of the company and the potential to earn. Financial analysis helps any company to

make the projections in terms of revenue and profit and so on. Performing financial analysis requires domain experts in finance and also knowledge of the industry that they are working in or consultation

with the respective industrial experts while making financial analysis. In short, the financial analysis should be a blend of pure finance mixed with the nuances of the industry that they analyze. For example, if a financial analyst is working on insurance sector, he/she should be very strong in the financial fundamentals, but should also take help of the insurance experts and actuaries to understand the nuances of the insurance industry also.

Financial engineering is different from financial analysis. While financial analysis focuses more on the standing of the company and discusses about the projections of the company , financial engineering works on financial analysis and leverages upon various specialized tools and techniques derived from computer programmes, mathematical finance, and so on in order to solve the problems in finance. Financial engineering is very well used to design the financial products that can be used in the contemporary market scenarios.

For example: a few centuries bank financial, financial products were limited only to deposits, savings bank account, and so on. But in the current world, there are numerous financial products with innovative designs such as derivatives, stocks, options, ESOP's, and so on. All these financial products have been invented because analysts and financial engineers thoroughly analyzed the various factors as follows:

- What is the market for such financial products?
- Who will buy them?
- How much will they pay?
- What will be their expected rate of return?
- What are the promises that should be made to the customers with respect to the returns?
- What are the risk factors involved for the investors and the company designing such products?
- How to price those products, that too attractively and competitively?
- Where the money invested or collected from the customers should be used?
- How to ensure that the investments made reap profits more than the expected rate of returns of the customers?
- Who will govern those products?
- Who will monitor the product performance?

- What are the regulatory requirements to make the product more legal?
- What are the compliance requirements for the sustainability of the product?
- What will be the asset inflows and liability outflows for such products?
- What will be the gap between the assets and liabilities?
- How to match the assets and liabilities?
- Will there be a liquidity crisis?
- How to monitor and meet the liquidity requirements?
- What is the market risk associated with such products?
- What are the credit risks, counter-party risks?
- What are the operational risks involved in such product management?
- What are the likely disputes that may arise and how to overcome them?
- How much will be the contribution of such products to the overall revenue of the company?

The above factors are only indicative. Financial engineering thus involves a host of activities to design innovative products. Most of the times, new innovative products are designed in order to derive some solutions for the finance.

4.6 DEMERITS OF FINANCIAL ENGINEERING

Apart from the advantages that financial engineering provides, it has also a number of disadvantages to its credit. Some of them are as mentioned below:

- Sometimes, the calculations made by financial engineering backfire due to the other factors. For example: ULIP's in insurance sector, which was aggressively sold and bought in the market, is seeing a set back because of wrong selling of products by insurance agents.
- There are still many unresolved issues to be solved using financial engineering. For example, India is still struggling to bring the financial inclusion for every citizen in the country. Financial inclusion involves making the banking network reach all the citizens of the country.
- There is also some misconception that financial engineering means engineering financial statements in order to show profits on paper but not in real terms. Such terms make people think lowly about financial engineering.

- Financial engineering sometimes leads to chaos such as introduction of algorithmic trading in the stock markets leading to artificial fall or rise of the stocks. Algorithmic trading is a process wherein machines will be programmed and will be involved in the buying and selling of stocks based on various algorithmic calculations.
- Financial engineering is not recognized as a branch of engineering as the most of the work is fictitious.
- Products designed with the lack of skills in financial engineering leads to disasters, for example, closure of various chit fund products and some finance companies offering higher rate of interest to the tune of 36percent to 48 percent and so on. Such high rate of returns is not possible unless they get a return of more than 50 per cent on their own. If some company has to earn 50 percent on their investments, it is very hard to earn in a legal manner. Hence, it is important for someone to analyze financial engineering behind the innovative financial products floated in the market

However, it is important to learn the aspects of financial engineering as it always gives the analyst to work and derive a solution for a financial problem by considering almost 360 degree view of the situation.

4.7 CORPORATE GOVERNANCE CHALLENGES IN STRATEGIC FINANCIAL MANAGEMENT

Corporate Governance refers to the way a company runs in a more transparent and ethical manner. In a way, it represents a parliament of the corporate wherein the managing director acts like a prime minister of the company and the chairman acts like a president of the company. Each director represents a minister of various portfolios.

In some cases, independent directors who are supposed to act like the representative of the public investors are not given enough opportunity or have enough bandwidth to dwell deep into the company affairs. The formation of various committees such as audit committee, ethics committee, risk committee, and compensation committee should be represented by the competent people.

In some cases, compensation are fixed based on incentives related to the growth and, hence, it becomes a culture of the management to achieve the growth in order to grab the incentives; thereby, forgetting about the long-term interests of the company. Currently, some institutions are scanning themselves to set good standards, and there is also research going on to find out the ways to set ideal standards for independent directions.

4.8 REGULATORY CHALLENGES IN STRATEGIC FINANCIAL MANAGEMENT

Regulations and various compliance acts are imposed on the organisations on the basis of the learning of the past. However, most of the organisations face severe challenges in complying with it due to the following factors:

- Underestimation of the compliance work
- Lack of technology
- Lack of software programmes to undertake complete workflow
- Cost involved in complying with the regulations and acts
- Lack of skilled people
- Prolonged project work affecting the productivity of the people at the top
- Lack of consistency to maintain after first-time compliance
- Managing the data in unsecured formats leading to manipulations later
- Highly frequent new regulations coming up on after the other, thus making the companies to look for the ways to comply with it, delaying the completion of projects.
- Infrequent regulations also alter the business models, thus forcing the companies to rework on the financials every time new regulations are passed.
- Integrated global economy and the spread of multinational companies in different geographies warrant the companies to comply with multiple regulations beyond their own company regulations, for example, some MNC's in India have to comply with Indians, US, as well as European regulations. Thus, it makes it tiring for the companies and also making compliance very complex.

4.9 NOTES

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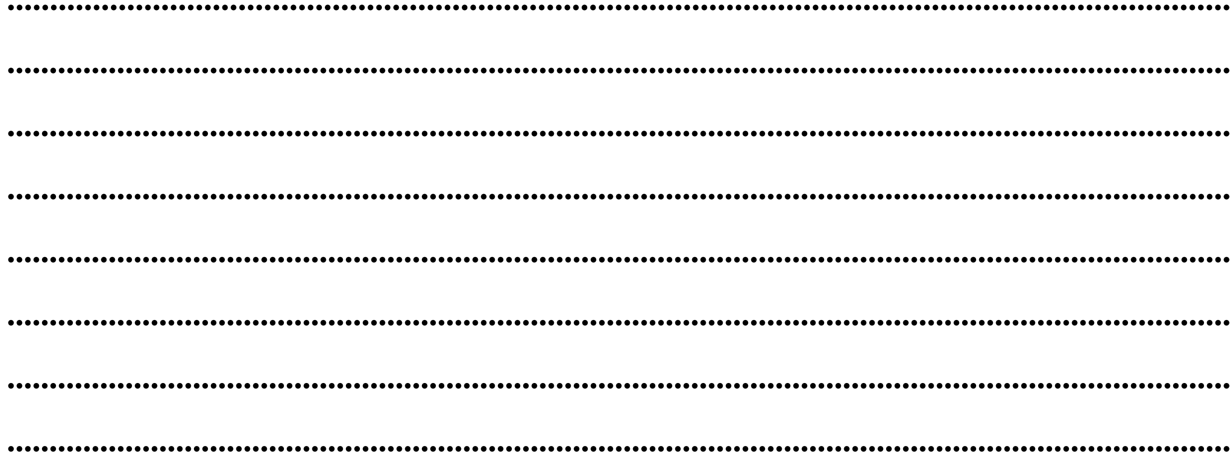

4.10 SUMMARY

Financial engineering is a multidisciplinary field involving financial theory, methods of engineering, tools of mathematics and the practice of programming. It has also been defined as the application of technical methods, especially from mathematical finance and computational finance, in the practice of finance. Despite its name, financial engineering does not belong to any of the fields in traditional professional engineering even though many financial engineers have studied engineering beforehand and many universities offering a postgraduate degree in this field require applicants to have a background in engineering as well. In the United States, the Accreditation Board for Engineering and Technology (ABET) does not accredit financial engineering degrees. In the United States, financial engineering programs are accredited by the International Association of Quantitative Finance.

Financial engineering draws on tools from applied mathematics, computer science, statistics and economic theory. In the broadest sense, anyone who uses technical tools in finance could be called a financial engineer, for example any computer programmer in a bank or any statistician in a government economic bureau. However, most practitioners restrict the term to someone educated in the full range of tools of modern finance and whose work is informed by financial theory. It is sometimes restricted even further, to cover only those originating new financial products and strategies. Financial engineering plays a key role in the customer-driven derivatives business, which encompasses quantitative modelling and programming, trading and risk managing derivative products in compliance with the regulations and Basel capital/liquidity requirements.

4.11 KEY WORDS

- **Financial engineering:** is the use of mathematical techniques to solve financial problems. Financial engineering uses tools and knowledge from the fields of computer science, statistics, economics and applied mathematics to address current financial issues as well as to devise new and innovative financial products.
- **Industrial Sickness**: is a phenomenon characterised by loss of production and employment of industries.
- The term "sickness" is used to describe the phenomenon of the closure of industries and loss of production with the assumption that, if a nursing programme is taken then the industrial unit may be nursed back to health.

4.12 SELF ASSESSMENT QUESTIONS

1. Explain the Challenges in Strategic Financial Management.
2. Mention the Regulatory challenges in Strategic Financial Management.
3. Discuss the Tobin's Q Ratio.
4. Mention the Demerits of Financial Engineering.
5. Discuss scope of Financial Engineering.

4.13 REFERENCES

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MODULE-II
PRIVATE EQUITY AND VENTURE CAPITAL

UNIT-5 : RUDIMENTS OF VALUING AND FINANCING A VENTURE

Structure:

5.0 Objectives

5.1 Introduction

5.2 Conceptual Framework

5.3 Features of Venture Capital Investments

5.4 Vision of venture capital

5.5 Methods of Venture Capital Financing

5.6 The Funding Process

5.7 Case Study

5.8 Notes

5.9 Summary

5.10 Keywords

5.11 Self - Assessment Questions

5.12 References

5.0 OBJECTIVES

After studying this unit, you should be able to;

- Define Venture Capital financing
- Explain the process of Venture Capital Financing
- Describe the methods of Venture Capital Financing
- Evaluate related cases

5.1 INTRODUCTION

Venture capital funds are likely to be an important source of finance for a nascent venture. A young private company that is not yet read or willing to tap the public financial market may seek venture capital (VC), such capital is provided by venture capital funds which are prepared to finance an untried concept that appears to have promising prospects. Venture capital funds seed to support growing firms during their initial stages, before they are ready to make a public offering of securities. Generally, venture capital is provided in the form of equity capital. Venture capital represents financial investment in a highly risky proposition made in the hope of earning a high rate of return in the future.

Venture capital fund organizations are specifically designed to provide risk capital to entrepreneurs. Venture Capital- is the capital which funds the early, seed or initial stages of potentially high risk business ideas. The investment is usually in the form of shares (stock) or an instrument, which can be converted into shares at a future date. Venture capitalists (VC's) expect high annual returns (generally varying between 25% and 75%) on their investment. Investment is generally in the range of Rs.10 mn. to Rs.500 mn. in a single proposal.

Venture capital plays a strategic role in financing small-scale enterprises and high technology and risky ventures. The activities of venture capital is quite advanced in the developed countries. It has also taken root in a number of developing countries. Venture capital has potential to become an important source for financing of small-scale enterprises (SSEs).

The concept of venture capital is not new. Venture capitalists often relate the story of Christopher Columbus. In the fifteenth century, he sought to travel westwards instead of eastwards from Europe and so planned to reach India. His far-fetched idea did

not find favor with the King of Portugal, who refused to finance him. Finally, Queen Isabella of Spain, decided to fund him and the voyages of Christopher Columbus are now empaneled in history. The significance of the venture capital is found in twentieth century.

Venture capital is a popular method of financing high technology and high-risk enterprises in developed countries like the United States, the United Kingdom, and Japan. And recently, a number of developing countries have established venture capital firms in the private and/or public sectors to finance technology-related and new small- and medium-sized enterprises. In the emerging markets of Asia, venture capital activity has been growing at an impressive rate, especially since the late 1980s. During the five-year span of 1988-1993 the Asian venture capital pool increased from US$9.9 to $26.2 billion, an annual growth rate of 21.5%, while cumulative investment increased from $4.5 to $11.6 billion or 26.7% annually [Asia Private Equity and Venture Capital Intelligence (AVCJ), 1994].

5.1.1 Overview of the PE/VC Industry

From the first modern VC firm, American Research and Development (1946), organized as a publicly traded closed-end fund, to the first VC limited partnership, to the present day, the PE/VC industry has undergone significant structural change which has led to a dramatic increase in the amount of committed capital flowing into the industry and the number of PE/VC funds. During the 1980s and 1990s, the private equity market experienced tremendous growth, significantly outpacing the growth in the public equity and debt markets and the private placement debt market. From 1980 to 1995, for example, the total amount of private equity capital under management increased from under $5bn to over $175bn, which represents over a 25% compounded annual growth rate. Not surprisingly then, the capital committed to the private equity industry often exceeded the financing raised through initial public offerings and gross high-yield corporate bond issuances. There were three regulatory and structural changes fueling the unprecedented growth in capital committed to PE/VC funds and helping to make the PE/VC industry the fastest growing corporate finance market. First, in 1979 there was an amendment to the "prudent man" rule governing the types of investments allowable for pension funds. Prior to this amendment, the Employee Retirement Income Security Act (ERISA, 1974) placed restrictions on institutional investors that limited them from investing substantial amounts in venture, non-venture, and other high risk asset classes. The "prudent man" rule amendment, however, permitted pension funds to make significant investments in venture capital and other high-risk assets. As a direct result of this amendment, pension funds became the single largest contributor to the venture capital industry. As of year-

end 1996, for example, the two largest contributors to the private equity market were public pension funds and corporate pension funds, which contributed $39.5bn and $34.7bn, respectively, of the total $176.3bn private equity outstanding. In addition, a study showed that while only 11% of the three major investor groups (pension funds, endowments, and foundations) committed capital to private equity funds in 1975, approximately 56% of these same investor groups contributed capital to the private equity industry in 1995. Thus, the rapid growth in the private equity market has been driven significantly by the regulatory changes to the “prudent man” rule.

The second contributing factor to the growth in private equity was due to structural changes in the manner in which capital was contributed by investors to private equity funds. Specifically, through the 1970s and 1980s, the use of investment advisors, or gatekeepers, by institutional investors became more prevalent and these agents helped to monitor VC funds and advise investors on choosing appropriate VC funds in which to invest. These gatekeepers would pool capital from their many clients in order to gain more bargaining power when contracting with the private equity fund managers, whose fundraising costs would be significantly lowered by these gatekeepers. Thus, the rise of gatekeepers was an organizational innovation that helped the private equity market function more efficiently, and by the 1990s, roughly 1/3 of pension fund commitments came through the use of an investment advisor.

Third, and perhaps most important, was the development and use of the limited partnership structure as the primary financial intermediary between the investors, or limited partners (LPs) and the private equity fund managers, the general partners (GPs) . While only accounting for 40% of the venture pool in 1980, the limited partnership organizational structure comprised over 80% of the VC pool of capital by 1992. Similar to the increased use of investment advisors as lubricants for the private equity machine, the organizational innovations provided by the limited partnership structure has allowed for the mitigation of principal-agent problems prevalent between investors and entrepreneurs.

Globalization

The growing integration of the economies of the world has become a global village. As a nation’s economy grows, it will have to be increasingly a part of the global economy. Whether it is in the area of media, technology, manufacturing or retail there is no choice but to be a player with global linkages, perspectives and practices.

Knowledge and Intellectual Property

Of all the factors of production, knowledge and intellectual property are the most critical in this increasingly complex, inter-linked, fast growing world. Every physical good and every service being delivered today, at the global level has a knowledge component to it that was not present a few years ago. Productivity of knowledge workers has become engine of economic growth today.

Technology

The development of technology to solve critical problems is only now being recognised by the economies of the world. Technology is a fundamental enabler of the creation and dissemination of knowledge and intellectual property-based goods and services which in turn are the natural outcomes of an increasingly globally competitive world.

However, for a substantial number of technocrats who seek to capitalize on their strengths and business opportunities, starting-up a new venture is a distant dream. There are a number of critical factors that contribute to its success or failure of new business. Experience, integrity, prudence and a clear understanding of the market are among the most sought after qualities of a promoter. Besides these there are other external factors which lie beyond the control of the entrepreneur. Prominent among them are the timely infusion of funds, technical skills, cost competitive manpower etc. this is where the 'venture capitalist' comes in with money, business sense and a lot more.

Therefore, a predominant success factor in entrepreneurial business is 'Venture Capital' which can be propelled into a powerful engine of economic growth and wealth. The study conducted by Organisation for Economic Co-operation and Development (OECD) in 1985also shows that there is possibly no substitute for Venture Capital as a source of funds and management skills for new technology firms and it is not possible for small and medium-sized enterprises (SMEs) to develop without the country having a venture capital market.

5.2 CONCEPTUAL FRAMEWORK

The companies or industries engaged in traditional line of business can easily procure necessary financial capital from several traditional institutions which invest in industry or company for gains. But, the companies or industries likely to engage in risky lines of business having no time-tested foundation in the commercial world-electronics, computer application industries-are not favored by the traditional and orthodox investors as an attractive avenue of investment.

Under this circumstances, the concept of 'Venture Capital Fund' was born with a fundamental objective to provide initial capital and support in building capital-base to the entrepreneurs having a sound background of professional education and expertise who take initiative to launch the business based on fast-changing technology. Common investors like institutions and banks show apathy to invest in the firms which are projected to deal in new technology, strategic and innovative market. Venture capital Funds, thus, come forward to finance those firms in the form of long-term equity finance with an objective to earn their returns in the form of capital gain.

The term 'Venture Capital Financing' comprises of three words viz., venture, capital and financing. The word **venture** has several meanings, depending on the context of its usage. It means business or commercial deal involving a risk, which refers to variability in the expected rate of return. The word **capital** is the resources to start an enterprise. From the functional point of view, capital to a company is what is blood to human body. Here capital refers to financial capital and not exactly produced means of production in the version of economists. **Financing** is the process of organizing the flow of funds so that a business firm can carryout its objectives efficiently and meet its payment obligations as they fall due.

The term **Venture Capital** may be defined as investment in the form of equity, quasi-equity or conditional loan made in new, unlisted, high-risk or high-technology firms started by technically or professionally qualified entrepreneurs.

Where venture capitalists expects,

- The enterprise to have a very high growth rate
- Medium to long-term capital gains
- Provide management and business skills to the enterprise
- Does not expect any collateral to cover the capital provided.

Entrepreneur is a professionally or technically qualified person with inadequate resources of backing to finance the project.

Venture capitalists may be defined as organizational units or persons-who can take-up substantial activity in the management of equity or quasi-equity financing for the start-up and or development of small, and medium-sized unquoted enterprises having significant growth potential in terms of products, technology, business concepts and services, and can provide active management support to investees. He can be described as a 'probability lender', lending on ideas, the drive of the entrepreneur and his own

assessment of the final product and market. Hence, from the perspective of the venture capitalist, venture capital is seen as "you have got the idea, we have the money". Empirically, there are three types of venture capitalists.

- Purposeful risk managers who will consider venture fulfilling all essential requirements.
- Determined electives who will consider most deals fulfilling minimum criteria.
- Parachutists who will consider any venture provided it has liquidity 'parachute' through which they could escape in case of difficulty.

The key factors for the success of any project under the consideration of a venture capitalist are:

- Clear and objective thinking
- Operational experience, especially in a start-up
- People management skills
- Ability to spot technology and market trends
- Wide network of contacts
- Knowledge of all facets of business finance, marketing and human resources
- Judgement to evaluate them on the basis of integrity and ability
- Patience to pursue the final goal
- Drive to guide budding entrepreneurs
- Empathy with entrepreneurs

From the above description, it can be concluded that **'venture capital financing'** means providing a proper mix of medium and long-term investments in high-risk industrial projects with high reward possibilities. It may be at any stage of implementation of the project or its production cycle viz., to start-up an economic activity or an industrial or commercial projects or to improve a process or a product in an enterprise associated with both risk and reward.

Definition

Capital invested in a project in which there is a substantial element of risk, typically a new or expanding business.

Startup or growth equity capital or loan capital provided by private investors (the venture capitalists) or specialized financial institutions (development finance houses or venture capital firms). Also called risk capital.

Venture capital is a type of funding for a new or growing business. It usually comes from venture capital firms that specialize in building high risk financial portfolios. With venture capital, the venture capital firm gives funding to the startup company in exchange for equity in the startup. This is most commonly found in high growth technology industries like biotech and software.

A person who deals in venture capital is a venture capitalist, and usually works for a venture capital firm.

Meaning

The concept of venture capital is not new. Venture capitalists often relate the story of Christopher Columbus. In the fifteenth century, he sought to travel westwards instead of eastwards from Europe and so planned to reach India. His far-fetched idea did not find favor with the King of Portugal, who refused to finance him. Finally, Queen Isabella of Spain, decided to fund him and the voyages of Christopher Columbus are now empanelled in history.

Venture capital (VC) is a type of private equity, a form of financing that is provided by firms or funds to small, early-stage, emerging firms that are deemed to have high growth potential, or which have demonstrated high growth (in terms of number of employees, annual revenue, or both). Venture capital firms or funds invest in these early-stage companies in exchange for equity–an ownership stake–in the companies they invest in. Venture capitalists take on the risk of financing risky start-ups in the hopes that some of the firms they support will become successful. The start-ups are usually based on an innovative technology or business model and they are usually from the high technology industries, such as information technology (IT), social media or biotechnology. Usually, venture capitalists involve in the management of the client enterprises. Venture capital funds seek to support growing firms during their initial stages, before they are ready to make a public offering of securities.

The typical venture capital investment occurs after an initial "seed funding" round. The first round of institutional venture capital to fund growth is called the Series A round. Venture capitalists provide this financing in the interest of generating a return through an eventual "exit" event, such as the company selling shares to the public for the first

time in an Initial public offering (IPO) or doing a merger and acquisition (also known as a “trade sale”) of the company.

In addition to angel investing, equity crowd funding and other seed funding options, venture capital is attractive for new companies with limited operating history that are too small to raise capital in the public markets and have not reached the point where they are able to secure a bank loan or complete a debt offering. In exchange for the high risk that venture capitalists assume by investing in smaller and early-stage companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the companies’ ownership (and consequently value). Companies like Uber, Airbnb, Flipkart, ReviewAdda, Xiaomi & Didi Chuxing are highly valued startups, where venture capitalists contribute more than financing to these early-stage firms; they also often provide strategic advice to the firm’s executives on its business model and marketing strategies.

Venture capital is also a way in which the private and public sectors can construct an institution that systematically creates business networks for the new firms and industries, so that they can progress and develop. This institution helps identify promising new firms and provide them with finance, technical expertise, mentoring, marketing “know-how”, and business models. Once integrated into the business network, these firms are more likely to succeed, as they become “nodes” in the search networks for designing and building products in their domain. However, venture capitalists’ decisions are often biased, exhibiting for instance overconfidence and illusion of control, much like entrepreneurial decisions in general.

5.3 FEATURES OF VENTURE CAPITAL INVESTMENTS

From the above description of venture capital, some of its characteristic features that distinguish it from other capital investments standout.

1. **Equity participation:** Venture capital financing is, basically equity finance in relatively new companies when it is too early to go to the capital market to raise funds. The equity funds help up the company to leverage further bank finance and provide a low-cost source of funds in the early stages of business, because dividends can be delayed unless the company starts making profits. Further, the equity investment implies that investor bears the risks of the venture and would earn of medium-term capital gains. The objective may be to keep the management under influence and force it to perform in the best interest of the project so financed.

2. Long term Horizon: Venture financing a long-term illiquid investment, not repayable on demand requires long-term investment attitude requiring the venture capital firms (VCFs) to wait for a long periods, say 5-10 years to make profits.

3. Participation in Management

According to Wilson, "Success in venture capital most often comes from a creative partnership in which the investor's lengthy and painful experience in the company formation process is combined with the entrepreneur's management skill and detailed knowledge of market or technology. Venture capitalists do not just invest, but they also contribute to the development of the company by providing the entrepreneur with active management advice, thus reducing the element of high risk.

They bring to the venture more than capital, although that is obviously the most tangible contribution. Besides being an investor he is disciplinarian, a sounding board and a point man with a valuable network of contacts with experts in technology and management areas, who can be called on to provide strategic inputs to the management team. This active involvement is assisted venture may be attributed to the fact that since the risks are high, venture capitalist in order to reduce uncertainties and to protect and enhance the value of his investment, becomes actively involved, which is commonly known as hands-on/after care management.

4. Value added Services

A distinctive feature of venture capital is the value-added services provided by the venture capitalists to the investee companies. Venture capitalists deal with numerous entrepreneurs of various ventures across industries. They have wide experience of handling diverse situations and are thus in a highly advantageous position to provide appropriate assistance and competent advice to the investee companies in their management and development. The most important services are:

- Acting as a sounding board for the investee company's planning and decision-making
- Helping in building networks of contacts for the investee company
- Providing advice and assistance in a highly professional and competent way in managerial and technical fields
- Helping in raising subsequent finances from banks or by organizing Initial Public Offerings (IPOs).

5. Managerial Support and Monitoring

Another distinctive feature of Venture financing is that VCFs not only provide finance but also managerial assistance to the entrepreneurs. The hands-on style is a form of supportive and direct involvement, which is generally practiced through the VCFs representation on the assisted firm's board. It also entails close and regular discussion between the venture capital fund manager and the entrepreneur on problems of technology, marketing and general management. The venture capitalist helps a great deal in shaping the stratifies, policies and practices and business plan of the entrepreneur's firm. He also assists in affecting prudent financial discipline. Some venture capitalists may choose to act passively, such as hands-off style. Under this they do not participate in management of the firm. A venture capitalist bases his assessment of the management on the evaluation of financial reports which the entrepreneur sends to them periodically. He may choose to follow a middle approach between the hands-on and hands-off styles of management. He may identify key decision areas such as capital investment, appointment of key personnel etc., on which he may like the entrepreneur to consult him. He can also specify the kind of information which the entrepreneur has to furnish regularly to him.

Whether or not a venture capitalist is directly involved in the management of the assisted firm, he has to develop a sound monitoring system needed not only to safeguard the capital of the venture capitalist but also to help in improving the worth of investment through timely actions. New entrepreneurs require continuous monitoring and support because of their managerial inexperience. Monitoring becomes easy and more effective if the venture capitalist also takes active participation in the management of the enterprise.

6. High-Risk Proposition

Venture capital financing involves high risk-return spectrum. Matthias Plum believes that "in the venture realm the business risks are usually higher, the assessment of progress in more tenuous, and the evaluation judgements are more difficult. A venture capitalist, while investing, assumes four types of risk, viz., management risk, when team may not be able to work together due to infrequent payrolls; product risk, when product does not become commercially viable; market risk, when product is not accepted by buyers in the market; and the operations risk arising from increased product cost and decreased gross margins. If these risks are successfully combated then the potential exits for very substantial reward.

7. Investment in Hi-Tech Areas

Venture capital is not technology finance, though technology finance may form a sub-set of venture capital financing. In reality, venture capitalists are attracted by the

prospect of high rewards to compensate themselves for the high risks they undertake and the pre-dominance of Hi-Tech investments made may be explained by the fact that in general terms hi-tech projects offer a high prospective terurn than projects in more traditional areas. The opportunities in low-tech areas are found to be scattered and miscellaneous. However, a venture capitalist looks not only for high technology but the innovativeness through which the project can succeed.

5.4 VISION OF VENTURE CAPITAL

The vision of venture capital is focused on new projects, seed capital, technology and innovation. It aims at

- Fueling ambitions and dreams
- Breathing life into promising business ventures
- Charting the course of incisive business ideas
- Providing foresight with a free sense of direction
- Helping in building enterprise vision
- Guiding smoothly over rough passages
- Partnering enterprises on to script thrilling success
- Complementing acumen and enterprise with a steady flow of resources
- Inspiring enterprises to script thrilling success,
- Venture capital finances are plotted on a firm lifecycle curve.

5.5 METHODS OF VENTURE CAPITAL FINANCING

Venture finance, conceptually being risk finance, should be available in the form of equity or quash-equity (conditional or convertible loans). A straight or conventional loan, involving fixed payments, would be unsuitable form of providing assistance to a new, risky venture. New ventures have the problem of cash flows in the initial years of their development; hence they are not able to service debt. However, the requirement for this kind of assistance could still arise in a few cases, particularly during the second stage of financing after the venture has taken off. Venture capital financing in India in the past took three forms: equity, conditional loans and income notes. Conventional loan has been a quite popular source of funds made available by VCFs in India in the past.

Equity

All VCFs in India provide equity. Generally, their contribution may not exceed 49 per cent of the total equity capital. Thus, the effective control and majority ownership of the firm may remain with the entrepreneur. When a venture capitalist contributes equity capital, he acquires the status of an owner, and becomes entitled to a share in the firm's profits as much as he is liable for losses. VCFs buy shares of an enterprise with an intention to ultimately sell them off to make capital gains. The advantage of the equity financing for the company seeking venture finance is that it does not have the burden of serving the capital, as dividends will not be paid if the company has no cash flows. The advantage to the VCF is that it can share in the high value of the venture and makes capital gains if the venture succeeds. But the flip side is that the VCF will lose if the venture is unsuccessful. Venture financing is a risky business.

Conditional loan

A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans in India, VCFs charged royalty ranging between 2 and 15 per cent gestation period, cost-flow patterns, risk and other factors of the enterprise. Some VCFs gave a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound. Some funds recovered only half of the loan if the venture failed.

Income note

A unique way of venture financing in India was income note. It was a hybrid security which combined the features of both conventional loan and conditional loan. The entrepreneur had to bay both interest on royalty on sales, but at substantially low rates. Some venture funds provided funding equal to about 80 percent of a project's cost for commercial application of indigenous technology adapting imported technology to wider domestic applications. Funds were made available in the form of unsecured loans at a lower rate of interest during development phase and at a higher rate after development. In addition to interest charges, royalty on sales could also be charged.

Other financing methods

A few venture capitalists, particularly in the private sector introduced innovative financial securities. The participating debenture; is an example of innovative venture financial. Such security carries charges in three phases: in the start-up phase, before the venture attains operations to a minimum level, no interest is charged. After this, a low rate of interest is charged up to a particular level of operation. Once the venture starts

operating on full commercial basis, a high rate of interest is required to be paid. A variation could be in terms of paying a certain share of the post-tax profits of royalty.

VCFs in India provide venture finance through partially or fully convertible debentures and cumulative convertible preference share (CPP). CPP could be particularly attractive in the Indian context since CPP shareholders do not have a right to vote.

In developed countries, like the USA and the UK, the venture capital firms are accustomed to using a wide range of financial instruments. They include:

1. **Deferred shares: –** where ordinary share rights are deferred for a certain number of years.
2. **Convertible loan stock: –** which is unsecured long-term loan convertible into ordinary shares and subordinated to all creditors.
3. **Special ordinary shares: –** with voting rights bit without a commitment towards dividends.
4. **Preferred ordinary shares: –** with voting rights and a modest fixed dividend right and a right to share in profits.

Venture capital funds abroad also provide conventional loans, hire-purchase finance, lease finance and even overdraft finance, but the overall financial package is always tilted in favour of equity component.

5.6 THE FUNDING PROCESS

The venture capital funding process typically involves four phases in the company's development:

1. Idea generation and submission of the Business Plan
2. Introductory Meeting
3. Due Diligence
4. Term Sheets and Funding

Source: http://www.edupristine.com/blog/venture-capital

Step 1: Idea generation and submission of the Business Plan

The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

Step 2: Introductory Meeting

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

In order to evaluate a company, one must have an initial understanding of it. Therefore, at Venture Valuation, we pursue a holistic evaluation approach. All valuations are based on a careful consideration of both hard facts and soft factors. We apply a thorough risk assessment of factors which include:

- Management
- Market
- Science and technology
- Financials / funding phase

To determine the value of a company as accurately and as objectively as possible, we use a mixture of different assessment methods. All methods are specifically suited for the evaluation of technology companies, with high growth potential and start-up companies of all types. Although not every kind of valuation method is appropriate, Venture Valuation assesses each company according to their industry and financing phase.

1. Discounted Cash Flow (DCF)

Method: The discounted cash flow method takes free cash flows generated in the future by a specific project / company and discounts them to derive a present value (i.e. today's value).

The discounting value usually used is the weighted average cost of capital (WACC) and is symbolized as the 'r' in the following formula:

DCF = Calculated DCF value

CF = Cash Flow

r = Discount rate (WACC: Weighted average cost of capital)

Uses: DCF calculations are used to estimate the value of potential investments. When DCF calculations produce values that are higher than the initial investment, this usually indicates that the investment may be worthwhile and should be considered.

2. Risk adjusted NPV

Method: The risk adjusted net present value (NPV) method employs the same principle as the DCF method, except that each future cash flow is risk adjusted to the probability of it actually occurring.

The probability of the cash flow occurring is also known as the 'success rate'.

$$DCF = \frac{CF_1}{(1+r)^1} + \frac{CF_{21}}{(1+r)^2} + \cdots + \frac{CF_n}{(1+r)^n}$$

$$DCF = \sum \frac{CF_n}{(1+r)^n}$$

Source: http://www.venturevaluation.com/en/methodology/valuation-methods

Uses: Risk adjusted NPV is a common method of valuing compounds or products in the pharmaceutical and biotech industry, for example. The success rates of a particular compound/drug can be estimated, by comparing the probability that the compound/drug will pass the various development phases (i.e. phases I, II or III) often undertaken in the drug development process.

Also known as: rNPV, eNPV (e=estimated/expected)

3. Venture Capital method

Method: The venture capital method reflects the process of investors, where they are looking for an exit within 3 to 7 years. First an expected exit price for the investment

is estimated. From there, one calculates back to the post-money valuation today taking into account the time and the risk the investors takes.

The return on investment can be estimated by determining what return an investor could expect from that investment with the specific level of risk attached.

Uses: The Venture Capital method is an often used in valuations of pre revenue companies where it is easier to estimate a potential exit value once certain milestones are reached.

4. Market comparable method

Method: The market comparable method attempts to estimate a valuation based on the market capitalization of comparable listed companies.

Uses: The market comparable method is a simple calculation using different key ratios like earning, sales, R&D investments, to estimate the value of a company.

5. Comparable Transaction method

Method: The comparable transaction method attempts to value an entire company by comparing a similar sized private company in a similar field, and using different key ratios. The price for a similar company can either come from an M&A transaction or a financing round.

Uses: The comparable transaction method is a simple calculation estimating the value of a target company based on comparable investments or M&A deals.

6. Decision Tree analysis

Method: Decision trees are used to forecast future outcomes by assigning a certain probability to a particular decision.

The name decision tree analysis comes from the ‘tree’ like shape the analysis creates where each ‘branch’ is a particular decision that can be undertaken.

Uses: Decision trees are used to give a graphical representation of options, strategies or decisions that can be undertaken to reach a particular goal or “decision”.

5.7 CASE STUDY

In May 2012, **Face book** raised US$ 16 billion through its Initial Public Offering (IPO), valuing the company at US$ 104.2 billion. Face book embarked on the IPO to meet regulatory requirements as well as raise the requisite funds for its future expansion.

It planned to use the funds raised through the IPO to develop new technologies, make acquisitions, and recruit the talented people needed for its future expansion. Face book was facing heightened competition from rivals like Google Inc. (Google) which had started its own social network, 'Google+'. Face book could not successfully expand itself into other internet services despite its attempts to provide new services like email.

So, it decided to focus more on social networking to expand its business. Face book started to concentrate more on increasing its revenues through mobile advertising as more and more people were accessing the internet through their mobile devices like smart phones. It started a new initiative for mobile devices called 'sponsored stories' where business organizations and individuals could pay Face book to highlight stories related to their businesses.

Face book also started to focus more on emerging markets as its growth rate in the developed markets was nearing saturation point. The company was getting more users from developing markets like India and Brazil. It started attracting more software developers to develop applications for emerging markets. To meet the problem of low PC penetration in the emerging markets, Face book planned to make its services more accessible on low-end mobile devices. It had entered into a global partnership with Media Tek, Inc. (Media Tek) in November 2011 to integrate Face book into Media Tek's mobile platform for low-end feature phones. It also acquired the mobile application developer Snaptu to bring the Face book application to more feature phones around the world. Despite the initiatives taken by Face book, its share price underperformed after it came out with its IPO, an indication of low investor confidence in its future growth prospects.

Face book was launched on February 4, 2004, by Mark Elliot Zuckerberg (Zuckerberg), an undergraduate computer science student at Harvard University. When he was studying at Harvard, Zuckerberg was actively engaged in building easy to build websites for students. In the process, he launched 'thefacebook.com' (Face book) from his Harvard dormitory room. The name of the site was taken from the Phillips Exeter Academy's student directory, The Photo Address Book, which students referred to as 'The Face book'. Zuckerberg studied in the Phillips Exeter Academy before joining Harvard.

Face book became an instant hit on the Harvard campus as all the students were interested in getting to know other students. Within the first 24 hours of its launch, 1,200 Harvard students had joined on Face book and half of the undergraduate students had a Face book profile within the first one month. The students and faculty of Harvard

could enlist themselves on Face book with an official Harvard email address along with their personal profile. Initially, it was possible to join Face book only after receiving an invitation from an existing member. This was done to restrict member listings and thereby ensure hardware functionality. After joining Face book, the personal profiles of the members along with their email addresses were made visible to all others. In this way, Face book enabled everyone with a Harvard email address to know about everyone else who shared the same email address. Many analysts attributed the early success of Face book to two key factors - the social necessity of knowing about others on the Harvard campus and technical filtering using the Harvard email address.

Enthused by the success of Face book on the Harvard campus, Zuckerberg introduced it on other university campuses with the help of his roommate Dustin Moskovitz (Moskovitz). In March 2004, Face book expanded to Stanford, Columbia, and Yale Universities. Gradually, it was opened to all other Ivy League schools and Boston University, New York University, and MIT. Once Facebook became a success in these universities, it was expanded to other universities in the US and Canada which had social contacts with Harvard University. The name of the site was changed from 'thefacebook.com' to 'facebook.com' in August 2005 and the address was purchased for a reported amount of US$200,000.

To meet its expansion needs, Face book started raising money through various channels, the most important among them being private placement of its shares. In one such important deal, Goldman Sachs and Digital Sky Technologies invested US$ 500 million in Face book in January 2011. The money raised by such private placement of shares was used by Face book to acquire smaller companies, recruit talented staff, and develop new products. Face book's shares started becoming increasingly popular in the private market. This popularity made Zuckerberg realize that it would have more than 500 shareholders by the end of 2011.

In a letter written to potential investors by Zuckerberg at the time of the IPO, he said that Face book was started with the social mission of making the world a more open and connected place. He hoped to achieve this by strengthening the way people related to each other. He further said in the letter that Face book worked to build tools to help people easily connect with others they liked and share what they wanted. Another task highlighted by Zuckerberg in the letter was improving how people connected to the business and the economy. After emerging as the top social network in the world, Zuckerberg started expanding Face book to ensure it would emerge as a leader on the internet.

Another area on which Face book was focusing to increase its revenues was mobile advertising. After the advent of the latest high-end smart phones, more and more people were using these phones to connect to the internet. Mobile ads were a growing niche in the online advertising space. Nearly half of the Face book users accessed the social network through their mobile phones in 2012. And that number was expected to swell further in future as even more people, mostly from developing countries, started using their mobile phones to access the internet.

As Face book had already emerged as the undisputed leader among all the social networking sites, there was not much scope for increasing its user base at least in the developed countries. Face book's growth rate in the US and some parts of Europe was nearing saturation point. Traditionally, nearly 25 percent of Face book's new users used to come from the US. But by the end of 2010, only 5 percent of its new users were from the US.

Despite all its expansion plans into other areas, a major chunk of Face book's total advertising still came from display advertising. If users spent more time on Face book, they ended up clicking on more advertisements which would resulted in more revenue. As the new user additions in developed countries slowed, making its existing users spend more time on its site was another way Face book was looking to maintain its growth rate. Face book started some initiatives like offering new features to make its existing users spend more time on the site.

Questions:

1. What are the issues and challenges in venture financing, especially for later stage companies
2. Explain the issues and challenges faced by the company in this case in expanding its businesses in a highly competitive market dominated by established players
3. Discuss and debate how Face book can use the funds it raised through the IPO to fuel its future expansion
4. Discuss the new strategies that Face book should follow to expand its reach in emerging markets

5.8 NOTES

5.9 SUMMARY

In the wake of globalization and its resultant, high competition as marks all national economies of the world, India being no exception. The banking and financial industry has been evolving to meet the changing requirements of the business from commercial banking to industrial finance, to venture capital financing. VC is based on the dictum that no innovative business idea shall meet its death for lack of venture capital finance. Among many features of VC, the note-worthy features are equity participation, long-term horizon, high-risk investment in high-tech areas. Broadly instruments of VC are equity and debt instruments. These two instruments of VC are equity and debt instruments. These two instruments are tailor made to fit into the requirements of portfolio enterprises in two stages namely, early stage and later stage. In early stage and included three sub-stages and later stage. In early stage are included three sub-stages viz., seed capital, start-up and second round finance. Later stage includes four sub-stages such as bridge capital, replacement capital, buyouts and turnarounds. VC activity is a four stage activity: generating deal flow, screening and due diligence, deal structuring and monitoring, and exit.

5.10 KEYWORDS

- **Venture Capital:** The capital which invest in the start-up, risky venture.
- **Venture Capital Fund (VCF):** The Fund which invested by the venture capitalist in new start-up, risky venture, expecting better future returns.
- **Equity Participation:** Equity participation is the ownership of shares in a company or property.
- **Risk Capital:** Risk capital consists of investment funds allocated to speculative activity and refers to the funds used for high-risk, high-reward investments such as junior mining or emerging biotechnology stocks.
- **Early Stage Financing:** Venture capital financing is a type of financing by venture capital. It is private equity capital provided as seed funding to early-stage, high-potential, growth companies (startup companies) or more often it is after the seed funding round as a growth funding round (also referred to as series A round)
- **Conditional Loan:** A Conditional loan means the loan is approved subject to additional conditions you must provide or meet to the satisfaction of the Underwriter.

5.11 SELF - ASSESSMENT QUESTIONS

1. What is venture capital? Describe the significance of venture capital.
2. Explain the process of Venture Capital Financing.
3. Describe the methods of Venture Capital Financing.
4. Explain the features of Venture Capital Financing.

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UNIT-6 : THE STAGES OF VENTURE DEVELOPMENT AND FINANCING

Structure:

6.0 Objectives
6.1 Introduction
6.2 Stages of Venture Capital Financing
6.3 The Funding Process
6.4 Exit Route
6.5 Methods of Venture Capital Financing
6.6 The Funding Process
6.7 Case Study
6.8 Notes
6.9 Summary
6.10 Keywords
6.11 Self - Assessment Questions
6.12 References

6.0 OBJECTIVES

After studying this unit, you should be able to;

- identify the stages of Venture Capital Financing
- explain the funding process of Venture capital financing
- design the exit routes of Venture Capital Financing
- evaluate related cases

6.1 INTRODUCTION

Venture capital is made available through equity participation to finance a project in its developmental stages which are spread to encompass the entire period of completion and growth of the project. The selection of investment by a venture capital company is closely related to the stage and type of investment. Venture Capital Companies (VCCs) all over the world follow more or less similar practices of financing. Enterprises in different stages of their growth with equity funds as per their requirements. In other words, venture capital financing is dependent upon the growth stages of corporate enterprises.

Venture capital companies all over the world follow more or less similar practices of financing. Enterprises in different stages of their growth are provided equity funds as per their requirements. In other words, venture capital financing is dependent upon the growth stages of corporate enterprises.

Venture capital plays a strategic role in financing small-scale enterprises and high technology and risky ventures. The activities of venture capital is quite advanced in the developed countries. It has also taken root in a number of developing countries. Venture capital has potential to become an important source for financing of Small-Scale Enterprises (SSEs).

Venture capital is a popular method of financing high technology and high-risk enterprises in developed countries like the United States, the United Kingdom, and Japan. And recently, a number of developing countries have established venture capital firms in the private and/or public sectors to finance technology-related and new small- and medium-sized enterprises. In the emerging markets of Asia, venture capital activity has been growing at an impressive rate, especially since the late 1980s.

6.2 STAGES OF VENTURE CAPITAL FINANCING

Table 1 - Stages of Venture Capital Financing (VCF)

Stages in VCF	*Name of Stage*	*Description of Status*
Stage 1	Seed	Conceptualization / Planning
Stage 2	Start-up	Operational / Production
Stage 3	Expansion	Expansion in Production / Marketing
Stage 4	Mezzanine	Last Stage before Public Offering
Stage 5	Buy-out	Acquisition of a Product Line / Business
Stage 6	Turnaround	Re-establishment of Business

Source: India Venture Capital and Private Equity Report, 2013

Based on the experiences of Venture Capital Companies (VCCs), the stages can broadly be divided into two broad categories viz., (i) early stage venture financing; and (ii) later stage venture financing. Under each of these two broad stages venture financing is provided in sub-divisions, the time span of each of which depends on the degree of risk involved.

Stages	*Period involved while funds are blocked up (in years)*	*Degree of Risk*	*Finance for the activity involved*
(1) Early-Stage Investment:			
(i) Seed capital	7-10	Extreme	Manufacturing and research based
(ii) Start-up	5-10	Very High	Business commitment
(iii) Second round	3-7	High	Marginal progress
(2) Later-Stage Investment:			
(i) Developmental finance	1-3	Medium	Expansion finance
(ii) Replacement finance	1-3	Low	Planned exit
(iii) Buy-outs	1-3	Low	New Management
(iv) Turnarounds	3-5	Medium to High	Rescue Finance

Table 2 Stages of Growth and Venture Capital Financing (VCF) is given in next page.

Source: India Venture Capital and Private Equity Report, 2013

Early-Stage Financing

Based on the stages of development of a business, the early stage financing may be sub-classified as seed capital, start-up finance and second round finance. During the first stage of starting a business, i.e., formulation of an idea stage, the risk associated is very high. Here an idea needs to be translated into a business proposition. So the finance required in this stage is the seed finance from the venture capital company. In the next stage, being the implementation phase, start-up finance from venture capital company is required for the purpose of implementing the appropriate production processes. In second

round finance, commercial production is to be started and beginners finance is required to develop marketing and other infrastructures.

1. Seed Financing Stage

This stage is a pre-start up stage needing funds for testing the prototype and giving it a commercial shape. This is the preliminary stage associated with Research and Development (R&D). Briefly the following situations are typical of the pre-starting stage.

- ♦ Research and development prior to commercial application
- ♦ Initial period of technology transfer, licensing stage for technology transfer
- ♦ Testing of proto-type prior to commercialization.
- ♦ Generating commercial awareness of the invention prior to marketing
- ♦ Industrial joint ventures
- ♦ Establishment of business by entrepreneur in university- or research institution – linked science parks.

2. Start-up stage

An entrepreneur may feel the need for finance when the business activity is just starting which involves the launching of a new business. Start-up of a new business activity may have the following features.

- New business activity could be based on the experiences of the industry experts, spin-off from R&D institutions, R&D of a big corporation, transfer of technology from overseas-based business, or a joint venture between an entrepreneur and a technology expert, etc;
- New product/service from the above activity yet to be tried;
- Entrepreneur lacks financial resources required for the enterprises.
- Indication of potential but untried market for the product/ service
- The enterprise, which has a formal organizational structure as a limited company, is no longer an individual owner-managed set-up but needs the support of experts.

3. Second Round Finance

The circumstances under which second-round finance is needed by an enterprise after start-up may be positive or negative. The reasons are:

- Over-runs in the project before completion necessitating a second round of equity funding to avoid liquidations
- A period of loss after start-up, necessitating equity-type funding for maintaining acceptable debt-equity ratio
- Inability to get further equity finance from other sources, necessitating backing by venture capitalists who have earlier provided funding.

On a positive note, if a start-up is successful and the business is growing space, additional funding is required for expansion.

Later Stage Financing

It refers to post-early stage financing when a project has established itself and business is spreading its wings and is looking for higher growth. Funds are utilized for further plant expansion, marketing, working capital or development of an improved product. The fund seeks a minimum level of achieved profitability in a potential investee. In United States such type of financing is popularly called 'mezzanine finance', combing equity with debt or subordinate debt packages which after significant spreads.

Most VCCs in India as well as developed countries prefer investing in the later stage of a project for the following reasons:

- For immediate income in addition to expected high capital gains
- To gain high controlling interest in the enterprise by increasing the quantity of funds

The various sub-divisions of later-stage financing are:

- Expansion or developmental finance
- Replacement capital
- Buy-outs
- Turnarounds

1. Expansion or Developmental Finance

Expansion of an undertaking or enterprise may be through an organic growth or by way of acquisition or takeover. For the venture capitalist there is no difference between the two growth forms from the point of investment.

In the case of organic development the entrepreneur retains maximum equity holding. In case of acquisition equity holdings of the purchases and the investor could be in the ratio of 50:50 depending upon the net-worth of the required business, its purchase price and the amount raised from the investors by the acquiring company.

2. Replacement Capital / Money-out Deal

Replacement capital, which essentially means substituting one shareholder for another rather than raising new capital, aims at enhancing the equity base in an enterprise, resulting in a change of owners/ownership pattern of the enterprise. Venture capitalists make finance available by purchasing existing shares from entrepreneurs or their associates to reduce their holdings in the unlisted company. This sale if shares may be by persons other than entrepreneurs or their associates. This is known as 'money out deal'. The venture capitalist may buy ordinary shares from vendors and may convert them into preference shares bearing fixed dividend coupons. Such shares may be reconverted into ordinary shares if the company is listed or sold. This mode of later-stage financing was much in vogue when unlisted security markets or over-the-counter-sales were not developed, but is not very common now.

3. Buy-outs

Buy-outs, which refer to transfer of management control, fall into two categories viz., Management Buy-Outs (MBOs) and Management Buy-Ins (MBIs). In MBOs funds are provided by the VCCs to enable the current operating management to acquire an existing product line/business. In MBIs funds are provided to enable an outside group of managers to buy an on-going company. They usually bring three elements together i.e. a management team, a target company and an investor. They are less popular than MBOs. An MBIs is inherently more risky because the management comes from outside who finds it difficult to assess the actual potential of the target company. Generally, MBIs are able to target only the weaker under-performing companies.

4. The Leveraged Buyouts (LBOs),

By contrast, is a less risky mechanism that enables a venture capitalist to invest in solid, on-going businesses, for example, by buying subsidiaries from top heavy conglomerates. It has low-business risk because the company has existed for sometime and often has a positive cash flow to service the debt needed for an LBO.

5. Turnaround / Recovery Finance

Turnaround deal, which implies the recovery of an enterprise, resembles early-stage financing where the business is not yet profitable. Turnaround situations arise when established company runs into trouble, even bankruptcy, and needs money to prepare for a major restructuring to revitalize profit growth. The company may also face mounting debt burden, and slowing down of cash inflows, and need more funds to reach a recovery point. The enterprise may seek a moratorium from creditors for unpaid liabilities. The original entrepreneur may be compelled to relinquish the enterprise to a new management. The venture capitalist plays an active role in such a situation by providing more equity investments and deploying managerial experts.

6.3 THE FUNDING PROCESS

The venture capital funding process typically involves four phases in the company's development:

1. Idea generation
2. Start-up
3. Ramp up
4. Exit

Step 1: Idea generation and submission of the Business Plan

The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

Step 2: Introductory Meeting

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project

in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

6.4 EXIT ROUTE

Every ownership position in every company held by a venture capitalist is for sale. Venture capitalists are not in the business of owning and operating companies. They are in the business of investing for a period of time, helping build up a business, and then cashing in on those investments by selling their positions. The precise timing of exit depends on several factors such as nature of the investment, the extent and type of financial stage, the state of actual and potential competition, market condition, and the style of functioning as well as perception of the investee companies and so on.

Venture capitalist typically aims at making medium to long-term capital gains. They generally want to cash-out their gains in 3-7 years after the initial investment. They play a positive role in directing the company towards particular exit routes. A venture capitalist can exit in four ways.

- Initial Public Offerings (IPOs)
- Acquisition by another company
- Re-purchase of the venture capitalist's share by the investee company
- Purchase of the venture capitalist's share by a third party.

1. Initial Public Offerings (IPOs)

Most venture capitalists will spend a great deal of time talking about the virtues of going public. By establishing a public market, entrepreneur can take a position in the market. The public market gives the venture capitalists an exit for part of the VC fund's holdings and a method of selling additional shares as time goes on. In a publicly owned

company in which the venture capitalists merely has an investment, the role of the VC in the policy making is relatively small.

Over the last several years, private equity sponsors have increasingly been looking to the public markets to exit portfolio company investments. Although there is nothing new about sponsors exiting through an initial public offering, stockholders agreements entered into by sponsors at the time of the original investment have not always anticipated properly the various nuances of owning interests in a public company and the expectations of a sponsor (and management and its co-investors) with respect to the sell-down of that investment and post-IPO governance arrangements.

2. Acquisition by another company

The venture capitalist and the entrepreneur selling the entire company to another individual or a large conglomerate or to another company. This will rid both entrepreneur and the venture capitalist and dissolve the agreement. This helps the entrepreneur to start a new company without the assistance of VCF.

When the entire company is sold to a conglomerate, the venture capitalist and entrepreneur will be paid in one, two, or three different kinds of payments for the purchase of the stock in the company or the assets of the company. There are six basic ways in which a company may be sold. They are,

i. **Selling stock for cash:** The simplest of all methods is to sell the stock of the company to someone else for cash. This triggers capital gains and is a straight-forward method of selling your company.

ii. **Selling stock for notes:** The acquisition company may buy the stocks owned by the entrepreneur in his company, by giving a note that pays off over a certain period of time. These notes are called 'paper', when these notes are taken back and the process is called as 'take back paper', and these notes are taken back in the place of cash.

iii. **Selling stock for stock:** This is the process of taking stocks in a very large conglomerate or strategic buyer for the stock that entrepreneur own. The tax benefit can avail by the entrepreneur until the day he sells those shares.

iv. **Selling assets for cash:** This is the situation where entrepreneur agrees to sell all of the assets for cash. All the operating assets and all the operating liabilities are assumed by the buying corporation for a specified cash amount. The company left with only cash as its asset.

v. **Selling assets for notes:** The entrepreneur can take notes, secured by the assets being sold as payment in the case where the acquiring company not in a position to pay the cash for purchase.

vi. **Selling assets for stock:** If entrepreneur is receiving, as payment for the assets, registered shares (or even shares that are restricted), it is quite easy to exchange the assets for the stock in a large conglomerate.

3. Re-purchase of the venture capitalist's share by the investee company

This is another way exit of VCF from the venture. The entrepreneur may purchase venture capitalist holding shares of the company. If the entrepreneur does not have the cash he can borrow the loan from bank and buy the shares, and this leaves the entrepreneur and any other stakeholders owning 100 percent of a company.

4. Purchase of the venture capitalist's share by a third party.

Sometimes entrepreneur may be able to find an investor who will buy the ownership position of the venture capital firm. Perhaps the new owner become a working partner.

6.5 METHODS OF VENTURE CAPITAL FINANCING

Venture finance, conceptually being risk finance, should be available in the form of equity or quash-equity (conditional or convertible loans). A straight or conventional loan, involving fixed payments, would be unsuitable form of providing assistance to a new, risky venture. New ventures have the problem of cash flows in the initial years of their development; hence they are not able to service debt. However, the requirement for this kind of assistance could still arise in a few cases, particularly during the second stage of financing after the venture has taken off. Venture capital financing in India in the past took three forms: equity, conditional loans and income notes. Conventional loan has been a quite popular source of funds made available by VCFs in India in the past.

Equity

All VCFs in India provide equity. Generally, their contribution may not exceed 49 per cent of the total equity capital. Thus, the effective control and majority ownership of the firm may remain with the entrepreneur. When a venture capitalist contributes equity capital, he acquires the status of an owner, and becomes entitled to a share in the firm's profits as much as he is liable for losses. VCFs buy shares of an enterprise with an intention to ultimately sell them off to make capital gains. The advantage of the equity

financing for the company seeking venture finance is that it does not have the burden of serving the capital, as dividends will not be paid if the company has no cash flows. The advantage to the VCF is that it can share in the high value of the venture and makes capital gains if the venture succeeds. But the flip side is that the VCF will lose if the venture is unsuccessful. Venture financing is a risky business.

Conditional loan

A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans in India, VCFs charged royalty ranging between 2 and 15 per cent gestation period, cost-flow patterns, risk and other factors of the enterprise. Some VCFs gave a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sound. Some funds recovered only half of the loan if the venture failed.

Income note

A unique way of venture financing in India was income note. It was a hybrid security which combined the features of both conventional loan and conditional loan. The entrepreneur had to bay both interest on royalty on sales, but at substantially low rates. Some venture funds provided funding equal to about 80 percent of a project's cost for commercial application of indigenous technology adapting imported technology to wider domestic applications. Funds were made available in the form of unsecured loans at a lower rate of interest during development phase and at a higher rate after development. In addition to interest charges, royalty on sales could also be charged.

Other financing methods

A few venture capitalists, particularly in the private sector introduced innovative financial securities. The participating debenture; is an example of innovative venture financial. Such security carries charges in three phases: in the start-up phase, before the venture attains operations to a minimum level, no interest is charged. After this, a low rate of interest is charged up to a particular level of operation. Once the venture starts operating on full commercial basis, a high rate of interest is required to be paid. A variation could be in terms of paying a certain share of the post-tax profits of royalty.

VCFs in India provide venture finance through partially or fully convertible debentures and cumulative Convertible Preference Share (CPP). CPP could be

particularly attractive in the Indian context since CPP shareholders do not have a right to vote.

In developed countries, like the USA and the UK, the venture capital firms are accustomed to using a wide range of financial instruments. They include:

1. **Deferred shares: –** where ordinary share rights are deferred for a certain number of years.
2. **Convertible loan stock: –** which is unsecured long-term loan convertible into ordinary shares and subordinated to all creditors.
3. **Special ordinary shares: –** with voting rights bit without a commitment towards dividends.
4. **Preferred ordinary shares: –** with voting rights and a modest fixed dividend right and a right to share in profits.

Venture capital funds abroad also provide conventional loans, hire-purchase finance, lease finance and even overdraft finance, but the overall financial package is always tilted in favour of equity component.

6.6 THE FUNDING PROCESS

The venture capital funding process typically involves four phases in the company's development:

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Step 2: Introductory Meeting

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

6.7 CASE STUDY

Henry Kravis (Kravis), the man who was once touted as King Henry, was under pressure in early 2003. The company that he had cofounded in 1976, Kohlberg, Kravis & Roberts (KKR), along with his cousin George Roberts (Roberts) and mentor Jerome Kohlberg (Kohlberg) was at the crossroads. While Kohlberg had left the firm long back, Kravis and Roberts at 60 were approaching the end of their careers. The Leveraged Buyout (LBO) business in which the company specialized had been in a slump since the late 1990s. Competition from other firms had significantly eroded KKR's market share. Kravis wondered what KKR needed to do under the circumstances.

Performance of LBO funds declined from an annualized return of 35% in 1989 to 20% in the first quarter of 2000. In the same period, venture-capital returns soared to over 50% from 5%[2]. This made investors sceptical about investing in LBO fund. Oregon Investment Council (OIC) and Washington State Pension Funds (WSPF) had been the foremost investors in KKR's takeover ventures during the period 1986 to 2002.

The Oregon Treasury had committed $2.34 bn of retirees' pension money in various KKR takeovers. By and large, the pension fund had been handsomely rewarded. The state had invested an additional $800 mn in KKR's latest fund in 1996, as it believed the company's ill-fated takeover of RJR Nabisco in 1989 was an exception and that most of

its deals earned annual returns of 20% or more. The state's most prominent KKR deal, the 1981 buyout of Fred Meyer Inc., had fetched returns of nearly 22% annually.

WSPF and OIC had decided to pull out of a deal to invest up to $1 bn in a direct stake in KKR. WSPF did so because of fears about the liquidity of the investment. The fund needed the flexibility to sell assets to meet potential withdrawals. OIC had pulled out taking a cue from WSPF's decision. The $30 bn Massachusetts Pension Reserves Investment Management System decided against investing in the KKR Millennium Fund after putting money into KKR's previous funds. The $ 8.5 bn Montana Board of Investments, an investor in KKR funds since 1987, also complained that KKR had held its stakes for too long. It would be pulling out of the next fund.

Some early forays in the 1990s were among KKR's most successful ventures. It made $ 2.25 bn on a $280 mn investment in the Bank of New England and $1.97 bn on a $300 mn investment in insurer American Re Corp. In 1996, KKR raised a record $6 bn. The firm averaged two investments a year from 1987 to 1994. It tripled its pace from 1995 to 1999. From early 2000, KKR found the deals drying up. After making two investments in 2000, KKR did not close a single new deal in 2001. Instead it pumped $ 475 mn into existing holdings. Before its $ 225 mn April 2002 buyout of Covanta Energy Group, KKR's most recent US buyout had been in November 2000: The $1.2 bn purchase of chemical company Rockwood Specialties. In July 2002, KKR agreed to Europe's biggest-ever buyout, the $ 5.1 bn purchase of electrical products maker Legrand SA from Schneider Electric SA. That same week, KKR bought seven industrial businesses from Siemens AG for $ 1.7 bn. KKR had made only one new investment in the US in the period early 2002 till fall 2002. In September 2002 KKR bought BCE Inc.'s Canadian yellow pages business for $ 1.8 bn.

It had been the experience, ingenuity and resources of KKR that had set the firm apart. KKR was in the business of identifying compelling investment opportunities and acting as a catalyst to bring together the right people and the right financial and operational resources to create substantial value for its investors and management-partners.

In 2003, though KKR believed that its capabilities had never been greater, it looked thin on management talent even as competition had intensified. Kohlberg had left the firm in the mid-1980s after developing serious differences of opinion with his two younger colleagues. Kravis and Roberts were approaching 60.

KKR was facing an acute shortage of good people. It had just 12 partners and 28 other executives. In contrast, firms like Carlyle and Blackstone, each of which employed

more than 400 people could assign dozens of executives to each transaction. KKR had tried to make up for its smaller size with greater attention to detail. The 10 partners other than Kravis and Roberts were on average 45 years old. Scott Stuart, 43, and Ned Gilhuly, 42, served on the firm's investment committee with Michael Michelson, 51, Kravis and Roberts. KKR no longer controlled the LBO business or intimidated its rivals like it once used to. As the number of attractive deals decreased, buyout firms were sharing takeover targets. LBO firms were raising funds much more quickly than they were able to invest them. Caught amidst the vagaries of the market and the shrinking pie of potential acquisitions, KKR seemed like it was past its prime. The dearth of deal-flow was looming like a large black cloud on this once invincible firm's horizon."

Questions:

1. Explain Venture Capital financing in KKR
2. What process of Venture Capital Financing was adopted in this case?
3. Describe the methods of Venture Capital Financing considered by KKR

6.8 NOTES

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6.9 SUMMARY

The seeds of Venture capitalism that were sown in the US long back have become a big rewarding crop today. Apart from the wealth-creation and job-creation, Venture capitalism have made big returns for their investors, created industries and paved the road for future innovations. Though riskier than other asset classes, the uncertainty involved in this class of investments is worth the social benefit it creates and sustains. Without VCs we might not have seen companies such as Apple, Compaq, Sun Microsystems, Intel to name just a few.

Venture capital funds are potential instruments of growth and sustenance of emerging industries in an economy. Venture capital is required for innovative products and services to prosper in a competitive market. VCs strive to provide entrepreneurs with the support they need to create scalable business with sustainable growth, while providing their contributors with outstanding returns on investment, for the higher risks they take.

6.10 KEYWORDS

- **Start-up:** A startup company (startup or start-up) is an entrepreneurial venture which is typically a newly emerged, fast-growing business that aims to meet a marketplace need by developing or offering an innovative product, process or service. A startup is usually a company such as a small business, a partnership or an organization designed to rapidly develop scalable business model. Often, startup companies deploy technologies, such as Internet, e-commerce, computers, telecommunications, or robotics. These companies are generally involved in the design and implementation of the innovative processes of the development, validation and research for target markets. While start-ups do not all operate in technology realms, the term became internationally widespread during the dot-com bubble in the late 1990s, when a great number of Internet-based companies were founded.

- **Expansion:** Expansion is the phase of the business cycle when the economy moves from a trough to a peak. It is a period when the level of business activity surges and Gross Domestic Product (GDP) expands until it reaches a peak.

- **Mezzanine:** Mezzanine financing is a hybrid of debt and equity financing that gives the lender the rights to convert to an ownership or equity interest in the company in case of default, after venture capital companies and other senior lenders are paid.

♦ **Buy-out:** A buyout is the purchase of a company's shares in which the acquiring party gains controlling interest of the targeted firm. A leveraged buyout (LBO) is accomplished by borrowed money or by issuing more stock.

♦ **Turnaround:** A turnaround is the financial recovery of a company that has been performing poorly for an extended time. To effect a turnaround, a company must acknowledge and identify its problems, consider changes in management, and develop and implement a problem-solving strategy.

♦ **IPO:** An Initial Public Offering (IPO) is the first time that the stock of a private company is offered to the public. IPOs are often issued by smaller, younger companies seeking capital to expand, but they can also be done by large privately owned companies looking to become publicly traded.

♦ **Exit Route:** An exit strategy is a contingency plan that is executed by an investor, trader, venture capitalist or business owner to liquidate a position in a financial asset or dispose of tangible business assets once certain predetermined criteria for either has been met or exceeded.

6.11 SELF - ASSESSMENT QUESTIONS

1. Identify and explain the various stages of Venture Capital Financing
2. How the funding process of Venture capital financing is done?
3. Elaborate theexit routes of Venture Capital Financing.

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UNIT-7 : VENTURE CAPITAL FIRMS

Structure:

7.0 Objectives

7.1 Introduction

7.2 Conceptual Framework

7.3 Structure of Venture Capital Firms

7.4 Venture Capital Industry in India

7.5 Sector Wise Comparison of Venture Capital Investment

7.6 Geographical Distribution of Investments

7.7 Case Study

7.8 Notes

7.9 Summary

7.10 Keywords

7.11 Self - Assessment Questions

7.12 References

7.0 OBJECTIVES

After studying this unit, you should be able to;

- explain the structure of Venture Capital financing
- sketch out Venture Capital Industry in India
- classify the different sectors of Venture Capital Financing
- evaluate related cases

7.1 INTRODUCTION

Government, semi-government, or private firm that provides startup or growth equity capital and/or loan capital to promising ventures for returns that are higher than market interest rates.

In the 20th century, technology companies often required tens or hundreds of millions of dollars to build out and prove. Companies like Intel, Microsoft, Amazon and Google required hundreds of millions of dollars to scale up to the size where they were proven winners. This was one of the factors that led to venture capital firms becoming ever larger.

Being a VC fund manager was also a great job for the fund principles, once the fund was large enough. Most VC funds are structured so the fund managers charge a management fee of about 2.5% of the value of the fund each year. The management fee pays the salaries of the fund managers and their support staff. A small VC firm usually has four partners and some support staff. This means that the annual operating budget for even a small fund quickly grows to more than $2 million per year.

Most VC managers believe a fund under $100 million isn't economical. The goal of most VC managers is to grow the fund to several hundred million, in part, because then they can start pull down some very attractive compensations. This is another reason that venture capital firms have continued to grow.

7.2 CONCEPTUAL FRAMEWORK

Startup or growth equity **capital** or loan **capital** provided by private investors (the**venture capitalists**) or specialized financial institutions (development finance houses or **venture capital firms**). Also called risk **capital**. **Venture capital** is a type of funding for a new or growing business.

Venture Capital firms invest funds on any business with a professional outlook. Given the nature of equity financing, venture capital investors are therefore exposed to the risk of the company failing. As a result the venture capitalist must look to invest in companies which have the ability to grow very successfully and provide higher than average returns to compensate for the risk. Venture capitalist's management approach differs to that of a lender or a bank. The bank does not participate with the management and keeps its ties away from the venture's management, operations and other decision making. When venture capitalists invest in a business they typically direct and guide the venture so as to lead it towards capital gains. They are a crucial part of the company's decision making and occupy a place in board of directors. These professional venture capitalists act as mentors and aim to provide support and advice ona range of management, sales and technical issues to assist the company to develop its full potential.

7.3 STRUCTURE OF VENTURE CAPITAL FIRMS

The private equity and venture capital (PE/VC) industries have grown tremendously over the past few decades. However, due to the relatively recent development of the industry and the private nature of these investments, there have been relatively few studies addressing the structural and organizational factors that have led to a larger and more efficient PE/VC industry. While this paper will give a general overview of the PE/VC industries and the organizational characteristics of PE/VC funds, I am particularly interested in determining the key characteristics of limited partnership contracts that govern the relationship between the general partners (GPs) who manage PE/VC funds and the limited partners (LPs) who invest capital in these funds. Due to potential problems of adverse selection and moral hazard between the GPs and the LPs, the compensation structure and covenants set out in contracts are key factors by which investors are able to screen and monitor PE/VC professionals. If these contracts can be appropriately designed to align the GP's incentives with those of the investors, then the PE/VC industry will continue to be an attractive market for long-term, high-reward investments. This paper will address the various principal-agent problems that arise in PE/VC investing and will seek to provide a broad model that characterizes the key explanatory variables for GP compensation and covenant levels.

The organization of the venture capital market has three major players and an assortment of minor ones. Venture capital firms are intermediariesbetween investors (the capital suppliers) and entrepreneurs (the founders or investees). The venture capitalist typically serves as general partner and the investor as limited partner. The capital of

venture funds is committed by the limited partners, who are typically pension plans and life insurance companies but also endowments, banks, corporations and wealthy individuals.Unlike the investor, whose liability is limited to her committed capital, the general partner bears unlimited liability.

Venture capitalists are responsible for managing a partnership's investment and contribute only a small fraction of the partnership's capital personal (around one percent). Hence, the important part to investigate is the amount of effort that they invest into the partnerships to increase the value of their portfolio. This effort is primarily put into the relationship between venture capitalist and entrepreneur. Therefore capital commitment is only one part of the relationship and consulting the other one. The effort in consulting of a portfolio company is the main difference between venture capital financing and standard debt or direct equity financing. It plays a crucial role considering the return on investment. On average a venture capitalist spends more than one hundred hours a year in consulting a portfolio company. Generally they become a member of the board of directors and support the entrepreneur primary in respect to establish tactics and strategies or recruit or dismiss key individuals. Only in some cases he is involved in the day-to-day operations. This effort of the general partner is not compensated in cash. The compensation of the venture capitalist can be divided into two main parts, the management fee, and some percentage of the profit in the life of a fund. Typically management fee increases annually with the rate of consumer price inflation.

Sometimes a third relationship is mentioned in this context, the intra-organizational relationship between partners and employees. Most venture capital firms consist of general partners and personnel that mainly support them in administrative work. They are organized as management companies, i.e. several pools of capital are managed by few people. Due to considering this as a standard employer-employee problem it will not be discussed in this paper. Certainly this can be said about the portfolio company and its staff, too.

To understand the relationship of investor, venture capitalist and entrepreneur it is necessary to understand the venture capital cycle. The first step of the venture capitalist is to develop an investment strategy and find potential capital suppliers, e.g. for raising a fund. Each partnership has a limited lifetime, which is mostly ten years. The success of fund raising depend primary on the vibration of the public market and also on the reputation of the venture capital firm. Typically the number of limited partners that commit capital to the fund is not fixed, but mostly varies between ten to thirty investors. On the other hand the portfolio companies which are funded typically consist of ten to fifty

investees. The fundraising process is followed by the investment process. This one is distinguishable in the collection of information about potential portfolio companies, checking whether these companies meet the criteria of the investment strategy andthan negotiate about investment condition with the portfolio companies. After the investment has been made, entrepreneur and venture capitalist try to increase the value of the company. The last stage of the “venture cycle” is the exit of the investment. Five main groups can be classified: initial public offering (IPO), acquisition exit, secondary sale, buyback exit and write-off. Typically, the most profitable exit opportunity is an initial public offering; however the administrative costs and requirements for information disclosure are high. In general, this process repeats itself, after three to five years, when the investment phase of the existing partnership has been completed. Thus the investment is a continuous process.

7.4 VENTURE CAPITAL INDUSTRY IN INDIA

Venture capital is not a new phenomenon in the world; it is growing with a great pace. Venture capital industry growth rate holds steady in India. This industry is still at a nascent stage in India. Two decades ago, Indian companies were receiving low amount of venture capital. The scenario changed in late 1990s with the growth of India’s IT sector companies. During five year period from 2000 to 2005, the industry growth rate in India was the fastest globally and it rose to occupy the number three slot worldwide in terms of quantum of investments.

Venture capital has played a major role in developing entrepreneurship in India by building up professional companies which compete globally. It has made smart money available for projects which cannot be funded by conventional methods like IPOs (Initial Public Offer). The quality of entrepreneurs has improved considerably in the last decade. Entrepreneurs have the motivation to compete globally and the necessary attributes to build successful companies. Still Indian venture capital industry is far from reaching its full potential and growth is low in comparison to the other countries.

As Private Equity firms invested $7.5 billion (over 384 deals) in India during the 12 months ending December 2013, representing one of the lowest levels of investment made in the last four years in both value and volume terms. According to analysis by Venture Intelligence, a research service focused on private company financials, transactions and valuations, in 2013 private equity investment numbers, were down over 18.5% compared to the $9.2 billion (across 484 deals) invested in 2012. 154 investments worth about $2.3 billion, Information Technology and IT-Enabled Services (IT & ITES)

companies topped in terms of both investment value and volume during 2013. India's recent success story in the area of information technology has shown that there is a tremendous potential for growth of knowledge based industries. This potential is not only confined to information technology but is equally relevant in several areas such as biotechnology, pharmaceuticals and drugs, agriculture, food processing, telecommunications, services, etc. Given the inherent strength by way of its skilled and cost competitive manpower, technology, research and entrepreneurship, with proper environment and policy support, India can achieve rapid economic growth and competitive global strength in a sustainable manner.

VC activity in India was largely in line with 2012 levels in terms of deal value and volume. While the number of deals fell marginally by 2% compared to 2012, the amount invested increased by 13%. India saw revenue-generation stage investment decline to 63% of total investment in 2013, down from 82% in 2012. However investments made at a profitable during the year represented a third of total investment — more than double the proportion in 2012. This indicates both that investors continue to be cautious about the early stage, and are increasingly confident in making late –stage investments in companies as they scale. A slowdown in economic growth — to less than 5% at the end of 2013 –is, to the extent, impacting investor confidence and the impending Federal Election in mid-2014 is having a similar effect, as investors take a cautious approach ahead of a potential change in administration.

Angel Activity funding is gathering pace in India. India's funding ecosystem is evolving at pace. As the number of people with high levels of disposable income increases, crowd funding is expected to generate more interest and angel funding is clearly becoming more established. Over the last 2 years, the percentage of angel and incubator participation in India-at 16% in 2013, up from 3% in 2011 — has been bettered in just one other hotbed: Canada, with 19% in 2013. Significantly in India the product development and revenue generation are the only two development stages that are attracting significant

interest from angel investors and incubators, in contrast to other markets where the focus tends to be mainly on start-ups. The rise in angel funding has been recognized by government. It has produced new regulations that will help to lay the foundations needed to formalize this form of investment and help to ensure its future growth.

7.5 SECTOR WISE COMPARISON OF VENTURE CAPITAL INVESTMENT

Table 3: The Distribution of Investments in Different Industry Sectors.

Industry	*Total Investment ($, Million)*	*% of total investment*	*No of deals*	*% of total deal*	*Average Investment/deal ($, million)*	*No of Companies*
Agriculture and healthcare	156.69	12%	54	10%	3.48	35
BFSI	835.3	64%	287	55%	3.02	72
Engineering and construction	29.08	2%	40	8%	1.04	16
IT and ITES	59.64	5%	34	7%	2.39	19
Manufacturing	1.39	0%	7	1%	0.28	5
Travel and Transport	1.2	0%	1	0%	1.20	1
Other services	39.07	3%	35	7%	1.56	17
Non-financial consumer services	180.91	14%	65	12%	3.23	47
Total	**1303.28**	**100%**	**523**	**100%**	**2.82**	**212**

Source: India Venture Capital and Private Equity Report, 2013

Investments were classified into eight categories based on the industry / sector. In terms of investment, close to two-thirds of the total investment has been in the BFSI segment, most of which can be attributed to the micro-finance segment. The other sectors that account for a reasonable amount of investment are Agriculture & Healthcare and Nonfinancial Consumer Services. These three industries account for 90% of the total

investments. The trends are similar when the analysis is done based on the number of investments. Though the proportion of BFSI is the largest even when considered by the number of deals, it does not account for as large a proportion as it does when the analysis was based on investment value. In terms of the number of deals, the top three sectors account for 77% of the total. Of the total number of companies that have received investment, 72 (34%) are in the BFSI sector. It can be seen that this proportion is considerably lower as compared to the proportion accounted for by the BFSI sector when the analysis was in terms of investment amount or the number of deals. While the top three sectors accounted for 73% of the total companies that have received venture investments, the dominance of BFSI has considerably reduced. The ratio of number of deals to number of companies is the highest for BFSI sector (3.98) among all the sectors. An inference from this trend is that investors seem to be more upbeat about the prospects of companies in the BFSI sector, which is evidenced by the number of investors investing in companies in the BFSI sector as compared to other industries. The trends in impact investment differ markedly when compared to other segments of venture capital investing. For example, BFSI segment accounts for only 24% of the overall VCPE investment. In terms of number of investments, IT & ITES and Manufacturing sector were the top two sectors in the overall VCPE investments. Analysis of incubation investments revealed that IT & ITES accounted for the highest proportion of incubates, whereas BFSI contribution was just 1%. The trends in angel investments were similar to that seen in incubation support. Impact investments are thus characterized by a high degree of concentration in the BFSI segment, because of the micro-finance sector. Average investment per deal presents an interesting picture. The average investment per deal in impact investments works out to be $2.82 million. This is much lower than the overall average deal size ($32million) seen in VCPE investments. This is also lower than the average deal size seen in early stage VCPE investments ($12.6 million).

7.6 GEOGRAPHICAL DISTRIBUTION OF INVESTMENTS

It can be seen that Southern region clearly dominates across all parameters. It accounts for 65% of the total investment, 55% of the total deals, and 48% of the total companies that have received investment. The ratio of number of deals to number of companies is also the highest for South (2.84) as compared to that of the other three regions. The average investment per deal is also the highest for South, and difference between South and West, which has the second highest average investment per deal is close to 30%. This indicates the favorable conditions for business, entrepreneurship, and investment in the Southern region. Though Western region, comprising investment

friendly states such as Maharashtra and Gujarat, should also rank favorably on the above characteristics, there is substantial difference in the numbers between the two regions. The dominance of the Southern region is more prominent in the impact investments segment as compared to the overall trends in VCPE investments. While most VCPE investment happened in companies in the Western region (~40%), in terms of number of investments, Southern region accounted for the largest share (~40%). But the difference between South and West is not as high as what is seen in the case of impact investments. However, the trends in impact investment seem to be in line with the trends seen in incubation support, which is characterized by a strong dominance of incubate from the Southern region.

Table 4: Distribution of Investments by Region

Region	*Total Investment ($, Million)*	*% of total investment*	*No of deals*	*% of total deal*	*Average Investment/deal ($, million)*	*No of Companies*
East	61.47	5%	30	6%	2.20	17
North	181.85	14%	109	21%	1.96	42
South	847.93	65%	290	55%	3029	102
West	212.03	16%	94	18%	2.55	51
Total	**1303.28**	**100%**	**523**	**100%**	**2.82**	**212**

Source: India Venture Capital and Private Equity Report, 2013

Table 5: Distribution based on Year of Investments

Year	*Investment ($, Million)*	*Cumulative % of total investment*	*No of deals*	*Cumulative % of total deal*	*Average Investment/deal ($, million)*	*No of Companies*
2001	7.82	1%	8	2%	0.98	5
2002	18.02	2%	2	2%	9.01	2
2003	0.67	2%	2	2%	0.34	2
2004	1.25	2%	6	3%	0.21	4
2005	8.52	3%	19	7%	0.50	14
2006	121.04	12%	42	15%	3.10	28
2007	273.39	33%	83	47%	2.09	52
2008	162.77	45%	83	47%	2.09	52
2009	277.79	66%	98	66%	3.02	58
2010	235.62	84%	82	81%	3.57	58
2011	160.27	96%	70	95%	2.72	39
2012	36.12	99%	28	100%	0.98	5
2013	7.82	100%	8	100%	0.98	5

Source: India Venture Capital and Private Equity Report, 2013

This indicates that the impact investment as a sector is in the very early stages. The investment activity picked up only after 2006. The noticeable drop in investment activity during 2011 and 2012 can be attributed to the micro-finance crisis and also to the general slowdown in the VCPE industry during these years. The number of yearly investments that happen in the impact segment is only a fraction of the overall VCPE investments. The average amount of impact investments made in a year is around $180million (based on the investments during the seven year period (2006–12), whereas

the average yearly VC investment in India during the same period is about $812million. During the same period is about $9.1 billion. Therefore, in terms of size, impact investments account for about 22% and 2% of the total VC and PE investment in the country. However, the picture changes slightly when analyzed in terms of number of deals. There is an average of about 69 impact investments in a year (during 2006 –12), whereas in the case of VC and PE investments, it is about 354and 878respectively for the same period. Thus, in terms of deals, impact investments are about 20% and 8% of the deals in the VC and PE investments respectively. Since impact investments is at a much lower proportion of the overall VCPE investments, when compared in terms of investment amount as compared to that of number of deals, the inference is that the average investment size is much smaller as compared to the overall VCPE industry. As the segment matures, and when a greater number of companies that have obtained early stage funding start getting late stage funding, the average investment per deal can also be expected to increase.

7.7 CASE STUDY

On June 23, 1998, Deepak Singhania (Singhania), managing director, LML Ltd (Lohia Machines Ltd)., received letters from two companies of the Piaggio Group. The letters curtly informed him that four of the group companies would be merged with Piaggio & C SpA on July 1, 1998, under a restructuring plan. There had also been a change in the shareholding pattern.

Singhania immediately sensed that the reorganization and the changing shareholding pattern of Piaggio & C SpA would strengthen the anti-Singhania faction in Piaggio. Proactively, Singhania invoked certain articles of the joint venture agreement with Piaggio. He contended that he had the right to buy out Piaggio’s stake in LML.

According to him, the demise of Giovanni Alberto Agnelli(Giovanni) triggered an event that gave LML the right to purchase Piaggio’s stake. He took the matter to the court of the civil judge (Senior Division) Kanpur. Singhania’s petition contended that Piaggio should be forced to sell its stake.

During the same time, Piaggio moved the International Court of Arbitration (ICA), Paris, contesting Singhania’s claim. The Kanpur court gave an interim order restraining both LML and Piaggio from selling their holdings. This sequence of claims and counter-claims by LML and Piaggio continued for more than a year. In November 1999, the partners finally entered into a ‘good-faith out-of-court settlement’ under which LML

bought Piaggio's stake. Piaggio, established in 1884 in Pontedera, (Pisa, Italy), was one of the world's leading producers of motorized two-wheeled vehicles.

A leader in the European two-wheeler market, the company was also a manufacturer of three- and four-wheeled light transport vehicles and engines. The Piaggio family owned the company until December 1999, after which Morgan Grenfell Private Equity, a member of the Deutsche Bank Group, acquired 81.5% stake.

The remaining 18.5% stake was held by Umberto Agnelli (10%), and Texas Pacific Group (8.5%). Piaggio entered the Indian automobile market in 1948, by launching its two-and three-wheelers in Mumbai. Very soon, the company signed a licensing agreement with Bajaj Auto for the production of two- and three- wheelers locally.

Piaggio had many firsts to its credit. It was the first European manufacturer to launch a 4-stroke scooter in 1995. In 1997, the company produced the first and only scooter in the world with an injected 2-storke engine, - Vespa ET2 Injection. This scooter, it was claimed to reduce emissions by up to 70% and fuel consumption by up to 30%, as compared to other scooters. In 2000, Piaggio was the first European manufacturer to introduce a 50cc 4-stroke engine. It also developed the innovative range of four stroke LEADER (Low Emission Advanced Engine Range) engines, which included engines of 125 to 180 cc with air or liquid cooling and two or four valves. Lohia Machinery Ltd. (LML), established in 1975 in Kanpur, was a manufacturer of textile machinery.

The LML-Piaggio relationship started with a licensing agreement in 1984, for the production of Vespa. The contract was later converted into a technical and financial joint venture in 1990, with Piaggio taking up a 23.6% equity stake in LML. In the same year, LML was spun off as a separate company. The Indian promoters had a 23.6% equity stake in the new company. Two of these were Singhania, and his brother Lalit Singhania, who held the stake through a holding company, Suryodaya Trading and Investment Co. The third Indian promoter was Sanjiv Shreya, a cousin of the Singhanias, who held the stake through Gold Rock Investments. Piaggio held the stake through Piaggio Vespa BV and Piaggio & C SpA. However, Singhania believed that Giovanni personally held the stake.

Questions:

1. Evaluate the relationship between Venture Capitalist and Entrepreneurs base on the private equity in this case.
2. Critically assess the Principal-Agent problem in PE/VC Financing in LML-Piaggio relationship.
3. Explain the Limited Partnership Structure appeared in this case.

7.8 NOTES

7.9 SUMMARY

So it is observed that around two-thirds of the total impact investment has been in the BFSI segment, most of which can be attributed to the micro-finance segment. We can also visualize the other major sectors that accounts for considerable amount of investment are Agriculture & Healthcare and Non-financial Consumer Services. These three industries account for 90% of the total investments. The trends in impact investment differ markedly when compared to other segments of venture capital investing. For example, BFSI segment accounts for only 24% of the overall VCPE investment. It is also concluded that in terms of number of investments, IT&ITES and Manufacturing sector were the top two sectors in the overall VCPE investments.

7.10 KEYWORDS

- **Private equity (PE):** PE is capital that is not noted on a public exchange. **PE** is composed of funds and investors that directly invest in **private** companies, or that engage in buyouts of public companies, resulting in the delisting of public **equity**.
- **Leveraged buyout** (**LBO**): LBO is the acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition. The assets of the company being acquired are often used as collateral for the loans, along with the assets of the acquiring company.
- **Limited Partnership (LP):**LP is a form of **partnership** similar to a general **partnership**, except that where a general **partnership** must have at least two general partners (GPs), a **limited partnership** must have at least one GP and at least one **limited partner**.
- **General Partnership (GP):** GP is an arrangement by which partners conducting a business jointly have unlimited liability, which means their personal assets are liable to the **partnership's** obligations.
- **Venture Capital Firms:** Government, semi-government, or private firm that provides startup or growth equity capital and/or loan capital to promising ventures for returns that are higher than market interest rates.

7.11 SELF - ASSESSMENT QUESTIONS

1. Explain the structure of Venture Capital financing and its importance.
2. Bring out the importance of Venture Capital Industry in India
3. Describe the different sectors of Venture Capital Financing

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UNIT-8 : THE ROLE OF STAGING AND VC MONITORING IN RESOLVING PRINCIPAL – AGENT CONFLICTS

Structure :

8.0 Objectives
8.1 Introduction
8.2 Conceptual Framework
8.3 Venture Capital Firm
8.4 Relationship between Venture Capitalist and Entrepreneurs
8.5 Principal-Agent Issues within PE/VC Settings
8.6 Overview of the Limited Partnership Structure
8.7 Case Study
8.8 Notes
8.9 Summary
8.10 Keywords
8.11 Self - Assessment Questions
8.12 References

8.0 OBJECTIVES

After studying this unit, you should be able to;

- explain Venture Capital Firm
- evaluate the relationship between Venture Capitalist and Entrepreneurs
- assess the Principal-Agent problem in PE/VC Financing
- explain the Limited Partnership Structure
- evaluate related cases

8.1 INTRODUCTION

The principle-agent problem (agency dilemma) exists when conflicts of interest arise between a principal and an agent in a business setting.

The principal-agent relationship is an arrangement in which one entity legally appoints another to act on its behalf. In a principal-agent relationship, the agent acts on behalf of the principal and should not have a conflict of interest in carrying out the act. The relationship between the principal and the agent is called the "agency," and the law of agency establishes guidelines for such a relationship.

The formal terms of a specific principal-agent relationship are often described in a contract. For example, when an investor buys shares of an index fund, he is the principal, and the fund manager becomes his agent. As an agent, the index fund manager must manage the fund, which consists of many principals' assets, in a way that will maximize returns for a given level of risk in accordance with the fund's prospectus.

The principal-agent relationship can be entered into by any willing and able parties for the purpose of any legal transaction. In simple cases, the principal within the relationship is a sole individual who assigns an agent to carry out a task; however, other relationships under this guise have a principal that is a corporation, a nonprofit organization, a government agency or a partnership. The agent is most often an individual capable of understanding and ultimately carrying out the task assigned by the principal. Common examples of the principal-agent relationship include hiring a contractor to complete a repair on a home, retaining an attorney to perform legal work, or asking an investment advisor to diversify a portfolio of stocks. In each scenario, the principal is the individual seeking out the service or advice of a professional, while the agent is the professional performing the work.

Young growth companies and ventures have always been essential for the development of a country's economy and its society. Obtaining finance for the risky ventures has always been problematic, especially since in the beginning of the project a significant investment without immediate return is necessary. "Before the profit, there is risk", still holds centuries later, as the venture capital industry offers equity finance to risky ventures, i.e. young growth companies. This risk is not only due to the venture's innate risk but also to the danger that the entrepreneur/discoverer may behave in a selfish and undesirable way. In addition to the problems that come with any economic transaction, there are special problems of asymmetric information. The finance of young growth companies that have the potential to become giant corporates influencing our daily lives is a very current issue. The Internet boom in the 1990s opened the door for the transition to the information society. Big corporates that we perceive as established players today not long ago were start-ups: Microsoft, Dell, AOL, Virgin, Wal-Mart or SAP are just some examples for that. Most of these companies were funded with venture capital, i.e. external equity. Although currently experiencing a setback in its development, venture capital has been a growing market for the past three decades and plays an important role in financing young high risk companies, especially in the innovative high-tech sectors, such as biotech or nanotech.

8.2 CONCEPTUAL FRAMEWORK

Definition: The principle agent problem arises when one party (agent) agrees to work in favor of another party (principle) in return for some incentives. Such an agreement may incur huge costs for the agent, thereby leading to the problems of moral hazard and conflict of interest. Owing to the costs incurred, the agent might begin to pursue his own agenda and ignore the best interest of the principle, thereby causing the principal agent problem to occur.

Description: The costs to agent and subsequent conflict of interest arise due to the skewed information symmetry and the risk of failure faced by the principal.

For example: Shareholders of a company appoint managers to look after the proceedings of the company and earn profits on their behalf. The shareholders expect the managers to distribute all the profits to the shareholders. But the managers sensing their own growth and salary expectation try to retain the profits for future as a safe side. This can lead to principle agent problem. It is one of the most noticed problems in the current situation when most companies are not being managed by the owners themselves.

8.3 VENTURE CAPITAL FIRM

The organization of the venture capital market has three major players and an assortment of minor ones. Venture capital firms are intermediariesbetween investors (the capital suppliers) and entrepreneurs (the founders or investees). The venture capitalist typically serves as general partner and the investor as limited partner. The capital of venture funds is committed by the limited partners, who are typically pension plans and life insurance companies but also endowments, banks, corporations and wealthy individuals.Unlike the investor, whose liability is limited to her committed capital, the general partner bears unlimited liability.

Venture capitalists are responsible for managing a partnership's investment and contribute only a small fraction of the partnership's capital personal (around one percent). Hence, the important part to investigate is the amount of effort that they invest into the partnerships to increase the value of their portfolio. This effort is primarily put into the relationship between venture capitalist and entrepreneur. Therefore capital commitment is only one part of the relationship and consulting the other one. The effort in consulting of a portfolio company is the main difference between venture capital financing and standard debt or direct equity financing. It plays a crucial role considering the return on investment. On average a venture capitalist spends more than one hundred hours a year in consulting a portfolio company. Generally they become a member of the board of directors and support the entrepreneur primary in respect to establish tactics and strategies or recruit or dismiss key individuals. Only in some cases he is involved in the day-to-day operations. This effort of the general partner is not compensated in cash. The compensation of the venture capitalist can be divided into two main parts, the management fee, and some percentage of the profit in the life of a fund. Typically management fee increases annually with the rate of consumer price inflation.

Sometimes a third relationship is mentioned in this context, the intra-organizational relationship between partners and employees. Most venture capital firms consist of general partners and personnel that mainly support them in administrative work. They are organized as management companies, i.e. several pools of capital are managed by few people. Due to considering this as a standard employer-employee problem it will not be discussed in this paper. Certainly this can be said about the portfolio company and its staff, too.

To understand the relationship of investor, venture capitalist and entrepreneur it is necessary to understand the venture capital cycle. The first step of the venture capitalist

is to develop an investment strategy and find potential capital suppliers, e.g. for raising a fund. Each partnership has a limited lifetime, which is mostly ten years. The success of fund raising depend primary on the vibration of the public market and also on the reputation of the venture capital firm. Typically the number of limited partners that commit capital to the fund is not fixed, but mostly varies between ten to thirty investors. On the other hand the portfolio companies which are funded typically consist of ten to fifty investees.

The fundraising process is followed by the investment process. This one is distinguishable in the collection of information about potential portfolio companies, checking whether these companies meet the criteria of the investment strategy and then negotiate about investment condition with the portfolio companies. After the investment has been made, entrepreneur and venture capitalist try to increase the value of the company. The last stage of the "venture cycle" is the exit of the investment. Five main groups can be classified: initial public offering (IPO), acquisition exit, secondary sale, buyback exit and write-off. Typically, the most profitable exit opportunity is an initial public offering; however the administrative costs and requirements for information disclosure are high. In general, this process repeats itself, after three to five years, when the investment phase of the existing partnership has been completed. Thus the investment is a continuous process.

8.4 RELATIONSHIP BETWEEN VENTURE CAPITALIST AND ENTREPRENEURS

The venture capitalist is the investor that may provide the funds for the venture of the entrepreneur. The first problem in this relationship arises during the selection of the entrepreneur by the venture capitalist. Reasons for the selection problem are different qualifications among entrepreneurs. The entrepreneur knows her project best and has the incentive to overstate her position, because she may obtain a bigger stake in the financial return of the company or get a lower discount rate. If the venture capitalist tries to preselect by using very high discount rates, he might have the unintended effect to scare away the most competent entrepreneurs to seek for alternative capital sources like debt financing. A counterproductive result could be the adverse selection in a pool of entrepreneurs that have no other financing options. It is obvious that the entrepreneur has much more information about the technical part of the project. On the other side the venture capitalist may have much deeper insight into the economic quality of the project, i.e. he knows if there might be a market for the project or not. That venture capitalists

are screening several hundreds of investment proposals each year confirms the difficulty of the adverse selection problem.

8.5 PRINCIPAL-AGENT ISSUES WITHIN PE/VC SETTINGS

A fertile ground for studying principal-agent issues is within the PE/VC industries, where information asymmetry is rampant between the investors and entrepreneurs looking for start-up capital. Private equity/venture capital is a unique and expensive source of financing sought by companies that do not have access to traditional bank loans or capital market financing due to their high risk, sometimes unproven track records, and severe information problems presented to investors. Investments in these firms require intensive pre-investment due diligence, post investment monitoring, and a long time horizon before returns can be realized, which further inhibits the ability of these firms to raise capital through traditional outlets such as public security offerings. Over time, however, the PE/VC industry has developed mechanisms to mitigate the various information asymmetry problems inherent in this industry in an attempt to minimize the agency loss – the potential loss that arises due to imperfect information between principals and agents. The two primary informational problems within the principal-agent framework are known as hidden information, or asymmetric information, and hidden action, or moral hazard. These agency problems are prevalent in the PE/VC industry.

Hidden information problems exist when an agent is privy to something that the principal has not observed. This information would influence how the principal values the agent's actions. The agent then uses this superior information when making business decisions, but the principal is not aware of whether or not the agent used the hidden information in the best interest of the principal. Rather, the principal only knows that the agent used the information in his own best interest. In the PE/VC industry, the entrepreneur (agent) may have better information than the investor (principal) regarding the prospects of his business, technology, and managerial skills. Consequently, it is in the best interest of the entrepreneur, seeking the highest valuation possible, to highlight the positives while downplaying the negatives of his enterprise. This hidden information is especially prevalent in the venture capital industry, where entrepreneurs may not have a proven track record and are not required to issue public financial statements. Hidden action problems can arise throughout the normal operation of the business, when the investor (principal) cannot directly observe the effort levels exerted by the entrepreneur (agent). These entrepreneurs, if not appropriately incentivized by the investors, can take

actions that give themselves private benefits at the expense of the investors; for example, if the entrepreneur did not retain an adequate equity stake in the firm, he may shirk and invest in perks rather than productive investments.

In order to mitigate these hidden information and hidden action problems, the limited partnership organizational structure has become the vehicle of choice for the majority of private equity investments. On one hand, the managers of these private equity partnerships have the requisite time and expertise necessary to conduct due diligence in selecting investments and monitoring the start-up funds following investment. Surely, it would be inefficient for each investor to conduct this time intensive diligence and monitoring because

1) there would be too much overlap in the monitoring conducted by the investors, or

2) some investors would free-ride off the monitoring services of others.

Thus, it is often more efficient to allow the experienced private equity fund managers to solely engage in contracting and monitoring activities. In addition to the diligence and monitoring costs, institutional investors do not invest in private equity because they may not reach the critical mass necessary to achieve expertise in making these investments, and they could potentially lose the benefits of diversification that comes with investing through private equity funds, each holding a portfolio of firms.

Limited partnership structure is created as an intermediary to reduce the agency problems between the investor and entrepreneur, the limited partnership itself creates an agency relationship between the investor (principal) and the fund managers (agents). The agency relationship between the LPs (principals) and the GPs (agents) can potentially lead to both adverse selection and moral hazard problems.

One of the primary adverse selection problems arises since the GPs may have better information regarding their talent or skill level in investing funds than do the LPs. If there were no profit sharing rule, then it would be more difficult for the LP to choose between two competing PE/VC organizations raising their first fund. With the profit sharing, the LPs can screen between those GPs that have a lot of confidence in their abilities and those who are not willing to take the majority of their compensation in carried interest. In addition, the profit sharing rule allows the LP to monitor the GP throughout the life of the fund. Since the GP receives the bulk of his compensation through the carried interest, he will be continually motivated to exert appropriate effort levels rather than shirking. Thus, the use of pay-for-performance incentives in typical PE/VC partnerships helps to alleviate the hidden information and hidden action problems that could potentially arise over the life of the partnership. Likewise, various covenants

are included in limited partnership agreements to mitigate the information asymmetry between the LPs and the GPs. For example, covenants may limit the amount a PE/VC fund can invest in the organization's earlier funds.

The information on earlier funds' investments may not be publicly available, and venture capitalists may seek to invest more money in an unprofitable investment made by their earlier fund in the hopes of salvaging a failing investment. Since the LPs do not have as much information on these issues, this particular covenant curbs the hidden information problem. In addition, one of the most common moral hazard problems between the LP (principal) and GP (agent) is monitoring the effort level exerted by the agent. In PE/VC funds, the GPs actively manage the fund's activities, but the LPs who commit capital cannot perfectly observe the effort levels exerted by the GPs. Since the effort levels are correlated with the outcome, or profitability of the fund, the LPs must incentivize the GPs to exert appropriate effort levels in structuring and monitoring investments in order to maximize the LP's own returns. However, if GP compensation were a fixed amount, then GPs would shirk and exert the minimum effort level required to remain employed and retain the fixed salary.

To address this moral hazard problem, LPs typically share profits with GPs to give them incentives to create the most value for the fund. In addition, there are various covenants included in limited partnership agreements that specifically limit the activities of the GPs. For example, covenants may limit the amount of personal funds a GP can invest in a single firm, to ensure proper effort levels are exerted across all investments; other covenants restrict the different asset classes and amounts of capital that GPs can invest in order to reduce the level of risk chosen by the GP. Thus, contractual covenants and compensation schemes are two primary ways that the limited partnership structure addresses adverse selection and moral hazard problems between investors and the PE/VC fund managers. For the reasons outlined above, the limited partnership has become an intermediary between the investor and the entrepreneur that allows for the private equity market to function more efficiently.

8.6 OVERVIEW OF THE LIMITED PARTNERSHIP STRUCTURE

As mentioned earlier, the most widespread organizational structure used in PE/VC investing is the limited partnership, through which limited partners (LPs) passively invest money in funds which are actively managed by general partners (GPs). In order to maintain their limited liability status, the LPs cannot participate in the day-to-day decision-making processes of the funds; hence, the LPs are not able to actively monitor

the GP's actions. In the PE/VC industry, the agents are the GPs who have practically full information over the fund's activities, performance, and their own effort levels exerted. In order to protect the interests of the LPs, the limited partnership agreements try to maximize efficiency and minimize the informational asymmetries between LPs and GPs through contractual (compensation and covenant) features. Typical PE/VC Limited Partnerships agreement is a long-term commitment, spanning a period of 10-13 years with terms renegotiated very rarely. During the first three to five years of the fund's life, the GPs conduct extensive due diligence on potential investments and execute investments in chosen portfolio firms. Following majority stake investments, the GPs secure board and voting rights and actively help manage their portfolio firms. GPs typically add value through their industry and financial management expertise and through their experience in hiring key management personnel, dealing with suppliers, and overseeing daily operations. Once most of the committed capital is put to work in portfolio firms, GPs generally begin the fundraising process for another fund in order to continue to make investments in the market. However, in the later years of the fund's life, the GPs must return capital and profits to their LPs, and thus, they look for potential exits for their portfolio firms. Common exit strategies can include a private sale to a third party, a recapitalization, or an initial public offering (IPO) which generally provides the bulk of returns for PE/VC funds.

The venture capital cycle beginning with fundraising, followed by GPs structuring and monitoring investments, and concluding with exiting investments occurs continually so long as there is enough demand for the services that the PE/VC GPs provide. The limited partnership structure incorporates two key features to align the incentives of the GPs with those of the LPs throughout this PE/VC cycle:

1) Performance Incentives and

2) Direct Means of Control

Performance Incentives:

The two main types of performance incentives for the GPs are reputation and compensation. Developing a sound reputation is critical in the PE/VC industry in which there are a relatively few number of key players who interact repeatedly. Due to the limited lifetime of the limited partnership structure, a fund must develop a proven track record in order to raise additional funds in the future and remain in the PE/VC business. Reputation may also allow GPs to raise larger funds, to negotiate higher profit sharing percentages, and to gain access to better deals.

In addition to developing a good reputation with the investment community, GPs are very concerned with their compensation structure, which has a fixed component and variable component. The GPs generally receive a fixed annual payment, or management fee, of roughly 1.5-2.5% of the fund's total committed capital in order to cover day-to-day operations and monitoring costs of the portfolio companies. The bulk of the GP's compensation, however, typically comes in the form of a variable payment, or carried interest, in 13 which the GP shares a certain percentage, usually 20%, of the profits of the fund after the initial capital is returned to the LPs. This performance-based pay reduces hidden action problems by giving GPs an incentive to exert appropriate effort levels in managing the fund. The carried interest can also help to limit excessive risk taking, or "swinging for the fences" which could result in lower overall profits for the fund and thus lower GP carry. The carried interest induces GPs to make responsible investments in order to first return capital to their investors because then only will they share in any profits. At the same time, however, the typical carried interest structure can be viewed as a fraction of a call on the value of the fund. From this perspective, the performance-based pay could induce GPs to increase the riskiness of their investments in order to increase the value of their call option. The true affect of this carried interest feature will only be borne out through time, but here it will suffice to say that the preferred return can have different implications for its use in different situations. In addition, certain non-venture funds, and to a lesser extent venture funds, have the added provision that GPs must meet some minimum hurdle-rate or achieve a "preferred return" before taking their 20% share of the profits.

The most common preferred return, or hurdle rate, is 8% for both venture and non-venture funds. The 8% represents the annual compounded return that GPs must provide for their investors, over and above returning their initial capital, before beginning to share in the upside profits of the fund. While the payoff structure for carried interest without preferred return provisions is similar to a fraction of a call option on the total value of the fund's capital, the payoff diagram for carried interest with preferred returns is significantly different from a call option. Under preferred returns, the GP must first return to investors their total invested capital including growth at the preferred return rate. Then, the GPs are entitled to 100% of the profits until it catches up to its carried interest percent on the total committed capital; any incremental revenue above this amount is split between the GP and LP according to the carried interest amount. Since the probability that the GP begins sharing in the profits is reduced by preferred return

provisions, the expected and actual compensation received by GPs may be much lower than without these provisions.

Direct Means of Control:

While carried interest and preferred returns represent performance-based metrics utilized by limited partnerships to align the incentives of the LPs and GPs, there are also direct means of control that influence and restrict the actions of the GPs. Thus, in some cases, the largest LPs are able to sit on advisory boards for the limited partnership. While these advisory boards cannot take an active role in the management of the fund's resources, the board can provide an advisory and oversight role when key decisions are made for the fund – such as the hiring or firing of a GP. More commonly, however, LPs are able to add a variety of covenants that control the actions of the GPs. These restrictive covenants can be viewed as a cost to the GPs of entering a partnership agreement or conversely, an added perk for LPs that enter into partnerships.

Although the power and extent to which advisory boards are used is fairly limited, it is common for these partnership agreements to include covenants which protect the interests of the investors (LPs) and help to ensure that proper actions are taken by the GPs. Here, it should be noted that these additional information problems could potentially be mitigated by variations in compensation structures, such as lower fixed pay and higher carried interest. However, we do not observe drastic changes to compensation structures in practice because this would attract unwanted attention from regulators and investors. For example, in a sample of over 400 venture 15 capital partnerships whose first fund closed between January 1978 and December 1992, Gompers observes that 81% of the funds had carried interest figures ranging from 20-21%, which seems quite homogenous. This apparent clustering may indicate that while carried interest remains fairly stable across funds, variations in control may primarily come through the addition or subtraction of covenants which are a much less obvious way to adjust for particular informational asymmetries that exist within the PE/VC industry.

Thus, it has been classified common covenants into three functional groups:

1. those related to overall fund management,
2. those governing the activities of GPs, and
3. those restricting the type of investments made by the VC fund.

Since carried interest shows little variation, covenants may be a key factor in the total benefits received by GPs since covenants serve as a restriction on GPs time, action, and compensation.

There were different covenant types that fit this criterion, and each was categorized into one of three groups depending on whether the covenant governed

1) the overall management of the fund,
2) the activities of the GP, or
3) the permissible types of investments

The first category involves covenants that control the overall management of the fund. An example of such a covenant would be to limit the dollar amount invested in any one firm. Since GPs may be inclined to bail out faltering investments through additional follow-on funding, this covenant reduces the potential agency costs between GP and LP. Another way to look at the agency problem is to consider the GP as holding a call option on the value of the fund; all else equal, the GP would like to increase the variance of the fund by investing in only a few firms. Hence, this particular covenant limits the GP's ability to take on excessive risk. Using the same options framework, the GP would be able to increase the variance of the funds' returns by taking on debt or guaranteeing the debt of portfolio firms. Consequently, LPs may contract for a covenant that limits the GPs ability to borrow additional funds. Other covenants that fall into this category include restrictions on co-investing with earlier or later funds or reinvesting profits of the fund into firms requiring additional capital. These covenants make specific actions prohibitively unlikely by mandating approval from an advisory board or a supermajority vote.

The second broad class of covenants includes those associated with restricting specific activities of the GPs. Since the GP's effort is unobservable to the LP, yet highly correlated with fund performance, LPs favor covenants that prevent GPs from shirking or focusing on only certain portfolio firms. Thus, limited partnerships agreements can include covenants that limit the GP's ability to invest personal funds in portfolio firms. If a GP invests a large sum in one portfolio fund, for example, he would be motivated to put more effort into monitoring that one investment perhaps at the expense of other portfolio firms. Thus, the LP may require the GP to invest equally across all investments, if allowing them to invest any money at all. In addition, to keep GP effort levels high it is critical that GPs do not sell off their interest in the profits of the fund to a third party. Even though only a weak and illiquid market exists for GP interests, a covenant preventing this type of GP activity is critical in keeping GP effort level high. Other covenants in this group may restrict the GP's ability to participate in outside activities, such as sitting on the advisory boards for the community, since this may reduce the time available for

GPs to add value to their investments. Similarly, the GP may be restricted from raising additional funds, which is a time consuming process, before all of the capital of the current fund is invested.

Finally, GPs may try to reduce their effort levels or increase the scope of their fund by bringing on less experienced GPs. However, this would reduce fund returns for the LPs, and thus, they try to restrict the ability of the GP to hire additional personnel to manage a given fund. The third general category of covenants restricts the permissible types of investments that can be made by the GPs. These covenants are primarily motivated by the fact that compensation levels for PE/VC professionals are much higher relative to typical money managers and investment manager. While the typical money manager investing in public securities receives an annual fee of a mere .5% of asset, the typical PE/VC GP will receive a management fee of 2% along with carried interest of 20%. Thus, it would not be efficient for LPs to compensate GPs at such high levels if GPs merely invested in public securities. Thus, LPs typically specify the different types of asset classes and the allowable percentage of total capital that can be dedicated to each asset class. Another agency conflict can arise if the GP wishes to accumulate private benefits from investing LP money in markets that the GP has no prior experience in the hopes of gaining experience. With this additional experience, the GP will be able to raise more and larger funds focusing on other industries; this was a concern in the 1980s when many venture capitalists began investing in leveraged buyouts in the hopes of gaining this additional experience. All else equal, however, the LP would like to limit these actions that may reduce the expected value of their fund.

Principal-Agent Framework

Now that we have explored the basic structure of the PE/VC industry and the common contractual features of the limited partnership organization, we will take a closer look at the principal-agent relationship that can arise between the investor (LP) and the fund manager (GP). We will first evaluate the general principal-agent relationship and then discuss 4 models which we will use to measure the time-series and cross-sectional variations in contracting between the GPs and LPs. The learning and signaling models help to explain the differences over time in compensation and covenant levels, while the supply-demand and costly contracting models help to explain differences in compensation and covenant levels across PE/VC funds. The general principal-agent relationship is prevalent in many business settings and everyday life. Generally, when one individual, the principal, depends on the actions of another individual, the agent, an agency relationship exists. Thus, the patient is the principal and the doctor the agent, and corporate

managers are the agents, the shareholders their principals. Within this agency framework, the agent must choose an action from a number of alternative possibilities knowing that this action affects the welfare of both the principal and the agent. An added characteristic is that the principal generally determines the payoff rules before the agent chooses an effort level and undertakes a specific action. While the agent's action or effort level is not directly observable by the principal, the outcome of the agent's action is discernible. However, the outcome is only partially driven by the agent's chosen effort and action since the outcome may be influenced by some exogenous random variable. If the action were completely dependent on the agent's action, then the principal would be able to determine with certainty the agent's action once the outcome is observed.

The central problem arises in agency relationships whenever the principal cannot cost less monitor the agent's information and effort level. While the agent has better information about the specific nature of his task, the principal has a better idea of what he wants accomplished. Due to this information asymmetry, the interests of both the principal and agent may not be aligned. Thus, the real-world firm performs less efficiently than if there were perfect and costless information shared between principal and agent, and this reduction in efficiency is known as agency loss. Over time, principals and agents have created mechanisms to minimize this agency loss through contractual agreements that help principals to monitor and to provide proper incentives for agents. There are four different principal-agent models that will be used to analyze the PE/VC limited partnership contracts and the key compensation schemes for GPs. The first two models, the Learning Model and the Signaling Model, deal primarily with time series differences in GP contract features; the second two models, the Costly Contracting Model and the Supply-Demand Model, will help to explain cross-sectional variations in limited partnership contracts. Each of these models makes predictions regarding the actions of the principal and agent when contracting and the resulting effect on GP (agent) compensation.

Learning Model

The learning model assumes that neither the venture capitalist nor the investor knows the ability of the venture capitalist when raising a first fund. This is not unlikely since GPs may have been hired from various professions, such as academia or industry, which may require different skill sets from those required for successful private equity

investing. The fund's return is then a function of the GP's ability to select and monitor investments, the GPs effort, and some random noise. While the LPs cannot directly observe the GP's effort level, the LP can determine the general quality of the GP from analyzing the fund's performance, which will be positively correlated with GP effort and ability. Thus, investors in the second fund will have better information about GP quality due to verifiable information about returns from the GP's first fund returns.

Signaling Model

Unlike the learning model which assumes symmetric information (insofar as neither the GP nor the LP knows the ability of the GP in the first period), the signaling model assumes that the GP and investor have asymmetric information regarding the skill level of the GP when raising an initial fund. Specifically, the signaling model assumes that the GP has better information regarding his skill level than the investor in the first period. To differentiate themselves, the high-ability GPs will attempt to signal their superior capabilities by accepting more risky, variable compensation at the expense of more stable, fixed compensation. Even low-ability GPs will attempt to signal that they are of high-ability by accepting higher variable compensation at the expense of fixed compensation. This model predicts that the second fund's carried interest will be the same for both high- and low-ability GPs, but the second fund's compensation will differ in the fixed management fees charged. The more experienced GPs will require higher fixed fees as a form of insurance, which the lower quality GPs will not be able to negotiate.

Costly Contracting Model

The basic premise of the Costly Contracting model is that negotiating contracts between LPs and GPs is costly and that renegotiation of contracts is prohibitively expensive. Thus, when establishing a contract that will serve for the fund's entire life, GPs and LPs must weigh the potential benefits of including a provision into the contract against the costs of having that feature included. For example, the benefits of adding covenants that restrict the behavior of GPs must be weighed against the costs of monitoring behavior based on the covenant and the extra time and resources used in adding that covenant to the contract. This theory predicts that an LP will be more likely to add contractual features that restrain GP action when there are either more benefits associated with adding that feature or fewer costs associated with monitoring it. The different costs and benefits associated with funds of different size, age, reputation, and industry focus lead to cross-sectional variations in limited partnership contracts.

Supply-Demand Model

A second model that seeks to explain cross-sectional variation in limited partnership contract features is the Supply-Demand model. The premise of this theory is that the supply of experienced PE/VC services is relatively fixed in the short-run. This is because PE/VC funds generally raise funds every 3-5 years once their initial fund's capital has been fully invested. Since it takes a long time to develop expertise in PE/VC investing, the number of new, experienced entrants into the PE/VC industry is limited in the short run as well. Also, because PE/VC funds are often highly specialized by size, industry focus, stage of investment, and reputation, they are imperfect substitutes for each other, which further limits the supply of experienced PE/VC professionals in the short-run. Holding the supply of PE/VC funds fixed, an increase in demand for PE/VC services, measured by either the number of entrepreneurs looking for start-up capital or the number of institutional investors looking to invest, will cause an increase in the price charged to an LP to buy into a limited partnership agreement. In addition, size and age characteristics of PE/VC funds can be a proxy for reputation and skill of the GPs. Since more reputable funds will be in more demand, the Supply-Demand model predicts that the GPs of these funds will have more bargaining power relative to the LPs. Consequently, the GPs of older and larger funds will be able to negotiate more favorable contracts than those at less reputable funds.

8.7 CASE STUDY

CIAL(Cochin International Airport) was initially registered as a society under the Travancore Cochin Literary Scientific and Charitable Societies Registration Act so that the society could seek interest-free loans from Non Resident Indians, donations and loans from major industrial undertakings, small scale units, exporters, banks, financial institutions and the state government.

However later on to mobilize funds CIAL was incorporated as a public limited company in 1994 with an authorized capital of Rs.900 million. The project was to be funded by equity share capital of Rs.7000 million and loan funds of nearly Rs.1300 million.

In 1995, HUDCO sanctioned a term loan of Rs.250 million at 16.5% interest. The Federal Bank Limited, a local scheduled commercial bank from Nedumbasserry sanctioned a bridge loan of Rs.100 million for six months, at 15% interest.

The Government of Kerala sanctioned Rs.50 million towards equity. Another Rs.150 million came in as private equity. But the money was still not sufficient. The only way out seemed to be a public issue. But in the Board Meeting, it became clear that the Government was unwilling to lose its prime position in the project. Instead the Government decided to have an equity participation to the tune of 51%.

Questions:

1. Explain the role of private public partnership.
2. Explain the need of private equity in this case.

8.8 NOTES

8.9 SUMMARY

The principal-agent relationship is an arrangement in which one entity legally appoints another to act on its behalf. In a principal-agent relationship, the agent acts on behalf of the principal and should not have a conflict of interest in carrying out the act. The principal–agent problem, in political science and economics, (also known as agency dilemma or the agency problem) occurs when one person or entity (the "agent") is able to make decisions on behalf of, or that impact, another person or entity: the "principal". The principle agent problem arises when one party (agent) agrees to work in favor of another party (principle) in return for some incentives. Such an agreement may incur huge costs for the agent, thereby leading to the problems of moral hazard and conflict of interest. Owing to the costs incurred, the agent might begin to pursue his own agenda and ignore the best interest of the principle, thereby causing the principal agent problem to occur.

8.10 KEYWORDS

- **Agent:**Party that has express (oral or written) or implied authority to act for another (the principal) so as to bring the principal into contractual relationships with other parties. An agent is under the control (is obligated to) the principal, and (when acting within the scope of authority delegated by the principal) binds the principal with his or her acts. Additional powers are assigned to agent under the legal concept of 'apparent authority.' The agent, however, does not have title to the principal's goods in his or her possession, except where agent's lien is applicable. In general, advertising agencies do not fall under this definition of an agent, because they act as principals for the services they buy on behalf of their clients.

- **Principal:** Principal is a person legal or natural–who authorizes an agent to act to create one or more legal relationships with a third party. Effectively, this means that the principal is the business.

- **Cost control**: Cost control is the practice of identifying and reducing **business** expenses to increase profits, and it starts with the budgeting process. A business owner compares actual results to the budget expectations, and if actual **costs** are higher than planned, management takes action.

- **Limited Partnership (LP):**LP is a form of partnership similar to a general partnership, except that where a general partnership must have at least two general

partners (GPs), a limited partnership must have at least one GP and at least one limited partner.

♦ **General Partnership (GP):** GP is an arrangement by which partners conducting a business jointly have unlimited liability, which means their personal assets are liable to the partnership's obligations.

8.11 SELF - ASSESSMENT QUESTIONS

1. What is the role of Venture Capital Firms economic development?
2. Critically evaluate the relationship between Venture Capitalist and Entrepreneurs.
3. Explain the Principal-Agent problem in PE/VC Financing
4. Explain the importance of Limited Partnership Structure

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MODULE - lll

MERGER AND ACQUISITIONS TAKEOVERS AND BUYOUTS

UNIT-9 : BASIC CONCEPTS OF MERGERS AND ACQUISITIONS

Structure

9.0 Objectives

9.2 Introduction

9.2 Definition and Difference between Merger and Acquisition

9.3 Defining the Transactions

9.4 Process of Merger and Acquisition

9.5 Characteristics of M&A Transactions

9.6 Specific Motives for Mergers and Acquisitions

9.7 Steps to Make Mergers and Acquisitions More Successful

9.8 Advantages and Disadvantages of Mergers and Acquisitions

9.9 Notes

9.10 Case Study

9.11 Summary

9.12 Key words

9.13 Self Assessment Questions

9.14 References

9.0 OBJECTIVES

After studying this unit, you will be able to :

- Give the meaning of
- Explain the features of
- Describe the scope of
- Bring out the importance of the
- Identify the significance of
- Highlight the problems of

9.1 INTRODUCTION

Mergers and acquisitions are increasingly becoming strategic choice for organizational growth and achievement of business goals including profit, empire building, market dominance and long term survival. The ultimate goal of this strategic choice of inorganic growth is, however, maximization of shareholder value. The phenomenon of rising M&A activity is observed world over across various continents, although, it has commenced much earlier in developed countries (as early as 1895 in US and 1920s in Europe), and is relatively recent in developing countries. In India, the real impetus for growth in M&A activity had been the ushering of economic reforms introduced in the year 1991, following the financial crisis and subsequent implementation of structural adjustment programme under the aegis of International Monetary Fund (IMF). In recent times, though the pace of M&A's has increased significantly in India too and varied forms of this inorganic growth strategy are visible across various economic sectors.

The term mergers and acquisitions encompasses varied activities of stake acquisition and control of assets of different firms. Besides, there are several motives for different types of mergers and acquisitions seen in corporate world. This chapter provides an understanding of the concept of mergers and acquisitions from industry and regulatory point of view and motives for mergers and acquisitions.

Mergers and Acquisitions (M&A) are considered a very complex financial topic. This is a type of business alliance are used by companies either to diversify or to grow their businesses. A typical M&A will have a lot of intricate issues in tax, legal and synergy. Although M&A is a generic term now, mergers and acquisitions are entirely different business combinations.

9.2 DEFINITION AND DIFFERENCE BETWEEN MERGER AND ACQUISITION

- An acquisition involves one firm buying only a portion of another firm. The acquisition may happen to acquire assets or an altogether different segment of the other firm.
- A merger involves the total absorption of a target firm by the acquirer. As a result, one firm ceases to exist and only the new firm (acquirer) remains.

Mergers and acquisitions are generally used synonymously; however, as defined above the two combinations are different in subtle ways. In a merger transaction, a new company is formed by two companies. Post-merger, these separately owned firms become a single entity and are jointly owned. During the process of merger, the stocks of these companies are surrendered and the new company's stocks are issued. Generally, companies of similar sizes undergo the process of merger.

Whereas in the case of an acquisition, one company is taken over by another company and in the process a single owner is established. Generally, a stronger and a bigger company takes over a smaller and a less powerful one. The bigger company runs the whole establishment with its identity and the smaller company has to lose its existence. In contrast to the merger, shares of the acquired company are not surrendered at all. These shares continue to be traded by the general public in the stock market.

A merger typically refers to a friendly deal between two firms, even if it is a complete buyout. However, an acquisition refers to an unfriendly takeover of the smaller firm, at times even unwillingly, by the stronger firm. Several times a less powerful company is compelled by the bigger company to announce the transaction as a merger, even if it is an acquisition. Companies do this to avoid any negative marketing.

9.3 DEFINING THE TRANSACTIONS

Mergers and acquisitions (M&A's) are part of the life cycle of any business. They can help businesses expand, acquire new knowledge, move into new areas, or improve their output with one simple transaction – it's no wonder that M&A activity hit a record high in 2015. But along with these benefits and opportunities comes great expense – for both parties. A standard M&A deal will usually involve lawyers, administrators, and investment banks, and that's before the actual cost of the acquisition has been factored in.

There's no doubt about it – mergers and acquisitions are expensive, and without huge amounts of spare cash on hand, companies will have to seek out alternative financing options in order to pay for their transactions.

There are a number of different methods for financing mergers and acquisitions, and the chosen method will depend not only on the state of the company, but also on overall activity in M&A and finance at the time of the transaction.

Mergers and acquisitions (M&A) are very common in today's technologically advanced world. There are various industries around the world that are getting integrated through these business combinations. However, not every M&A transaction is same. M&A transactions are different in various ways. It is important to understand the characteristics of such transactions as it affects a lot of important things in the process.

9.4 PROCESS OF MERGER AND ACQUISITION:

The process involving merger and acquisition is important as it can dictate the benefits derived from the deal. The process involves the following steps:

- **Preliminary Valuation:** This step primarily focuses on the business assessment of the target company. Not only the latest financials of the target company are scrutinized, its expected market value in future is also calculated. This close analysis includes the company's products, capital requirements, brand value, organizational structure, etc.
- **Proposal Phase:** Once the target company's business performance is analyzed and reviewed, the proposal for the business transaction is given. It could be either a merger or an acquisition. Generally, the mode of giving a proposal is an issuance of a non-binding offer document.
- **Planning for Exit:** After the proposal is given to the target company and it takes the offer, the target company then engages in planning for the exit. This includes planning the right time to exit and considering all the options such as a full sale or partial sale. This is also a time for tax planning and evaluating the reinvestment options.
- **Marketing:** Once the exit plan is finalized, the target company engages in a marketing plan and aims to achieve the highest selling price.
- **Agreement:** In the case of an acquisition deal, the purchase agreement is finalized. In the case of a merger, the final agreement is signed.
- **Integration:** This is the final step that involves the complete integration of the two companies. It is important to ensure that the same rules are followed throughout in the new company.

9.5 CHARACTERISTICS OF M&A TRANSACTIONS

The characteristics of an M&A transaction is important as they will decide how the entire transaction is concluded, how will the valuation be performed and what all tax and regulatory rules will apply.

The characteristics of merger transactions are different depending on the classification of the transaction on the following basis:

- Forms of Acquisition
- Payment Method
- Target Management's Attitude

Forms of Acquisition

There are two types of transactions based on the form of acquisition:

Stock Purchase

In this transaction, the acquiring company gives cash and/ or stocks to the shareholders of the target company in exchange for the stock of the target company. The characteristics of this transaction are:

The shareholders of the target company (and not the target company) receive the compensation. Therefore, a majority vote from shareholders is required to approve the merger transaction. It can be a lengthy procedure but preferred in a hostile merger.

Any tax issues related to the transaction will be borne by the shareholders. They need to pay taxes on any gains. However, the company is not bound to pay any taxes.

Mostly stock purchases deal with purchasing the entire target company, and not a part of it. So, the acquiring company gains both the assets and the liabilities of the target company.

Asset Purchase

In this transaction, the acquiring company purchases only the assets of the target company. The payment is directly done to the acquired company. The transaction has the following characteristics:

Generally, there is no need for shareholder's approval, unless the percentage of assets is substantial.

Since the company receives the payment, it is liable to pay all capital gain taxes related to the transaction. The shareholder does not have any tax consequences directly.

Since an asset purchase is directed more towards buying a particular part of the company that interests the acquirer, and not the entire company, it may translate into the acquirer avoiding assuming any liabilities of the company. However, legally such transactions are not allowed where the asset is purchased and the liabilities are clearly avoided.

Payment Method

There are two types of transactions based on the payment methods:

Securities Offering

In this transaction, the shareholders of the target company receive the stocks of the acquiring company in exchange for their stocks of the target company. For this kind of exchange, a ratio is derived which decides the number of the stocks of the acquiring company received for each stock of the target company. Such ratio is called an exchange ratio. For example, the target company's shareholders may receive 2 shares of the acquiring company for every one stock they own of the target company.

Generally, the negotiations for the exchange ratios are done in advance so as not to be affected by the daily fluctuations that can happen in prices of the stocks. The total amount of compensation paid by the acquiring company depends on the exchange ratio, the value of the stock of the acquirer on the day of the deal and the number of outstanding shares of the target.

Cash Offering

In this transaction, the acquirer only pays an agreed upon cash amount for the shares of the target.

There can also be a mixed offering, using a combination of both securities and cash.

Target Management's Attitude

There are two types of transactions based on the attitude of the target company's management:

Friendly Merger

In this transaction, the acquiring company directly approaches the management of the target. If both the parties are in favor, the transaction terms, and the payment method are negotiated. Both the parties conduct due diligence on each other by going through financials and other data. Once the due diligence and negotiations are complete, a definitive merger agreement outlining the transaction terms and each party's rights is drafted. The public announcements are made once the agreement is signed. The deal needs to be approved by the shareholders and the regulators. Post this, the money is paid and the deal is completed.

Hostile Merger

In this transaction, the target's management is not in favor of the deal. The acquirer directly approaches the board of directors of the company, which is called a bear hug. If it does not work out, the acquirer then approaches the shareholders of the target using either a proxy battle or a tender offer.

9.6 SPECIFIC MOTIVES FOR MERGERS AND ACQUISITIONS

Mergers are undertaken if it is believed two or more companies which are merging will be greater together than sum of its parts. The math of a merger is "1+1=3" or "2+2=5". Specific motives for mergers for strategic and financial reasons include the following:

Tax advantages: Tax advantages in mergers will differ from one location to another. In US it can be utilized if the acquiring firm or target company has a tax loss carry-forward. **Tax loss carry-forward** refers to the ability to deduct past losses from the taxable income. This advantage is available in mergers but not for **holding companies**. To decrease the attractiveness of this motive, the US and many other countries limit the amount of tax loss carry-forward that can be deducted annually from the taxable income of merged companies.

For example, assume the acquiring company is a profitable company and the target company is a loss maker which incurred losses in the past two years. When the merger is completed, the operating results of a merged company, which probably will have the identity of the acquiring company, will be reported on a consolidated basis.

This means the acquiring company will be able to deduct past losses of the target company from the consolidated taxable income, within limits. Merged firms will continue deducting the tax loss carry-forward (within limits) until it is recovered completely over a duration of up to 20 years.

Increases liquidity for owners: If the acquiring firm is a large company and target company is a small organization then the target company's shareholders may find it very appealing that after merger their shares' liquidity and marketability will likely be considerably better.

Gaining access to funds: The acquiring company may have high financial leverage (a lot of debt) thereby making access to additional external debt financing very limited. Therefore, one of the motives of the acquiring company to undertake the merger is to merge with a company which has a healthy liquidity position with low or non-existent financial leverage (very little or no debt).

Growth: This is one of the most common motives for mergers. It may be cheaper and less risky for the acquiring company to merge with another provider in a similar line of business than to expand operations internally. It is also much faster to grow by acquisition. Sometimes an organization may have a window of opportunity that will be closing fast and the only way the organization can take advantage of this opportunity is by acquiring a company with competencies and resources necessary to take advantage of the opportunity. Additional benefits of growth motivated mergers are that a competitor or potential future competitor is eliminated.

Diversification: Diversification is an external growth strategy and sometimes serves as a motive for a merger. For example, if an organization operates in a volatile industry, it may decide to undertake a merger to hedge itself against fluctuations in its own market. Another example can be when an acquiring company pursues a target company which is located in different state or country. This is called a geographical diversification.

Related diversification seems to have a better track record. It refers to expanding in the current market or entering new markets and adding related new products and services to the product or service line of the acquiring company.

Diversification usually does not deliver value to the shareholders because they can diversify their portfolio on their own at much lower cost. Therefore, diversification on its own is unlikely to be sufficient motive for a merger.

Synergistic benefits: Synergy occurs when the whole is greater than sum of its parts. For example, in terms of math it could be represented as "1+1=3" or as "2+2=5". Within the context of mergers, synergy means the performance of firms after a merger (in certain areas and overall) will be better than the sum of their performances before the merger. For example, a larger merged company may be able to order larger quantities from suppliers and obtain greater discounts due to the size of the order.

In the context of mergers, there can be two types of synergy. The first type of synergy results in economies of scale, which refers to decreased costs. Another type of synergy results in increased revenues such as cross-selling.

As per the above, economies of scale are derived from synergy. For example, merging businesses in the same business line will allow elimination of some of the duplicated overhead costs. A new business will not need two human resources and public relations departments. Instead, the best employees will be kept and the rest of personnel and unused office space will be reallocated or no longer used.

Cross-selling is another benefit derived from synergy. If some of the products and services of merged companies differ then cross-selling those products and services to the other firm's customer base can be a cost effective way to increase sales. Being able to effectively meet more of the customers' needs may also increase customer loyalty due to higher customer satisfaction which can occur by effectively providing customers with a broader spectrum of products and services which meet customers' needs.

Synergy benefits with regard to an increase in revenue are usually more difficult to achieve than synergy benefits with regard to decreasing costs. Management also needs to be careful to ensure that potential synergy benefits are not overestimated as this may result in overpayment for the target company.

Protection against a hostile takeover: Defensive acquisition is one of the **hostile takeover defense strategies** that may be undertaken by target of the hostile takeover to make itself less attractive to the acquiring company. In such a situation, the target company will acquire another company as a defensive acquisition and finance such an acquisition through adding substantial debt. Due to the increased debt of the target company, the acquiring company, which planned the hostile takeover, will likely lose interest in acquiring the now highly leveraged target company. Before a defensive acquisition is undertaken, it is important to make sure that such action is better for shareholders' wealth than a merger with the acquiring company which started off the whole process by proposing a hostile takeover.

Acquisition of required managerial skills, assets or technology: The target company may have managerial skills, assets and/or technology that the acquiring company needs to improve its performance, profits, revenue, cut costs, reduce productivity etc. This can become a motive for merger.

9.7 STEPS TO MAKE MERGERS AND ACQUISITIONS MORE SUCCESSFUL

1. Improving negotiation and price by knowing the company's exact market position
2. Providing credibility and insurance to investors and bankers
3. Selecting the optimal acquisition candidate for your company.
4. Identifying market opportunities that an acquisition strategy can exploit
5. Measuring customer attitudes on company's products to indicate their image in market
6. Providing customer demographic data that gives insight into future market potential and growth for targeted company
7. Identifying opportunities for growth in market segmentation analysis

8. Providing competitive benchmarking measurements to identify areas for fast improvement in company
9. Measuring market and technical trends to forecast future growth potential of company's technology
10. Identifying key trends in the market, the company's customers and relative position with competitors to pinpoint future problems and opportunities.

9.8 ADVANTAGES AND DISADVANTAGES OF MERGERS AND ACQUISITIONS:

The following are the advantages of the mergers and acquisitions:

- **Cost Efficiency:** The merger results in improving the purchasing power of the company which helps in negotiating the bulk orders and leads to cost efficiency. The reduction in staff reduces the salary costs and increases the margins of the company. The increase in production volume causes the per unit production cost resulting in benefits from economies of scale.
- **Competitive Edge:** The combined talent and resources of the new company helps it gain and maintain a competitive edge.
- **New Markets:** The market reach is improved by the merger due to the diversification or the combination of two businesses. This results in better sales opportunities.
- **To Become Bigger:** Most of the companies enter into M&A agreements to increase their size and to eliminate their rivals from the market. In the normal circumstances, it can take many years for a company to double its size, but the same can be achieved much more rapidly through mergers or acquisitions.
- **To Eliminate Competition:** M&A deals are usually done so as to allow the acquirer company to eliminate the future competition by gaining a larger market share in its product's market. However, there is a con attached to it, which is that a large premium is usually required to convince the shareholder of the target company to accept the offer. In such cases, the shareholders of the acquiring companies get disappointed by the fact that their company is issuing huge premiums to another companies shareholder's, and thus the shareholders of the acquiring company sell their shares which further results in decreasing their value.
- **Synergies and Economies of Scale:** This is usually one of the primary motivating factors for small companies as they have limited resources and usually deal with financial constraints. Companies merge to take advantage of synergies and economies of scale. Synergies occur when two companies who deal with the similar type of business combine with each other, as

they can then consolidate or eliminate duplicate resources like a branch and regional offices, manufacturing facilities, research projects etc. Every amount of money which is saved goes straight to the bottom line, boosting earnings per share and making the M&A transaction an "accretive" one.

- **Tax Purposes:** Companies also enter M&A agreements for tax purposes, although this may be an implied rather than an overt motive. For instance, countries like U.S., have a huge corporate tax rate, so to avoid payment of these taxes, some American companies have resorted to corporate "inversions". This involves a U.S. company buying a smaller foreign competitor and moving the merged entity's tax home overseas to a lower-tax jurisdiction, in order to substantially reduce its tax bill.

The following are the disadvantages of the mergers and acquisitions:

- **Lack of research:** Acquisition requires gathering a lot of data and information and analyzing it. It requires extensive research. A carelessly carried out research about the acquisition causes the destruction of acquirer's wealth.
- **Size Issues:** A mismatch in the size between acquirer and target has been found to lead to poor acquisition performance. Many acquisitions fail either because of 'acquisition indigestion' through buying too big targets or failed to give the smaller acquisitions the time and attention it required
- **Excessive premium:** In a competitive bidding situation, a company may tend to pay more. Often highest bidder is one who overestimates value out of ignorance. Though he emerges as the winner, he happens to be in a way the unfortunate winner. This is called winners curse hypothesis.
- **Substantial Increase in Prices**: A merger reduces competition and thus can give the acquiring company the monopoly power in the market. With less competition and greater market share, the new firm can increase prices of the products for consumers. **For example:** let's consider a hypothetical situation, where some major automobile companies merge with each other, the probable outcome is that they will substantially increase the prices of their product, because of the fact that the consumers will not do not have many options to choose from thus leaving them with no other option but to purchase those products at the increased prices. Thus, this is one of the biggest drawbacks of the M&A's, wherein the market is highly disrupted, and the consumers are the ultimate sufferers.
- **Job Losses**: A merger can lead to a situation wherein the employees have to lose their jobs. Usually, while a merger or acquisition takes place, the companies tend to

reduce and remove those assets which will not be resulting in their profiting rearing process. This is a particular reason for concern if it is an aggressive takeover by an 'asset stripping' company. An asset stripping company is a company, which seeks to merge and get rid of under-performing sectors of the target company.

- **Diseconomies of Scale:** The new company may experience diseconomies of scale from the increased size. After a merger, since the size of the company is increased, it may lack the same degree of control and thus may struggle to motivate workers. If workers feel they are just part of a big multinational, they may be less motivated to try hard.
- **Loss in Productivity:** In cases where the small companies are being merged or acquired by big companies, the employees of the small companies may require exhaustive re-skilling. Thus, the time during which is required for such re-skilling, the company will have to suffer the non-productivity of those employees, which indirectly would cast a burden on the capital of the company.

9.9 NOTES

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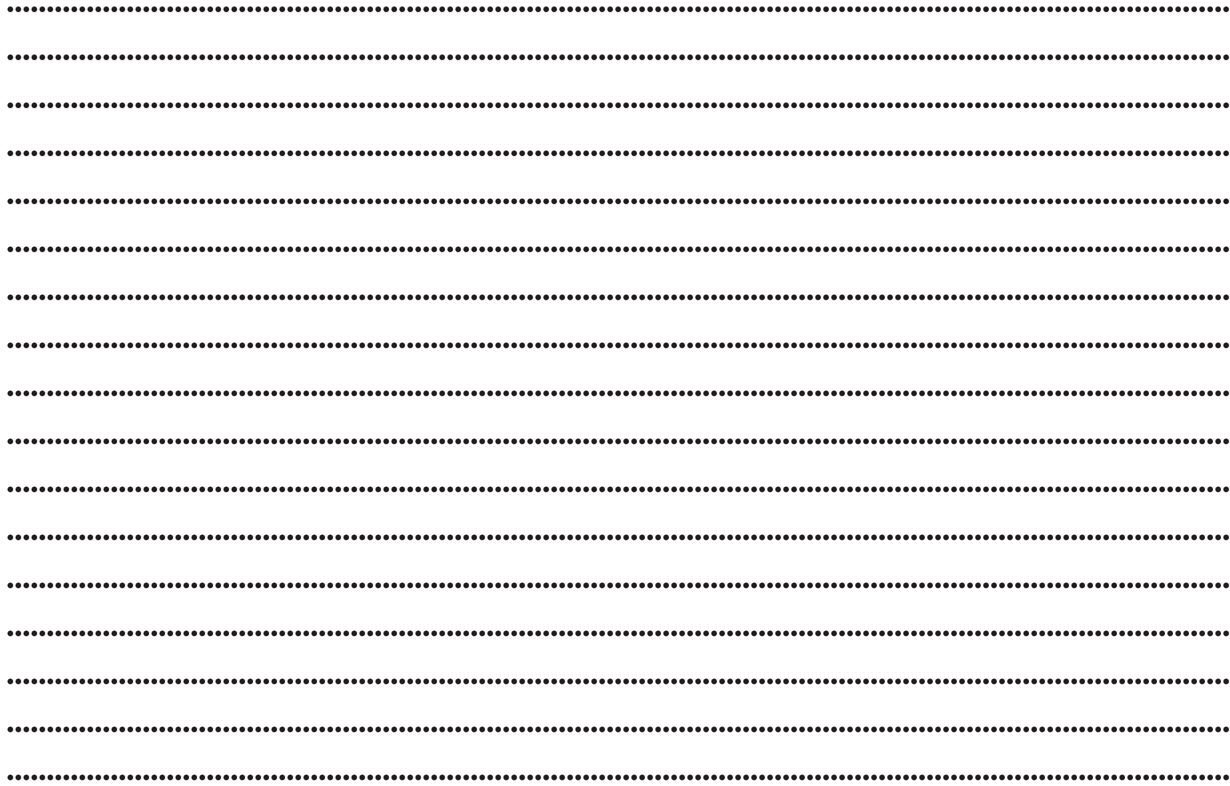

9.10 CASE STUDY

ADIDAS - REEBOK MERGER:

Mergers and Acquisitions (M&As) had become quite common in the sporting goods industry during the late 1990s and the early 2000s. Adidas acquired the Salomon Group for $1.4 billion in 1997. Nike acquired Converse in 2003 for $305 million, while Reebok acquired The Hockey Company in 2004 for $330 million. These mergers were prompted by the increasing competition and growth in the industry.

The US market is the largest market for sporting goods. Experts estimate that the US sporting goods market will grow at a rate of approximately 8.9°/a between 2004 and 2008 to reach a value of $51 billion, forming 47.6% of the world market. It is estimated that 33% of the athletic footwear purchased by the US consumers is used for sports and fitness activities and bought on the basis of price, comfortability and fashion. In 2004, 40% of the consumers of sports apparel lay in the age group 12-24. T-shirts and running shoes were considered as the top selected categories. In 2004, sports apparel retail sales in the US were worth $38.8 billion - compared with $37 billion in 2003. Athletic footwear retail sales were $16.4 billion in 2004, compared with $15.9 billion in 2003.

According to the merger deal, Adidas would buy all the outstanding shares of Reebok at $59 per share in cash. This price represented a premium of 34.2%, as per the closing share price of $43.95 on August 02, 2005. Adidas proposed to fund the purchase through an arrangement of debt and equity. The deal price was equal to the latest twelve month sales of Reebok and 11.7 times its EBITDA. Some analysts felt that the deal was priced too high. As Uwe Weinrich, an analyst at HVI3 Group remarked, The price Adidas will pay for Reebok is ambitious."Both the companies claimed that their missions were complementary. As Fireman remarked, Adidas is a perfect partner for Reebok.

Reebok's mission is to enroll global youth inclining towards the music-and-lifestyle image that it promotes through sports, music and technology. This complements Adidas's mission to be the leading sports brand in the world, with a focus on performance and international presence...

Adidas said the companies would grow as a combined entity but would retain separate management. The companies also ruled out any workforce reductions.

The new entity would continue to have separate headquarters and their individual sales forces. The companies would also keep most of the distribution centers independent and would have separate advertising programs for their brands. Mainer said, "The brands will be kept separate because each brand has a lot of value and it would be stupid to bring them together.

The companies would continue selling products under respective brand names and labels." Adidas declared that the deal would involve investment in both Adidas and Reebok. These investments would guide the companies towards effective consolidation.

Analysts had varied opinions about the deal. Some analysts felt that Adidas could beat Nike to become the industry leader. Al Ries said that, The biggest benefits that It removes a competitor. Now, all they need to do is to focus all their efforts on competing with Nike." However, a few analysts opined that it was impossible to dislodge Nike from its No. 1 position.

Nike was a preferred brand because of its fashion status, colors, and combinations. Although Adidas was perceived to have good quality products that offered comfort and Reebok was perceived as a 'cool' brand.

Questions:

1. As the two companies merged together, what would be the new competition strategies to compete with N Ike?

2. How far the decision taken by Adidas to manage the brands separately would be successful?

3. Will there be any aspects of organization and human resource to be considered?

9.11 SUMMARY

Mergers and acquisitions (M&A) are two different concepts, however, over the period of time, the distinction has blurred, and now they are often used in exchange for each other. In mergers, two similarly sized companies combine with each other to form a new company. The acquisition, on the other hand, occurs when one company purchases another company and thus becomes the new owner. The process which is generally followed in both these concepts usually starts out with a series of informal discussions between the companies by their representatives, which is followed by formal negotiation, then the issuance of a letter of intent, the process of due diligence, entering into a purchase or merger agreement, and finally, the execution of the deal and the transfer of payment.

9.12 KEY WORDS

Economies of scale: Is the cost advantage that arises with increased output of a product. Economies of scale may also reduce variable costs per unit because of operational efficiencies and synergies.

Competitive Advantage: is an **advantage** gained over **competitors** by offering customers greater value, either through lower prices or by providing additional benefits and service that justify similar, or possibly higher, prices.

Hostile Takeover: is the acquisition of one company (called the target company) by another (called the acquirer) that is accomplished by going directly to the company's shareholders or fighting to replace management to get the acquisition approved. A hostile takeover can be accomplished through either a tender offer or a proxy fight.

Synergy: is the concept that the value and performance of two companies combined will be greater than the sum of the separate individual parts. Synergy is a term that is most commonly used in the context of mergers and acquisitions.

Synergy, or the potential financial benefit achieved through the combining of companies, is often a driving force behind a merger. Shareholders will benefit if a company's post-merger share price increases due to the synergistic effect of the deal. The expected synergy achieved through the merger can be attributed to various factors, such as increased revenues, combined talent and technology, or cost reduction.

9.13 SELF ASSASSMENT QUESTIONS

1. What do you mean by mergers and acquisitions?
2. Define the difference between merger and acquisition.
3. Explain the process of merger and acquisition.
4. Identify the characteristics of M&A transactions.
5. Explain the specific motives for mergers and acquisitions.

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UNIT-10 : MERGERS AND ACQUISITIONS

Structure:

10.0 Objectives

10.1 Introduction

10.2 Concept of Merger

10.3 Traditional and Modern Views

10.4 Classification of Mergers

10.5 Value Creation in Mergers

10.6 Ten biggest Mergers and Acquisitions Deals in India

10.7 Concept of Acquisition

10.8 Types of acquisition

10.9 Difference between Mergers and Acquisitions

10.10 Notes

10.11 Case Study

10.12 Summary

10.13 Key words

10.14 Self Assessment Questions

10.15 References

10.0 OBJECTIVES

After studying this unit, you will be able to

- Give the meaning of Mergers and Acquisitions
- Explain the Classification of Mergers
- Describe the Value Creation in Mergers
- Bring out the Traditional and Modern Views
- Highlight the Ten biggest Mergers and Acquisitions

10.1 INTRODUCTION

The corporate world is undergoing a paradigm shift, from expansion and diversification to ever-increasing mergers and acquisitions (M&A's). Merger waves began in 1883 following the depression that ended that year. The first merger wave came about due to the economic expansion that occurred at the time. The initial trend was dominated by a few 'mega' deals involving corporate giants. However, today the whole picture is undergoing a sea change. Companies have started realizing that in the increasingly competitive, changing, and challenging environment, M&A's can boost the value of their businesses.

Mergers and acquisitions have become a strategic tool that is being effectively used to acquire established brands and to expand to emerging and often low cost markets, particularly markets that provide an enormous number of skilled workers. They help counter competition, acquire new consumers, get a technological edge, improve bottom lines, etc. It is no wonder then that the corporate world is fast realizing that M&A's are here to stay.

10.2 CONCEPT OF MERGER

A merger is a tool used by companies to increase their long-term profitability by expanding their operations. Mergers are carried out with mutual consent between the two companies merging with each other. The company buying the other company is called the merged or surviving entity, and the one merging with it is called the merging entity.

A merger is thus a strategy where two or more companies agree to combine their operations. Once the merger happens, one company survives and the other loses its corporate identity. The surviving company acquires all the assets and liabilities of the merging company. It either retains its identity or is re-christened.

The simplest definition of merger is, ‘a combination of two or more businesses into one business’. Laws in India use the term ‘amalgamation’ for merger. The Income Tax Act, 1961 [Section 2(1A)] defines an amalgamation as the merger of one or more companies with another, or the merger of two or more companies to form a new company, in such a way that all assets and liabilities of the amalgamating companies become the assets and liabilities of the amalgamated company. Shareholders holding not less than nine-tenths in value of the shares in the amalgamating company or companies become shareholders of the amalgamated company (Income Tax Act, 196 l—Bare Act).

What is Mergers: A merger is a deal to unite two existing companies into one new company. There are several types of mergers and also several reasons why companies complete mergers. Most mergers unite two existing companies into one newly named company. Mergers and acquisitions are commonly done to expand a company’s reach, expand into new segments, or gain market share. All of these are done to please shareholders and create value. Voluntary amalgamation of two firms on roughly equal terms into one new legal entity. Mergers are effected by exchange of the pre-merger stock (shares) for the stock of the new firm. Owners of each pre-merger firm continue as owners, and the resources of the merging entities are pooled for the benefit of the new entity. If the merged entities were competitors, the merger is called horizontal integration, if they were supplier or customer of one another, it is called vertical integration.

Genesis of Mergers and Acquisitions

A detailed analysis of the history of M&A’s indicates that many merger movements occurred in the US, and every such movement was dominated by mergers of a particular type.

Some key observations of the merger movements of the so-called merger waves indicate:

- Merger movements often occur when the economy experiences sustained high rates of growth, as this reflects favourable business prospects.
- These movements coincide with developments in the business environment.
- The waves occur when firms respond to new investment and profit opportunities arising out of changes in economic conditions and technological innovations.
- They often result in efficient resource allocation, reallocation processes, and efficient resource utilization.
- In each of the waves, mistakes have been repeated and failures have been common.
- Mergers and acquisitions have become a global phenomenon and are no longer restricted to the US.

- A new trend that is being observed is the rise of acquirers from emerging markets.
- Research shows that merger waves result from a combination of economic, regulatory, and technological shocks (Mitchell and Muiherin 1996). Economic shocks deal with economic expansion that motivates companies to expand to meet the ever-growing demand. Regulatory shocks occur when regulatory barriers are eliminated, paving the way for corporate communication. Technological shocks represent changes in technology that not only change the existing industries but also create new ones.

In the light of these factors, understanding the history of M&A's becomes important. Let us now study the merger waves in brief.

10.3 TRADITIONALAND MODERN VIEWS

If one tries to analyse the turn of events in the area of M&As, one can notice adrastic shift in the way they are looked at, over a period of time. Thus, M&Ascan be analysed on the basis of the traditional and modern points of view.The traditional view focused on competition (Machiraju 2008) and oftenresulted in horizontal mergers, creating a condition of monopolistic competition. The basic motivation was survival in the market through growth generallyachieved through M&As. The entity would thus protect itself from takeoverattempts. The motto was 'make them like us' and the selection of the target wasbased on its size and quality.

One major weakness of the traditional practices was that there was very littledone on the front of due diligence. In addition, the post-merger integration wascommonly applied after the deal got consummated. The end result would bedelays and frictions that diminished the benefits of the transaction (Walters 2004).

The general perception created as result of these frictions was that M&As destroyed, rather than created shareholder value.

The modern view looks at M&As as a vehicle to change the control of the firms' assets (Walters 2004). Mergers and acquisitions are favoured because they initiate a process of allocation and reallocation of resources by firms in response to changes in economic conditions and technological innovations. From being looked upon as a vehicle to combat competition, M&As are today being looked upon as a tool for gaining competitive advantage and strategic growth.

It is argued that to become a global organization, organic growth alone is not enough. The entities should be effectively integrated so that they create shareholder value and improve the competitive strength of the business. This is where M&As are becoming indispensable.

The success rate of M&As is increasing due to better deal governance, better deal selection, effective due diligence, and better focus on integration. The main reason behind this increased success rate has been identified as the early application of the integration process and the same being carried out in a disciplined way.

The motivation for M&As in modern times is to expand geographically into markets in which the entity is traditionally absent or weak. The other motives that drive this process include benefits of economies of scale, improvements in operating efficiency, impact on the market structure and power pricing, improved financial stability, and increased possibility of attracting and retaining human capital. In short, the modern approach talks of achieving strategic interdependence through resource sharing, functional and management skill transfer, and combination benefits.

10.4 CLASSIFICATION OF MERGERS

Mergers may take different forms. The most commonly evolved relationships between the merging companies can be classified as follows:

1. Horizontal Merger

Under this strategy, two companies that are in direct competition and sharing the same product lines and markets merge. The merger is based on the assumption that it will provide synergy and allow enhanced cost efficiencies to the new business. It is presumed that the merger would give benefits such as staff reduction and decrease in related costs, economies of scale, opportunity to acquire technologies unique to the target company, and increased market reach and industry visibility.

Some popular horizontal mergers include Daimler Benz and Chrysler, GlaxoWellcome Plc., SmithKline Beecham Plc., Exxon and Mobil, Volkswagen andRolls Royce and Lamborghini, and Ford and Volvo.Though popular, horizontal merges have a flip side too. They result in thecreation of large entities that cause ripple effects in the sector and sometimesthroughout the economy. Large horizontal mergers are perceived as anti-competitive, for they give the new entity an unfair competitive advantage over its competitors. Hence, most countries regulate large horizontal mergers byenacting competition acts. This does not mean that horizontal mergers are alwaysbad. They are encouraged when the resulting benefits outweigh the ill effects ofreduction in competition (Fenton Kathryn 2008).

To evaluate the proposals of horizontal mergers in a fair way, some regulatory authorities grant permission, but impose ex ante obligations on the mergedentity where the merger would otherwise be perceived as anti-competitive. Forexample, in both the US and Europe,

national regulatory authorities imposeconditions on a merger perceived as anti-competitive (US Department ofJusticeand Federal Trade Commission 1992).

2. Vertical Merger

Vertical mergers are usually mergers of non-competing companies where one'sproduct is a necessary component or complement of the other's. Such a mergeris typified by one firm engaged in different aspects of production say, growingraw materials, manufacturing, transporting, marketing, and/or retailing.

Such mergers can achieve pro-competitive efficiency benefits. Vertical integration can lower transaction costs, lead to synergistic improvements in design,production, and distribution of the final output/product and thus enhancecompetition. Consequently, most vertical arrangements raise few competitiveconcerns (Varney 1995).

Vertical mergers involve two firms in different stages of production/operationmerger. Such mergers can take the following forms.

Market extension merger: As the name suggests, this is a merger betweentwo companies that sell the same products, but in different markets.

Product extension merger:A product extension merger is designed to increasethe type/ range of products that a company sells in a particular market. Such amerger occurs when two companies selling different but related products in thesame market merge.

Vertical mergers may also take the form of forward, backward, and balancedintegration.

Forward integration: Here the target firm is involved in the next stage(s) ofproduction/ operation. For example, the supplier of raw materials merges his firmwith a regular procurer of the raw material from him. This can help him createopportunities to monitor the upstream supplier's competition.

Backward integration: Here the target company is involved in the previousstages of production/operation. For example, a manufacturer of a product mergeshis firm with the provider of the raw materials. By eliminating the provider of raw materials, the manufacturer can achieve collusion in the upstream market.

Balanced integration: This is a situation where the company sets up subsidiaries that both supply them with inputs and distribute their outputs.

The basic objective of a vertical merger is to eliminate costs of searching for vendors, contracting prices, payment collection, advertising and communication, and coordinating

production. Such a merger can have a very positive impact on production and inventory since information flows efficiently within the organization.

It is to be noted that vertical mergers need to be timed appropriately. History shows that vertical mergers occur when two firms decide to integrate their businesses to capitalize on the rising demand for their products.

Some examples of vertical mergers are Usha Martin and Usha Beltron, TimeWarner Inc. and Turner Corporation, Silicon Graphics Inc.'s merger with AliasResearch Inc. and Wavefront Technologies Inc., Apple and Intel, RelianceIndustries Limited and Reliance Petrochemicals Limited, Tata Industrial FinanceLtd and Tata Finance, Hindustan Unilever Limited (formerly Hindustani LeverLimited) and Tata Oil Mills Co. (TOMCO), Torrent group and AhmedabadElectric Company, Surat Electric Company, and so on.

Vertical mergers are also viewed as anti-competitive as they can rob the supply business of its competition. For example, if a firm has been receiving material from two separate firms and the receiving firm decides to acquire both the firms, the merger would put an end to the competition between the supplying entities. Such mergers tend to create monopolies.

In addition, vertical mergers are designed to evade pricing regulations. For example, when regulation seeks to constrain the market power of a natural monopoly, the monopolist may have incentives to integrate vertically into unregulated markets to extract the monopoly gains denied to it in the regulated market (www.business.gov.in).

Due to the flip side of vertical mergers, regulatory authorities do not always favour them. In many cases, such mergers are granted approvals subject to certain conditions, such as the merged entity being directed to stay away from activities that are anti-competitive to the extent that they could harm public interest. This is because all antitrust laws work on the maxim 'the protection of competition, not competitors'.

An anti-competitive theory states that vertical mergers create barriers in the market by foreclosing rivals from access to needed inputs in the market and/or raise the prices in the market or reduce the quality of the product (www.learnmergers. corn). Such strategies make it difficult for new firms to enter the market.

3. Conglomerate Merger

The US Supreme Court describes a conglomerate merger as 'one in which there is no economic relationship between the acquiring and the acquired firm' (FTC and Procter & Gamble Company 1967), i.e., companies which have no relation with their products.

Conglomerate mergers are mergers involving firms in different or unrelated business activity. Such mergers are preferred by firms that plan to increase their product lines.

Firms opting for conglomerate mergers control a range of activities in various industries that require different skills in specific managerial functions, such as research, applied engineering, production, and marketing. A competitive edge in these functions can be attained by external acquisition and mergers; it is generally not possible through internal development. These types of mergers are also called concentric mergers. Firms operating in different geographic locations prefer conglomerate mergers.

Conglomerate mergers can be classified as follows:

- Pure conglomerate mergers involve firms that have nothing in common.
- Mixed conglomerate mergers involve firms that are looking for product extensions or market extensions.

These mergers are further classified as follows:

Financial conglomerates: These are active in providing funds to every segment of operation and in exercising control. They are the ultimate financial risk takers. They not only assume financial responsibility and control, but also play a major role in all the operating decisions.

They focus mainly on improving risk return ratio, reducing business-related risks, improving the quality of general and functional managerial performance, and providing an effective competitive process. They can distinguish between performance based on underlying potentials in the product market area and results related to managerial performance.

Managerial conglomerates: They focus on providing managerial counseling and interacting on decisions with the motive of increasing the potential for improving performance. Such conglomerates come into play when two firms of unequal managerial competence combine.

Concentric companies: A merger is termed concentric when there is a carryover of specific management functions or any complementarities in relative strengths between management functions. This distinction between general and specific management functions is the primary difference between managerial conglomerate and concentric company.

There are many reasons for firms deciding to merge into a conglomerate, including increasing market share, synergy, and cross-selling. Firms also merge to diversify and reduce their risk exposure. However, if a conglomerate becomes too large as a result of acquisitions,

the performance of the entire conglomerate can suffer. This was seen during the conglomerate merger phase of the 1960s.

Conglomerates are guided by two philosophies. One, by participating in a number of unrelated businesses, the parent corporation is able to reduce costs by using fewer resources. Two, by diversifying business interests, the risks inherent in operating in a single market are mitigated.

The most common examples of conglomerate mergers are News Corporation, Sony, Time Warner, Walt Disney Company, Aditya Birla Group, Berkshire Hathaway, General Motors, Mahindra Group, Motorola, Tata Group, Hyundai, and Mitsubishi.

The flip side of conglomerate mergers is that contributing to aggregate increase in economic power often results in possible non-economic effects dueto an increase in the general economic concentration (Staff of Federal Trade Commission 1969). Critics also fear that economic concentration would lead to corresponding aggression in political power by fewer but more powerful conglomerate firms, placing major decisions—both political and economic—in the hands of a few individuals or firms that have direct accountability to the general public (Hearings on Acquisitions and Mergers by Conglomerates of Unrelated Businesses 1978).

Accretive Merger

Accretion is natural growth in size or extent by gradual external addition.Accretion implies ‘value creation’. Accretive mergers occur when a companywith a high price-to-earnings ratio (P/E) purchases a company with a low P/E.As a result, the EPS of the acquiring company increases.

In an all-stock deal, if a company acquires a target with a lower P/E ratio, it must be accretive to earnings. Here the target company’s earnings are lower and the acquirer can add these to its own earnings and still achieve a higher earnings rate. This is because the merger results in operational and financial synergies and boosts the earnings of the acquiring company. For example, Hewlett-Packard announced a merger with services company EDS in 2008. The belief of the company was that in view of the Generally Accepted Accounting Principles (GAAP), the deal would be non-GAAP accretive in 2009 and GAAP accretive in fiscal year 2010. Similarly, when RIL approved the merger with IPCL, the swap was decided to be one share of RIL for every five shares of IPCL. This was believed to be EPS accretive for the shareholders of RIL.

4. Dilutive Merger

The word dilutive implies ‘destruction’ or ‘dilution’. A dilutive merger is one where the EPS of the acquiring company falls after merger. Since the EPS declines, the acquiring company’s share price also declines, as the market expects a decrease in the company’s future earnings. The expected decline could be because the market forces feel the merger would destroy value and would not result in synergies post merger.

As a matter of principle, a dilutive merger or acquisition occurs when the P/E ratio of the acquiring firm is less than that of the target firm.

In cases where there is lack of a reliable and standard measure of post-merger performance, EPS earnings are used as a proxy for value creation. They get represented through accretion or dilution. For example, copper mining company Phelps Dodge International Corp. entered a dilutive merger with Canadian nickel miners Inco and Falconbridge in 2006.

10.5 VALUE CREATION IN MERGERS

Money gets left on the table in M&A, when people do a poor job of thinking through how a merger will create incremental value, over and above the sum of the parts or when they miss the most promising target.

An acquirer has to seek a target company which combines a good strategic fit and an attractive return on investment. It is true that many mergers and acquisitions fail to live up to expectations. This is because of lack of focus on the detailed upfront analysis is of how two businesses will mesh a combined company that is more valuable than the sum of the parts.

Sellers: “Strategic valuation” is vague. When an emerging growth venture is acquired, there is typically a big increase in valuation if the acquirer sees the target as having significant strategic value—rather than being a simple financial acquisition, with a value related to an industry-standard earnings multiple.

Unfortunately, many emerging ventures fail to take full advantage of this potential strategic value premium — either because they fail to identify companies for whom they represent a truly strategic acquisition; or because they articulate poorly the true strategic impact that they can have on the future of the acquirer’s business.

Buyers: Finding the “gems” is hard. On the flip-side of the transaction, large businesses often have trouble separating the wheat from the chaff among the many similar-sounding startups out there. All too often this leads to acquisitions that fail to live up to expectations. Or, to waking up one day and realizing the competitor has gained a huge advantage as a result of last-year’s acquisition of a startup which the company overlooked or passed on.

1. Value creation in Horizontal mergers

Horizontal mergers often take place in the industries and markets whose products are generally in the mature or declining stages of product life cycle. The reason is the overall growth in the industry may go down and if the two equally efficient companies come together or if an efficient company acquires a small company, then the new company may have access to more market share and can take the advantage of the economies of scale through which the company can extend the maturity period for some more time by postponing the decline stage.

Factors motivating the firms in mature industries for horizontal mergers:

Generally, the mature industries are characterized by

1. low overall growth in demand for the products produced in the industry
2. Excess capacity
3. A small number of large competitors
4. Considerable price pressure and stress costs to reduce

Sources of value creation in horizontal mergers:

The following are the sources available for value creation in horizontal merger:

(a) Revenue enhancement

(b) Reducing the costs

(c) Generating new resources

(a) Revenue Enhancement:

(i) Revenue Enhancement through increased markets:

A firm can enhance the revenue by three alternative sources via., increasing the market power, network externalities and leveraging the market resources and capabilities.

In order to enhance the revenue by increased market share, the firm must merger with another firm which is an equal competitor in the market. If the merger is done successfully, the new firm can extend the market by dictating the output price of the products, which are price sensitive. If the firm efficiently plans the price of the output, it can increase its revenue when compared to the other firms in the industry.

Here the question may arise whether the horizontal merger leads to collusion among the remaining players in the market and increased profitability. Under the collusion hypothesis,

the rivals of the merging firms benefit from the merger since successful collusion limits the output and raises the product prices. Under the efficiency hypothesis, the merger releases information about scope for productive efficiency and the rivals may also benefit from that information. However, the rivals are unable to implement the efficiency measures hidden in the new information, they lose. These gains and losses are measures in the form of gains and losses to the shareholders of the concerned companies.

(ii) Revenue enhanced through network externalities:

A network externality exists whenever the value of a product to an individual customer depends on the number of other users of the product such as the internet or email. Network externality arises from the creation of a customer data base. This customer database consists of the experiences shared by the customers which can be facilitated, enriched or made more effective by interacting with them. This provides an incentive to intensify interaction and to join the installed basethat in turn provides the incentive to buy a product. The firm which desires to enhance its revenue can plan for a target firm which is with potential network externalities.

(iii) Revenue enhanced through acquisition of complementors:

Complementors, Porter's sixth force, are companies or entities that sell or offer goods or services that are compatible with, or complementary to, the goods or services produced and sold in a given industry. Complementary goods offer more value to the consumer together than apart. When one product or service complements another there exists a condition called complementarity; a sort of commercial symbiosis. Complementors are often considered the sixth force of Porter's industry analysis framework. The presence of Porter's complementors can influence the competitive structure of an industry.

Firms can increase revenue by introducing complementors into the market. In the merger context, a firm may perceive the products of another firm as complementary but the complementarity of the products of the two firms may have been under-exploited. The merger may enable the firm to leverage its competencies to enhance and make more visible the hidden complementarity.

(iv) Leveraging marketing resources and capabilities:

Merging companies may be able to exploit each other's marketing resources and capabilities including the brand management, to augment the sales or revenue of each other's products. Distribution channels already established by each firm may be used to sell the

other firm's products., thereby increasing the overall throughput of the products of both firms. Each firm's distribution capacity is thus more effectively used to enhance revenue.

(b) Reducing the Costs:

A horizontal merger can help the merging firms rationalize their production and take out the excess capacity. Such rationalization can reduce fixed production and other fixed costs. By reducing supply to match the demand, it will also reduce the price pressure and improve profit margins. The surplus resources resulting from the rationalization will be laid off at a one-off cost in the form of, say., redundancy payoffs to the work force.

Horizontal mergers also provide opportunities foreconomies of scale in various functional aspects. Many of theactivities carried out by the merging firms separately cap nowbe combined and streamlined.

(c) Generating new resources:

Most of the mergers and acquisitions are driven by thesharing and transfer of complementary resources and capabilities between the acquirer and acquired firms. The resources exchanged and the extent of that exchanged depends on the particular source of value driving an acquisition. A resource based mergers takes place when:

1. The merging firm needs to reconfigure their R & D and maintain their competitive advantage.
2. There is asymmetry in the R & D between the two firms and the firms consider merger a means of overcoming that asymmetry.
3. The deficit of R & D cannot bridge through organic growth or market purchase.

Success of a diversifying acquisition depends on the fungibility of the resources being redeployed. Fungibility is the resource characteristic that allows its application to different organizational and market settings.

2. Value creation in Vertical mergers

Vertical merger is a merger between two companies producing different goods or services for one specific finished product. It happens where a firm merges with another that carries out the immediately preceding upstream activity, it results in backward integration.

The economic rationale for vertical mergers is derived from the comparative efficiency of vertical integration in terms of the technical and coordination efficiency. For vertical merger to create sustainable competitive advantage, in addition to these cost efficiencies, the merger must also lead to other sources of value such as revenue enhancement and new

growth opportunities through leveraging existing resources and capabilities of the merging firms and the creation of new resources and capabilities.

Revenue enhancement may arise from the ability to offer a package of services and products rather than just products alone. But strategy of the bundling the products with the succeeding product or service may not always be successful unless serious care is taken.

Higher profitability may be realized through the increased market power that vertical integration can confer. Vertical mergers also have anti-competitive consequences. They are as follows

1. Provide opportunities for indirect price discrimination.
2. Squeeze non-integrated final product manufacturers by cutting the price of the final products
3. Remove firms such as suppliers or distributor with countervailing power
4. Raise entry barriers by raising the capital requirement for new entrants.

Whether integration is more efficient than market exchange or long-term contractual relationship depends on the governance structure with in the integrated firm. The governance structure consists of various building blocks:

1. the level of autonomy versus centralization among the divisions
2. the locus of the decision making
3. how information asymmetry is resolved
4. the performance measurement system and incentive structure
5. the performance benchmarks to guide transfer pricing between supplier and user divisions
6. How the acquired resources and capabilities are integrated into the vertical acquirer.

3. Value creation in Conglomerate mergers

A merger between firms that are involved in totally unrelated business activities. There are two types of conglomerate mergers: pure and mixed. Pure conglomerate mergers involve firms with nothing in common, while mixed conglomerate mergers involve firms that are looking for product extensions or market extensions.

There are many reasons for firms to want to merge, which include increasing market share, synergy and cross selling. Firms also merge to diversify and reduce their risk exposure.

However, if a conglomerate becomes too large as a result of acquisitions, the performance of the entire firm can suffer. This was seen during the conglomerate merger phase of the 1960s.

Diversification of a firm is measured in the terms of the number of industries a firm had entered. The larger the number of the firms, the lager is the diversification. This measurement of diversification depends upon the industrial classification system by which industries are grouped. The classification is done at different levels of aggregation with each level assigned a number. The lowest level of aggregation is often coded with a four-digit number and at this level of grouping; firms have the narrowest spread of businesses. They are almost single business units.

10.6 TEN BIGGEST MERGERS AND ACQUISITIONS DEALS IN INDIA

- Tata Steel acquired 100% stake in Corus Group on January 30, 2007. It was an all cash deal which cumulatively amounted to $12.2 billion.
- Vodafone purchased administering interest of 67% owned by Hutch-Essar for a total worth of $11.1 billion on February 11, 2007.
- India Aluminium and copper giant Hindalco Industries purchased Canada-based firm NovelisInc in February 2007. The total worth of the deal was $6-billion.
- Indian pharma industry registered its first biggest in 2008 M&A deal through the acquisition of Japanese pharmaceutical company Daiichi Sankyo by Indian major Ranbaxy for $4.5 billion.
- The Oil and Natural Gas Corp purchased Imperial Energy Plc in January 2009. The deal amounted to $2.8 billion and was considered as one of the biggest takeovers after 96.8% of London based companies' shareholders acknowledged the buyout proposal.
- In November 2008 NTT DoCoMo, the Japan based telecom firm acquired 26% stake in Tata Teleservices for USD 2.7 billion.
- India's financial industry saw the merging of two prominent banks - HDFC Bank and Centurion Bank of Punjab. The deal took place in February 2008 for $2.4 billion.
- Tata Motors acquired Jaguar and Land Rover brands from Ford Motor in March 2008. The deal amounted to $2.3 billion.
- 2009 saw the acquisition Asarco LLC by Sterlite Industries Ltd's for $1.8 billion making it ninth biggest-ever M&A agreement involving an Indian company.

- In May 2007, Suzlon Energy obtained the Germany-based wind turbine producer Repower. The 10th largest in India, the M&A deal amounted to $1.7 billion.

BIGGEST MERGERS AND ACQUISITIONS OF 2016

1. The $32 billion deal between Shire and Baxalta (Industry: Pharmaceuticals)

After a lengthy six month courtship, London-based drugmaker Shire announced plans to buy Baxalta in a $32 billion cash and stock offer, giving Shire a better foothold in treating rare diseases.The year though, is just halfway through. One major deal that could supplant the crown is the back-and-forth between German pharmaceutical giant, Bayer, and its intended target, Monsanto. Bayer offered a whopping $62 billion to the latter in May. Monsanto then rejected the offer, calling the proposal "incomplete and financially inadequate." Discussions for that deal are still ongoing.

2. The $30.6 billion bid for St Jude Medical by Abbott Laboratories (Industry: Medical Appliances and Equipment)

In April, Abbot Labs announced plans to buy St. Jude Medical for $25 billion in a cash and stock deal, and assume or refinance St. Jude's net debt of about $5.7 billion.

One of the flurry of mergers and acquisitions in the healthcare space this year, the combined company will have a stronger medical-devices business in an increasingly competitive market. Increased scale will also give Abbot Labs more pricing power in the market.

3. The $28.1 billion acquisition of LinkedIn by Microsoft (Sector: Tech)

On Monday, Microsoft announced it would buy social networking company, LinkedIn for a smooth $26.2 billion in an all-cash deal. That took LinkedIn's stock up 47% in trading. The deal, Microsoft's' largest ever by a $20 billion long shot, will "accelerate the growth of LinkedIn, as well as Microsoft Office 365 and Dynamics," according to Microsoft CEO Satya Nadella.The deal is also sixth largest tech merger and acquisition on record, according to Dealogic.

4. The $16.6 billion deal for Tyco International by Johnson Controls (Sector: Auto Parts)

In January, car parks manufacturer, Johnson Controls and Ireland-based security systems maker, Tyco International agreed to merge in a deal that would help Johnson Controls dodge the high, about 35%, corporate tax rate in the U.S. by moving headquarters to

Ireland.The deal will lead to at least $500 million in savings in the first three years, and at least $150 million in annual tax savings, the companies said.

5. The $13.6 billion bid to buy Starwood by Marriott International (Sector: Service)

Perhaps one of the most tense mergers and acquisitions of 2016 that ended with Starwood's top bidder, Anbang Insurance, calling it quits, the acquisition of Starwood by Marriott International takes number four on the list. After several months of bidding, the two companies agreed to merge in March, becoming the world's largest hotel chain in a cash and stock deal.The merger would give the combined company scale to combat smaller, and rapidly growing competitors such as Airbnb. Its new size would also allow the company to negotiate better fees with online booking sites including Expedia.

6. The $13.2 billion acquisition of Columbia Pipeline Group by TransCanada (Sector: Oil and Gas)

The company behind the controversial Keystone XL oil pipeline, TransCanada, agreed to buy Columbia Pipeline Group for $10.2 billion in March, making the combined giant one of North America's largest regulated natural gas transmission businesses in an all cash deal.

For TransCanada, the deal allows them to take Columbia off its list of rivals, and also access the cheaper gas from Marcellus and Utica shale regions. Competition from the latter has been eating away at TransCanada's revenue.

7. A $12.8 billion merger between IMS Health Holdings and Quintiles Transnational Holdings (Sector: Biotech)

Contract medical research provider, Quintiles, agreed to merge with healthcare information company, IMS Health to make a giant known as Quintiles IMS in an all-stock deal."This combination addresses life-science companies' most pressing needs: to transform the clinical development of innovative medicines, demonstrate the value of these medicines in the real world, and drive commercial success," Ari Bousbib, chairman and CEO of IMS Health said in a statement.

8. The $12.4 billion acquisition of ADT by Protection 1 (Sector: Security)

In February, a security service for residential and small business properties, ADT, agreed to be acquired by an affiliate of Apollo Global Management, and merged with another home security firm, Protection 1. The merger would give the combined company greater reach throughout the U.S. and Canada, and also help ADT accelerate its expansion into the commerical sector.

9. Great Plains Energy's Bid for Westar Energy Worth $12.2 billion (Sector: Electrical Utilities)

Great Plains Energy, based out of Kansas City, Mo., and Westar Energy, based out of Kansas, announced the deal late May in a cash and stock transaction.

"The utility industry is facing rising customer expectations, increasing environmental standards and emerging cyber security threats. These factors, coupled with slower demand growth for electricity, are driving our costs and customer rates higher," said Terry Bassham, chairman and chief executive officer of Great Plains Energy. By buying Westar however, the company hopes to reduce expenses and combine operations.

10. The $11.4 billion acquisition of Fortis by ITC Holdings announced in February (Sector: Electric Utility)

Canadian utility operator Fortis announced plans to buy Novi-Mich.-based ITC Holdings in February. For Fortis, the acquisition would give the company a foothold in the Midwest, and give the combined company a chance to expand.

10.7 CONCEPT OF ACQUISITION

Acquisition is an attempt made by one firm to gain a majority interest in another firm. The firm attempting to gain a majority interest is called the acquiring firm and the other firm is called the target firm. Once the acquisition is completed,the acquiring firm becomes the legal owner and controller of the business of thetarget firm. The acquiring firm pays for the net assets, goodwill, and brand nameof the company bought.

Acquisitions are actions through which companies seek to achieve economiesof scale, increased efficiency, and enhanced market visibility. In an acquisition,unlike in a merger, there is no exchange of stock or consolidation as a new company even though it involves one company purchasing another.

Some prominent acquisitions include the following:

- Google's largest acquisition in March 2008 when it acquired DoubleClik, an advertising company
- Mahindra & Mahindra's acquisition of 90°/o stake in German company Schoneweiss
- Acquisition of Mumbai-based Ambit RSM by PricewaterhouseCoopers' (PwC)

It is important to note that acquisitions may lead to the following:

- A subsequent merger

- Establishment of a parent subsidiary relationship
- A strategy of breaking up the target firm and disposing off part or all its assets
- Conversion of the target firm into a private firm

Strategies for Acquisition

Acquisition involves a process of identifying the right target. However, research shows that most companies identify the wrong acquisition targets. A research conducted by PwC, HBS, and Acquisitions International indicates that 6O% of the companies that go for acquisitions in the UK in any given year achieve nothing. Of the remaining 40% of the companies, 63% regret the purchase they made. This happens because the structure of the marketplace lends itself to failure due to four reasons (Sweeting 2007):

- Too few targets
- Inappropriate targets
- Lack of creativity
- Lack of forward planning

The most surprising element is that corporate buyers make all the four mistakes concurrently.

To make acquisitions more effective and meaningful, companies need to adhere to the following:

- Increase the number of targets
- Always explore alternatives available and not chase the one everyone else is bidding for
- Compare the targets concurrently in an attempt to choose the right and the best target
- Buy firms with assets that meet the current needs to build competitiveness
- Provide adequate financial resources so that profitable projects would not be lost
- Identify targets that are more likely to lead to easy integration and building synergies
- Continue to invest in research and development as a part of the firm's overall strategy

10.8 TYPES OF ACQUISITIONS

Acquisitions, as discussed, involve acquiring a majority stake in another company so that control changes hands. It is imperative that the right target is identified or else the process itself can escalate into a major problem for all the parties involved. In order to ensure that the right target is found, a company may choose between various forms and options.

1. **Assets Purchase**

Under this method, the acquiring firm purchases specific identifiable assets for the business. These assets are perceived as having potential to add value to the acquiring company. In some cases, it may also assume specified liabilities. This helps the acquiring company to reduce the risk of taking on unknown liabilities such as seller's contracts, employees, etc.

The acquiring company is keen on the purchase mode as it can acquire the assets at a comparatively lower price. This potentially reduces future capital gains tax upon a sale of the assets. In addition, it increases the future depreciation cost, thereby reducing income tax.

If one evaluates this method from the point of view of the target company, it typically does not prefer asset sales method, for the target company has to pay capital gains tax on the difference between the assets sold and purchase price allocated to such assets. This could be substantial if assets are heavily depreciated. In addition, if the target company desires to use the proceeds of the asset sale for paying dividend to the stockholders, dividend would be subject to an additional tax, thus increasing the burden on the target company. Instead, the target company prefers selling the entire business, with employees in place and without the need to wind down the company.

This method suffers from the following limitations:

- It requires purchase agreement to allocate purchase price among specific list of assets.
- The acquiring company must be assured that all necessary assets are listed.
- Closing the deal is comparatively difficult for the following reasons:
- For titled assets such as vehicles and property transferring, the ownership title of each asset becomes a tedious task.
- The consent of the shareholders is required for each transfer.
- If the entire business is being sold, each employee must be terminated and re-hired by the acquirer. This can create a lot of employee benefit issues.

2. **Stock Purchase**

Under this method, the acquirer purchases the entire outstanding equity of the target company. It is a method whereby the acquirer purchases the entire company and all assets and liabilities of the business that come with it. Stock purchase does not cause any disruption in the operations which can continue as usual.

This method is popular because of the following reasons: Closings are simplified.

- Fewer contract consents and very little paper work is required to transfer specific assets.
- All employees and employee benefits are transferred with the stock sale.

One needs to take care that if the shares are widely held, a transmittal letter needs to be distributed to shareholders to facilitate the exchange of their shares for the consideration by delivery of their stock certificates.

This method is preferred by the target company as the target only incurs capital gain on the difference between basis in stock sold, which is not subject to depreciation, and purchase price for stock. In addition, no dividend has to be paid to distribute the proceeds of sale to stockholders and double taxation can be avoided. Finally, the target is not required to tackle any issues relating to winding up of the company after closing.

However, the acquiring company quite obviously does not prefer this method for it cannot pick and choose assets and liabilities. In addition, it has to inherit everything, including unknown liabilities such as seller's contracts and employees. The tax basis in the assets purchased does not step up. There is potential of aheavier capital gains tax on a future sale of heavily depreciated assets althoughlower depreciation provision reduces the tax liability.

10.9 DIFFERENCE BETWEEN MERGERS AND ACQUISITION

Mergers and Acquisitions (M&A) are two terms that are jointly uttered, whenever we hear them. But, Are they both one? The answer is no, Merger means "to combine" while Acquisition means "to acquire." In business terminology, **Merger** is a type of Amalgamation where two entities combine to form a new entity. But, if we talk about **Acquisition**, it is similar to a takeover, in which one company acquires another company. In this article, we have compiled the important differences between Merger and Acquisition, in tabular form.

Comparison Chart		
Basis For Comparison	**Merger**	**Acquisition**
Meaning	The merger means the fusion of two or more than two companies voluntarily to form a new company.	When one entity purchases the business of another entity, it is known as Acquisition.
Formation of a new company	Yes	No
Nature of Decision	The mutual decision of the companies going through mergers.	Friendly or hostile decision of acquiring and acquired companies.
Minimum number of companies involved	3	2
Purpose	To decrease competition and increase operational efficiency.	For Instantaneous growth
Size of Business	Generally, the size of merging companies is more or less same.	The size of the acquiring company will be more than the size of acquired company.
Legal Formalities	More	Less

Key Differences between Merger and Acquisition

The points presented below explain the substantial differences between merger and acquisition in a detailed manner:

1. A type of corporate strategy in which two companies amalgamate to form a new company is known as Merger. A corporate strategy, in which one company purchases another company and gain control over it, is known as Acquisition.
2. In the merger, the two companies dissolve to form a new enterprise whereas, in the acquisition, the two companies do not lose their existence.

3. Two companies of the same nature and size go for the merger. Unlike acquisition, in which the larger company overpowers the smaller company.
4. In a merger, the minimum numbers of companies involved are three, but in the acquisition, the minimum number of companies involved is 2.
5. The merger is done voluntarily by the companies while the acquisition is done either voluntarily or involuntarily.
6. In a merger, there are more legal formalities as compared to the acquisition.

10.10 NOTES

10.11 CASE STUDY

DISNEY'S ACQUISITION OF PIXAR

On January 24, 2006, the US based media and entertainment company - Walt Disney Company (Disney) announced that it would acquire its animation partner, Pixar for US$ 7.4 billion in stock. Disney had been in partnership for producing and distributing animation films with Pixar since 1991. In January 2004, owing to differences with Disney's then CEO Michael Eisner (Eisner), Pixar had announced that it would partner with another distribution company in 2006.

But Robert Iger (Iger), who took over from Eisner on September 30, 2005, revived talks with Pixar and finally succeeded in acquiring it. The deal expected to be finalized by May 2006 would make Steve Jobs (Jobs), CEO of Apple Computer Inc. (Apple), the major shareholder in Disney with an equity stake of approximately 7%. This was because Jobs had a 50.6% equity stake in Pixar. He would also become a member of Disney's Board of Directors. Even after the merger, Disney and Pixar were to work from their separate headquarters at Burbank, and Emeryville (both in California), respectively.

Disney's press release said, "This acquisition combines Pixar's preeminent creative and technological resources with Disney's unparalleled portfolio of world-class family entertainment, characters, theme parks and other franchises, resulting in vast potential for new landmark creative output and technological innovation that can fuel future growth across Disney's businesses." Analysts said that the deal was more important to Disney than to Pixar.

While all of Pixar's films like Toy Story, The Incredibles and Finding Nemo were successful, Disney's animation films like Treasure Planet, Home on the Range and Brother Bear had performed below expectations. Some analysts felt that the deal was priced a bit higher than expected. In the US$ 7.4 billion deal, Disney got a library of six Pixar films. This seemed expensive for Disney, especially when compared to Viacom's acquisition of DreamWorks SKG in December 2005, which had 59 films, for US$ 1.6 billion. However, according to Nelson Gayton, Professor at Wharton, "Any premium that Disney might have paid for the Pixar acquisition must also be evaluated in light of the nature of the animation content that Pixar produces and the distribution possibilities it offers via new technologies.

Industry analysts were of the view that, apart from gaining access to Pixar's technology, it was important that Disney got a person of the caliber of Jobs on its board. Asserting this, Tim Bajarin, President, Creative Strategies said, "His biggest impact will be to help guide Disney into the digital age and be the mediator of this major media company's content to the world of next-generation digital content delivery.

In May 1991, Disney entered into an agreement with Pixar for developing and producing three computer animated feature films. According to the agreement, Disney agreed to produce movies to be developed and directed by Pixar's John Lasseter. Disney agreed to market and distribute these movies.

Pixar was to receive compensation based on the revenue obtained from distributing these films and related products. Including distribution fees, Disney was to get 87% of the distribution proceeds. Analysts felt that the agreement gave Pixar an expert partner in the film business with great marketing capabilities. The first film under the agreement was Toy Story which was released in November 1995. It was the first computer animated feature film that was of one hour and twenty one minutes duration. The film was a huge success and generated over US$ 360 million in worldwide revenues. After the release of Toy Story, Disney extended its partnership with Pixar to a co-production agreement in 1997, under which Pixar agreed to produce five original computer-animated feature films, in a span of ten years...

In March 2005, the Disney Board elected Iger as the company's CEO to succeed Eisner on September 30, 2005. Iger got a call from Jobs who hinted at a possible discusion on working

together again. Analysts felt that Iger would find it difficult to strike a new deal as proposed by Jobs as it was heavily loaded in favor of Pixar.

However, Iger adapted the proposal his own way. He asked for Disney's content to be distributed over the Internet through Apple's online store - iTunes. In October 2005, Iger and Jobs signed a deal to sell the past and current episodes of television shows of its ABC and Disney channels through iTunes. It started with five shows which included the popular shows Desperate Housewives and Lost. Jobs was pleased with the Iger's suggestion of linking up to offer videos through iTunes. Iger said that the deal with Apple was finalized in just three days. Meanwhile, Jobs also started re-negotiating on the Disney-Pixar agreement. With this rapprochement, there was speculation that Disney might acquire Pixar..

Analysts said this deal was more important to Disney than to Pixar. For Disney, the acquisition gave it ownership of the world's most famous computer animation studio and its talent, with whom it had teamed up to create block busters since the 1990s.

The timing was also perfect as its own animation films had failed one after another. Its first full computer animation film Chicken Little (released in November 2005) fared only marginally well. The deal would bring the technology company Apple (through Steve Jobs) closer to Disney, and Iger could further increase the digital content that was being offered through Apple. Analysts said that having Jobs on the Disney board would certainly give the company the necessary technology edge and direction. Further, with Lasseter, the creative genius behind Pixar's block busters, in charge of the new division, Disney would get the necessary push in creativity which it seemed to lack in recent times.

Questions:

1. Was pixar technology was an advantage to Disney?
2. Biocom acquisition comparison was benchmark for Disney?
3. Compensation for Pixar was great outcome in this business explain
4. Iger Strategy was a game changer from the point of Disney. Justify

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10.12 SUMMARY

Mergers and acquisitions (M&A) are defined as consolidation of companies. Differentiating the two terms, Mergers is the combination of two companies to form one, while Acquisitions is one company taken over by the other. M&A is one of the major aspects of corporate finance world. The reasoning behind M&A generally given is that two separate

companies together create more value compared to being on an individual stand. With the objective of wealth maximization, companies keep evaluating different opportunities through the route of merger or acquisition. Merger or amalgamation may take two forms: merger through absorption or merger through consolidation. Mergers can also be classified into three types from an economic perspective depending on the business combinations, whether in the same industry or not, into horizontal (two firms are in the same industry), vertical (at different production stages or value chain) and conglomerate (unrelated industries). From a legal perspective, there are different types of mergers like short form merger, statutory merger, subsidiary merger and merger of equals.

10.13 KEY WORDS

Amalgamation: is the combination of one or more companies into a new entity. An amalgamation is distinct from a merger because neither of the combining companies survives as a legal entity; a completely new entity is formed to house the combined assets and liabilities of both companies. This sense of the term amalgamation has generally fallen out of popular use, and the terms "merger" or "consolidation" are often used instead.

Vertical Merger: A vertical merger is a merger between two companies that operate at separate stages of the production process for a specific finished product. A vertical merger occurs when two or more firms, operating at different levels within an industry's supply chain, merge operations. Most often, the logic behind the merger is to increase synergies created by merging firms that would be more efficient operating as one.

Horizontal Merger: A horizontal merger is a merger or business consolidation that occurs between firms that operate in the same space, as competition tends to be higher and the synergies and potential gains in market share are much greater for merging firms in such an industry.

R&D: Research and development (R&D) refers to the investigative activities a business conducts to improve existing products and procedures or to lead to the development of new products and procedures.

10.14 SELF ASSESSMENT QUESTIONS

1. What do you mean by Value Creation in Mergers?
2. Define the Mergers and Acquisitions.
3. Explain the Traditional and Modern Views.

4. Identify the Ten biggest Mergers and Acquisitions.
5. Explain the Classification of Mergers.

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UNIT-11 : TAKEOVERS AND BUYOUTS

Steucture:

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11.0 OBJECTIVES:

After studying this unit, you will be able to :

- Give the meaning of Emergence and Objectives of takeover
- Explain the Types of Corporate Takeovers
- Describe the Buyout Firm Structure and Organization
- Bring out the Hostile Takeover Defenses
- Identify the Business alliance / Strategic alliance
- Highlight the Theory and Mechanics of the Leveraged Buyout

11.1 INTRODUCTION

A high level of competitive pressure and an increasing appetite for growth have led firms across geographies and industries to choose the inorganic growth path. Mergers & Acquisitions and Takeovers provide a robust growth vehicle often best suited for such firms seeking an entry into a market, geography, and product category or broadening its product and / or client base. Takeover, an inorganic corporate growth device whereby one company acquires control over another company, usually by purchasing all or a majority of its shares. Takeover implies acquisition of control of a company, which is already registered, through the purchase or exchange of shares. Takeovers usually take place when shares are acquired or purchased from the shareholders of a company at a specified price to the extent of at least controlling interest in order to gain control of that company. Takeover of management and control of a business enterprise could take place in different modes.

The management of a company may be acquired by acquiring the majority stake in the share capital of a company. A company may acquire shares of an unlisted company through what is called the acquisition under Section 395 of the Companies Act, 1956. Where the shares of the company are closely held by a small number of persons, a takeover may be effected by agreement with the holders of those shares. However, where the shares of a company are widely held by the general public, it involves the process as set out in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. Ordinarily, a larger company takes over a smaller company. In a reverse takeover, a smaller company acquires control over a larger company. The takeover strategy has been conceived to improve corporate value, achieve better productivity and profitability by making optimum use of the

available resources in the form of men, materials and machines. Company Secretaries have important role to play in the take over process especially with regard to compliances under the Companies Act, SEBI (SAST) Regulations 2011, Competition Law aspects, FEMA regulations etc. The role would be with respect to preparation of checklist, drafting of documents, obtaining of necessary approvals etc. The advisory role of company secretaries in the effective execution of takeover deals is vital throughout the takeover process.

11.2 EMERGENCE AND OBJECTIVES OF TAKEOVER

Corporate Sector is an attractive medium for carrying on business as it offers a lot of benefits. Raising money from public has its own positive features and it helps setting up big projects. When promoters of a company desire to expand, they take a quick view of the industrial and business map. If they find there are opportunities, they will always yearn for capitalizing such opportunities. Compared to the efforts required, cost and time needed in setting up a new business, it would make sense to them to look at the possibilities of acquiring an existing entity. While the possibility of takeover of a company through share acquisition is desirable for achieving certain strategic objectives, there has to be well defined regulations so that the interests of all concerned are not jeopardized by sudden takeover threats. In this perspective, if one were to analyze, it would be clear that there has to be a systematic approach enabling and leading the takeovers, while simultaneously providing adequate opportunity to the original promoters to protect/counter such moves.

Thus, while the acquirer should adopt a disciplined method with proper disclosure of intentions so that not only the original promoters who are in command are protected but also the investors. It would be in the interests of all concerned that the takeover is carried out in a transparent manner. When adequate checks and balances are introduced and ensured, takeovers become a good tool. That is the reason why regulations have been put in place and these regulations require sufficient disclosures at every stage of acquisition. These regulations take so much care that they cover not only direct acquisition of the acquirer but also includes acquisitions through relatives and associates and group concerns. In India, the process of economic liberalisation and globalisation ushered in the early 1990’s created a highly competitive business environment, which motivated many companies to restructure their corporate strategies. The restructuring process led to an unprecedented rise in strategies like amalgamations, mergers including reverse mergers, demergers, takeovers, reverse takeovers and other strategic alliances.

Objects of Takeover

The objects of a takeover as given below:

(i) To effect savings in overheads and other working expenses on the strength of combined resources;

(ii) To achieve product development through acquiring firms with compatible products and technological/manufacturing competence, which can be sold to the acquirer's existing marketing areas, dealers and end users;

(iii) To diversify through acquiring companies with new product lines as well as new market areas, as one of the entry strategies to reduce some of the risks inherent in stepping out of the acquirer's historical core competence;

(iv) To improve productivity and profitability by joint efforts of technical and other personnel of both companies as a consequence of unified control;

(v) To create shareholder value and wealth by optimum utilisation of the resources of both companies;

(vi) To achieve economy of numbers by mass production at economical costs;

(vii) To secure advantage of vertical combination by having under one command and under one roof, all the stages or processes in the manufacture of the end product, which had earlier been available in two companies at different locations, thereby saving loading, unloading, transportation costs and other expenses and also by affecting saving of time and energy unnecessarily spent on excise formalities at different places and stages;

(viii) To secure substantial facilities as available to a large company compared to smaller companies for raising additional capital, increasing market potential, expanding consumer base, buying raw materials at economical rates and for having own combined and improved research and development activities for continuous improvement of the products, so as to ensure a permanent market share in the industry;

(ix) To increase market share;

(x) To achieve market development by acquiring one or more companies in new geographical territories or segments, in which the activities of acquirer are absent or do not have a strong presence.

11.3 TYPES OF CORPORATE TAKEOVERS

There are several different types of takeover. The main types are:

1. Friendly Takeover'— It is a direct approach to takeover. The buying (bidder) company approaches the directors of the Target company and offers to takeover for a specified price before proposing it to the shareholders of that company. The proposed buyer may be accessible to the target company accounts. It is known as due intelligence. Following are examples of friendly deals.

(a) Hindustan Lever Limited (HLL) has taken complete control of Lakme-Lever, a joint venture with the Tata in which it earlier had a 50% stake.

(b) Workharclt had bought out the Tata stake in Pharma Company Merind. These have been friendly deals.

2. Hostile Takeover' —It is an indirect method of takeover. If direct offer made by the bidder is rejected by the board of the target company, the bidder starts buying enough number of shares so that the bidder can control the Board of target company which helps the bidder to acquire the target company. The hostile bidder has no access to privateinformation about the company. Financial institutions areusually more cautious about lending money for hostiletakeovers. Following are some of the hostile deals.

(a) India Cements did cast its eyes on Raasi Cementsafter buying out the stake of one of the RaasiCements' promoters.

(b) A potent take over attempt, targeting a 20% stake inIndian Aluminium (INDAL) was made by SterliteIndustries,

(c) Swaraj Paul through his boisterous nature shook upthe quiet world of Indian board rooms and launchedhis bid for Escorts and DCM.

(d) R.P. cloenka cobbled together an industrial empire bytaking over companies like Ceat and CESC.

(e) The Hindujas raided and took over Ashok leyland andEnnoreFoundaries.

(f) The Ambanis succeeded in taking control of Larsenand Toubro (L&T) which instructed the FinancialInstitution (19's) to keep their distance during take-over struggles.

3. 'Reverse Takeover'—Sometimes reverse takeover happens when the target company starts buying the acqirer's(buying) company shares and tries to take control over thebuying company. In the U.S. A Bendix Corporation made ahostile attempt to acquire Martin Marietta

in 1992. In order tohit back, Martin Marietta (target company) started buying sharesof Bendix Corporation and tried to take control over BendixCorporation,

Or some time it can be classified as following three types

Takeovers may be broadly classified into three kinds:

(i) Friendly Takeover: Friendly takeover is with the consent of taken over company. In friendly takeover, there is an agreement between the management of two companies through negotiations and the takeover bid may be with the consent of majority or all shareholders of the target company. This kind of takeover is done through negotiations between two groups. Therefore, it is also called negotiated takeover.

(ii) Hostile Takeover: When an acquirer company does not offer the target company the proposal to acquire its undertaking but silently and unilaterally pursues efforts to gain control against the wishes of existing management.

(iii) Bail out Takeover: Takeover of a financially sick company by a profit earning company to bail out the former is known as bail out takeover. There are several advantages for a profit making company to takeover a sick company. The price would be very attractive as creditors, mostly banks and financial institutions having a charge on the industrial assets, would like to recover to the extent possible. Banks and other lending financial institutions would evaluate various options and if there is no other go except to sell the property, they will invite bids. Such a sale could take place in the form by transfer of shares. While identifying a party (acquirer), lenders do evaluate the bids received, the purchase price, the track record of the acquirer and the overall financial position of the acquirer. Thus a bail out takeover takes place with the approval of the Financial Institutions and banks.

11.4 HOSTILE TAKEOVER AND POISON PILL DEFENSE

1. 'Hostile Takeover: Acquirer (buying) company offers to a target company's board to buy at a price per share, ifaccepted, the merger takes place. If rejected, the acquirer starts buying the target company's shares and gets into theBoard of the target company and ensures that acquisition takesplace by force. This type of takeover is known as hostiletakeover.

2. Poison pill is a term referring to any strategy, generallyin business or socially to increase the likelihood of negativeresults over positive ones for a party that attempts any kind oftakeover. It derives from its original meaning of a literal poisonpill carried by various spicies throughout history, taken whendiscovered, to eliminate the possibility of being interrogated forthe enemy's gain. Poison pills are protective mechanisms athostile takeover. The target company board tries to protectitself from hostile takeover by using various

devices.Sometimes it may be beneficial to the shareholders or harmfulto the company. The various strategic moves are known aspoison pills. It gives management time to find other competing offers from other companies which bring better premiums and values to the shareholders. Sometimes poison pills are detrimental to the shareholder's interest if such take over fails and it also underestimate the current management. For instance, Microsoft made an unsolicited bid for Yahoo. Microsoft offered $33 per share which was already expensive, but yahoo raised the offer to $37.As Microsoft dropped their bid, Yahoo's stock price plunged.

Martin Lipton invented the poison pill in 1982 when tenderbased hostile takeovers or corporate raids took place in 1980s.

How do Poison pills Work?

Takeovers are of different types. Some takeovers are friendly some are hostile. In a normal takeover the buying company approaches the Board of the target (selling) company and expreses its willingness to take over at a particular price per share. The target (selling) company either obliges or rejects the offer. If offer is accepted, the merger takes place, if not, the buying company abandons the takeover or follows negative techniques to acquire such proposed target company by buying enough number of shares in the market and gets into the Board as directors and tries to control the target company as the Board of directors can initiate the process of merger. This mechanism through which a target company is forced to merge with the buying company is known as hostile takeover. The target company plans devices (various business strategies)to protect itself if hostile takeover happens in future.

1. Business strategies

Let us see various techniques followed by companies in thepast to protect themselves. Those business strategies toprotect oneself will help us understand the poison pills better.

1. Yahoo! in order to protect itself from hostile takeover had created a poison pill in 2000 allowing the board to issue upto 10 million shares with unlimited voting power on new stock. Furthermore, they entitled every director to cash all of their outstanding stock options which amounted to about 16 million potential new shares. This defense mechanism made it practically impossible for Microsoft to proceed with a hostile bid after Yahoo! expressed its unwillingness towards Microsoft's offer for Yahoo! and ultimately resulted in the withdrawal of the same. Yahoo! demanded US$37 per share from Microsoft; Microsoft's raised offer of $33 per share was already too expensive.

Can you find why Yahoo! CEO Jerry Yang resigned afterMicrosoft dropped their bid?

2. Normally transfer of rights over new equity shares canbe exercised only when new shares are offered. Thenotional right on issue of future equity shares cannot betransferred by the present target companyshareholders. But On 1998, Motorola, Inc. adopted anew rights plan to replace an existing plan. Under theplan, one right attaches to each existing share ofcommon stock. If a person or group acquires a tenpercent stake, all other right holders will be entitled topurchase the company's stock at a fifty percentdiscount. Motorola may redeem the new rights at onepercent per right at any time before a person or grouptakes a ten percent stake.

3. Peoplesoft had given guarantee to its customers in June2003 for four years product support, if peoplesoft wastakenover by someone within 2 years as they thoughtthat Oracle Corporation might takeover,suchguaranteed customers would receive refund between2 to 5 times of the fees paid to the Peoplesoft softwarelicences. If such takeover event happens, thehypothetical cost was valued at US $ 1.5 billion, This is one of the reasons why Oracle Corporation paid toPeoplesoft $4.1 billion more.

4. Some times reverse takeover happens when the targetcompany starts buying the acqirer's (buying) companyshares and tries to control over buying company. In theU.S. A Bendix Corporation made a hostile attempt toacquire Martin Marietta in 1992. In order to hit backMartin Marietta (target company) started buying sharesof Bendix Corporation and tried to control over BendixCorporation.

11.5 HOSTILE TAKEOVER DEFENSES

There are many defenses available or chartered to defend at the time of hostile takeover. Different hostile takeoverdefenses are explained below.

1. Bankmail defence: It is a kind of financial restrictionmade by the target firm's bank who refuses to financeor increase transaction costs which increases the costto the acquirer. It helps the target firm to buy timeand give pressure to the hostile acquiring firm

2. People pill defence: The strength of any organization depends on the management team. The managementteam of the target company threatens to quit if thehostile or coercive takeover happens. In suchsituation, the acquirer may have to run with remainingemployees or management. Therefore theacquirer looses his interest in the target firm.

3. Staggered board defence: Board of directors are appointed in the annual general meeting. Normally 1/3 rd of directors retire and are reappointed. If the same group of directors continue they may act in favour of a hostile merger or act for personal interests rather than shareholders' interests. Therefore

company makes strategic rules that the company's directorial board is to be replaced every year. In this way the acquirer may not be able to seize control over the target company.

4. White Knight defence: In order avoid hostile takeover the target company joins hands with friendlyacquirer called White Knight. White knight can be a company or any person who offers a higher bid. The hostile bidder may not be able to acquire the target company as it has to acquire at a higher price due to White knight's offer. Bxamples of White knights

• 1953—United Paramount Theaters buys nearly bankrupt ABC.

• 1982—Allied Corporation buys Bendix Corporation in a situation involving the E'ac-Man defense. Allied is drafted in when the company that Bendix tries a hostile takeover on fights back by buying up Bendix stock in attempt to create a reverse hostile takeover.

• 1984—Chevron Corporation acquired Gulf Oil after Gulf tried being a white knight to Citgo in 1982 in order for Citgo to avoid a hostile takeover by T. Boone Pickens. l'ickens then turned his attention to Gulf, leading to the Chevron-Gulf deal.

• 1984—Sid Bass and his sons buying significant interest in Walt Disney Productions as a defense against Saul Steinberg's hostile bid for the company.

• 1986-George Soros's ilarken Energy buying George W. Bush's Spectrum.

• 1998 — Compaq merging with financially weakDEC

• 2001—Dynegy attempts to merge with Enron to cover Enron's massive debts (the merger failed as it became obvious that Enron had been committing fraud, resulting in the Enron scandal).

• 2003—SAP was seen by analysts as the most likely to help defeat Oracle's hostile bid for peopleSoft, however it came to nothing.

• 2006-Severstal almost acted as a white knight to Arcelor as the merger negotiations were in place between Arcelor and Mittal Steel

• 2006—Bayer acted as a. white knight to Schering as the merger negotiations were in place between Schering and Merck P1aA

• 2007—Nissin Foods launching a friendly 37bn yen ($314m; £166m) bid for llyojo Foods after US hedge fund Steel l'artners offered 29bn yen to buy the firm.

• 2008-JFMorgan Chase acquired Bear Steams allowing Bear Stearns to avoid insolvency after Bear Stearns stock price suffered a precipitous decline, with its market capitalization dropping by92%.

• 2008-PNC Financial Services bought National City Corp. after National City was denied TARP funds in order to stay afloat due to increasing concerns that National City would fail due to the subprime mortgage crisis.

• 2009.-Fiat took over Chrysler, saving the struggling automaker from liquidation.

5. Safe harbors: In order to avoid unsolicited takeover and to raise acquisition price, the target firm will acquire a troublesome firm to raise the acquisition price and make acquisition by other parties financially/economically unattractive.

6. The scorched-earth defense: The target firm threatens the unsolicited acquirer that it would sell attractive assets in which the acquirer is interested say, (new software developed by the target company or division of the target firm/ department).Sometimes the target firm may advance the schedule of debt payment so that the acquirer might think that it will be difficult to run after acquisition.

7. A standstill agreement: It limits the bidder's holdings at any point of time in the target firm. Sometimes the target firm starts acquiring the hostile bidder's shares in defense. It will help the target firm to build up other takeover defenses thereby delay the takeover.

8. A targeted repurchase: When unfriendly bidder tries to take over by acquiring a reasonable number of shares, the target company buys back its own shares more than the market price from the unfriendly bidder.

9. A voting plan or voting rights plan: Right to vote is in the hands of equity share holders. If any hostile attempt is made by unsolicited buyer, the target firm restricts the equity shareholders' rights and charters preference stock with superior rights over equity shareholders. In such circumstances the hostile bidder may not be able to control the company by acquiring equity shares. For example, Asarco's equity shareholders can exercise only 1 6.5% of total voting power.

10. Brand pills: Rules are made not allowing the acquirer to use the name or brand name of the target firm. If anyone acquires TATA companies, the acquirer cannot use the name TATA. This is an Indian poison pill by TATA.

11. Poison Debt: At the time of hostile takeover, the target company issues debt securities and makes covenants that restrict sale of assets, higher interest rate, quickening maturity date, buy notes at premium. It restricts the hostile bidder some extent.

12. Put rights plan: (Other than) the hostile acquirer are allowed to sell their common stock to the target company for a specified sum of cash, debt securities, preferred stock etc.

13. A lobster trap: The target firm's convertible debenture holders with more than 10% cannot convert them into voting equity shares. This is created by using a charter.

14. The Nancy Reagan Defense: "Just say no" to the hostile bidder when the Board of Directors of the target company meets to consider the bid.

15. Pac man defense: This term is derived from video game star Pac-Man who is a hero and chased by four ghosts, but after eating 'Power Pellet' the hero is able to chase the ghosts. Sometimes reverse takeover happens when the target company starts buying the acqirer's (buying) company shares and tries to control over buying company. In the U.S. A Bendix Corporation made a hostile attempt to acquire Martin Marietta in 1992. In order to hit back Martin Marietta (target company) started buying shares of Bendix Corporation and tried to control over Bendix Corporation.

a. The next Pac-Man defense to occur was in 1988, when American Brands Inc., fighting a hostile takeover attempt by E-H Holdings Inc., announced a cash tender offer for IS-Il.

b. In 2007, British mining giant Rio Tinto PLC, fighting off an unsolicited $131.57 billiontakeover bid from Australian rival BHP BillitonPLC. considered turning the tables on its rivaland launching a counterbid for BHP.

c. In 2009, Cadbury plc considered trying aI'ac-Man defense if no bid emerged to challenge kraftFoods' hostile offer.

16. Greenmail or greenmailing: It is the practice of purchasing enough shares in a firm to threaten atakeover and thereby forcing the target firm to buythose shares back at a premium in order to suspendthe takeover.

The term is a neologism derived from the wordsblackmail and greenback as commentators andjournalists saw the practice of said corporate raidersas attempts by well-financed individuals to blackmail acompany into handing over money by using the threat of a takeover.

1. Greenmail proved lucrative for investors such asT. Boone Pickens and Sir James Goldsmithduring the 1980s. In the latter example,Goldsmith made $90 million from the GoodyearTire and Rubber Company in the 1980s in thismanner.

2. Occidental Petroleum paid greenmail to DavidMurdoch in 1984.

3. The St. Regis Paper Company provides anexample of greenmail. When an investor groupled by Sir James Goldsmith acquired 8.6°% stake in St. Regis and expressed interest intaking over the paper concern, the companyagreed to repurchase the shares at a premium.

Goldsmith's group acquired the shares for anaverage price of $35.50 per share, a total of$109 million. It sold its stake at $52 per share,netting a profit of $51 million. Shortly after thepayoff in March 1984, St. Regis became the targetof publisher Rupert Murdoch. St Regis turned toChampion International and agreed to a $1.84billion takeover. Murdoch tendered his 5.6% stake in St. Regis to the Champion offer for a pro

17. A pension parachute: This poison pill prevents theunsolicited attempt made by hostile company. Thetarget company does not allow the acquirer to makeuse of pension amount for funding the acquisition.This is done by creating a charter mainly to protectthe company employees as pension assets belong tothem. Ford has to pay of around USD 600-million ofpension deficits of its massive staff across the WestMidlands and Merseysicle of its Jaguar and Land Rover brand as the part of the deal and it is expected that Tata has to assure the Ford about secure future of the employees of both the brands.

a. The law firm of Kelley Drye& Warren claims to be the pioneers of the pension parachute. Their first pension parachute was implemented for Union Carbide, and its design was upheld in Union Carbide's litigation with OAF.

18. Whitemail: This term is used when a job is to be quickly finished by someone and extra incentive(extra pay) is offered to the person for such reason. The extra incentive is called white mail. In a hostile attempt the target company sells discounted price of its stock to a friendly third party in order to raise the acquisition price offered by a hostile bidder. The purpose is to increase the total value to the target company shareholders.

11.6 BUYOUTS/ LEVERAGE BUYOUTS

A leveraged buyout, or LBO, is an acquisition of a company or division of another company financed with a substantial portion of borrowed funds. In the 1980s, LBO firms and their professionals were the focus of considerable attention, not all of it favorable. LBO activity accelerated throughout the 1980s, starting from a basis of four deals with an aggregate value of $1.7 billion in 1980 and reaching its peak in 1988, when 410 buyouts were completed with an aggregate value of $188 billion . In the years since 1988, downturns in the business cycle, the near-collapse of the junk bond market, and diminished structural advantages all contributed to dramatic changes in the LBO market. In addition, LBO fund raising has accelerated dramatically. From 1980 to 1988 LBO funds raised approximately $46 billion;

from 1988 to 2000, LBO funds raised over $385 billion. As increasing amounts of capital competed for the same number of deals, it became increasingly difficult for LBO firms to acquire businesses at attractive prices.

In addition, senior lenders have become increasingly wary of highly levered transactions, forcing LBO firms to contribute higher levels of equity. In 1988 the average equity contribution to leveraged buyouts was 9.7%. In 2000 the average equity contribution to leveraged buyouts was almost 38%, and for the first three quarters of 2001 average equity contributions were above 40%. These developments have made generating target returns (usually 25 to 30%) much more difficult for LBO firms. Where once they could rely on leverage to generate returns, LBO firms today are seeking to build value in acquired companies by improving profitability, pursuing growth including roll-up strategies (in which an acquired company serves as a "platform" for additional acquisitions of related businesses to achieve critical mass and generate economies of scale), and improving corporate governance to better align management incentives with those of shareholders. History of the LBO While it is unclear when the first leveraged buyout was carried out, it is generally agreed that the first early leveraged buyouts were carried out in the years following World War II. Prior to the 1980s, the leveraged buyout (previously known as a "bootstrap" acquisition) was for years little more than an obscure financing technique.

In the years following the end of World War II the Great Depression was still relatively fresh in the minds of America's corporate leaders, who considered it wise to keep corporate debt ratios low. As a result, for the first three decades following World War II, very few American companies relied on debt as a significant source of funding. At the same time, American business became caught up in a wave of conglomerate building that began in the early 1960s. Executives filled boards of directors with subordinates and friendly "outsiders" and engaged in rampant empire building. The ranks of middle management swelled and corporate profitability began to slide. It was in this environment that the modern LBO was born.

In the late 1970s and early 1980s, newly formed firms such as Kohlberg Kravis Roberts and Thomas H. Lee Company saw an opportunity to profit from inefficient and undervalued corporate assets. Many public companies were trading at a discount to net asset value, and many early leveraged buyouts were motivated by profits available from buying entire companies, breaking them up and selling off the pieces. This "bust-up" approach was largely responsible for the eventual media backlash against the greed of so-called "corporate raiders", illustrated by books such as The Rain on Macy's Parade and films such as Wall Street and Barbarians at the Gate, based on the book by the same name. As a new generation

of managers began to take over American companies in the late 1970s, many were willing to consider debt financing as a viable alternative for financing operations. Soon LBO firms' constant pitching began to convince some of the merits of debt-financed buyouts of their businesses. From a manager's perspective, leveraged buyouts had a number of appealing characteristics:

- Tax advantages associated with debt financing,
- Freedom from the scrutiny of being a public company or a captive division of a larger parent,
- The ability for founders to take advantage of a liquidity event without ceding operational influence or sacrificing continued day-to-day involvement, and
- The opportunity for managers to become owners of a significant percentage of a firm's equity.

11.7 THE THEORY AND MECHANICS OF THE LEVERAGED BUYOUT

While every leveraged buyout is unique with respect to its specific capital structure, the one common element of a leveraged buyout is the use of financial leverage to complete the acquisition of a target company. In an LBO, the private equity firm acquiring the target company will finance the acquisition with a combination of debt and equity, much like an individual buying a house with a mortgage. Just as a mortgage is secured by the value of the house being purchased, some portion of the debt incurred in an LBO is secured by the assets of the acquired business. Unlike a house, however, the bought-out business generates cash flows which are used to service the debt incurred in its buyout – in essence, the acquired company helps pay for itself (hence the term "bootstrap" acquisition).

The use of significant amounts of debt to finance the acquisition of a company has a number of advantages, as well as risks. The most obvious risk associated with a leveraged buyout is that of financial distress. Unforeseen events such as recession, litigation, or changes in the regulatory environment can lead to difficulties meeting scheduled interest payments, technical default (the violation of the terms of a debt covenant) or outright liquidation. Weak management at the Target Company or misalignment of incentives between management and shareholders can also pose threats to the ultimate success of an LBO. There are a number of advantages to the use of leverage in acquisitions. Large interest and principal payments can force management to improve performance and operating efficiency. This "discipline of debt" can force management to focus on certain initiatives

such as divesting non-core businesses, downsizing, cost cutting or investing in technological upgrades that might otherwise be postponed or rejected outright. In this manner, the use of debt serves not just as a financing technique, but also as a tool to force changes in managerial behavior.

Another advantage of the leverage in LBO financing is that, as the debt ratio increases, the equity portion of the acquisition financing shrinks to a level at which a private equity firm can acquire a company by putting up anywhere from 20-40% of the total purchase price. Private equity firms typically invest alongside management, encouraging (if not requiring) top executives to commit a significant portion of their personal net worth to the deal. By requiring the target's management team to invest in the acquisition, the private equity firm guarantees that management's incentives will be aligned with their own.

Mechanics

To illustrate the mechanics of a leveraged buyout we will look at an LBO of Target Company. Exhibit 1 lays out operating and transaction assumptions for a leveraged buyout of Target Company, as well as a rudimentary set of financial projections and a summary of Target's post LBO capitalization. Exhibit 1 should be largely self-explanatory, with the possible exception of a few line items:

Transaction Fee Amortization: This line item reflects the capitalization and amortization of financing, legal, and accounting fees associated with the transaction. Transaction fee amortization, like depreciation, is a tax-deductible non-cash expense. In most cases the allowable amortization period for such fees is five to seven years (although in some cases LBO firms may choose to expense all such fees in year one so as to present the "cleanest" set of numbers possible going forward).

Interest Expense: For simplicity, interest expense for each tranche of debt financing is calculated based upon the yearly beginning balance of each tranche. In reality, interest payments are often made quarterly, so interest expense in the case of the Target LBO may be slightly overstated.

Capitalization: Most leveraged buyouts make use of multiple tranches of debt to finance the transaction. Looking at the sources and uses of funds of funds in exhibit 1 it can be seen that the LBO of Target is financed with only two tranches of debt, senior and junior. In reality, a large leveraged buyout will likely be financed with multiple tranches of debt that could include (in decreasing order of seniority) some or all of the following:

- A revolving credit facility ("revolver") is a source of funds that the bought-out firm can draw upon as its working capital needs dictate. A revolving credit facility is designed to offer the bought-out firm some flexibility with respect to its capital needs – it serves as a line of credit that allows the firm to make certain capital investments, deal with unforeseen costs, or cover increases in working capital without having to seek additional debt or equity financing.
- Bank debt, which is often secured by the assets of the bought-out firm, is the most senior claim against the cash flows of the business. As such, bank debt is repaid first, with its interest and principal payments taking precedence over other, junior sources of debt financing.
- Mezzanine debt, so named because it exists in the middle of the capital structure, is junior to the bank debt incurred in financing the leveraged buyout. As a result, mezzanine debt (like each succeeding level of junior debt) is compensated for its lower priority with a higher interest rate.
- Subordinated or High-Yield Notes are what are commonly referred to as junk bonds. Usually sold to the public, these notes are the most junior source of debt financing and as such command the highest interest rates to compensate holders for their increased risk exposure.

Each tranche of debt financing will likely have different maturities and repayment terms. For example, some sources of financing require mandatory amortization of principal in addition to scheduled interest payments. Some lenders may receive warrants, which allow lenders to participate in the equity upside in the event the deal is highly successful. There are a number of ways private equity firms can adjust the target's capital structure. The ability to be creative in structuring and financing a leveraged buyout allows private equity firms to adjust to changing market conditions.

In addition to the debt financing component of an LBO, there is also an equity component.

- Private equity firms typically invest alongside management to ensure the alignment of management and shareholder interests. In large LBOs, private equity firms will sometimes team up to create a consortium of buyers, thereby reducing the amount of capital exposed to any one investment. As a general rule, private equity firms will own 70-90% of the common equity of the bought-out firm, with the remainder held by management and former shareholders.

- Another potential source of financing for leveraged buyouts is preferred equity. Preferred equity is often attractive because its dividend interest payments represent a minimum return on investment while its equity ownership component allows holders to participate in any equity upside. Preferred interest is often structured as pay-in-kind, or PIK, dividends, which means any interest is paid in the form of additional shares of preferred stock. LBO firms will often structure their equity investment in the form of preferred stock, with management and employees receiving common stock.

Cash Sweep: A cash sweep is simply a provision of certain debt covenants that stipulates that any excess cash (namely free cash flow available after mandatory amortization payments have been made) generated by the bought-out business will be used to pay down principal. For those tranches of debt with provisions for a cash sweep, excess cash is used to pay down debt in the order of seniority. For example, in the case of Target the cash sweep does not begin to pay down Junior Debt until Year 4.

Exit Scenario: As a general rule, leveraged buyout firms seek to exit their investments in 5 to 7 years. An exit usually involves either a sale of the portfolio company, an IPO or a recapitalization (effectively an acquisition and relevering of the company by another LBO firm). Exhibit 2 describes returns to an LBO investor in a sale of a portfolio company at various EBITDA multiples (companies are often valued based upon a multiple of Earnings before Interest, Taxes, Depreciation and Amortization, or EBITDA).

11.8 BUYOUT FIRM STRUCTURE AND ORGANIZATION

The equity that LBO firms invest in an acquisition comes from a fund of committed capital that has been raised from a pool of "qualified" investors (defined by the SEC as (i) an individual with net worth, or joint net worth with spouse, over $1 million, or (ii) an individual with income over $200,000 in each of the two most recent years or joint income with spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year). These funds are structured as limited partnerships, with the firm's principals acting as general partner and investors in the fund (usually investment funds, insurance companies, pension funds and wealthy individuals) acting as limited partners. The general partner is responsible for making all investment decisions relating to the fund, with the limited partners responsible for transferring committed capital to the fund upon notice of the general partner.

As a general rule, funds raised by private equity firms have a number of fairly standard provisions:

Minimum Commitment: Prospective limited partners are required to commit a minimum amount of equity. Limited partners make a capital commitment, which is then drawn down (a "takedown" or "capital call") by the general partner in order to make investments with the fund's equity.

Investment or Commitment Period: During the term of the commitment period, limited partners are obligated to meet capital calls upon notice by the general partner by transferring capital to the fund within an agreed-upon period of time (often 10 days). The term of the commitment period usually lasts for either five or six years after the closing of the fund or until 75 to 100% of the fund's capital has been invested, whichever comes first.

Term: The term of the partnership formed during the fund-raising process is usually ten to twelve years, the first half of which represents the commitment period (defined above), the second half of which is reserved for managing and exiting investments made during the commitment period.

Diversification: Most funds' partnership agreements stipulate that the partnership may not invest more than 25% of the fund's equity in any single investment.

The LBO firm generates revenue in three ways:

Carried Interest: Carried interest is a share of any profits generated by acquisitions made by the fund. Once all the partners have received an amount equal to their contributed capital any remaining profits are split between the general partner and the limited partners. Typically, the general partner's carried interest is 20% of any profits remaining once all the partners' capital has been returned; although some funds guarantee the limited partners a priority return of 8% on their committed capital before the general partner's carried interest begins to accrue.

Management Fees: LBO firms charge a management fee to cover overhead and expenses associated with identifying, evaluating and executing acquisitions by the fund. The management fee is intended to cover legal, accounting, and consulting fees associated with conducting due diligence on potential targets, as well as general overhead. Other fees, such as lenders' fees and investment banking fees are generally charged to the acquired company after the closing of a transaction. Management fees range from 0.75% to 3% of committed capital, although 2% is common. Management fees are often reduced after the end of the commitment period to reflect the lower costs of monitoring and harvesting investments.

Co-Investment: Executives and employees of the leveraged buyout firm may co-invest along with the partnership on any acquisition made by the fund, provided the terms of the investment are equal to those afforded to the partnership.

11.9 ADVANTAGES AND DISADVANTAGES OF LBOS

Following are advantages of LBOs.

1. It can increase management commitment and effort because they have greater equity stake in the company.

2. The enhanced performance due to LBOs which can realize a major gain to managers

After an LBO, however, executives can realize substantial financial gains from enhanced performance. This improvement in financial incentives for the firm's managers should result in greater effort on the part of management.

3. When employees are involved in an LEO, their increased stake in the company's success tends to improve their productivity and loyalty.
4. All of a sudden, the acquiring company's net worth and market share increase.
5. The interest tax shield resulting from the higher levels of debt should enhance the value of firm.
6. Wealth transfers from old public shareholders to the buyout group; transfers from public bond holders to the investor group;
7. Wealth creation from improved incentives for managerial decision making; and
8. Wealth transfers from the government via tax advantages.

Disadvantages

Following are the major disadvantages of LBOs.

1. The hostile take over's by this means would affect financial position as all most 90% of the total funds are financed out of borrowed funds by mortgaging the assets of the acquired company. The intention of the hostile takeover company may be to use the acquirer's assets rather than making such company to survive. Some times after making use of such assets and other resources hostile acquirer may sell the company to gain further from sale.

2. Some times L130s are used to downsize the employees, employees may lose their jobs. It may have negative impact on the communities where such company has business operations.

3. Much of the controversy regarding Ll3Os has resulted from the concern that senior executives negotiating the sale of the company to themselves are engaged in self-dealing.

4. Since management has superior information about their business, the real intrinsic value may not be known to the existing shareholders. The target company may be transferred by such hostile company again to another company. Due to which the accumulated debt and interest burden may collapse the company in the long run. Following an LBO, the target company (surviving company) may find that it needs to raise money to satisfy the debt payments, and interest. Companies thus frequently sell off good divisions or portions of their business.

11.10 BUSINESS ALLIANCE / STRATEGIC ALLIANCE

An arrangement or relationship among independent businesses with corresponding goals, established for a specific purpose and often for reducing costs and improving customer service. The collaboration is usually managed by a team with members from each business and held together by one agreement giving an equal share of risk and opportunity to each business. An example would be a shared marketing program between Wal-Mart and Procter & Gamble.

Business alliance / Strategic alliance - concept

A strategic alliance is an agreement between two or more parties to pursue a set of agreed upon objectives needed while remaining independent organizations. A strategic alliance will usually fall short of a legal partnership entity, agency, or corporate affiliate relationship. Typically, two companies form a strategic alliance when each possesses one or more business assets or have expertise that will help the other by enhancing their businesses. Strategic alliances can develop in outsourcing relationships where the parties desire to achieve long-term win-win benefits and innovation based on mutually desired outcomes.

This form of cooperation lies between mergers and acquisitions and organic growth. Strategic alliances occurs when two or more organizations join together to pursue mutual benefits.

Partners may provide the strategic alliance with resources such as products, distribution channels, manufacturing capability, project funding, capital equipment, knowledge, expertise, or intellectual property. The alliance is co-operation or collaboration which aims for a synergy

where each partner hopes that the benefits from the alliance will be greater than those from individual efforts. The alliance often involves technology transfer (access to knowledge and expertise), economic specialization, shared expenses and shared risk.

Strategic alliances have emerged to solve many company business problems, and to spur collaboration and innovation. The book Vested: How P&G, McDonald's and Microsoft are Redefining Winning in Business Relationships profiles strategic partnerships in large-scale business process outsourcing relationships, public-private infrastructure projects, facilities management and supply chain relationships. Contemporary strategic sourcing and procurement processes enable organizations to use Performance-Based or Vested sourcing business models for establishing strategic supplier relationships.

There are several ways of defining a strategic alliance. Some of the definitions emphasize the fact that the partners do not create a new legal entity, i.e. a new company. This excludes legal formations like joint ventures from the field of Strategic Alliances. Others see joint ventures as possible manifestations of Strategic Alliances. Some definitions are given here:

Definitions including joint ventures

- A strategic alliance is an agreement between two or more players to share resources or knowledge, to be beneficial to all parties involved. It is a way to supplement internal assets, capabilities and activities, with access to needed resources or processes from outside players such as suppliers, customers, competitors, companies in different industries, brand owners, universities, institutes or divisions of government.
- A strategic alliance is an organizational and legal construct wherein "partners" are willing-in fact, motivated-to act in concert and share core competencies. This is especially relevant in strategic outsourcing relationships. To a greater or lesser degree, some alliances result in the virtual integration of the parties through partial equity ownership, through contracts that define rights, roles and responsibilities over a span of time or through the purchase of non-controlling equity interests. Eventually, many result in integration through acquisition.

Definitions excluding joint ventures

- An arrangement between two companies that have decided to share resources to undertake a specific, mutually beneficial project. A strategic alliance is less involved and less permanent than a joint venture, in which two companies typically pool resources to create a separate business entity. In a strategic alliance, each company maintains its autonomy while gaining a new opportunity. A strategic alliance could help a company

develop a more effective process, expand into a new market or develop an advantage over a competitor, among other possibilities.

- Agreement for cooperation among two or more independent firms to work together toward common objectives. Unlike in a joint venture, firms in a strategic alliance do not form a new entity to further their aims but collaborate while remaining apart and distinct.

Some types of business / strategic alliances include

- Horizontal strategic alliances, which are formed by firms that are active in the same business area. That means that the partners in the alliance used to be competitors and work together In order to improve their position in the market and improve market power compared to other competitors. Research &Development collaborations of enterprises in high-tech markets are typical Horizontal Alliances. Raue& Wieland (2015) describe the example of horizontal alliances between logistics service providers. They argue that such companies can benefit twofold from such an alliance. On the one hand, they can "access tangible resources which are directly exploitable". This includes extending common transportation networks, their warehouse infrastructure and the ability to provide more complex service packages by combining resources. On the other hand, they can "access intangible resources, which are not directly exploitable". This includes know-how and information and, in turn, innovativeness.
- Vertical strategic alliances, which describe the collaboration between a company and its upstream and downstream partners in the Supply Chain, that means a partnership between a company its suppliers and distributors. Vertical Alliances aim at intensifying and improving these relationships and to enlarge the company´s network to be able to offer lower prices. Especially suppliers get involved in product design and distribution decisions. An example would be the close relation between car manufacturers and their suppliers.
- Intersectional alliances are partnerships where the involved firms are neither connected by a vertical chain, nor work in the same business area, which means that they normally would not get in touch with each other and have totally different markets and know-how.
- Joint ventures, in which two or more companies decide to form a new company. This new company is then a separate legal entity. The forming companies invest equity and resources in general, like know-how. These new firms can be formed for a finite time, like for a certain project or for a lasting long-term business relationship, while control, revenues and risks are shared according to their capital contribution.

- Equity alliances, which are formed when one company acquires equity stake of another company and vice versa. These shareholdings make the company stakeholders and shareholders of each other. The acquired share of a company is a minor equity share, so that decision power remains at the respective companies. This is also called cross-shareholding and leads to complex network structures, especially when several companies are involved. Companies which are connected this way share profits and common goals, which leads to the fact that the will to competition between these firms is reduced. In addition this makes take-overs by other companies more difficult.
- Non-equity strategic alliances, which cover a wide field of possible cooperation between companies. This can range from close relations between customer and supplier, to outsourcing of certain corporate tasks or licensing, to vast networks in R&D. This cooperation can either be an informal alliance which is not contractually designated, which appears mostly among smaller enterprises, or the alliance can be set by a contract.

Michael Porter and Mark Fuller, founding members of the Monitor Group (now Monitor Deloitte), draw a distinction among types of strategic alliances according to their purposes:

- Technology development alliances, which are alliances with the purpose of improvement in technology and know-how, for example consolidated Research & Development departments, agreements about simultaneous engineering, technology commercialization agreements as well as licensing or joint development agreements.
- Operations and logistics alliances, where partners either share the costs of implementing new manufacturing or production facilities, or utilize already existing infrastructure in foreign countries owned by a local company.
- Marketing, sales and service strategic alliances, in which companies take advantage of the existing marketing and distribution infrastructure of another enterprise in a foreign market to distribute its own products to provide easier access to these markets.
- Multiple activity alliance, which connect several of the described types of alliances. Marketing alliances most often operate as single country alliances, international enterprises use several alliances in each country and technology and development alliances are usually multi-country alliances. These different types and characters can be combined in a multiple activity alliance.

Further kinds of strategic alliances include:

- **Cartels:** Big companies can cooperate unofficially, to control production and /or prices within a certain market segment or business area and constrain their competition

- **Franchising:** a franchiser gives the right to use a brand-name and corporate concept to a frachisee who has to pay a fixed amount of money. The franchiser keeps the control over pricing, marketing and corporate decisions in general.
- **Licensing:** A company pays for the right to use another companies´ technology or production processes.
- **Industry Standard Groups:** These are groups of normally large enterprises, that try to enforce technical standards according to their own production processes.
- **Outsourcing:** Production steps that do not belong to the core competencies of a firm are likely to be outsourced, which means that another company is paid to accomplish these tasks. For a discussion of outsourcing and core competencies see Vested Outsourcing: Five Rules That Will Transform Outsourcing
- **Affiliate Marketing:** Affiliate marketing is a web-based distribution method where one partner provides the possibility of selling products via its sales channels in exchange of a beforehand defined provision.

11.11 LIFE CYCLE OF A BUSINESS OR STRATEGIC ALLIANCE

Formation:

Forming a Strategic Alliance is a process which usually implies some major steps that are mentioned below:

Strategy Development: In this stage the possibility of a Strategic Alliance is examined with respect to objectives, major issues, resource strategies for production, technology and people. It is necessary that objectives of the company and of the alliance are compatible.

Partner Assessment: In this phase potential partners for the Strategic Alliance are analyzed, in order to find an appropriate company to cooperate with. A company must know the weaknesses and strengths and the motivation for joining an alliance of another company. Besides that appropriate criteria for the partner selection are defined and strategies are developed how to accommodate the partner´s management style.

Contract Negotiations: After having selected the right partner for a Strategic Alliance the contract negotiations start. At first all parties involved discuss if their goals and objectives are realistic and feasible. Dedicated negotiation teams are formed which determine each partner´s role in the alliance like contribution and reward, penalties and retaining companies´ interests.

Operation

In this phase in the life of a Strategic Alliance, an internal structure occurs under which its functions develop. While operating it, the alliance becomes an own new organization itself with members from the origin companies with the aim of meeting all previously set objectives and improving the overall performance of the alliance which requires effective structures and processes and a good, strong and reliable leadership. Budges have to be linked, as well as resources which are strategically most important and the performance of the alliance has to be measured and assessed.

End/ Development

There are several ways how a Strategic Alliance can come to an end:

Natural End: When the objectives, the Strategic Alliance was founded for have been achieved, and no further cooperation is necessary or beneficial for the involved enterprises the alliance can come to a natural end. An example for such a natural end is the alliance between Dassault and British Aerospace which was founded to manufacture the Jaguar fighter aircraft. After the end of the program no further jets were ordered so the involved companies ended their cooperation.

Extension: After the end of the actual reason for the alliance, the cooperating enterprises decide to extend the cooperation for following generations of a respective product or expand the alliance to new products or projects. Renault for example worked together with Matra on three successive generations of their Espace minivan, whereas Airbus expanded its cooperation to include a complete family of airplanes.

Premature Termination: In this case the Strategic Alliance is ended before the actual objectives of its existence have been achieved. In 1987 Matra-Harris and Intel broke up their Cimatel partnership before one of the planned VLSI chips was manufactured.

Exclusive Continuation: If one partner decides to get out of the alliance before the common goals have been achieved, the other partner can decide to continue the project on its own. This happened when Saab decided to continue with the designing of a commuter aircraft (SF-340), after the partner Fairchild had to cancel the alliance because of internal problems. After Fairchild left the project it was named Saab 340.

Takeover of Partner: Many equity alliances end by Mergers and Acquisitions that one partner buys out the stake of the other parter. This may even have been foreseen from the very beginning to grant sales and/or put option. Strong companies sometimes have the

opportunity to take over smaller partners. If one firm acquires another the strategic alliance comes to an end. After almost ten years of cooperation in the field of mainframe computers a British computer manufacturer, named ICL, was taken over by Fujitsu in 1990.

11.12 REASONS FOR HOSTILE TAKEOVERS

There are several reasons why a company might want or need a hostile takeover. They may think the target company can generate more profit in the future than the selling price. If a company can make $100 million in profits each year, then buying the company for $200 million makes sense. That's why so many corporations have subsidiaries that don't have anything in common — they were bought purely for financial reasons. Currently, strategic mergers and acquisitions are more common. In a strategic acquisition, the buyer acquires the target company because it wants access to its distribution channels, customer base, brand name, or technology.

These purchase factors are the same for friendly acquisitions as well as hostile ones. But sometimes the target doesn't want to be acquired. Perhaps they are a company that simply wants to stay independent. Members of management might want to avoid acquisition because they are often replaced in the aftermath of a buyout. They are simply protecting their jobs. The board of directors or the shareholders might feel that the deal would reduce the value of the company, or put it in danger of going out of business. In this case, a hostile takeover will be required to make the acquisition. In some cases, purchasers use a hostile takeover because they can do it quickly, and they can make the acquisition with better terms than if they had to negotiate a deal with the target's shareholders and board of directors. The two primary methods of conducting a hostile takeover are the **tender offer** and the **proxy fight**.

A tender offer is a public bid for a large chunk of the target's stock at a fixed price, usually higher than the current market value of the stock. The purchaser uses a premium price to encourage the shareholders to sell their shares. The offer has a time limit, and it may have other provisions that the target company must abide by if shareholders accept the offer. The bidding company must disclose their plans for the target company and file the proper documents with the **Securities and Exchange Commission** (SEC). The 1966 Williams Act put restrictions and provisions on tender offers.

Sometimes, a purchaser or group of purchasers will gradually buy up enough stock to gain a controlling interest (known as a creeping tender offer), without making a public tender

offer. This bypasses the Williams Act, but is risky because the target company could discover the takeover and take steps to prevent it.

In a proxy fight, the buyer doesn't attempt to buy stock. Instead, they try to convince the shareholders to vote out current management or the current board of directors in favor of a team that will approve the takeover. The term "proxy" refers to the shareholders' ability to let someone else make their vote for them — the buyer votes for the new board by proxy.

Often, a proxy fight originates within the company itself. A group of disgruntled shareholders or even managers might seek a change in ownership, so they try to convince other shareholders to band together. The proxy fight is popular because it bypasses many of the defenses that companies put into place to prevent takeovers. Most of those defenses are designed to prevent takeover by purchase of a controlling interest of stock, which the proxy fight sidesteps by changing the opinions of the people who already own it.

The most famous recent proxy fight was Hewlett-Packard's takeover of Compaq. The deal was valued at $25 billion, but Hewlett-Packard reportedly spent huge sums on advertising to sway shareholders. HP wasn't fighting Compaq — they were fighting a group of investors that included founding members of the company who opposed the merge. About 51 percent of shareholders voted in favor of the merger. Despite attempts to halt the deal on legal grounds, it went as planned.

11.13 NOTES

11.14 SUMMARY

A takeover occurs when an acquiring company makes a bid in an effort to assume control of a target company, often by purchasing a majority stake. If the takeover goes through, the acquiring company becomes responsible for all of the target company's operations, holdings and debt. When the target is a publicly traded company, the acquiring company makes an offer for all of the target's outstanding shares. A welcome takeover, such as an acquisition or merger, generally goes smoothly because both companies consider it a positive situation. In contrast, an unwelcome or hostile takeover can be quite aggressive as one party is not participating voluntarily.

A buyout is the purchase of a company's shares in which the acquiring party gains controlling interest of the targeted firm. A leveraged buyout (LBO) is accomplished by borrowed money or by issuing more stock. Buyout strategies are often seen as a fast way for a company to grow because it allows the acquiring firm to align itself with other companies that have a competitive advantage. A buyout may occur because the purchaser believes it will receive financial and strategic benefits, such as higher revenues, easier entry into new markets, less competition or improved operational efficiency.

11.15 KEY WORDS

LBO: A leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition. The assets of the company being acquired are often used as collateral for the loans, along with the assets of the acquiring company.

Strategic alliance: is an arrangement between two companies that have decided to share resources to undertake a specific, mutually beneficial project.

Joint Venture (JV): is a business arrangement in which two or more parties agree to pool their resources for the purpose of accomplishing a specific task. This task can be a new project or any other business activity.

Outsourcing: Outsourcing is a practice used by different companies to reduce costs by transferring portions of work to outside suppliers rather than completing it internally. **Outsourcing** is an effective cost-saving strategy when used properly. It is sometimes more affordable to purchase a good from companies with than it is to produce the good internally.

11.16 SELF ASSESSMENT QUESTIONS

1) What is Hostile Takeover Defenses?

2) Explain the Types of Corporate Takeovers.

3) Discuss the Buyout Firm Structure and Organization.

4) Differentiate Advantages and disadvantages of LBOs.

5) Bring out the Life cycle of a Business or Strategic Alliance.

6) Briefly explain the Theory and Mechanics of the Leveraged Buyout

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UNIT-12 : LEGAL AND PROCEDURAL ASPECTS

Structure:

12.0 Objectives

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12.0 OBJECTIVES

After studying this unit, you will be able to ;

- Explain the Legal Aspects of Mergers & Acquisition
- Describe the Legal Aspects of Takeover
- Bring out Provisions of the Companies Act 1956
- Identify the Check List Required For Takeover
- Highlight that India Wants More Taxes From Cross Border M&A

12.1 INTRODUCTION

A business identity goes for mergers and acquisitions for strengthening a disjointed market and for elevating their functional competence in order to boost their competitive streak. Many countries have propagated Mergers and Acquisitions Laws to control the operations of the trade units within.

Most of the mergers and acquisitions have been successful in elevating the functional competence of companies but on the flip side this activity can lead to formation of monopolistic power. The anti-competitive results are accomplished either by synchronized effects or by one-sided effects.

An open and unbiased competition is ideal for capitalizing on the consumers' interests both in contexts of capacity and worth.

Laws governing Mergers and Acquisitions in India

- **Mergers and Acquisitions** in India are governed by the Indian Companies Act, 1956, under Sections 391 to 394. Although mergers and acquisitions may be instigated through mutual agreements between the two firms, the procedure remains chiefly court driven. The approval of the High Court is highly desirable for the commencement of any such process and the proposal for any merger or acquisition should be sanctioned by a 3/4th of the shareholders or creditors present at the General Board Meetings of the concerned firm.
- **Indian antagonism** law permits the utmost time period of 210 days for the companies for going ahead with the process of merger or acquisition. The allotted time period is clearly different from the minimum obligatory stay period for claimants. According to the law, the obligatory time frame for claimants can either be 210 days commencing from the filing of the notice or acknowledgment of the Commission's order.

- **The entry limits for companies** merging under the Indian law are considerably high. The entry limits are allocated in context of asset worth or in context of the company's annual incomes. The entry limits in India are higher than the European Union and are twofold as compared to the United Kingdom.
- The Indian M&A laws also permit the combination of any Indian firm with its international counterparts, providing the cross-border firm has its set up in India.

There have been recent modifications in the Competition Act, 2002. It has replaced the voluntary announcement system with a mandatory one. Out of 106 nations which have formulated competition laws, only 9 are acclaimed with a voluntary announcement system. Voluntary announcement systems are often correlated with business ambiguities and if the companies are identified for practicing monopoly after merging, the law strictly order them opt for de-merging of the business identity.

12.2 LEGAL ASPECTS OF MERGERS & ACQUISITIONS

The Regulatory Framework of Mergers and Acquisition covers

1. The Companies Act, 1956
2. Companies (Court) Rules, 1959
3. Income Tax Act, 1961
4. Listing Agreement
5. The Indian Stamp Act, 1899
6. Competition Act, 2002

1. Companies Act, 1956

Chapter V of Companies Act, 1956 comprising Section 390 to 396A contains provisions on 'Arbitration, Compromises, Arrangements and Reconstructions'. There are however, no provisions on Arbitration; Since Section 389 which dealt with Arbitration was deleted. The scheme of Chapter V goes as follows.

1. Section 390 contains interpretation of certain expressions used in Section 391 and 393
2. Section 391 is relating to the power of the company to compromise or to make arrangement with its creditors and members.
3. Section 393 deals with regard to information as to compromises and arrangements with creditors and members.
4. Section 394 deals with facilitation of reconstruction and amalgamation of companies.

5. Section 394A deals with a notice to be given to the Central Government in respect of applications under Section 391 and 394.
6. Section 395 deals with provisions regarding the power and duty to acquire shares of shareholders dissenting from scheme or contract approved by majority shareholders.
7. Section 396 contains provisions as to the power of the central government to provide for amalgamation of companies in national interest.
8. Section 396 A deals with preservation of books and papers of amalgamated companies.

2. Companies Court Rules, 1959

Rules 67-87 contains provisions dealing with the procedure for carrying out a scheme of compromise orarrangement including amalgamation or reconstruction.

3. Under the Income Tax Act, 1961

The Income Tax Act, 1961 covers aspects such as tax reliefs to amalgamating/amalgamated companies, carry forward of losses, exemptions from capital gains tax etc. For example, when a scheme of merger or demerger involves the merger of a loss making company or a hiving off of a loss making division, it is necessary to check the relevant provisions of the Income Tax Act and the Rules for the purpose of ensuring, *inter alia*, the availability of the benefit of carrying forward the accumulated losses and setting of such losses against the profits of the Transferor Company.

4. under the Listing Agreement

Under Clause 24(f) of the Listing Agreement, where the scheme of merger or demerger involves a listed company, it is necessary to send a copy of the scheme to the stock exchanges where the shares of the said company are listed to obtain their No Objection Certificate (NOC). Generally stock exchanges raise several queries and on being satisfied that the scheme does not violate any laws concerning securities such as the takeover code or the SEBI (ICDR) Regulations, Stock Exchanges accord their approval. Where the shares are listed on BSE or NSE, other Stock Exchanges wait for the approval by BSE or NSE before granting their approval.

5. under the Indian Stamp Act

It is necessary to refer to the Stamp Act to check the stamp duty payable on transfer of undertaking through a merger or demerger.

6. Competition Act, 2002

The provisions of Competition Act and the Competition Commission of India (Procedure in regard to the Transaction of Business relating to Combinations) Regulations, 2011 are to be complied with.

12.3 PROVISIONS OF THE COMPANIES ACT 1956

Section 391 – Power to compromise or make arrangements with creditors and members.

Section 391 lays down in detail the power to make compromise or arrangements with its creditors and members. Under this Section, a company can enter into a compromise or arrangement with its creditors or its members, or any class thereof.

Scope of Section 391

Section 391 deals with the rights of a company to enter into a compromise or arrangement (i) between itselfand its creditors or any class of them; and (ii) between itself and its members or any class of them. Thearrangement contemplated by the section includes a reorganisation of the share capital of a company byconsolidation of its shares of different classes or by sub-division of its shares into shares of different classesor by both these methods.

Once a compromise or arrangement comes within the ambit of the section, it may be sanctioned by thecourt, even if it involves certain acts for which a particular procedure is specified in other sections of the Acte.g., reduction of share capital of a company may form part of a compromise or arrangement and when thecourt sanctions the compromise or arrangement as a whole, reduction of share capital is also sanctioned andthe company is not required to follow the procedure laid down in Section 100 of the Act. The court can refuseto sanction a scheme of merger or amalgamation or reconstruction if it is satisfied that the scheme involvesany fraud or illegality. Once the reduction of share capital of a company is a part of a compromise orarrangement, the requirements of the Companies Act as regards reduction of share capital are not applicablebecause the court is empowered to sanction reduction of share capital as a part of the compromise orarrangement.

The section also applies to compromise or a management entered into by companies under winding up.Therefore, an arrangement under this section can take a company out of winding up.Once a compromise or arrangement under this section is approved by statutory majority, it binds thedissenting minority, the company and also the liquidator, if the company is in the process of winding up.

Sub-section (1) – Application to the court for convening meetings of members/creditors.

Where a company proposes a compromise or arrangement between it and its creditors or between it and itsmembers or with any class of the creditors or any class of members, the company or the creditor or membermay make an application to the court. On such application the court may order a meeting of the creditors ormembers or any class of them as the case may be and such meeting shall be called, held and conducted insuch manner as the court may direct. In the case of a company which is being wound up, any suchapplication should be made by the liquidator.

The key words and expressions under sub-section are 'creditors', 'court', 'class of creditors or members', 'acompany which is being wound up', 'liquidator'. When a company is ordered to be wound up, the liquidator isappointed and once winding up commences liquidator takes charge of the company in all respects andtherefore it is he who could file any application of any compromise or arrangement in the case of a companywhich is being wound up. A company which is being wound up would mean a company in respect of which the court has passed the winding up order.

Sub-section (2) – Approval of the Scheme and order of the court sanctioning the scheme of amalgamation.

Sub-section (2) provides that when the court directs the convening, holding and conducting of a meeting of creditors or members or a class of them, a particular majority of the creditors or members or a class of them should agree to the scheme of compromise or arrangement. As per the sub-section, the majority required is the majority in number representing three-fourths in value of the creditors or members or a class of them, as the case may be, present and voting in the meeting so convened either in person, or by proxy. After the said meeting agrees with such majority, if the scheme is sanctioned, by the court, it shall be binding upon the creditors or members or a class of them, as the case may be.

As per the proviso under Sub-section (2), no order sanctioning any compromise or arrangement shall be made by the court unless it is satisfied that the applicant has made sufficient disclosure about the following particulars:

- All material facts relating to the company;
- Latest financial position of the company;
- Latest auditor's report on the accounts of the company;

- Information about pendency of any investigation proceeding in relation to the company under Sections 235 to 251 and the like.

Sub-section (3) – Filing of court order with ROC.

The order made by the court under Sub-section (2) should be filed with the Registrar of Companies. If theorder is not filed with the Registrar, it will not have any effect. The requirement under this section is limited tofiling of the order of the court and it does not specify the need for the Registrar to register it.

The order of the court under Section 391 sanctioning compromise or arrangement will not have effect unlessfiled with Registrar of Companies.

Sub-section (4) – Memorandum to be annexed to the copy of court order while filing.

It is necessary to annex a copy of every such order to every copy of the Memorandum of company issuedafter the filing of the certified copy of the order. In the case of a company not having a memorandum theorder aforesaid shall be annexed to every copy of the instrument constituting or defining the constitution ofthe company.

Sub-section (5) – Penalty.

Any default in complying with Sub-section (4) invites the penalty prescribed in this sub-section. As per thepenal clause contained in this sub-section, the company and every officer of the company who is in defaultshall be punishable with fine which may extend to ‘100/- for each copy in respect of which the default ismade.

Sub-section (6)

The court has powers to stay the commencement of or continuation of any suit or proceeding against thecompany on such terms as it thinks fit until the application is finally disposed of.

Section 392 – Power to enforce compromise and arrangement.

Sub-section (1)

The court has the power to supervise the carrying out of the scheme. The court may give such directions ormake such modifications to the scheme for the purpose of proper working of the scheme.

Sub-section (2)

The court has the power to order winding up of the company if it thinks that the scheme sanctioned cannotwork satisfactorily.

Section 393 – Information as to compromise or arrangements with creditors and members.

Sub-section (1)

Every notice of any meeting called as per orders of court under Section 391, should include an explanatorystatement. The statement should set out the terms of compromise or arrangement and all material interestsof the directors, managing director or manager of the company and effect of such interest on the scheme. Itcan also be given by way of an advertisement containing the above mentioned particulars.

Sub-section (2)

Such disclosure shall also be made, in the case of a scheme affecting debenture holders, about the interestof the debenture trustees.

Sub-section (3)

If the notice states that creditors or members can have copies of the scheme from the company, thecompany shall provide copies of the scheme of compromise or arrangement, to the creditor or member whoapplies for the same.

Sub-section (4)

This sub-section is a penal clause. In case of default in complying with the requirements of Section 393, thedefault is a punishable offence.

Sub-section (5)

Every director, managing director, manager or as the case may be, the debenture trustees, shall give allnecessary information to the company failing which they shall be liable for the penal consequencesstipulated in this sub-section.

Section 394 – Provisions for facilitating reconstruction and amalgamation of companies.

It is only in Section 394 of the Act there is reference to reconstruction of any company or companies oramalgamation of any two or more companies.

Sub-section (1)

Where the scheme involves reconstruction of any company or companies or amalgamation of any two ormore companies and vesting of the whole or substantially the whole of the properties or liabilities of anycompany concerned in the scheme (Transferor

Company) to another company (Transferee company), thecourt may make provision for the following matters also:

- Transfer to the Transferee Company of the whole or any part of the undertaking, property or liabilities of any transferor company;
- The allotment or appropriation by the Transferee company of any shares, debentures to any person under the scheme.
- Continuation of proceedings by or against the Transferee Company of any legal matters pending byor against any Transferor Company.
- The dissolution, without winding up, of any Transferor Company.
- Provision to be made for any person who does not agree to the scheme.
- Such incidental, consequential and supplemental orders passed by the court as it may think fit sothat the reconstruction or amalgamation could be fully and effectively carried out.

As per the proviso under this sub-section, it is necessary to have the report from the Registrar of Companiesin case the scheme involves a company that is being wound up and the report of the liquidator, in case thescheme involves the dissolution of a company. These reports are mandatory in order to ensure that theaffairs of the company in question have not been conducted in a manner prejudicial to the interests of itsmembers or to public interest.

Sub-section (2)

The sub-section provides for the order of the Court and the vesting of the properties and liabilities of thetransferor company to the transferee company.

Sub-section (3)

Under this sub-section, the time limit for filing the order of the Court for registration by the Registrar is 30days after the making of the order.

Sub-section (4)

As per clause (a), the expression 'property' has been defined to include property, rights and powers of everydescription and the expression 'liabilities' includes duties of every description. As per clause (b), 'TransfereeCompany' does not include any company other than a company within the meaning of this Act but'Transferor company' includes any body corporate, whether a company within the meaning of this Act or not.

Thus, the transferee company in a scheme of merger or amalgamation has to be necessarily a companywithin the meaning of the Act.

Section 394A

The court is supposed to give notice of every scheme under Section 391 or 394 to the Central Governmentand consider representation, if any by the said Government.

Therefore, merger or amalgamation under a scheme of arrangement as provided under Sections 391-394 ofthe Act is the most convenient and most common method of a complete merger or amalgamation betweenthe companies. There is active involvement of the Court and an amalgamation is complete only after theCourt sanctions it under Section 394(2) and takes effect when such order of court is filed with the Registrarof Companies. In fact, Sections 391 to 394 of the Act read with Companies (Court) Rules, 1959 serve as acomplete code in themselves in respect of provisions and procedures relating to sponsoring of the scheme,the approval thereof by the creditors and members, and the sanction thereof by the Court.

Accordingly, amalgamation can be effected in any one of the following ways:

(i) Transfer of undertaking by order of the High Court (Section 394 of the Companies Act, 1956)

Under Section 394 of the Companies Act, the High Court may sanction a scheme of amalgamationproposed by two or more companies after it has been approved by a meeting of the members of thecompany convened under the orders of the court with majority in number of shareholders holdingmore than 75 percent of the shares who vote at the meeting, approve the scheme of amalgamation,and the companies make a petition to the High Court for approving the Scheme. The High Courtserves a copy of petition on the Regional Director, Company Law Board and if they do not object tothe amalgamation, the Court sanctions it. Once the Court sanctions the scheme, it is binding on allthe members of the respective companies.

(ii) Purchase of shares of one company by another company (Section 395 of the Companies Act, 1956)

Under Section 395 of the Companies Act, 1956, the undertaking of one company can be takenoverby another company by the purchase of shares. This section obviates the need to obtain the HighCourt's sanction. While purchasing shares, the company which acquires shares should comply withthe requirements of SEBI (Substantial Acquisition of Shares and

Takeovers) Regulations, 2011 andSection 372A of the Companies Act, 1956. This Section also provides the procedure for acquiringthe shares of dissenting members.

(iii) Amalgamation of Companies in National Interest (Section 396)

Where the Central Government is satisfied that an amalgamation of two or more companies isessential in the public interest, then the Government may, by an order notified in the Official Gazette, provide for the amalgamation of those companies into a single company. Theamalgamated company shall have such constitution, property, powers, rights, interest and privilegesas well as such liabilities, duties and obligations as may be specified in the Government's order.

(iv) Amalgamation for Revival and Rehabilitation

The Board for Financial and Industrial Reconstruction (BIFR) can in exceptional cases orderamalgamation for the revival and rehabilitation of a sick industrial company under the provisions ofSick Industrial Companies (Special Provisions) Act, 1985.

12.4 LEGAL ASPECTS OF TAKEOVER

The legislations/regulations that mainly govern takeover is as under

1. SEBI (SAST) Regulations 2011
2. Companies Act, 1956
3. Listing Agreement

SEBI (SAST) Regulations 2011 lays down the procedure to be followed by an acquirer for acquiring majority shares or controlling interest in another company. As far as Companies Act is concerned, the provisions of Section 372A apply to the acquisition of shares through a Company. Section 395 of the Companies Act lays down legal requirements for purpose of takeover of an unlisted company through transfer of undertaking to another company. The takeover of a listed company is regulated by clause 40A and 40B of the Listing Agreement. These clauses in the Listing Agreement seek to regulate takeover activities independently and impose certain requirements of disclosure and transparency.

Takeover of Unlisted and Closely Held Companies

Section 395 of the Companies Act contains a compulsory acquisition mode for the transferee company to acquire the shares of minority shareholders of Transferor Company. Where the scheme has been approved by the holders of not less than nine tenth (90%) in value of the shares of the transferor company whose transfer is involved, the transferee

company, may, give notice to any dissenting shareholders that transferee company desires to acquire their shares. The scheme shall be binding on all the shareholders of the transferor company (including dissenting shareholders), unless the Court Orders otherwise (i.e. that the scheme shall not be binding on all shareholders).

Accordingly, the transferor company shall be entitled and bound to acquire these shares on the terms on which it acquires under the scheme (the binding provision).

The advantage of going through the route contained in Section 395 of the Act is the facility for acquisition of minority stake. The transferee company shall give notice to the minority dissenting shareholders and express its desire to acquire their shares within 2 months of the expiry of the period of 4 months envisaged under Section 395 of the Act.

When a Company intends to take over another Company through acquisition of 90% or more in value of the shares of that Company, the procedure laid down under Section 395 of the Act could be beneficially utilized. When one Company has been able to acquire more than 90% control in another Company, the shareholders holding the remaining control in the other Company are reduced to a miserable minority. They do not even command a 10% stake so as to make any meaningful utilization of the power. Such minority can not even call an extra-ordinary general meeting under Section 168 of the Act nor can they constitute a valid strength on the grounds of their proportion of issued capital for making an application to Company Law Board under Section 397 and 398 of the Act alleging acts of oppression and/or mismanagement. Hence the statute itself provides them a meaningful exit route.

The advantage of going through the route is the facility for acquisition of minority stake. But even without going through this process, if an acquirer is confident of acquiring the entire control, there is no need to go through Section 395 of the Act. It is purely an option recognized by the statute.

The merit of this scheme is that without resort to tedious court procedures the takeover is affected. Only in cases where any dissentient shareholder or shareholders exist, the procedures prescribed by this section will have to be followed. It provides machinery for adequately safeguarding the rights of the dissentient shareholders also.

Section 395 lays down two safeguard in respect of expropriation of private property (by compulsory acquisition of majority shares). First the scheme requires approval of a large majority of shareholders. Second the Court's discretion to prevent compulsory acquisition.

Section 395 requires mandatory compliance of certain formalities including registration of a scheme or contract for acquisition of shares of Transferor Company. The scheme or contract between the Transferee Company and Transferor Company is solemnized with blessings of the Board of Directors of both the companies.

The following are the important ingredients of the Section 395 route:

- The Company, which intends to acquire control over another Company by acquiring share, held by shareholders of that another Company is known under Section 395 of the Act as the “Transferee Company”.
- The Company whose shares are proposed to be acquired is called the “Transferor Company”.
- The “Transferee Company” and “Transferor Company” join together at the Board level and come out with a scheme or contract.
- Every offer or every circular containing the terms of the scheme shall be duly approved by the Board of Directors of the companies and every recommendation to the members of the transferor Company by its directors to accept such offer. It shall be accompanied by such information as provided under the said Act.
- Every offer shall contain a statement by or on behalf of the Transferee Company, disclosing the steps it has taken to ensure that necessary cash will be available. This condition shall apply if the terms of acquisition as per the scheme or the contract provide for payment of cash in lieu of the shares of the Transferor Company which are proposed to be acquired.
- Every circular containing or recommending acceptance of the offer made by the transferee Company shall be duly accompanied by e-Form No. 35A of the Companies (Central Govt.’s) General Rules and Forms, 1956. They shall be filed with the Registrar for registration. Only after such registration can the Transferee Company arrange for circulation of the scheme or contract or the recommendatory letter, if any, of the directors of the transferor company to the shareholders of the Transferor Company.
- The Registrar may refuse to register any such circular, which does not contain the prescribed information, if such information is given in a manner likely to give a false impression.
- An appeal shall lie to the Court against an order of the Registrar refusing to register any such circular.

- Any person issuing a circular containing any false statement or giving any false impression or containing any omission shall be punishable with fine, which may extend to five hundred rupees.
- After the scheme or contract and the recommendation of the Board of Directors of the transferor Company, if any, shall be circulated and approval of not less than 9/10th in value of "Transferor Company" should be obtained within 4 months from the date of circulation. It is necessary that the Memorandum of Association of the transferee company should contain as one of the objects of the company, a provision to takeover the controlling shares in another company. If the memorandum does not have such a provision, the company must alter the objects clause in its memorandum, by convening an extra ordinary general meeting. The approval is not required to be necessarily obtained in a general meeting of the shareholders of the Transferor Company.
- Once approval is available, the 'Transferee Company' becomes eligible for the right of compulsory acquisition of minority interest.
- The Transferee Company has to send notice to the shareholders who have not accepted the offer (i.e. dissenting shareholders) intimating them the need to surrender their shares.
- Once the acquisition of shares in value, not less than 90% has been registered in the books of the transferor Company, the transferor Company shall within one month of the date of such registration, inform the dissenting shareholders of the fact of such registration and of the receipt of the amount or other consideration representing the price payable to them by the transferee Company.
- The transferee Company having acquired shares in value not less than 90% is under an obligation to acquire the minority stake as stated aforesaid and hence it is required to transfer the amount or other consideration equal to the amount or other consideration required for acquiring the minority stake to the transferee Company. The amount or consideration required to be so transferred by the transferee Company to the transferor company, shall not in any way, less than the terms of acquisition offered under the scheme or contract.
- Any amount or other consideration received by the Transferor Company in the manner aforesaid shall be paid into a separate bank account. Any such sums and any other consideration so received shall be held by the transferor Company in trust for the several persons entitled to the shares in respect of which the said sums or other consideration were respectively received.

The takeover achieved in the above process through this Section 395 of the Act will not fall within themeaning of amalgamation under the Income Tax Act and as such benefits of amalgamation provided under the said Act will not be available to the acquisition under consideration. The takeover in the above process will not enable carrying forward of unabsorbed depreciation and accumulated losses of the transferor Company in the transferee Company for the reason that the takeover does not result in the transferor Company losing its identity.

12.5 CHECK LIST REQUIRED FOR TAKEOVER

Transferor Company

The transferor company has to take care of the following points:

1. The offer of a company (Transferee Company) to acquire shares of a Transferor Company should be received from the transferee company.

2. It should have been approved by the Board of Directors at a duly convened and held meeting. If proviso to Sub-section (1) of Section 395 is attracted, the terms of offer should be same for all the holders of that class of shares, whose transfer is involved.

3. Offer received from the transferee company along with other documents, particulars etc. should have been circulated to the members of the company in e-Form No. 35A prescribed in the Companies (Central Government's) General Rules and Forms, 1956. [For e-form 35A, see Part B of the Company Secretarial Practice Study]

4. E-form No. 35A must be filed with the Registrar of companies before issuing to the members of the company.

5. The scheme or contract for transfer of shares of the company to the transferee company has been approved by the shareholders of not less than nine-tenths in value of the shares within the stipulated period of four months. If proviso to Sub-section (1) of Section 395 is attracted, the number of such approving shareholders should comprise not less than three-fourths in number of the holders of the shares proposed to be transferred.

6. Comply with any order of the court if any dissenting shareholder had approached the Court against the proposed transfer and if the Court had passed any order contrary to the proposed transfer.

7. If the transferee company wanted to acquire the shares held by dissenting shareholders, the transferor company has received from the transferee company a copy of the notice sent

by the transferor company to the dissenting shareholders together with duly filled in and signed transfer instruments along with value of the shares sought to be transferred.

8. The transferee company should have been registered as holder of the transferred shares and the consideration received for the shares has been deposited in a separate bank account to be held in trust for the dissenting shareholders.

Documents etc. involved in this process:

1. Offer of a scheme or contract from the transferee company.

2. Minutes of Board meeting containing consideration of the offer and its acceptance or rejection.

3. Notice calling general meeting.

4. e-form No. 35A circulated to the members.

5. Minutes of general meeting of the company containing approval of the offer by statutory majority in value and in numbers also, if required.

6. Court order if any.

7. Copy of e-form No. 21 which has been filed with the Registrar along with a copy of the Court Order.

8. Register of Members.

9. Notice sent by the transferee company to dissenting shareholders for acquiring their shares.

10. Duly filled in and executed instrument(s) of transfer of shares held by the dissenting shareholders.

11. Bank Pass Book or Statement of Account in respect of the amount deposited in the special bank account to be kept in trust for the dissenting shareholders.

12. Annual Report.

Transferee Company

The transferee company has to take care of the following points:

1. Offer made to the transferor company.

2. Copy of notice for the general meeting along with a copy of e-form No. 35A circulated by the transferor company to its members.

3. Intimation received from the transferor company in respect of approval of the offer by the requisite majority of the shareholders of that company.

4. Notice as prescribed in Section 395 of the Companies Act, 1956 given by the company to dissenting shareholders of the transferor company for the purpose of acquiring their shares.

5. If there is any Court order in favour of the dissenting shareholders of the transferor company, terms of the same has been complied with.

6. If Sub-section (2) is attracted, the company must ensure that the prescribed notice has been sent to those shareholders of the transferor company who have not assented to the transfer of the shares and that such shareholders have agreed to transfer their shares to the company.

7. To ensure that a copy of the notice has been sent to the dissenting shareholders of the transferor company and duly executed instrument(s) of transfer together with the value of the shares have been sent to the transferor company.

Documents etc. involved in this process

1. Minutes of Board meeting containing consideration and approval of the offer sent to the transferor company.

2. Offer of a scheme or contract sent to the transferor company.

3. Notice to dissenting shareholders if any, of the transferor company.

4. Notice to the remaining shareholders of the transferor company, who have not assented to the proposed acquisition, if any.

5. e-form No. 35A received from the transferor company, which has been circulated to its members by that company.

6. Minutes of general meeting of the company containing approval of the shareholders to the offer of scheme or contract sent to the transferor company.

7. Court order, if any.

8. Copy of e-form No. 21 which has been filed with the Registrar along with a copy of the Court Order

9. Register of Investments.

10. Duly filled in and executed instrument(s) of transfer for shares held by the dissenting shareholders.

11. Balance Sheets showing investments in the shares of the transferor company.

12.6 TAX IMPLICATIONS, CROSS BORDER ACQUISITIONS AND INTERNATIONAL ACQUISITIONS

Mergers and acquisitions (M&A) play a major role in the materialization of globalization. With increasing importance on globalization of businesses, cross-border transactions have become the quickest way of achieving the objective. Except for purely domestic legislation in some countries, there is little tax law at point, and no globally accepted norms. The market for these transactions, however, has expanded well beyond the regulatory reach of any single country. Tax law should better accommodate cross- border M&A. In an endeavor to geographically expand the utilization of their competitive advantages, M&A allow the firms to do so in a fast, effective and supposedly cheap manner

Many countries have some tax rules that grant certain benefits to M&A transactions, usually allowing some deferral of the tax otherwise imposed on the owners of some of the participating parties upon the transaction. On the other hand, once M&A transactions cross borders, countries are much less enthusiastic to provide tax benefits to the involved parties, understanding that, in some cases, relief of current taxation practically means exemption since such countries may completely lose jurisdiction to tax the transaction. Cross-border M&A, although presenting many of the same issues as domestic deals, are usually more complex and rife with surprises and other pitfalls, more so when the number of geographies involved in the transaction increases. The sheer range of concerns has expanded as the speed and volume of international deals have increased. Domestic M&A are, generally and on average, socially desirable transactions. In many countries they enjoy tax (deferral) preferences, but only to the extent to which they use stock to compensate target corporations or their shareholders

The boom in the cross-border M&A has given new urgency to understanding and managing the complex tax consequences of international expansion. The legal framework for business consolidations in India consists of numerous statutory provisions for tax concessions and tax neutrality for certain kinds of reorganizations and consolidations. With India rapidly globalising, and the economy growing and showing positive results, a sound tax policy is a must-have. Tax is an important business cost to be considered while taking any business decision, particularly when competing with other global players. The new direct tax code that the Government is planning to introduce, to replace the current Income-tax Act, is expected to emphasise on transparency and taxpayer-friendliness

A number of important issues arise in structuring a cross-border M&A deal to ensure that tax liabilities and cost will be minimized for the acquiring company. The first step is to explore leveraging local-country operations for cash management and repatriation advantages. Moreover the companies should be looking at the availability of asset-basis set up structures for tax purposes and keeping a keen eye on valuable tax attributes in M&A targets, including net operating losses, foreign tax credits and tax holidays. As per the provisions of the Income Tax Act (ITA), capital gains tax would be levied on such transactions when capital assets are transferred. From the definition of 'transfer' it is clear that if merger, amalgamation, demerger or any sort of restructuring results in transfer of capital asset, it would lead to a taxable event.

A. SALE OF SHARES

1. Capital Gains and Security Transaction Tax: The sale of shares is subject to capital gains tax in India. Additionally, Securities Transaction Tax (STT) may be payable if the sale transaction for equity shares is through a recognized stock exchange in India. The STT has to be paid by the purchaser/seller of securities. In case of shares held for a periodof more than 12 months, the gains are characterized as long-term capital gains or otherwise as short-term capital gains (less than 12 months). If the transaction is not liable to STT, resident investors are entitled to the benefit of an inflation adjustment when calculating long-term capital gains; the inflation adjustment is derived from the inflation indices produced by the government of India. Non-resident investors are entitled to benefit from currency fluctuation adjustments when calculating long-term capital gains on a sale of shares of an Indian company purchased in foreign currency. In case the transaction is liable to STT, long-term capital gains arising on transfer of equity shares are exempt from tax.

2. Transfer Taxes: The transfer of shares (other than those in dematerialized form) is subject to transfer taxes; that is, stamp duty.

B. SALE OF ASSETS

(i) SLUMP SALE: The sale of a business undertaking is on a slump-sale basis when the entire business is transferred as a going concern for a lump-sum consideration; cherry-picking assets are not possible. Consideration in excess of the net worth of the business is taxed as capital gains

1. Transfer Taxes: The transfer of assets by way of a slump sale would attract stamp duty. Stamp duty implications differ from state to state. Depending on the nature of the assets transferred, appropriate structuring of the transfer mechanism may reduce the overall stamp duty cost.

(ii) ITEMIZED SALE: This happens when individual assets or liabilities of a business are transferred for separately stated consideration. The assets of the business can be classified into three categories:

a. Capital assets: The tax implications for the transfer of capital assets8 (including net current assets other than stock-in-trade) would depend on whether they are eligible for depreciation under the Act or not. In the case of assets on which no depreciation is allowed, consideration in excess of the cost of acquisition and improvement is chargeable to tax as capital gains. In the case of assets on which depreciation has been allowed, the consideration is deducted from the tax written down value of the block of assets, resulting in a lower claim for tax depreciation subsequently. If the unamortized amount of the respective block of assets is less than the consideration received, or the block of assets ceases to exist (that is, there are no assets of that category), the difference is treated as short-term capital gains. If all the assets in a block of assets are transferred and the consideration is less than the unamortized amount of the block of assets, the difference is treated as a short-term capital loss and could be set off against capital gains arising in up to eight succeeding years. The question of whether depreciation on goodwill acquired can be claimed has yet to be tested in the courts, but the chances of such depreciation of goodwill being allowed appear remote.

b. Stock in trade: Any gains or shortfalls on the transfer of stock-in-trade are considered as business income or loss. Business losses can be set off against income under any head of income arising in that year. If the current year's income is not adequate, business losses can be carried forward to be set off against business profits for eight succeeding years.

c. Intangibles (goodwill and brands, among others): The tax treatment for intangible capital assets would be identical to that of tangible capital assets, as already discussed. The question of whether depreciation on goodwill acquired can be claimed has yet to be tested in the courts, but the chances of such depreciation of goodwill being allowed appear remote.

1. Transfer Taxes: The transfer taxes with respect to an itemized sale would be identical to those under a slump sale.

C. LIABILITIES

Gains on transfers of liabilities are taxable as business income in the hands of the transferor

D. MERGER OR AMALGAMATION

For a merger to qualify as 'amalgamation' under the provisions of the ITA, the definition highlights that the following conditions need to be satisfied:

- The merger should be pursuant to a scheme of amalgamation.
- All the assets and liabilities of the amalgamating company should be included in the scheme of amalgamation.
- No prescribed time limit exists within which the property of the amalgamating company should be transferred to the amalgamated company.
- The requirement that the shareholders holding seventy five per cent (75%) in value of the shares in the amalgamating company to be shareholders in the amalgamated company applies to both preference and equity shareholders. However, it does not prescribe any minimum holding in the amalgamatedcompany, nor does it stipulate for how long they should continue being shareholders in the amalgamated company.
- The consideration to the shareholders of the amalgamating company can be a combination of cash and the shares in the amalgamated company

It is possible to issue even redeemable preference shares as consideration to qualify as amalgamation

a. Capital gains tax implication for the amalgamating (transferor) company: Section 47(vi) specifically exempts the transfer of a capital asset in a scheme of amalgamation by the amalgamating company to the amalgamated company, provided the amalgamated company is an Indian company. It is essential that the merger falls within the definition of amalgamation as given under section 2(1B), if the exemption hereunder is to be availed of.

b. Exemption from capital gains tax to a foreign amalgamating company for transfer of capital asset, being shares in an Indian company : In a cross-border scenario, when a foreign holding company transfers its shareholding in an Indian company to another foreign company as a result of a scheme of amalgamation, such a transfer of the capital asset i.e. shares in the Indian company would also be exempt from capital gains tax in India for the foreign amalgamating company if it satisfies the following two conditions: 1. At least 25% of the shareholders of the amalgamating foreign company continue to be the shareholders of the amalgamated foreign company. 2. Such transfer does not attract capital gains tax in the country where the amalgamating company is incorporated.

c. Capital gains tax liability on the shareholders of the amalgamating companyIn the case of a merger, the shareholders of amalgamating company would be allotted shares in amalgamated company as a result of the amalgamation. This process presupposes the relinquishment of shares in amalgamating company held by shareholders thereof. It is important to determine

whether this constitutes a transfer under section 2(47) of the ITA, which would be liable to capital gains tax. According to judicial precedents in this regard, including decisions of the Supreme Court till recently, this transaction did not result in a "transfer" as envisaged by section 2(47). In the case of Commissioner of Income Tax v. Mrs. Grace Collis and Another, the SC has held that "extinguishment of any rights in any capital asset" under the definition of "transfer" would include the extinguishment of the right of a holder of shares in an amalgamating company, which would be distinct from and independent of the transfer of the capital asset itself. Hence, the rights of shareholder of the amalgamating company in the capital asset, i.e. the shares, stands extinguished upon the amalgamation of the amalgamating company with the amalgamated company and this constitutes a transfer under Section 2(47) of the ITA. However, a transfer14 by the shareholders of the amalgamating company is specifically exempt from capital gains tax liability, provided the following conditions are satisfied:

1. The transfer is made in consideration of allotment to the shareholder of shares in the amalgamated company.

2. The amalgamated company is an Indian company. The issue addressed by Grace Collis case would arise in situations where the amalgamation does not satisfy all the conditions under section 47(vii) and section 2(1B) and is therefore not exempt from the capital gains tax. In view of this decision, the present position of law seems to be that such a merger would result in capital gains tax to the shareholders of the amalgamating company.

d. Computation of capital gains tax on disposal of the shares of amalgamated company

This section contemplates a situation in which shareholders of theamalgamating company, having acquired the shares in the amalgamated company as a result of the amalgamation, now elect to sell off such amalgamated company's shares. Accordingly, when these shareholders sell their shares in the amalgamated company, for computing the capital gains that would accrue to them as a result of the sale, the cost of acquisition would be the cost of their shares in the amalgamating company. Also the period of holding for determining long term or short term gains would begin from the date the shares were acquired by the shareholders in the amalgamating company.

e. Availability for set off of unabsorbed losses and other tax benefits: In case of amalgamation of a company owning an industrial undertaking, the amalgamated company would be able to get the benefit of carry forward of losses and depreciation to set off against its future profits, provided some conditions are fulfilled

f. Availability of carry forward and set off of losses by certain companies: Where there is a change in the shareholding of a company in which public are substantially interested, such a company would not be allowed the carry forward or set off of accumulated losses if shareholders carrying 51% of voting power of the company on the last day of the year in which the loss is sought to be set off are not the same as the shareholders carrying 51% of voting power on the last day of the year in which the loss was incurred.

12.7 INDIA WANTS MORE TAXES FROM CROSS BORDER M&A

Though mergers and acquisitions provide a substantial upside, shareholders will have to bear the brunt of the taxman. The revenue authorities are exploring the possibility of generating tax from cross-border M&A resulting in the transfer of beneficial interest of the Indian company. This is on the basis of the substance theory that the country has a right to claim tax on the profit generated from the business carried out in India, which itself is a debatable subject. The current tax legislation does not provide for the concept of levy of tax on transfer of beneficial ownership in a cross-border transfer. The Hutch-Vodafone and a spate of otheroverseas deals involve taxability of transfer of shares of a holding company (having an Indian operating subsidiary company) outside India

A. PRESENT POSITION OF LAW The current legislation provides for taxation of gains arising out of transfer of the legal ownership of the capital asset in the form of sale, exchange, relinquishment or extinguishment of any rights therein or compulsory acquisition under any law. Section 9 of the Act deems gains arising from transfer of a capital asset situated in India to accrue or arise in India. In a cross-border transfer involving transfer of shares, normally the situs of the capital asset provides the safe guide to decide as to which of the contracting states has the power to tax such income subject to the relevant tax treaty. The concept of levy of tax on the transfer of beneficial ownership in a cross-border transfer is not provided for in the current tax legislation but the revenue authorities are of the view that in a crossborder transaction, the valuation of the transaction includes valuation for the Indian entity as well and accordingly the overseas entity which has a business connection in India.

B. CHANGES IN THE INDIAN LAW Finance Act, 2007 has brought amendment to section 9 with retrospective effect. This is with a clear view to increase tax revenues from cross-border M&A transactions. Further amendments have been brought to sections 19 and 20 with retrospective effect bythe Finance Act, 2008 to remedy the mischief and ensure that the tax due and payable is not evaded.

C. THE LEGAL BATTLES In line with this approach, the Revenue authority recently issued notices to some 400 companies who were engaged in cross-border M&A deals in the recent past. Let us discuss some of the major deals.

1. Hutch-Vodafone deal: Hutchison International, a non-resident seller and parent company based in Hong Kong sold its stake in the foreign investment company CGP Investments Holdings Ltd., registered in the Cayman Islands (which in turn held shares of Hutchison-Essar – Indian operating company, through another Mauritius entity) to Vodafone, a Dutch non-resident buyer. The deal consummated for a total value of $ 11.2 billion, which comprised a majority stake in Hutchison Essar India. In light of this the Revenue issued show cause to Vodafone asking for an explanation as to why Vodafone Essar (which was formerly Hutchison Essar) should no b treated as an agent (representative assessee) of Hutchison International and asked Vodafone Essar to pay $ 1.7 billion as capital gains tax. The whole controversy in the case of Vodafone is about the taxability of transfer of share capital of the Indian entity. Generally the transfer of shares of a non-resident company to another non-resident is not subject to tax in India. But the revenue department is of the view that this transfer represents transfer of beneficial interest of the shares of the Indian company and hence, it will be subject to tax. On the contrary Vodafone's argument is that there is no sale of shares of the Indian company and what it had acquired is a company incorporated in Cayman Islands which in turn holds the Indian entity. Hence, the transaction is not subject to tax in India.

However, the revenue authorities are of the view that as the valuation for the transfer includes the valuation of the Indian entity also and as Vodafone has also approached the Foreign Investment Promotion Board (FIPB) for its approval for the deal, Vodafone has a business connection in India and, therefore the transaction is subject to capital gains tax in India. The much awaited Bombay High Court order in the case of Vodafone deal will be an eye opener for the taxation of cross-border deals in India, involving Indian entities.

2. The Genpact Deal: Genpact originally was established in 1997 as a GE Capital International Services, a captive subsidiary of GE Capital. At the end of 2004, GE invested 60% of the firm to US based private equity investors for $ 500 million dollars. GE did not pay any capital gains tax on such sale. Notices have been sent to the company following the deal. This matter is also pending before the court. Based on the above, the CBDT has reopened about 400 cases of large and midsized transactions that took place during the past six to seven years.

12.8 NOTES

12.9 SUMMARY

An essential characteristic of Indian capital market is that it is developing and making rapid strides by allowing the development of new financial institutions to happen. Important among them include venture capital firms, mutual firms, credit rating agencies, factoring firms, etc. an innovative feature of the capital market in India is the introduction , of late, of the new and innovative financial instruments used by the firms for raising capital. Notable among them are deep discount bonds, zero coupon bonds, equity shares with warrants etc. SEBI comes out regularly with necessary guidelines for regulating the working of various constituents of the Indian capital market. Indian securities market comprises of primary market and secondary market. Primary market is used for raising fresh capital in the form of shares and debentures. Secondary market, though the mechanism of stock exchanges provides necessary trading support to the primary market.

12.10 KEY WORDS

Capital gains tax: A capital gains tax is a type of tax levied on capital gains, profits an investor realizes when he sells a capital asset for a price that is higher than the purchase price.

Listing Agreement: A document in which a property owner (as principal) contracts with a real estate broker (as agent) to find a buyer for the owner's property. A listing agreement is executed by an owner to give a real estate broker the authority to act as the owner's agent in the sale of the owner's property, for which service the owner agrees to pay a commission. Unlike a real estate contract, a listing agreement is an employment contract in which the broker is hired to represent the principal, but no real property is transferred between the two.

Closely Held Companies: A closely held corporation is any company that has only a limited number of shareholders; its stock is publicly traded on occasion but not on a regular basis. These entities differ from privately owned firms that issue stock that is not publicly traded. Those who own shares of closely held corporations should consult a financial planner with expertise in the tax and estate ramifications that come with this type of stock.

12.11 SELF ASSESSMENT QUESTIONS

1. Explain the Legal Aspects of Mergers & Acquisition
2. Define the Legal Aspects of Takeover.
3. Explain the Provisions of the Companies Act 1956.
4. Identify theCheck List Required For Takeover.
5. Explain the Tax Implications Cross Border Acquisitions and International Acquisitions.

12.12 REFERENCES

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MODULE-IV
FINANCIAL DISTRESS AND RESTRUCTURING

UNIT- 13 : BASICS FINANCIAL DISTRESS AND RESTRUCTURING

Structure:

13.0 Objectives

13.1 Introduction

13.2 Management of corporate distress and restructuring strategy

13.3 Restructuring strategy

13.4 Types of Corporate Restructuring strategies

13.5 Causes of Financial Distress

13.6 Effects of Financial Distress

13.7 Operational cutbacks: causes and effects

13.8 Case Study

13.9 Notes

13.10 Summary

13.11 Key Words

13.12 Self-Assessment Questions

13.13 References

13.0 OBJECTIVES

After studying this unit, you will be able to;

- Understand Full implications of financial distress.
- Analyze Reasons and causes of financial distress
- Effects of financial distress

13.1 INTRODUCTION

When a company becomes financially distressed it incurs both direct and indirect costs. TheDirect costs such as litigation fees are relatively small.The indirect costs, on the other hand, are usually much larger2 which is why I have decided to concentrate my analysis on them. The two indirect costs of financial distress that this thesis analyses are the subsequent operational underperformance of financially distressed firms and the inefficient asset sales of these firms. Financial distress can be seen as a consequence of either poor prior operational performance or a conscious capital structure choice by the management. In this thesis I concentrate on the public markets which means that the majority of the companies that are labelled as distressedin this study have suffered from poor prior performance. However, the findings are also meaningful for those companies that choose a capital structure close to financial distress

Which is especially common in the private equity industry.

Financial distress is a term in corporate **finance** used to indicate a condition when promises to creditors of a company are broken or honored with difficulty. If **financial distress** cannot be relieved, it can lead to bankruptcy.Financial distress can be defined as a situation in which an institution is having operational, managerial and financial difficulties (Adeyemi, 2011). The value of any company reduces through the costs it undergoes during the period of distress. Direct costs of insolvency include auditor's fees, legal fees, management commissions, and other payments while indirect costs are those costs related to the action of employees, suppliers, investors and shareholders (Pandey, 2005).

Financial distress decreases the incentives of the employees to work hard and stimulates them to renegotiate their compensation packages or to leave the company. Both declining productivity and replacement of employees are costly and destroy the company's value. Competitors also may pursue an aggressive marketing and price strategy

in order to attract customers of the vulnerable company and, therefore, squeeze the troubled competitor out of the market. As a consequence, the distressed company suffers losses in sales leading to a loss of the market share (Natalia, 2007).

13.2 MANAGEMENT OF CORPORATE DISTRESS AND RESTRUCTURING STRATEGY

Corporate distress, including the legal processes of corporate insolvency reorganization and liquidation, is a sobering economic reality reflects the corporate demise. Many theorists stated that each firm is unavoidably exposed to ups and downs during its development (Burbank, 2005) and corporate collapse is not an unexpected event (Agarwal and Taffler, 2008). Corporate distress is reversible process through adopting restructuring strategies. Companies undergo a distressed financial situation usually share a series of common patterns which make it problematic to estimate a possible outcome of this situation (Barniv et al., 2002). Among the distressed firms, there are little divergences in the financial weakness indicators in the different failure processes (Ooghe and Prijcker, 2008).

Historically, the business failure phenomenon was visible during the 1970s, more during the recession years of 1980 to 1982, intensified attention during the outburst of defaults and large firm bankruptcies in the 1989–1991 period, and an unparalleled interest in the 2001–2002 corporate catastrophe and troubled years.

Main persistent reason for a firm's debacle and possible failure is managerial ineptitude. In its earlier annual publication of The Failure Record (no longer published), D&B detailed the numerous causes for failure, and those related to management invariably totalled about 90 percent. It is well established in management reports that most firms fail due to multiple reasons, but management insufficiencies are usually at the major issue. The vital cause of corporate upheaval is usually simply running out of cash, but there are a variety of means-related reasons that contribute to bankruptcies and other distressed conditions in which firms find themselves.

These causes are as under:

1. Chronically sick industries (such as agriculture, textiles, department stores).
2. Deregulation of major industries (i.e., airlines, financial services, health care, and energy).
3. High real interest rates in certain periods.

4. International competition.
5. Congestion within an industry.
6. Increased leveraging of corporate.
7. Comparatively high new business formation rates in certain periods.

Some of these reasons are understandable for corporate distress such as high interest rates, overleveraging, and competition. Deregulation eliminates the protection of a regulated industry and promotes larger numbers of entering and exiting firms. Competition is far greater in a deregulated environment, such as the airline industry. Therefore, airline failures increased in the period of 1980s following deregulation at the end of the 1970s and have continued nearly persistent since. New business creation is usually based on optimism about the future. But new businesses do not succeed with far greater frequency than do more seasoned entities, and the failure rate can be estimated to increase in new business activity.

When any firm undergo financial distress, it cannot typically meet its debt repayment obligations using its liquid assets. Unless there is an unexpected recovery of performance, the distressed firm is likely to default on its debt. This could result in a formal bankruptcy filing, a dismissal of the management, and possibly, liquidation of the firm (Gilson, 1989). To evade this, firms typically respond to financial distress by either reorganisation assets through fire sales, mergers, acquisitions and capital expenditures reductions or liabilities (by restructuring debt-both bank loans and public debt and by injections of new capital from outside sources) or both.

Managing a catastrophe situation of companies is a fundamental issue as it is not a spontaneous process. Moulton and Thomas (1993) avowed that the restructuring during a financial distress situation are not a simple matter and the probability of a successful exit is very low. However, the percentage of firms that succeed in getting through decline cannot be disregarded.

13.3 RESTRUCTURING STRATEGY

In case of corporate distress, there is a need of corporate restructuring as a company needs to improve its efficiency and profitability and it requires expert corporate management. When the companies are distressed, the government may intervene and support them to recover and revive. For this, firstly the company has to declare the sick unit, in accordance with the compliances of sick industry company's act 1985. Company is vested in the hands of board of industrial and financial reconstruction. In the best interest of company, the board may

revive it, rehabilitates it or sell off the unit. Company must follow restructuring to generate funds (Rajni Sofat, 2011). In broad sense, corporate restructuring refers to the changes in ownership, business mix, assets mix and alliances with a view to enhance the shareholder value. Hence, corporate restructuring may involve ownership restructuring, business restructuring and assets restructuring.

Purpose of Corporate Restructuring:

1. To enhance the shareholder value, the company should continuously evaluate its Portfolio of businesses, Capital mix, Ownership & Asset arrangements to find opportunities to increase the shareholder's value.
2. To focus on asset utilization and profitable investment opportunities.
3. To reorganize or divest less profitable or loss making businesses/products.
4. The company can also augment value through capital Restructuring, it can innovate securities that help to reduce cost of capital.

13.4 TYPES OF CORPORATE RESTRUCTURING STRATEGIES

1. **Mergers / Amalgamation:** It is a process by which at least two companies combined to establish single firm. It is a merger with a direct competitor and hence expands as the firm's operations in the same industry. Horizontal mergers are designed to accomplish economies of scale and result in reduce rivals in the industry. Vertical Merger is a merger which occurs upon the combination of two companies which are operating in the same industry but at different stages of production or distribution system.
2. **Acquisition and Takeover:** Takeovers and acquisitions are common process in business area. A takeover is a distinct form of acquisition that happens when a company takes control of another company without the acquired firm's agreement. Takeovers that occur without permission are commonly called hostile takeovers. Acquisitions happen when the acquiring company has the permission of the target company's board of directors to purchase and take over the company.
3. **Divesture:** Divesture is a transaction through which a firm sells a portion of its assets or a division to another company. It involves selling some of the assets or division for cash or securities to a third party which is an outsider. Divestiture is a form of contraction for the selling company. It is a means of expansion for the purchasing company. It represents the sale of a segment of a company (assets, a product line, a subsidiary) to a third party for cash and or securities.

4. **Demerger (spin off / split up / split off):** It is a type of corporate restructuring policy in which the entity's business operations are segregated into one or more components. A demerger is often done to help each of the segments operate more smoothly, as they can focus on a more specific task after demerger. Spinoffs are a way to offload underperforming or non-core business divisions that can drag down profits. Split-off is a transaction in which some, but not all, parent company shareholders receive shares in a subsidiary, in return for relinquishing their parent company's share. Split-up is a transaction in which a company spins off all of its subsidiaries to its shareholders and ceases to exist.
5. **Joint Ventures:** Joint ventures are new enterprises owned by two or more contributors. They are typically formed for special purposes for a certain period. It is a combination of subsets of assets contributed by two (or more) business entities for a specific business purpose and a limited duration. Each of the venture partners continues to exist as a separate firm, and the joint venture represents a new business enterprise. It is a contract to work jointly for a period of time. Each member expects to gain from the activity but also must make a contribution.
6. **Buy back of Securities:** Buy Back of Securities is significant process for Companies who wants to decrease their Share Capital.
7. **Franchising:** Franchising is also effective restricting strategy. It is an arrangement where one party (franchiser) grants another party (franchisee) the right to use trade name as well as certain business systems and process, to produce and market goods or services according to certain specifications.
8. A leverage buyout (LBO) is any acquisition of a company which leaves the acquired operating entity with a greater than traditional debt-to-worth ratio.

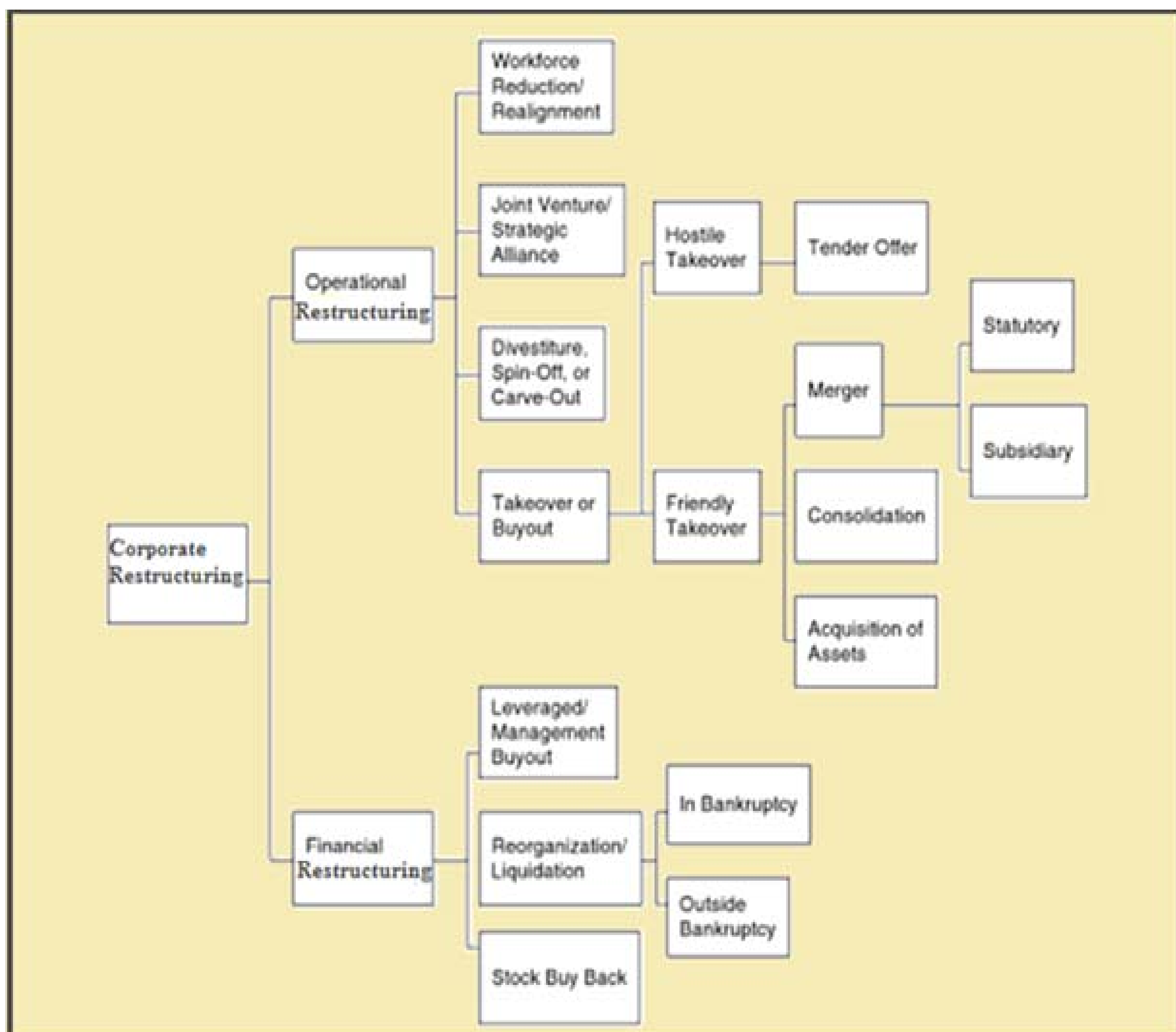
A corporate restructuring strategy involves the dismantling and renewal of areas within an organization that needs special attention from the management. The procedure of corporate reformation often ensues after buy-outs, corporate attainments, takeovers or bankruptcy. It can involve an important movement of an organization's accountabilities or properties.

Basically, organizational reorganisation involves making numerous transformation to the organizational setup. These changes have great impact on the flow of authority, responsibility and information across the organization. The causes for restructuring differ from diversification and growth to lessening losses and cutting down costs. Organizational restructuring may be done because of external factors such as amalgamation with some other company, or because of internal factors such as high employee costs. Restructuring strategy is about decreasing the manpower to retain employee costs under control.

When management formulate restructuring strategies for a business and implement, it can result in several changes to a company's organizational structure, product mix, financing strategies and overall operations. The modifications that occur during a corporate reorganization depend on the problem or opportunity that the business hopes to address with the change. Understanding the effects of reformation business will help management to make more informed decisions and lessen their need to take on more debt or sell part of company.

The unrelated business of highly diversified firm may be divested and all the resources focused on core products and services. This helps the company gain a competitive edge. This reduces cost and generate cash inflow which can be redirected to invest in core products production and marketing (Rajni Sofat, 2011).

Corporate restructuring process (Donald M. DePamphilis, 2007)



Restructuring is done through product differentiation. Company can opt for making significant changes in the existing products according to the recent market requirement (Rajni Sofat, 2011).

Company can also focus on quality enhancement of its product at each step in production process to add a new dimension and enhancement to existing product or services (Rajni Sofat, 2011).

Some restructuring strategies need an organizational change. This might result after a business go into a new market, requiring separate business units to share administrative functions or a corporate headquarters to supervise independent divisions. A reorganization may need to develop a new management team or a small business owner to sell part of the business and bring on a new partner or associates. A company that formerly subcontracted most of its administrative functions might bring them in-house. In other cases, a dealer of products who buys those products from sub-contractors might begin manufacturing the products instead of buying them. When two companies amalgamate, one layer of management and other redundant employees must be terminated, resulting in mass dismissals.

If a company cannot fulfil its capital requirements, it might sell stock or take on investors. This would permit the business to buy another company, open new places or add new products to its business. These changes requires the company to modify its financing strategies based on its new debt load and long-term financing needs. If a company has too much debt to operate lucratively, it might reorganize by taking out new loans at higher interest rates but lower monthly payments. Selling stock or part of the business are two possibilities to help reduce debt. Some restructurings focus on cost-containment, which can result in changing the mix of in-house and outsourced functions the company uses, as well as modifications to its product line, labour use and operations. In this situation, the company might renegotiate its contracts with vendors, suppliers, contractors, leasing companies, creditors and personnel.

In the process of restructuring, corporation enters into a new marketplace. It might need to restructure the business if the new products or services require a different skill set. This might mean adding a division to the company or opening a new production facility.

Another restructuring process is to devise different Distribution Strategy. To restructure a business, company sell using different distribution channels. If a company has sold only through intermediaries and decides to add direct sales, the company will need to address the operational changes that come with direct sales. This might include changes to its sales force, order-taking processes, product fulfilment, accounting services, and customer service

and information technology. An effective restructuring strategy that company in distress adopt is Re-branding. When a business goes through a restructuring due to a change in its product mix or distribution strategy, it might need to change its marketing message. Depending on whether the company's exclusive selling differential and key benefit change, the business might need to build a new brand message and brand-management policy.

To summarize, corporate distress may be due to intense competition, high interest rates and drastic changes in marketplace which put the company to bankruptcy. Financial distress has significant impact on the domestic economic activities (Papa M'B. P. N'Diaye, 2010). In this situation of corporate failure, there is requirement to devise restructuring strategies. Restructuring a business can assist a struggling company improve its position or help a successful business to expand more. A restructuring might involve altering significant processes in administration, marketing and adopting distribution strategies, addressing debt-service and financing strategies, entering into a new market or modifying the company's product or service.

13.5 CAUSES OF FINANCIAL DISTRESS

Causes of Distress

A company move to distress condition due to a number of reasons. Broadly these reasons can be classified into internal causes and external causes.

Internal Causes:

1. Managerial in competencies
2. Heavy debt burden and resultant service cost
3. Improper location
4. Lack of financial discipline
5. Technological failures
6. Uneconomic plant size
7. Over investments in fixed assets
8. Unsuitable plant and machinery
9. Poor emphasis on research and development
10. Weak production and quality control
11. Poor maintenance system
12. Lack of marketing policy

13. Weak demand projection
14. Wrong product mix
15. Improper product positioning
16. Irrational price structure
17. Inadequate sales promotion
18. High distribution cost
19. Poor customer service
20. Wrong capital structure
21. Wrong investment decisions
22. Lack of financial policies
23. Weak budgetary control
24. Absence of responsibility accounting
25. Inadequate management information system
26. Poor management of receivables
27. Bad cash planning and control
28. Strained relationship with suppliers of capital
29. Improper tax planning
30. Ineffective leadership
31. Poor labour relations
32. Inadequate human resources
33. Over staffing
34. Lack of commitment on the part of employees
35. Irrational compensation structure
36. Lack of expenditure control system
37. Excessive borrowings
38. Conflict among key personnel
39. Deteriorating quality

***External Environment*:**

The external environment may also affect the operations of a company adversely. Some of the major issues, which are generated by the external environment, are:

1. Government policies regarding taxation, power tariff, power supply, customs duties and import duties, restrictions on imports and exports etc.

2. Quota system imposed by the government on raw materials/ finished goods

3. Entry of large number of firm's thereby sudden increase in the capacity

4. Development of new technology

5. Sudden withdrawal by some of the major customers resulting into decline in orders

6. A change in the consumers' tastes and preferences

7. Strained relationship with the external government

8. A change in the lending policies of the financial institutions

13.6 EFFECTS OF FINANCIAL DISTRESS

1. Loss of Tax Benefit:

if a levered firm fails to make profits on a chronic basis, it loses the value of the tax shield provided by debt interest and depreciation. Depending on leverage and depreciationbase, these losses alone can place the firm at a competitive and strategic disadvantage.

2. Transaction Costs:

The cost of transacting in the financial markets is much higher from firms in financialdistress. In some cases, the capital markets may be effectively closed to a firm that is in severe distress, in part because, given the effort required by an investment bank that float the firm's equity or debt securities, undersriter spread would be prohbitively high.

3. Increase in Illiquidity:

Significant losses in the market value ofa firm's equity can have several negative liquidity effects.

a. First, the firm may lose some professionals who play vital role is supporting the flow of information about a stock, which is critical to liquidity.

b. **Secondly,** the investors' interest in trading that stock may reduce resulting in increase in the bid-ask spread.

c. **Third,** there are chances that stock exchange may delist that stock, but this will depend on the regulations of stock exchange.

Atthis point, the firm has lost most of its potential to raise equity funds raising debts funds will be moredifficult as well. Moreover, this may come at a time when the firm is most in need of external funds to survive.

13.7 OPERATIONAL CUTBACKS: CAUSES AND EFFECTS

Operational costs involve any expenses related to running your business, such as labor and office costs. Profit margin serves as the percentage of profit made from each sale. Operational expenses have a direct effect on your business' profit margin. This number tells a story of how well you controlled expenses, which can help or hurt in attracting investors and bolstering your company's stock.

Step 1:

Lower labor costs by increasing performance. When employees perform poorly, your labor costs increase, due to the need for more employees or because projects get completed late. When labor costs increase, profit margins decrease. To decrease labor costs, place an emphasis on high employee performance. Doing so involves training your employees thoroughly, hiring candidates that are best fit for the job, and reviewing employee performance consistently. Performance may also increase when motivational rewards are introduced.

Step 2:

Order enough materials to run your business, but so much that you're forced to waste. This only concerns certain businesses whose raw materials expire, such as those in the food industry. Wasting raw materials causes operational expenses to skyrocket, and profit margins to plummet. The best way to avoid waste is to base orders for raw materials off of estimated sales by looking at same-day sales from the previous year. For instance, look at the restaurant industry. A restaurant that orders three cases of strawberries and only goes through one in two weeks will have wasted two-thirds of its order.

Step 3:

Cut down on utility costs by implementing cost-saving equipment, such as CFL bulbs and Energy Star products. Turn off lights and computers once the workday ends, and make sure you're using as little energy as possible.

Step 4:

Set a marketing budget. Advertising can quickly erase profit margins. Without setting a budget, your advertising expenses may surpass the funds you can safely spend.

Step 5:

Reduce travel expenses. While it's not good for business to cut out travel expenses altogether — especially when traveling could mean landing a new client or selling a product — some means of travel can be reduced. For example, rather than paying for candidates to travel to your company's office for an interview, conduct the interview over the phone or via video chat.

Step 6:

Purchase used equipment, or lease, when older equipment becomes inoperable. Rather than spending money for new, spend less money on older but operable equipment. Doing so can save you thousands when you have to buy expensive equipment, such as printers and copiers. If you do not wish to buy equipment, consider leasing. Small Business Informer explains that leasing equipment allows you to make a change for new equipment after the lease is up.

Effects:

1. Low units of production
2. Reduction sales

13.8 CASESTUDY

Case study: BTA bank

Background to BTA's default

BTA was formed from the merger of Turan and Alem banks and privatised around 2000. BTA has expanded its operations both domestically and internationally to become the largest commercial bank in Kazakhstan. In 2007 Kazakhstan experienced the effects of the Global Financial Crisis. Kazakhstan banks experienced a significant contraction in profitability during the period from 2007 to 2009, which was reflected in significantly

increased levels in provisioning. Additionally, BTA experienced an increase in bad debt provisioning:

1. The rate of provision on BTA's loan book and off-balance sheet exposures increased from 6.6% in December 2008 to 45.8% in June 2009.

2. Corporate loans increased almost eight-fold over the same period. The blow out in bad debts has since been identified as a result of, in part, alleged fraudulent activity by the former management of BTA.BTA's former management are now in UK Courts facing criminal charges over fraud. The Global Steering Committee ("GSC") comprised representatives of each of the major foreign-creditor groups, including Bondholders, Commercial Banks, Trade Finance Providers and the Export Credit Agencies.

3. The government of Kazakhstan invoked the Law on Financial Stability following a review conducted by the National Bank of the Republic of Kazakhstan ("NBRK") and required that the sovereign wealth fund Samruk-Kazyna ("SK") recapitalise BTA in February 2009.

4. SK invested up to US$ 7 billion into BTA to support its liquidity and now controls a 75.1% stake in BTA.

5. The management of BTA was changed following SK's investment.

6. BTA's new management conducted further reviews of the loan portfolio resulting in additional provisions against the loan book being recognised for the period to 30 June 2009. BTA defaulted on its obligations on 20 April 2009 resulting in the acceleration of certain debt held by international creditors. The key commercial terms have been agreed amongst the GSC and BTA and memorialised in a document which became known as the Principal Commercial Terms Sheet ("PCTS") on 7 December 2009. As with most emerging market restructurings, the agreement of the PCTS was only a step in the process, one of many that would eventually realise an agreed restructuring plan, but several months later and in a diluted form.

By September 2009, provisioning for the loan portfolio had increased to a staggering average of 73.5%. At this point, BTA indicated its intention to restructure the loan book such that the impaired debt would be controlled by the Bad Bank, who would be tasked to effect recovery, to the extent possible, and return portions of the performing debt to the Good Bank by 2014. BTA expanded the options for restructuring and proposed to offer creditors a choice between four options, being:

1. Buy-Back – cash buyback at a discount of 82.25%.
2. Medium Term Roll-Over – 7 year roll over including 5 year grace period at a 60% discount.
3. Long Term Roll-Over – 15 year subordinated roll over at no discount, but reduced interest rates.
4. Equity Conversion – equity conversion at 80% discount In September 2009, BTA entered into a number of Memoranda of Understanding ("MOU") with SK, and the GSC. The MOU outlined the "Steering Committee Restructuring Plan Proposal", which included a proposal for the treatment of certain debt. The GSC's proposal included: Option 1 – Cash plus a discounted debt instrument, equity and Recovery Notes. Option 2 – ECA /Government related debt to be repaid over 8 years, with a 3-year grace period and a Government of Kazakhstan guarantee

Between September 2009 and May 2010, the restructuring plan was negotiated between the GSC and BTA with a view to resolving a number of issues, including key documentation, and the commercial outcomes. However, the final position remained a moving target, as a further assessment of the capital required for restructuring continued to grow as the loan portfolio was reviewed and found to be further impaired.

USD Billion

Total Regulatory Capital @ 31/08/2010	(12.26)
RWA	13.52
Minimum total Regulatory Capital	1.35
Required Capital Injection	13.62
Impact of additional provisions	2.26
SK Capital increase	4.56
Minimum requirement from restructuring	6.80
Profit from Haircut	6.45
Conversion of Equity under JP2	0.35
Total Creditors' Contribution to Capital	6.80

13.9 NOTES

13.10 SUMMARY

Financial distress is surprisingly hard to define precisely. This is true partly because of the variety of events befalling firms under financial distress. The list of events is almost endless, but here are some examples:

- Dividend reductions
- Plant closings
- Losses
- Layoffs
- CEO resignations
- Plummeting share prices

Financial distress is a situation where a firm's operating cash flows are not sufficient to satisfy current obligations (such as trade credits or interest expenses), and the firm is forced to take corrective action.1 Financial distress may lead a firm to default on a contract, and it may involve financial restructuringbetween the firm, its creditors, and its equity investors. Usually the firm is forced to take actions thatit would not have taken if it had sufficient cash flow. Our definition of financial distress can be expanded somewhat by linking it to insolvency. Insolvency is defined in *Black's Law Dictionary* as2

Inability to pay one's debts; lack of means of paying one's debts. Such a condition of awoman's(or man's) assets and liability that the former made immediately available would be insufficient to discharge the latter.

13.11 KEY WORDS

Financial distress, Operational Costs, Insolvency, information system, poor management, Equity, Buy-back.

13.12 SELF ASSESSMENT QUESTIONS

1. What is financial distress?
2. Explain in brief the causes of financial distress.
3. Elucidate the effects of financial distress
4. Write a short note on operational cut back.

5. Explain the ways of operational cut back.

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UNIT - 14 : DIVESTURE AND FINANCIAL RESTRUCTURING

Structure:

14.0 Objectives

14.1 Introduction

14.2 Basic Principles

14.3 Divesture via asset sales

14.4 Financial restructuring,

14.5 Forms of corporate restructuring.

14.6 Case Study

14.7 Notes

14.8 Summary

14.9 Key Words

14.10 Self-Assessment Questions

14.11 References

14.0 OBJECTIVES

After studying this unit, you will be able to ;

- Nature and Scope of Divestiture.
- Understand Financial Restructuring.
- Explain Various forms of Divestiture.
- Forms of corporate restructuring.

14.1 INTRODUCTION

Businesses have a life cycle. They are formed; they grow; and they mature. And, although there is no predetermined end to the life of a business, many businesses ultimately experience a transitional phase through a change in ownership, a divestiture, a merger, an acquisition or a public offering. Such transactions are opportunities to generate enormous value for companies and their owners. While the current market has proven to be a tougher market than years past, with smaller pools of available buyers, increased levels of market due diligence, and limitations on the availability of public debt and equity capital, it is clear that preparation and value generation from deals has never been more important.

Various exit structures exist to help companies achieve their priority objectives as they enter a transitional phase. Depending on the exit structure and approach taken, the regulatory, tax and reporting requirements of each alternative can significantly vary and may have different timelines for completion. Challenges will always exist with corporate exit strategies, but with the right understanding, strategic planning, and managing of priorities, companies assessing exit strategies in today's difficult market can achieve their goals and maximize deal value.

Divestiture involves the disposal of an ownership interest in a company or **subsidiary** in exchange for other forms of assets. Divestiture may be a voluntary act effected to raise money, stem operating losses, or reorganize a corporation. It also may be compulsory, where a government or regulator demands a divestment to achieve a public policy goal under the threat of legal action.Companies usually divest themselves of subsidiary business units because the capital invested in that operation could be more wisely employed

somewhere else. These disposals are frequently carried out under the authority of a board of directors, and usually do not require the express consent of shareholders.

Where the owner is not a corporation, but an investment trust, the investor may elect to divest the trust of a certain asset because that asset is performing poorly or is engaged in activities tat are opposed by the investor. Divestiture allows the owner to undertake a more beneficial employment of assets by making them transferable.Corporate laws and regulations provide few barriers for divestment, except when it is related to fraudulent or anticompetitive activity. The ability to convert an investment into a transferable asset benefits owners tremendously by allowing their capital to be employed with optimal efficiency.

14.2 BASIC PRINCIPLES

The basic concept of divestiture is as old as trade itself, but corporate divestiture as a principle has a relatively brief history. This is because the procedures involved developed out of modern forms of legal incorporation. Any company endowed with a certain asset maintained an ownership right that entitled it to employ that asset any way it chose, including financial disposal or divestment.

For example, a railroad line might purchase a coal mining company to provide a direct source of fuel for its fleet of locomotives. But with development of more efficient diesel engines, the value of that mine becomes seriously eroded. As the railroad replaces its steam engines with diesels, it has no use for its coal, except to sell it to someone else. Thus, it faces a crucial decision of whether to sell the mine or hold on to it and enter the coal supply business.

If the company decides that it could not compete effectively with other coal producers, and should remain only a railroad, it might choose to divest itself of the mine. If this were the case, the railroad would begin negotiations with potential buyers.

As an operating subsidiary of the railroad, the mine may be worth \$2 million. But one potential buyer, another coal company, offers \$2.5 million for the mine. A second buyer, a steel mill, offers \$2.8 million. This illustrates a necessary motivation for divestment: a difference in valuation among the parties. In this case, the steel mill wins the competition and agrees to take over the railroad's mine for payment of \$2.8 million.

A somewhat more complex scenario arises if the coal company offers only \$1.5 million for the mine, and the steel company's top bid is \$1.8 million. Again, there is a difference in valuation, but the railroad would incur a loss from the sale.

Under these circumstances, it might choose to go ahead with the sale anyway, because it could employ the $1.8 million offered by the steel mill to increase its profitability in other ways. It could use the proceeds of the sale to upgrade its facilities and purchase new diesel engines. This might enable the railroad to derive additional efficiencies from its existing operation that might be valued at $1 million. Despite the loss of $200,000 on the sale of its mine, the railroad stands to gain a net profit of $800,000.

These examples demonstrate the most common reasoning behind the divestiture of certain assets where a justification lies in increased economies of scale and **economies of scope.** The steel mill clearly could make better use of its coal mine in its own operations than could the railroad, and this is reflected in the valuation.

Divestiture may result from instances where anticipated synergies do not result. Although related to the concept of economies of scale, synergistic combinations attempt to translate product-specific technologies to entirely different markets.

For example, a manufacturer of military aircraft may purchase a company operating at a loss whose primary business is building business jets and other civilian aircraft. The justification for such an acquisition is that the company's engineering expertise from building fighter jets could be applied to design better, and therefore more profitable, airplanes for the private market.

But in practice, the company discovers that its primary strengths with military aircraft, such as high-speed maneuverability and radar-evading designs, provide no marketable benefit to private aircraft. As a result, the company is unable to apply the benefits from its most valuable military technologies to the civilian aircraft market.

In this case, the company's military and civilian aircraft enterprises remain divorced, each with distinctly separate engineering requirements, cost structures, and markets. Since no benefit can be derived from the combination, the company may elect to divest the civilian aircraft operation. With the proceeds, it might purchase another company that will benefit more from an association with the core business.

14.3 DIVESTURE VIA ASSET SALES

A practical review of corporate exit strategies

In the sections following, we review the major types of corporate exit strategies available to companies, the reasons why one strategy might be more appealing than

another, and the tactical differences in executing various strategies. Commentary from participants at recent PwC Corporate Roundtable events on exit strategies supplements the discussion. We have not attempted to discuss the specific challenges associated with a particular strategy or the solutions to over come these challenges as these are the subject of other publications of PwC. The overview in this paper should be read in conjunction with PwC's other deal publications.

Carving out a business— financially and operationally

Many exit strategies involve a piece of the company rather than the entire company. Such a transaction is often referred to as a "carve-out." Although there is no official legal or accounting definition for a carve out business, the term commonly refers to the separate financial and operational presentation of a component of an entity, subsidiary, or operating unit, which may or may not be a separate legal entity. Information and operations for such a presentation is derived or "carved-out" from a larger entity or parent company. Carve-outs may consist of subsidiaries, segments, business units, or lesser components, such as product lines of a business.

A carve-out business needs to be separated from the seller's existing operational and financial infrastructure. Often, the business may need to function as a standalone entity post-close, especially in transactions involving a financial buyer, such as a private equity fund. Consequently, the operational separation and transition service arrangements between the buyer and the seller that will exist subsequent to deal closing are critical components of any exit strategy involving a carve-out.

Additionally, standalone financial statements for the carve-out business may be a due diligence request; appear in a securities offering memorandum; be used to comply with regulatory reporting obligations, such the Securities and Exchange Commission's (SEC) requirements for significant acquisitions; or otherwise be required to complete a deal. The preparation of carve-out financial statements is among the more challenging financial reporting exercises an entity can undertake. Accordingly, the need for such information should be evaluated early in any deal involving a carve-out, so as not to derail anticipated timelines.

Taxes upon exit

As discussed further below, companies must consider a number of key tax issues in connection with any exit strategy. By engaging in up-front tax planning, a divesting entity is able to identify structuring opportunities and pitfalls, assess the tax cost of the various alternatives, and maximize after-tax proceeds. The tax considerations of an exit

can be simple or complex depending on the number of jurisdictions involved, the rules pertaining to each jurisdiction, and the structure of the transaction. Preservation of tax attributes, such as net operating loss carry-forwards and capital loss carry-forwards are key considerations in an exit transaction. Accordingly, pre- deal tax due diligence and proper structuring of the transaction can be critical to ensuring the seller maximizes the value of the deal.

Common forms of exit strategies

The following sections describe some of the more common forms of exit transactions that have emerged in the marketplace over the past decade, including the key financial and operational considerations associated with them.

- **Sale to buyer**

The most common form of divestiture is a "trade sale" transaction in which a company or a carve-out from a company is sold to an independent buyer. Buyers might include:

1) Corporate strategic buyers who often pursue a business because it strategically fits with their existing strategy and from which they are able to harvest financial and operational synergies; or

2) Financial buyers, such as private equity firms, who are looking to further develop or restructure the business, generally with the goal of "taking the business public" via an initial public offering (IPO) or implementing another exit strategy in the foreseeable future.

From the seller's perspective, this type of exit is often financially less onerous for the seller than spin-off or split-off transactions, which are discussed below. From a financial perspective, requirements are principally driven by:

1) Buyer due diligence,

2) Buyer financing, or

3) A buyer's SEC reporting requirements.

Based upon the significance of the divestiture, a sale may or may not trigger more complex SEC reporting requirements, such as pro forma or standalone financial statements, for the seller. In the case of selling an entire company, trade sales may also be operationally less onerous to the seller if the company has standalone operations.

Trade sales are typically taxable events for the seller. However, a transaction's tax treatment depends on a number of factors, including whether the transaction is

classified as a sale of stock or assets. In a stock sale, the seller's gain or loss is typically characterized as a capital gain or loss; while a seller's gain or loss for an asset sale can be characterized as either a capital or ordinary gain or loss, depending upon the nature of the assets sold. To the extent that the seller has tax attributes, such as net operating losses, capital losses, or tax credit carry-forwards, consideration needs to be given to

1) Whether such attributes will transfer to the buyer and directly impact deal consideration, or
2) Whether all or a portion of the gain triggered on the sale for the seller will be offset by such attributes. Prior to a divestiture being structured as a sale, sellers typically analyze the magnitude of any tax leakage from the deal, which typically includes a detailed analysis of how to optimize the tax attributes impacted in the deal.

In our experience, trade sales almost always take longer than expected. In the current environment, it is not uncommon for a trade sale to take as long as nine to 18 months from the time the decision is made to divest to the time a deal is closed. Preparation prior to marketing the sale is essential for a seller to minimize value leakage in what can be a lengthy and exhausting divestiture process.

Equity spin-off

An equity spin-off involves a pro rata distribution of a carve-out entity's ("spinnee") stock to the parent company's ("spinnor") shareholders. The effect of this transaction is to "dividend-off" a piece of the company to its existing shareholders. Thus, the spinnee becomes an independent, standalone company with its own equity structure. Although the SEC does not consider an equity spin-off to be an "offer" or "sale" of securities, if the spinnor is a public entity, then the spinnee's newly issued shares do need to be registered with the SEC. This is typically accomplished by filing a Form 10 for the spinnee, with the SEC that includes standalone historical, carve-out financial statements for the spinnee as well as any other historical and pro forma financial information required.

Companies typically use this structure to enable separate pieces of a larger business to more readily pursue individual long-term strategic goals. This may include providing the spunoff business with opportunities to access capital under separate, often more favorable, terms or to pursue strategic merger and acquisition activity. It is important to note that the spin-off transaction, by itself, does not raise capital for the parent or the spunoff company, nor does it change the overall value held by the shareholders. However, post-spin, shareholders do recognize the impact of separate

market valuations and borrowing rates that otherwise might not have been available to the spinnee under the combined company structure.

A key factor in assessing equity spinoffs is whether the transaction is classified as taxable or non-taxable for the spinnor or its shareholders. Typically, to be considered a nontaxable event, the distribution must be completed in compliance with Section 355 of the Internal Revenue Code (IRC). These tax rules were designed to prevent parent companies from disposing of assets on a tax-free basis through a spin-off and then entering into a tax-free business combination.

Consequently, spin-offs completed as a preliminary step to a merger transaction may not qualify for tax-free reorganization status. These rules, if applicable, would make the spin-off taxable to the distributing corporation, but not to the shareholders. Because of the importance of this determination, companies usually pre-clear their conclusions with respect to the taxable nature of spin-off transaction with the Internal Revenue Service (IRS) by obtaining a private letter ruling prior to effecting the spin-off.

Although there is no standard timeline for a spin-off, in our experience, the spin-off process often can easily take as long, if not longer, than a trade sale due to the complexities involved with the regulatory filings, the tax requirements, and the operational separation of the spinee from the spinnor. Such complexities may include: planning the operational separation, drafting the spin-off distribution agreement and related documents and drafting the Form 10 required by the SEC. Prior to going effective with the spin-off transaction, all SEC comments must be cleared, which, depending upon the depth of the review, can range from several weeks to several months. Finally, if a private letter ruling regarding the tax-free nature of the spin-off has been requested from the IRS, the rulingprocess can often take four to six months. Typically, the private letter ruling process runs concurrently with the SEC review process.

- **Equity Carve-Outs**

An equity carve-out is when a parent company (spinnor) carves-out a subsidiary from its business (spinnee) and offers securities in the carve-out subsidiary to the public through an IPO. Often, the offering comprises no greater than a 20 percent ownership interest in the spinee. Therefore, the spinnor retains the ability to later spin-off the remaining interests to existing shareholders at a later date on a tax free basis. Equity carve-outs are typically undertaken to monetize value in a subsidiary while still retaining control and an interest in the future value of a subsidiary.

Equity carve-outs are not reflected by a pro rata distribution to the parent company shareholders. Rather, such transactions reflect a genuine offer of securities to the public. Accordingly, equity carve-out transactions for public companies are typically reported in Form S-1 (IPO document) with the SEC. Filing requirements, tax considerations, and timelines for an equity carve-out resemble those described above for an equity spin-off transaction.

- **Split-off**

A split-off is a transaction in which the parent company conducts an exchange offer, whereby it gives its stockholders the opportunity to swap some or all of their parent company stock for subsidiary stock. Because the SEC considers a split-off to be an exchange offer for new securities under its rules and regulations, the exchange offer itself is conducted in accordance with the SEC's tender offer rules, typically on Form S-4, which includes financial and business disclosure for both the parent and the subsidiary. Similar to a spin-off, the split-off transaction is not inherently a capital-raising transaction. In order to raise capital, once the subsidiary has split off, it can establish a bank line of credit, sell securities, or engage in an IPO.

The principal difference between a spin-off and a split-off is that after completion of a split-off, the stock of the subsidiary is held by the parent's stockholders on a non-pro-rata basis. Some stockholders may hold only parent stock, while others may hold only subsidiary stock, and still others may hold both. Companies may choose to transact a split-off over a spin-off because in a split-off, the stockholders get to decide what combination of stock they wish to hold post-split. This flexibility maybe important when stockholders holding a significant interest express preferences for one stock over the other.

Split-offs may have a less dilutive effect on parent earnings per share than spinoffs. In a spin-off, the parent loses the benefit of any earnings the subsidiary generates and the proportionate number of outstanding shares of parent stock remains the same. Thus, if the subsidiary is profitable, parent earnings per share decreases. In a split-off, the parent also loses the benefit of the subsidiary's earnings; however, the number of outstanding shares of the parent stock decreases. As such, the earnings per share of the parent company may not decrease as significantly in a split-off as in a spinoff transaction.

From a tax perspective, at least 80 percent of the voting control of the subsidiary must be exchanged (or distributed) to comply with Section 355 of the IRC. Assuming all the requirements of Section 355 are met, the requirement of parent company stock in

exchange for the carve-out entity's stock enables the parent to obtain the benefits of a major share repurchase and a tax-free spin-off.

Like spin-off transactions, splitoff transactions can often take a considerable amount of time to execute. Although the parent can begin the exchange after it has initially filed its registration statement with the SEC, completion of the offer is contingent upon the SEC's review, clearance, and declaration that the registrationstatement is effective.

And, similar to the spin-off, if a private letter ruling is sought from the IRS regarding tax-free status, the transaction timeline can often be extended.

Dual tracking:

It is not uncommon for a organizations to pursue one or more of the above mentioned strategies, simultanteously. This process is commonly referred to as "dual tracking." For example, a company may commence an IPO process or an effort to spin-off a subsidiary, while simultanteously marketing the business or subsidary for sale. Though the primary transaction,e.g. IPO or spin-off, dictates the form and structure, deal documents for a dual track process are often tailored to accommodate both efforts. Though dual tracking places additional strain on company and the deal team, such a process can help ensure transaction value is maximized in a relatively efficient way.

Establishing priorities

In executing any exit strategy, companies encounter a number of functional cross-dependencies and competing demands. Establishing and managing primary objectives in this environment becomes critical to effective deal management. Examples of primary objectives a company may have in an exit transaction include:

Valuation

A divestiture strategy may be driven by the need to generate cash to repay debt obligations, meet debt covenants, fund working capital needs, or simply for an owner to "cash out" of its investment. For this reason the divestiture price may be a primary concern. Given the complexity associated with the transactions discussed above, trying to "time" the market is often a challenge for sellers in the current environment.

Speed-to-market or speed-to close

Sellers may prioritize speedto-market or speed-to-close not only to exit a non-core business and redirect management focus, but also to capture buyer opportunities

when and as they become available or to limit value leakage and deal deterioration over an extended period.

Tax strategy

The sale of a company can have significant tax implications both for the divested and retained businesses. If tax due diligence and structuring strategies are planned early, this can result in significant tax savings and, ultimately, cash inflow for the businesses. Occasionally, companies reach the counterintuitive conclusion to sell at a loss because of advantageous tax consequences.

Deconsolidation from seller's financial statements

To help ensure the business is no longer accounted for on the parent company's books at close, sellers may prioritize deconsolidation in their divestiture strategy. Certain deal structures may preclude deconsolidation from the parent company (e.g., seller financing, ongoing operational support) and therefore require ongoing accounting and reporting. Such considerations should be fully evaluated early in the deal process.

Additionally, a company may have to contend with one or more of the following operational and/or financial reporting challenges associated with an exit strategy:

Operational separation complexities

For example, transition service agreements in a trade sale or spin-off transaction can be time consuming and onnerous. Failing to have a well thought out plan with respect to transition services, including the costs to be charged, can adversely affect both transaction proceeds and time to close;

Complexities related to incremental accounting and reporting requirements associated with the divestiture transaction

A GAAP evaluation of discontinued operations treatment can be challenging and potentially lead to unintended financial reporting consequences if not evaluated properly;

Incremental Sarbanes-Oxley (SOX) compliance requirements applicable to the divestiture or the spin-off

In addition to ensuring there are proper controls around the divestiture and related financial reporting processes, a seller may need to augment its post divestiture control structure depending upon the materiality and impact of a divestiture. For a spin-off, the Spinee will need to separately consider its SOX compliance, prospectively; or

Complexities associated with related SEC filing requirements and disruption to either the core operations or retained employee base

A divestiture may trigger additional filing requirements such as Form 8-K or Pro Form Financial Information, which can create additional stress on and disruption to the management team and their ability to focus on the company's core operations. Additionally, consideration needs to be given to a perspective purchaser's need for audited financial statements for the target business as carve-out audits are complex, costly and often impact the transaction timeline. The company's ability to identify these objectives and challenges early in the planning phase, while taking into account the key value drivers and associated risks of the divestiture strategy, will help optimize transaction results and generate value from the exit strategy.

Lack of clarity in business performance drivers, growth rates, and profitability

Divested businesses may not have had the focus of core businesses, or often a buyer is looking for attributes not measured or monitored historically. Clear analysis and presentation can enhance value perceptions.

14.4 FINANCIAL RESTRUCTURING

Financial restructuring" is the process of reshuffling or reorganizing the **financial** structure, which primarily comprises of equity capital and debt capital. Financial restructuring is the reorganizing of a business' assets and liabilities. The process is often associated with corporate restructuring where an organization's overall structure and its processes are revamped. Although companies can restructure for any reason, in most cases it is done when there are serious problems with the business, and to avoid bankruptcy liquidation.

Every functioning company controls assets, or economic resources that can be owned and are otherwise considered valuable. Most businesses also hold liabilities, which are debts or other obligations that arise as a result of past transactions. These economic factors will often have the most significant impact on the success or failure of that business, so financial restructuring is likely to focus on effectively managing assets and reducing liabilities.

Debt Restructuring

When a company is in crisis, it may try to renegotiate with its creditors to reduce or eliminate some of its debts. Faced with the possibility that the distressed company may default on a loan, creditors will often work to adjust the terms of repayment, including

lowering interest rates and/or extending the repayment schedule. Debts may also be forgiven, in part, often in exchange for the creditor gaining some equity — part ownership — in the company.

Financial restructuring is not only a tool used by companies that are in financial trouble. Healthy companies may also choose to restructure their debt if it will provide a benefit. If interest rates fall, for example, a company may refinance its loans to take advantage of this drop.

Equity Restructuring

Companies that have little debt in comparison to their equity — that is, they are are underleveraged or have a low debt-to-equity ratio — may use some of their equity to buy back stock. This returns more control to the company, which will have fewer stockholders to satisfy and pay dividends to. If the company has excess cash, it can use it to repurchase shares; alternatively, if it doesn't have extra cash available, it may sell off some assets that are not bringing in profits or borrow money for the buyback.

Financial restructuring can also involve writing down assets that are overvalued. This change in value appears on a company's income statement as an expense, which lowers the company's income and, therefore, the amount of tax it owes. Because this is a "paper loss" — the company isn't actually losing any money except on the income statement — this method of restructuring can help reduce how much money a company owes without it needing to spend cash on repurchases.

Reasons for Restructuring

Most businesses go through a phase of financial restructuring at some point, though not necessarily to address shortfalls. In some cases, the process of restructuring takes place as a means of allocating resources for a new marketing campaign or the launch of a new product line. When this happens, the restructure is often viewed as a sign that the company is financially stable and has set goals for future growth and expansion.

A company may also need to restructure its finances if it merges with or acquires another company. When two firms merge, their debt and equity are also combined, and the resulting corporation may have a very different debt-to-equity ratio than either of the original companies. An acquisition may even be used as a form of financial restructuring, as a company with a low debt-to-equity ratio may target a business with a high ratio as a means of better balancing its finances.

Operational Restructuring

Along with financial restructuring, a company may need to restructure its operations to help eliminate waste. For example, two divisions or departments of a company may perform related functions and in some cases duplicate efforts. Rather than continue to use financial resources to fund the operation of both departments, their efforts are combined. This helps reduce costs without impairing the ability of the company to achieve the same ends in a timely manner. Operational restructuring, also known as corporate restructuring, may also involve downsizing, eliminating staff to reduce costs.

In some cases, restructuring must take place in order for the company to continue operations. This is especially true when sales decline and the corporation no longer generates a consistentnet profit. The operational restructuring process may include a review of the costs associated with each sector of the business and an analysis of ways to cut costs and increase the net profit. The process may also call for the reduction or suspension of obsolete facilities that produce goods that are not selling well and are scheduled to be phased out.

14.5 FORMS OF CORPORATE RESTRUCTURING

Types of Restructuring

Business firms engage in a wide range of activities that include expansion, diversification, collaboration, spinning off, hiving off, mergers and acquisitions. Privatization also forms an important part of the restructuring process. The different forms of restructuring may include:

1. **Expansion**
2. **Sell-Off**
3. **Corporate Control**
4. **Change in Ownership**

1. Expansion:

Expansions may include mergers, acquisitions, tender offers and joint ventures. Mergers per se, may either be horizontal mergers, vertical mergers or conglomerate mergers. In a tender offer, the acquiring firm seeks controlling interest in the firm to be acquired and requests the shareholders of the firm to be acquired, to tender their shares or stock to it. Joint ventures involve only a small part of the activities of the companies involved.

2. Sell-Off:

Sell-Off may either be through a spin-off or divestiture. Spin-Off creates a new entity with shares being distributed on a pro rata basis to existing shareholders of the parent company. Split-Off is a variation of Sell-Off. Divestiture involves sale of a portion of a firm/company to a third party.

3. Corporate Control:

Corporate control includes buy-backs and greenmail where the management of the firm wishes to have complete control and ownership.

4. Change in Ownership:

Change in ownership may either be through an exchange offer, share repurchase or going public.

An example: Essar Steel Announces Restructuring Plans

Essar Steel Limited recently announced its restructuring plan through which the company plans to reduce its interest burden. The company has also initiated several other steps including increasing production and lowering operating costs as a part of its restructuring program. The company also announced the development of a strategy addressing its debt burden-reduction and lengthening the maturity period.

Other restructuring programs initiated by the company included:

- Raising equity through rights issue
- Reduction in usage of power

The company, subsequent to its restructuring program, expects to be in a position to make net profits, declare dividends and enhance shareholder value.

14.6 CASE STUDY

Divestiture (Shell) Case Study

Client: Allianz

Objective: To sell a non core Excess & Surplus (E&S) lines **subsidiary** as a "shell" company. Maximize the value of the E&S authorizations over book value.

Our Process: Led by a senior advisor, Merger & Acquisition Services undertook the following initiatives:

- Worked with the company to understand the market for E&S lines "shell" companies and presented valuation comparables
- Drafted a Confidential Informational Memorandum (CIM) and Bid Packet
- Began the marketing process by utilizing M&A's industry contacts and proprietary database. In addition, the property was highlighted in both our email and hard copy Newsletter
- Provided interested parties with CIM and Bid Packet and responded to each group to answer specific questions relating to the company and/or the bid process
- Provided seller with a due diligence checklist and organized the diligence material in our Electronic Data Room
- Provided potential buyers, who had signed the appropriate confidentiality agreements, with access to the Data Room
- Set a firm Bid Deadline and followed up with each potential buyer to assist in the preparation of their respective bids
- After receiving four bids for the company, we worked with the seller in analyzing all aspects of each proposal, including assessing the strength of the bidder in terms of successfully completing the regulatory process

RESULT:

The client agreed to an exclusivity period with one bidder who subsequently executed a purchase agreement. The parties closed on the transaction with M&A's client receiving a 2x multiple based on other comparables which had previously sold.

14.7 NOTES

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14.8 SUMMARY

In order to achieve growth organizations give more importance to Merger & Acquisition. Merger & Acquisition plays pivotal role in organizations Corporate Strategy & maintaining portfolio of business to achieve high return on capital & growth. However situation arises once organization diversify itself into various businesses and its corporate portfolio becomes so huge that it is very difficult to maximize return on capital & take advantage of new growth opportunities.Divestitures and carve-out plays a very important role in restructuring organizations corporate portfolio to maximize return & growth.Normally organization doesn't give as much importance to divestitures as to M & A however if Divestiture/Carve-out activity carried out timely &sequencely then it can provide huge benefit in terms of shareholders value, future growth and cash flow.

Why organizations do Divestiture

The reasons to divest a business are wide-ranging, from short-term cash generation to a desire to restructure the business portfolio by spinning off non-core or low-performing assets. And regardless of the driving force behind a divestiture, the overall objective of most companies is to get the best possible return—i.e., the highest price.

In order to get optimum return from divestiture organizations should do it in an accelerated time frame. Best practice is to make sure that to-be-divested units are configured for maximum appeal to potential buyer, and putting effective program management in place to manage the complexity of divestiture.

Divestiture Strategy

In order to develop its divestiture strategy, a company should comprehensively assess its corporate portfolio to identify opportunities for value creation. This entails four basic steps:

- Aligning assets with the business' best opportunities
- Developing a timing and sequencing strategy for separation & divestiture transaction
- Define boundaries of assets being considered for divestiture
- Packaging the divestiture assets for maximum value

Aligning assets with the business' best opportunities

Organization should carefully study the overall business' growth opportunities, and the capital required for each business in the portfolio to take advantage of those

opportunities. This perspective then must be paired with an understanding of the potential value of each business to an external owner compared to its worth to the divesting company.

14.9 KEY WORDS

Divestitures, Financial restructuring, forms of restructuring, Sell off, Spin off, Equity carve out.

14.10 SELF ASSESSMENT QUESTIONS

1. What do you mean by financial restructuring?
2. Explain various forms of restructuring.
3. Various forms of Divestitures via asset sales.
4. Differentiate between divesture and asset sales

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UNIT - 15 : CORPORATE AND DISTRESS RESTRUCTURING

Structure:

15.0 Objectives

15.1 Introduction

15.2 Reasons for Corporate Restructuring

15.3 Process of Corporate Restructuring

15.4 Process of Distress Restructuring

15.5 Strategy for Corporate and Distress Restructuring

15.6 Case Study

15.7 Notes

15.8 Summary

15.9 Key Words

15.10 Self Assessment Questions

15.11 References

15.0 OBJECTIVES

After studying this unit, you will be able to ;

- Analyze the orderly redirection of the firm's activities
- Understands deploying surplus cash from one business to finance profitable growth in another;
- Examine the Development of core competencies.
- Various reason behind distress restructuring
- Techniques involved in overcoming in distress restructuring
- Evaluate the Revival strategies

15.1 INTRODUCTION

Corporate restructuring is a corporate action taken to significantly modify the structure or the operations of the company. This usually happens when a company is facing significant problems and is in financial jeopardy. Often, the restructuring is referred to the ways to reduce the size of the company and make it small. Corporate restructuring is essential to eliminate all the financial troubles and improve the performance of the company.

Restructuring is the corporate management term for the act of reorganizing the legal, ownership, operational, or other structures of a company for the purpose of making it more profitable, or better organized for its present needs.

The troubled company's management hire legal and financial experts to assist and advise in the negotiations and the transaction deals. The company can go as far as appointing a new CEO specifically for making the controversial and difficult decisions to save or restructure the company. Generally, the company may look at debt financing, operations reduction and sale of the company's portions to interested investors.

15.2 REASONS FOR CORPORATE RESTRUCTURING:

Corporate restructuring is implemented under the following scenarios:

- **Change in the Strategy:**

The management of the troubled company attempts to improve the company's performance by eliminating certain subsidiaries or divisions which do not align with the core focus of the company. The division may not seem to fit strategically with the long-term vision of the company. Thus, the company decides to focus on its core strategy and sell such assets to the buyers that can use them more effectively.

- **Lack of Profits:**

The division may not be profitable enough to cover the firm's **cost of capital** and cause economic losses to the firm. The poor performance of the division may be the result of the management making a wrong decision to start the division or the decline in the profitability of the division due to the increasing costs or changing customer needs.

- **Reverse Synergy:**

This concept is in contrast to the M&A principles of synergy, where a combined unit is worth more than the individual parts together. According to reverse synergy, the individual parts may be worth more than the combined unit. This is a common reasoning for divesting the assets. The company may decide that more value can be unlocked from a division by divesting it off to a third party rather than owning it.

Corporate distress, including the legal processes of corporate insolvency reorganization and liquidation, is a sobering economic reality reflects the corporate demise. Many theorists stated that each firm is unavoidably exposed to ups and downs during its development (Burbank, 2005) and corporate collapse is not an unexpected event (Agarwal and Taffler, 2008). Corporate distress is reversible process through adopting restructuring strategies. Companies undergo a distressed financial situation usually share a series of common patterns which make it problematic to estimate a possible outcome of this situation (Barniv et al., 2002). Among the distressed firms, there are little divergences in the financial weakness indicators in the different failure processes (Ooghe and Prijcker, 2008).

Historically, the business failure phenomenon was visible during the 1970s, more during the recession years of 1980 to 1982, intensified attention during the outburst of defaults and large firm bankruptcies in the 1989–1991 periods, and an unparalleled interest in the 2001–2002 corporate catastrophe and troubled years.

Main persistent reason for a firm's debacle and possible failure is managerial ineptitude. In its earlier annual publication of The Failure Record (no longer published), D&B detailed the numerous causes for failure, and those related to management invariably totaled about 90 percent. It is well established in management reports that most firms fail due to multiple reasons, but management insufficiencies are usually at the major issue. The vital cause of corporate upheaval is usually simply running out of cash, but there are a variety of means-related reasons that contribute to bankruptcies and other distressed conditions in which firms find themselves.

15.3 PROCESS OF CORPORATE RESTRUCTURING

Hardware Restructuring:

It involves redefining, dismantling or modification of the existing structure of the organization. The major areas are.

- Identification of core competency
- Flattering of organizational level
- Downsizing
- Creation of self-directed teams
- Benchmarking

Software Restructuring:

It involves cultural and process charges required to create the more collaborative environment needed for the renewal and growth of the company.

- Communication
- Organizational Support
- Trust
- Stretch
- Empowering people
- Industry foresight
- Training

15.4 PROCESS OF DISTRESS RESTRUCTURING

The restructuring process need not follow any set formula. The timing of a restructuring will be dictated by each particular situation. Some restructurings can be dealt with by a company entirely internally by focusing on performance improvement. That is, it is not necessary to involve external parties such as the company's bankers or trade creditors. In more serious situations a company will need to approach its creditors and agree some sort of forbearance by the creditors whilst the company deals with its problems. This is often referred to as a "workout". Where a restructuring involves creditors, the deal finally agreed between the company and its creditors need not follow a set prescription. In practice, the agreements are often quite imaginative and are designed

to suit the specific needs of the situation. The risk and reward considerations revolve around the:

1. type of debt instrument taken in exchange for existing debt;
2. debt to equity exchange ratio, which will require some sort of valuation;
3. proportion of equity dividend to creditors;
4. tax treatment of the residual debt and the converted amount.

15.5 STRATEGY FOR CORPORATE AND DISTRESS RESTRUCTURING

1. Mergers / Amalgamation:

It is a process by which at least two companies combined to establish single firm. It is a merger with a direct competitor and hence expands as the firm's operations in the same industry. Horizontal mergers are designed to accomplish economies of scale and result in reduce rivals in the industry. Vertical Merger is a merger which occurs upon the combination of two companies which are operating in the same industry but at different stages of production or distribution system.

2. Acquisition and Takeover:

Takeovers and acquisitions are common process in business area. A takeover is a distinct form of acquisition that happens when a company takes control of another company without the acquired firm's agreement. Takeovers that occur without permission are commonly called hostile takeovers. Acquisitions happen when the acquiring company has the permission of the target company's board of directors to purchase and take over the company.

3. Divesture:

Divesture is a transaction through which a firm sells a portion of its assets or a division to another company. It involves selling some of the assets or division for cash or securities to a third party which is an outsider. Divestiture is a form of contraction for the selling company. It is a means of expansion for the purchasing company. It represents the sale of a segment of a company (assets, a product line, a subsidiary) to a third party for cash and or securities.

4. Demerger (spins off / split up / split off):

It is a type of corporate restructuring policy in which the entity's business operations are segregated into one or more components. A demerger is often done to

help each of the segments operate more smoothly, as they can focus on a more specific task after demerger. Spinoffs are a way to offload underperforming or non-core business divisions that can drag down profits. Split-off is a transaction in which some, but not all, parent company shareholders receive shares in a subsidiary, in return for relinquishing their parent company's share. Split-up is a transaction in which a company spins off all of its subsidiaries to its shareholders and ceases to exist.

5. Joint Ventures:

Joint ventures are new enterprises owned by two or more contributors. They are typically formed for special purposes for a certain period. It is a combination of subsets of assets contributed by two (or more) business entities for a specific business purpose and a limited duration. Each of the venture partners continues to exist as a separate firm, and the joint venture represents a new business enterprise. It is a contract to work jointly for a period of time. Each member expects to gain from the activity but also must make a contribution.

6. Buy back of Securities:

Buy Back of Securities is significant process for Companies who wants to decrease their Share Capital.

7. Franchising:

Franchising is also effective restricting strategy. It is an arrangement where one party (franchiser) grants another party (franchisee) the right to use trade name as well as certain business systems and process, to produce and market goods or services according to certain specifications.

8. A leverage buyout (LBO) is any acquisition of a company which leaves the acquired operating entity with a greater than traditional debt-to-worth ratio.

A corporate restructuring strategy involves the dismantling and renewal of areas within an organization that needs special attention from the management. The procedure of corporate reformation often ensues after buy-outs, corporate attainments, takeovers or bankruptcy. It can involve an important movement of an organization's accountabilities or properties.

Basically, organizational reorganization involves making numerous transformation to the organizational setup. These changes have great impact on the flow of authority, responsibility and information across the organization. The causes for restructuring differ from diversification and growth to lessening losses and cutting down costs. Organizational

restructuring may be done because of external factors such as amalgamation with some other company, or because of internal factors such as high employee costs. Restructuring strategy is about decreasing the manpower to retain employee costs under control.

When management formulates restructuring strategies for a business and implement, it can result in several changes to a company's organizational structure, product mix, financing strategies and overall operations. The modifications that occur during a corporate reorganization depend on the problem or opportunity that the business hopes to address with the change. Understanding the effects of reformation business will help management to make more informed decisions and lessen their need to take on more debt or sell part of company.

The unrelated business of highly diversified firm may be divested and all the resources focused on core products and services. This helps the company gain a competitive edge. This reduces cost and generates cash inflow which can be redirected to invest in core products production and marketing (RajniSofat, 2011).

15.6 CASESTUDY

Restructuring of Reliance Industries Limited (RIL) Background In the current scenario restructuring has become the need of the hour for any organization to survive. However, this paper has tried to study the corporate restructuring of one Indian company which immensely enhanced the shareholders' market value and fortified their aggressive edge in recent times i.e Reliance Industries Limited (RIL).For example, the acquisition, merger, and demerger of Reliance Industries Ltd. like their acquisition of IPCL mergers of Reliance Petrochemicals Ltd., and the recent demergers of four entities like Reliance

Communication Ventures Ltd., Reliance Energy Ventures Ltd., Re-liance Natural Resources Ventures Ltd., and Reliance Capital Ventures Ltd. which spun off from Reliance Industries Ltd. (RIL), and were perhaps the most well-known restructurings in current times. RIL forayed into the telecom sector in the year 2000. The company also applied for open offers to take control of BSES stocks and took over BSES in 2002. It also intended to combine its finance company with another subsidiary Reliance Petrochemicals Ltd. (RPL). In March 2002, RPL amalgamated with RIL. RIL also bagged a 25 percent share of IPCL in the same year. After the RIL patriarch DhirubaiAmbani passed away ,RIL branched out further into the areas of biotech, life sciences, mining, and insurance.

Division of Reliance RIL split in June 2005 due to issues between the two successors. The RIL struggle was not only a conflict of titans, but it was also about

wealth in the area of Rs.1000 billion which was not uncomplicated to distribute. On January 17 th 2006, a unique trading and investment era was over. The demerger permitted by RIL board in August 2005, both brothers, Mukesh and Anil–directed different businesses and five listed companies emerged as potential investment opportunities for investors by March 2006. Among the group companies of RIL, Reliance Energy and Reliance Capital, were already listed at the exchanges. The remaining four companies were listed by the end of March 2006.

Corporate Restructuring in India: A Case Study of Reliance Industries 819 5. Current Structure The new RIL structure gave Mukesh absolute independent control in the business of oil exploration, refining, petrochemicals, and textile businesses through a standalone entity in RIL along with IPCL. His shares also included biotech firm Reliance Life Sciences and Trevira, a company in Europe which manufactures polyester fibers. Anil got control over power, communication, and financial businesses through four companies which came under Anil DhirubhaiAmbani Enterprise (ADAE) as part of the Reliance group. These four com-panies were named as Reliance Capital Ventures Ltd. (pro-posed to be merged with another listed company Reliance Capital Ltd.), Reliance Energy Ventures Ltd. (proposed to be merged with existing company Reliance Energy Ltd.), Reliance Communication Ventures Ltd.(these include both Reliance Infocomm and Reliance Telecom) and Reliance Natural Resources Ltd. (which includes businesses in gas based energy undertakings). 6. Impact of the Demerger Share prices of the listed five companies were cited differently at the Bombay Stock Exchange and National Stock Exchange after the Demerger. Before the split, RIL's share was traded around Rs 978 per share, but after the demerger the united demerged share values of five companies came to around Rs. 1235. This was a increase of nearly 26 percent for each shareholder. Long term aspect of the demerger sill needs to studied.

Corporate restructuring in a developing country like India is one of the most demanding tasks faced by fiscal policymakers. Measures that will assist to assuage the issues related to Corporate Restructuring in India are listed below: The central organization of India with intimidating political milieu makes it· unavoidable for the government and management to guide in creating restructuring precedence, discussing market collapse, changes in the legal and tax systems particularly in the come round of financial crisis when business agony is all-encompassing. A encouraging legal, regulatory, and accounting background is to be formed· for victorious corporate restructuring. Significant legal aspects of reorganization embrace foreclosure principles, foreign investment rules and Mergers and Acquisition policies. Restructuring should be based

on a holistic and transparent strategy· encompassing corporate and financial restructuring. Effective measures should be taken rapidly to offset the social costs of crisis· and reformation. Government should be equipped to take on a large role as almost immediately a crisis is reviewed to be systemic.

Conclusion

Corporate Restructuring has become very popular over the years especially during the last two decades owing to rapid changes that have taken place in the industry.Business firms now have to face greater than before opposition not only from Companies domestically but also from worldwide business groups, thanks to globalization, liberalization, technologicalupdating, etc. The objective of Corporate Restructuring is Shareholder wealth maximization by in quest of growth in terms of synergy, economies of scale, enhanced financial and marketing benefits, diversification and concentrated earnings instability, superior inventory organization, boost in domestic market share and also to attain rapidly increasing global markets. But astoundingly, though the number and value of Corporate Restructuring are on the rise , the effects of the studies on the impact of mergers on the performance from the acquirers' shareholders viewpoint has not been very good .Thorough reformation scheduling as well as carrying out appropriate due diligence, effectual communication during the combination, unswerving and skilled leadership, speediness with which the integration plan is integrated all this overlay for the accomplishment of Corporate Restructuring. While making the Restructuring deals, it is essential not only to make examination of the monetary aspects of the acquiring company but also the cultural and manpower issues of both the concerns for suitable post-acquisition integration.

15.7 NOTES

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15.8 SUMMARY

Corporate restructuring Summary

A corporate restructuring strategy involves the dismantling and renewal of areas within an organization that needs special attention from the management. The procedure of corporate reformation often ensues after buy-outs, corporate attainments, takeovers or bankruptcy. It can involve an important movement of an organization's accountabilities or properties.

When management formulate restructuring strategies for a business and implement, it can result in several changes to a company's organizational structure, product mix, financing strategies and overall operations. The modifications that occur during a corporate reorganization depend on the problem or opportunity that the business hopes to address with the change. Understanding the effects of reformation business will help management to make more informed decisions and lessen their need to take on more debt or sell part of company.

Restructuring strategies need an organizational change. This might result after a business go into a new market, requiring separate business units to share administrative functions or a corporate headquarters to supervise independent divisions. Reorganization may need to develop a new management team or a small business owner to sell part of the business and bring on a new partner or associates. A company that formerly subcontracted most of its administrative functions might bring them in-house. In other cases, a dealer of products who buys those products from sub-contractors might begin manufacturing the products instead of buying them. When two companies amalgamate, one layer of management and other redundant employees must be terminated, resulting in mass dismissals.

If a company cannot fulfil its capital requirements, it might sell stock or take on investors. This would permit the business to buy another company, open new places or add new products to its business. These changes requires the company to modify its financing strategies based on its new debt load and long-term financing needs. If a company has too much debt to operate lucratively, it might reorganize by taking out new loans at higher interest rates but lower monthly payments. Selling stock or part of the business are two possibilities to help reduce debt. Some restructurings focus on cost-containment, which can result in changing the mix of in-house and outsourced functions the company uses, as well as modifications to its product line, labour use and

operations. In this situation, the company might renegotiate its contracts with vendors, suppliers, contractors, leasing companies, creditors and personnel.

In the process of restructuring, corporation enters into a new marketplace. It might need to restructure the business if the new products or services require a different skill set. This might mean adding a division to the company or opening a new production facility.

Another restructuring process is to devise different Distribution Strategy. To restructure a business, company sell using different distribution channels. If a company has sold only through intermediaries and decides to add direct sales, the company will need to address the operational changes that come with direct sales. This might include changes to its sales force, order-taking processes, product fulfilment, accounting services, and customer service and information technology. An effective restructuring strategy that company in distress adopt is Re-branding. When a business goes through a restructuring due to a change in its product mix or distribution strategy, it might need to change its marketing message. Depending on whether the company's exclusive selling differential and key benefit change, the business might need to build a new brand message and brand-management policy.

Corporate Distress Restructuring Summary

Debt instruments (such as loans and bonds) that are in high danger of not being repaid are typically called "distressed". Seeing a high chance of bankruptcy, investors are only willing to pay a fraction of par-value for these instruments, pushing the yields up, to spreads that are often above 1000 basis points.

A company in distress cannot (or doesn't intend to) service is debt. In most cases, the number one problem is that the company is running out of cash, which is typically due to either operational cash burn or to a fragile capital structure. In the current environment, capital structure issues are the recurring element in distress stories.

A typical example of a fragile capital structure is one which is exposed to refinancing risk. As debt approaches its repayment date, existing lenders become reluctant to roll over the debt at existing amounts or under current terms, and new lenders are even less compelled to lend. Therefore, existing lenders start analysing whether recovery would be better in a bankruptcy scenario. A distressed company is at risk of breaching terms and covenants (such as EBIT/interest expense coverage) in the debt agreement even ahead of debt maturity date. Breaching covenants give lenders legal recourse to call back the debt, effectively pushing the company into insolvency.

In addition to high leverage, other important factors are: management inefficiency and complacency, overambitious expansion strategies, poor cash management, relaxation

of internal controls and reporting. Many of these are the result of the corporate slack developed during good times.

When a company is unable to pay its debt, it is technically defined as "insolvent". Companies close to insolvency typically have three options: 1) winding up the business, 2) a fire-sale (if they can find a buyer), and 3) debt restructuring. The latter option aims at modifying the original lending agreements, to allow the borrowing firm to survive while mitigating lenders' potential loss.

Restructuring usually involves both operating changes (disposal of assets, change in management etc) and capital structure changes, including a combination of: new debt, some degree of debt forgiveness, debt repayment extension, debt-equity swap, and shareholders re-capitalization. The new capital structure is based on the post-restructuring valuation of the company, the likely degree of debt the new company can support, and the negotiating clout of different stakeholders.

To summarize, corporate distress may be due to intense competition, high interest rates and drastic changes in marketplace which put the company to bankruptcy. Financial distress has significant impact on the domestic economic activities (Papa M'B. P. N'Diaye, 2010). In this situation of corporate failure, there is requirement to devise restructuring strategies. Restructuring a business can assist a struggling company improve its position or help a successful business to expand more. A restructuring might involve altering significant processes in administration, marketing and adopting distribution strategies, addressing debt-service and financing strategies, entering into a new market or modifying the company's product or service.

15.9 KEY WORDS

Corporate Restructuring, Distress Restructuring, Strategies, Process, Joint Venture, Merger, De-Merger, Divestiture.

15.10 SELF ASSESSMENT QUESTIONS

1. What is Corporate Restructuring? Explain the reasons for Corporate Structuring

2. Explain the process of Corporate Restructuring

3. Explain the process of distress restructuring

2. Explain Strategy for Corporate and Distress Restructuring

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UNIT-16 : FAILURES IN MERGER/ACQUISITION/JOINT VENTURES

Structure:

16.0 Objectives

16.1 Introduction

16.2 Reasons for Strategic Failures in Mergers &Acquisitions

16.3 Reasons for Strategic Failures in Joint Ventures.

16.4 Success mantra of mergers and acquisitions.

16.5 How to make the strategic alliance successful?

16.6 Case Study

16.7 Notes

16.8 Summary

16.9 Key Words

16.10 Self-Assessment Questions

16.11 References

16.0 OBJECTIVES

After studying this unit, you will be able to;

- Concept of Merger, Acquistion and Joint Ventures
- Reasons for the failures of Merger, Acquisitions and Joint Ventures.
- Success Mantra's
- Strategic Alliance

16.1 INTRODUCTION

The mergers and acquisition play a significant role in the industrial sector of any economy."Some people run the race on their own without purposes. Running by individual takes time.Collaborations and strategic alliances make the race winning" Peter Drucker. It is neither capital norknowledge, but the ability to form powerful partnership. All over the world record number of mergersand acquisitions deals takes place throughout the year. Mergers and acquisitions result in privatizationof the public undertakings in Europe, North America, China, Brazil which indicates that the trendtowards rapid growth of private Equity Funds. Winning depends on ability to understand the entitiesto merger implement and succeed.

Government of India brought section 2 (IB) and 72A under theIncome-Tax Act in order to encourage mergers, acquisitions and demerger of companies. Capital gainon transfer of properties, exchange of shares and debentures by Transferor to Transferee Company areexempted provided certain conditions are fulfilled mainly to attract mergers and acquisitions of companies to strengthen the economy. Between 2007 and 2009 Indian companies established 143 dealings related to merger in the US ranges between $0.8 million and $1,005 million(Joint report on 'Direct investments in the US by Indian enterprises', Ernst & Young and FCCI).The Indian companies have moved from horizontal, vertical, hostile merger to strategic mergers not only in India but also globally. After liberalization of Indian economy to global, the strategic mergers and conducive environments help Indian companies to meet global challenges through mergers andacquisitions.

16.2 REASONS FOR STRATEGIC FAILURES IN MERGERS&ACQUISITIONS

Most mergers fail at the execution stage itself. The two cultures do not get along easily at anearly stage of mergers but two talented minds are heading for the door. There are such instances, such as the marriage of HP and Compaq that are troubled from the start. More than two-thirds of transactions that fail do so at an early stage of execution. Daimler Chrysler, for example, neglected early on to establish a proper set of guiding principles based on strategic intent of merger, and misfired to align the leadership and integrate the cultures of the two organizations.

There are no set of rules for the implementation and success story of merging. Merging companies fail to develop a set of rules linked to the merger's strategic intent. Perfection may not be possible, but these set of rules will assure that all decisions drive the combined entity in the same direction. Ground rules for planning provide nuts-and-bolts guidance for how the planning teams should act as they begin to put the face of the merged entity in black and white. These rules should help for how decisions are to be made and how conflicts should be resolved.

Post-close transition plans can be lacking due to the daunting complexity of any integration such as the culture of the companies, a resistance to share information and top-down accountability and unwillingness to follow a methodical decision timeline.

All relevant stakeholder groups—both internal and external—must receive communication about the transaction, early and often. Management must strive to understand how these groups view the deal and how they might react to changes such as new pricing, vendors' elimination and adjustments in service and personnel.

Points for failure:

1. No Holistic Approach
2. Lack of Financial Bench Mark
3. Cultural Differences
4. Communication
5. Difficult to understand the Indian Income tax and sales tax rules and regulations
6. Right Person to Lead
7. Historical Experiences

Historical experience 1:

HP and Compaq: When Carly Fiorina was appointed CEO of Hewlett-Packard in 1999, it marked many firsts: the first outsider, the first woman, the first non-engineer, and the youngest person ever to head HP in its 60-year history. Six decades later, Walter Hewlett, an HP board member, votes "Yes" to the merger but immediately starts a campaign to stop it. With the support of other family members and the Packard Family Foundation, which in total own 18% of HP shares, the normally reserved Hewlett leads a fight that nearly puts an end to the highly publicized merger. In the end Fiorina wins, after receiving last-minute support from Deutsche Bank. Perhaps all would have proceeded smoothly if Fiorina had considered the concerns of the families before proceeding. They did, after-all, have large financial and emotional stakes in the company. The challenge of leadership when attempting to regenerate a highly regarded corporation is the significance of corporate culture in organizational transitions.

Historical experience 2:

In India, Capt. Gopinath of Deccan aviation said that the merger of King Fisher and Air Deccan has to be approved not only by the two boards, but also by the independent directors, institutional investors and other shareholders. The four independent Directors on the Air Deccan board include former tennis star Mr. Vijay Amritraj, Prof Thiru Narayan from Indian Institute of Management, and Mr. A.K. Ganguly, former Managing Director, Nabisco, Malaysia.

Historical Experience 3:

For the first time in its history, the President and Secretary of the ECIL Employees Union (EU) and the President and Secretary of the Officers Association (OA) were invited to join the Corporate Management Committee (CMC) of ECIL. They were invited to participate in deliberations of the committee comprising the Chairman and Managing Director, Functional Directors, Executive Directors and Heads of the Strategic Business Units (SBUs)-transparency levels rarely seen in any organisation. A 'MukhaMukhi (face to face)' scheme was launched to enable direct communication between employees and the Chairman and Managing Director.

No Holistic Approach

Management must set aggressive targets from the start both for cost savings and revenue growth. Majority of companies tend to focus on one or the other—but neglect to place adequate emphasis on both.

Lack of Financial Bench Mark

We have seen merging companies build detailed integration plans only to stop short of driving them into the combined entity's operating financials in a clearly identifiable manner. Short memory of Institutions and the plans are often redone. Integration plan should help in financial benchmarks which can track such plan of action.

Cultural Differences

Culture of a company can be identified through organizational structure and responsibility and accountability. There is a connection between group members shared language (method of understanding each other) and the way of representing the world and culture bringing disparate groups of people together as one company takes real and it is a critical aspect of any transaction (Schall 1983, Barley 1983, Hofstede 1984, Cremer 1993, laxear 1999). However, simply acknowledging the issue or handing it off to specialists may not solve the issues related to cultural differences.

Historical Experience 4:In India, Kingfisher Airlines:

Targets the well-heeled passenger and business traveller with promises of pampering customers with quality, full-flight service, while Air Deccan's vision is to empower every Indian to fly. Mixing everything in one company doesn't work. History is not on Mallya's side. Full-service carriers and low-cost carriers (LCC) belong to separate worlds, and their DNAs seldom match. Whenever they have tried to merge or work together under one umbrella, they have failed. It happened when British Airways tied up with budget carrier Go, and when Delta Air acquired budget carrier Song. These two airlines have different cost bases and pricing strategies. In the year 1994, Quaker Oats acquired Snapple Beverage Co. but, failed due to conflict between corporate cultures. Quaker had an extremely focused, mass-market working approach, whereas, Snapple focused on commercial and titled towards its distributors. Benz and Chrysler's merger failure is also due to cultural differences. Sprint and Nextel Communications is another example for cultural differences for failure. Sprint was bureaucratic and not much tuned to customer service, whereas, Nextel was entrepreneurial and customer oriented.

Communication

Management normally hesitates to share information and current regulations to employees and dependents before sharing such information to public. Rumors spread like wild fire which creates panic among employees and others who are dependent.

Difficult to understand the Indian Income tax and sales tax rules and regulations

There are tax experts and consultants to advise but failed to lead and guide mergers and acquisitions. Vodafone and Hutch merger were facing problems related to income tax, luckily, the Supreme Court of India cleared the hurdles. Sales tax regulations related to mergers and acquisitions differ from one state in India to another state in India. The companies land in paying sales tax twice/thrice if place of registration and the place of business situated in two or more States in India.

Right Person to Lead

Every company needs clear decision rights about who can change the agreed-upon plans, under what circumstances, and with what approvals. One key step is selecting the right person or people to lead the program integration team and track the plan's execution. In India, Air Deccan &Kingfisher airlines have decided to merge & create a new entity. Accenture, a management consulting firm, has recommended a merger of the companies for profitability & to cut costs. Mallya, the CEO of Kingfisher airline would have to be head of the company & Capt. Gopinath would be the vice chairman.

Historical Experience 5:

Tata Pleases, Ford 'Disappoints' British Workers' Union: The head of Britain's largest workers union reiterated his support for Tata's acquisition of the luxury car brands Jaguar and Land Rover, but said he was disappointed by seller Ford's failure to retain a stake. Union officials would have liked to see Ford take a minority stake, as it did while selling off the luxury car Aston Martin to two Kuwaiti investment companies last year. Ford retained a $77 million stake in Aston Martin.

Historical Experience 6: Merger Of National Carriers Air India and Indian Airlines:

It has been challenged in the Bombay High Court on the ground that it defies Parliament's intent to keepinternational and domestic carriers separate. The petition filed by Air India Cabin Crew Association (AICCA) also questions the Constitutional validity of section 620 of Companies Act, which empowers government to exempt any government company from provisions of the Act. Air India Limited and Indian Airlines Limited were created by a Parliamentary statute, and, therefore, without the Parliament's nod they cannot be amalgamated, the petition contended.

Historical experience 7:

Merger of Lord Krishna Bank with Centurion Bank: The affidavit was filed in response to a writ petition filed before the Kerala High Court, in India, by a minority shareholder, challenging the merger and seeking to appoint inspectors to investigate the amalgamation scheme. Resolutions were moved one by one and arrangements were made for members/proxies to exercise their votes. The allegation that 65 per cent of the shares were held by a single entity was totally false. No person holding share in excess of ten per cent of the bank exercised voting rights in excess of 10 per cent. With the permission of the RBI, a person could hold more than 10 per cent of the share of a banking company but the right to exercise vote was restricted to 10 percent of the total voting rights.

Historical experience 8: The French government pushed to make Sanofi and Aventis:

Due to interference of French Government Sanofi and Aventis come together but French officials placed phone calls to executives at the Swiss company on at least three occasions warning that Novartis should stay away. Afraid that Aventis, based in Strasbourg, France, would fall into Swiss hands, the French government had leaned on Sanofi Chief Executive Jean-Francois Dehecq to raise Sanofi's bid to improve the chances of an all-French deal. France's intervention in the takeover battle, against the free-market principles espoused by the European Union, Yet, in recent years, it has broken the union's economic rules more than once, giving state aid to ailing French companies, letting its budget deficit grow and thus contravening a pact that underpins the euro, and getting involved in takeover battles.

Historical experience 9: Vodafone and Hutchison Essar:

The Court has sent notices to the Hutchison Essar's Managing Director, Mr. Asim Ghosh, and the Chairman of Max Group, Mr. AnaljitSingh. The two individuals hold 12 per cent of Hutchison Essar, which is the bone of contention. The stake is being held indirectly by the two individuals on behalf of Vodafone. The sale-breached India's Foreign Exchange Management Act and also the licensing conditions for providing telecommunications services in India.

Merger and Anti Trust Act

Merger may have hurdles not only from within the organization but also from Antitrust Act or even by the elected government officials. Standard Oil in USA faced

antitrust intervention in 19th and 20th century. Canadian Competition bureau reported that the Royal Bank of Canada and the Bank of Montreal merger would result in substantial lessening competition in 104 out of 204 local markets. The European commission turned down international merger proposal between Canada's Alcan and France Pechiney and Switzerland's AL group. The U.S district court found that Microsoft was guilty of natural monopoly by combining internet browser with its operating system. The remedy is that breakup of Micro-soft into smaller independent companies. Canadian government restricts holding more than 10% of shares by any one shareholder in a bank which restricts foreign entry through the acquisition of the scheduled bank. The internal growth within a firm might attract the Antitrust Act. Antitrust had impact on Coca-Cola's acquisition ofDr.Pepper, Philip Morris to sell its Seven-Up softdrink unit to Pepsi and Google tried to acquire Yahoo. In China, Coca-Cola's bid for Juice maker Huiyuanwas rejected due to the Chinese Anti-Monopoly law in 2008.

16.3 REASONS FOR STRATEGIC FAILURES IN JOINT VENTURES

1. Absence of Governance:

Most of the alliances fail to adapt. The primary reason is missing governance. Governance is present in an alliance in the initial stages and post exit stage. Lack of Governance takes away the adaptability from the alliance. As per Doz and Hamel "managing the alliance relationship over time is usually more important than crafting the initial formal design."

2. Not planning for exit in Strategic alliance:

Most of the strategic alliances today fail to consider the exit strategy. Alliance managers fail to think about exit strategies while formulating the alliances. Most of the alliance contracts are based on assumptions of a static business relationship. Hence the alliance fails when the scenario changes example Sames alliance with the Japanese automaker. Sames failed to realize the dynamic nature of the alliance. Alliance managers often fail to quantify the value of the relationship. Hence the exit criteria's are not set properly. In many organizations the employees who initiate the contact do not run the alliance. Hence the exit criteria's are vague and result in unsuccessful alliance.

3. Prisoner's Dilemma:

Alliances often fail because many partners view them as prisoner's dilemma situation. Each partner believes that by not cooperating they will receive the highest payoff.

4. **Misunderstandings:**

Both the partner and the parent firm do not use same yardstick to evaluate the performance of the alliance. This leads to misunderstanding and a failed strategic alliance. This failure can be attributed to the expectations or the processes.

5. **Excessive persistence in failing alliance:**

Some alliances fail due to excessive persistence to keep the alliance alive, while both the parties should walk away from the alliance. The reasons for excessive persistence are the difficulty and cost of creating an alliance, non-economic output objectives (Value Creation), and difficulty of measuring alliance performance, involvement of senior management in alliance management, inaccurate assessment of partner competencies, closing costs, and conflict over how to end an alliance and differences between constituencies.

6. **Lack of Trust:**

Many alliances fail due to lack of trust during the initial contact and negotiations process. Trust requires the presence of an element of risk and mutual interdependence. The quality of inter-partner relationship is a critical determinant of the alliance success. Sometimes failure to broaden the negotiation process results in failure of the alliance for example FCB-Publicist joint venture.

16.4 SUCCESS MANTRA OF MERGERS AND ACQUISITIONS

Success Mantra of Mergers and Acquisitions:

1. Execution-related failures can be avoided provided you need to establish a program integration team early in the process that can respond to the execution risks inherent in all transactions. For instance, managers at the middle level were sent to various Godrej sites for training so that they could have a first-hand experience of systems and practices and such managers were playing as change agents.

2. The first step taken in the restructuring process was to establish clear channels of communication with the employees. They have to depend on the intrinsic strengths of the company rather than the external helps.

3. The board and management should have separate counsel during mergers to ensure unbiased advice and fair representation of shareholders views.

4. Build your targets with some stretch and expect that your people will find a way to get there.

5. Management must set a vision, align leadership around the cultural integration and hold substantive events to give employees a chance to participate. Detailed plan of action and well-articulated expectations of change in behaviour to inter-connect the culture plan to the business goals.

6. With proper planning and attention to detail throughout the merger process—from determining strategic planning and direction, transaction design, and post-merger integration require dynamic leader to lead, execute and integrate.

7. Tell employees what you can and what you can't tell them at the moment, why, and when you will be in a position to do so.

8. Training to employees before merger: One company may have entrepreneurial and risk taking style of functioning. Other company may have extreme authoritative and procedural orientation. Middle level managers were sent to various Godrej sites (An Indian Company) for training so that they could have a first-hand experience of systems and practices and such managers were playing as change agents.

9. Carefully give importance to rename, logo, colour, check in counter, check in staff, redesign of the reception, rebranding, consultancy firm and the leader to lead the Jumbo.

10. Insure your post-merger legal battles in India. Even mergers happen between two entities outside India can attract Income tax in India if there is a remote link with Indian entities before or after mergers.

16.5 HOW TO MAKE THE STRATEGIC ALLIANCE SUCCESSFUL?

1. Managing Governance adaptations in strategic alliance:

It is necessary to understand the environmental conditions, parent firm factors and alliance attributes in order to decide the governance changes in alliances. Avoid looking at alliance from a more static vantage point. Analyze the drivers behind the parent firms' specific governance interventions in alliances to predict the degree of alliance adaptation.

2. Clear understanding between the partner and the firm:

Understand the interest of the partner, both initial and emergent. Understand the value partner attributes to intermediate outcomes. Before blaming the partner think of alternative causes of trouble. Have clear communication with the partner; define a standard yardstick to evaluate performance in the initial stages of alliance.

3. **Planning exit strategy:**

Some of the key lessons while formulating the exit strategy are to understand the dependency of the firm on the partner and vice versa. One of the key success factors of formulating exit strategy is to quantify the value of relationship and to understand all the dynamic possibilities of the alliance, depending upon the above criteria's an easy, hard, or dynamic exit strategy should be formulated. A successful, reliable exit strategy makes a strategic alliance successful by ensuring commitment from both the parties involved in the strategic alliance.

4. **Avoiding persistence with failing alliance:**

Organizations should avoid excessive persistence with failing alliance. Things that can be done before the alliance is formed are define failure, make the intangibles tangible and define alliance as a tool and not an objective. During the alliance don't rely on partner to fix the problem and understand end game realities.

5. **Unilateral Commitment:**

Unilateral commitment help build the trust between alliance partners. Unilateral commitment of sequential, irreversible type helps to structure the alliance in a more profitable way as the decisions are made sequentially. Successful alliances are contractual in nature which provides the flexibility to the alliance to breathe. Example alliance between General Electric and Snecma is not permanent and is working for last 17 years.

6. **Improving Relational Quality:**

By improving relational quality trust can be built and long term alliances can be formed. Managers need to negotiate with broad bandwidth in mind, monitor their own behavior and not just partner's behavior, provide advanced warning of the intentions, manage expectations carefully, learn for past experience, manage cultural conflicts from the start and recognize the importance of national differences.

7. **Building Trust:**

In successful alliances trust is often touted as a prerequisite, a necessity, and an absolute must (Byrne, 1993). While forming an alliance various uncertainties are present, Trust is the key solution to answer all these uncertainties. While building trust it is important to understand the nature of the industry, the alliance, sources of uncertainty, mechanisms to gauge to likelihood that an alliance partner will behave in trustworthy manner and to understand the expectations. Managers should know and understand the various variables of trust.

8. Broad Contractual Interface Structure:

A broad contractual interface structure helps to build trust between the two firms. A broad contractual interface is characterized by an overlapping task division, the presence of obligations to exchange information and mechanisms to provide opportunities for not only performance but also behavior monitoring. This is proved in the case of successful JV between Jet and Graph to develop ESH technology.

9. Selection of Contract:

Selecting the type of contract based upon the ambiguity or volatility of the situation makes the alliance work. Relational contracts are effective against opportunism when the situation is volatile while in case of ambiguity formal contracts are effective to avoid opportunism.

16.6 CASE STUDY

When joint ventures go wrong?

Ten or even five years ago the arguments for strategic alliances and joint ventures as international market entry strategies for companies from developed countries entering a developing country seemed clear and compelling. They seemed particularly appropriate for China and in some cases appeared the only way. The theory was that the Chinese company provided access to cheap labour, local regulatory knowledge and access to what ten years ago appeared to be a relatively small, high-risk domestic market. The foreign partner provided capital knowledge, access to international markets and the promise of jobs in China. The attraction was that the market was promising, although at the same time it was geographically vast with very complex, contradictory and often invisible rules. Many of the largest companies in the world pursued collaborations of this type with what were then local Chinese companies in the belief that the arrangement would reduce risk but still allow high levels of control over the marketing strategy in China.

Danone, a French Food multinational, acquired a 51 per cent stake in the Chinese firm Wahaha Beverage in 1996 and believed they had struck an excellent deal. HSBC acquired a19.9 per cent stake in Bank of Communications, the smallest of the Chinese national banks and were pleased because this wasthe only bank by law allowed the possibility of a full takeover.

In practice like many other joint ventures and alliances they have failed to deliver the original promise. The list of joint venture failures involves companies from just

about every industry sector, including Peugeot (cars), Remy Martin (spirits), Foster's (beer), media (News Corporation) and many telecoms firms.

Chinese companies originally were keen to receive money, technology and business 'know-how', but they now haveglobal ambitions of their own and do not want to beconstrained by a global multinational partner who may want to curtail these ambitions. The joint venture partners frequently argued about the allocations of profits and decisions on investments.

China itself has also changed: having become a member of the World Trade Organisation it had to agree to be more open legally. As the domestic economy grew more rapidly than anyone expected domestic capital was freely available, with the result that there was little need for money from foreign investors. As the Chinese market became one of the most attractive in the world and sentiment in China became more nationalistic and self-reliant the balance of power shifted between the Chinese and foreign partners, and providing access to China for foreign partners was of much less interest.

Whilst Wahaha originally knew little about business and welcomed a partner, it now is aware of all the attractive possibilities and it objects to the fact that it must clear plans with its foreign majority owner before going ahead, especially as Danone is pursuing alternative strategies in China through its joint ventures with other Chinese companies. Even worse, Danone wants full ownership of the firm. Things came to a head when Danone eventually realised that Wahaha was operating a parallel firm, marketing similar products. The companies are involved in an acrimonious public dispute.

HSBC's problems are the result of success. Bank of Communication's assets have grown so much that it has now been included in the Chinese government's list of powerful banks that itwill not allow to be taken over. HSBC hasresponded by pursuing local incorporation, something only recently allowed, and made investments in the Bank of Shanghai and Ping An, an insurance firm, but these are far less attractive options.

A smaller number of firms that had a better understanding of the situation were able to legally end their joint ventures without too much pain. Unilever shut down more than a dozen joint ventures and Coca-Cola and Starbucks bought out their Chinese partners.

The moral of this experience confirms conventional wisdom about forming joint ventures – to ensure the joint ventures will be successful the most careful planning should focus on how to end them.

QUESTIONS:

1. What are the factors that a multinational firm should consider when deciding to use a joint venture as a market entry strategy for a developing country? What are the potential benefits and risks in taking this course of action?

2. Develop an outline international marketing strategy for a joint venture between Danone, French multinational food company, and a food producer from a developing country. Explain which companies would be responsible for providing the leadership and decision-making for the various activities detailed.

16.7 NOTES

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16.8 SUMMARY

There are many reasons to fail but a few reasons to Success of a merged entity. Failures arenot stepping stones to success with respect to mergers and acquisitions. Definitely, everyone understands that if new software fails by even by o.1%, the software fails by 100%. In the same wayif merger is not successful by 100%, it is considered failure. The studies undertaken guide the management and persons involved not to fail to understand the reasons for pre and post-merger failures. The government of India brought legislations under Income tax Act to encourage Indian companies to acquire companies outside India and multinationals taking over Indian companies by increasing foreign holdings in Indian companies such as insurance and telecommunication sectors. The acquiring company can set-off losses of the acquired company out of the operating profits earned and save tax. Understanding culture, training of managers to develop change agents, communicationto stake holders, building targets, developing a new culture, leader to lead careful planning and implementation at each stage of mergers make merger successful.

16.9 KEY WORDS

Mergers and Acquisitions, Implementation, Failure & Success, Mantra, Strategic Alliance.

16.10 SELF ASSESSMENT QUESTIONS

1. What do you mean by Merger & Acquisition?
2. What is meant by Joint Venture? And Strategic Alliance?
3. Why firms do fails during Mergers and Acquisitions?
4. List out causes of failure during Joint Venture.

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MODULE - V

BANKRUPTCY,REORGANIZATION,AND EMERGENCE, THE LIQUIDATION ALTERNATIVES

UNIT 17 : LIQUIDATION AND WINDING UP

Structure :

17.0 Objectives

17.1 Meaning

17.2 Modes of Liquidation

17.3 Compulsory winding up

17.4 Voluntary Winding Up

17.5 Kinds of Voluntary Winding Up

17.6 Companies in distress: Emerging from bankruptcy

17.7 Notes

17.8 Summary

17.9 Key Words

17.10 Self Assessment Questions

17.11 References

17.0 OBJECTIVES

After studying this unit, you will be able to:

- To understand the concept of bankruptcy/insolvency
- To know the modes of liquidation
- To understand the ways that companies emerge from bankruptcy

17.1 MEANING

Bankruptcy/Insolvency is when an individual, corporation, or other organization cannot meet its financial obligations for paying debts as they are due. Bankruptcy is not exactly the same as insolvency. Technically, bankruptcy occurs when a court has determined insolvency, and given legal orders for it to be resolved. Bankruptcy is a determination of insolvency made by a court of law with resulting legal orders intended to resolve the insolvency. Insolvency describes a situation where the debtor is unable to meet his/her obligations. Bankruptcy is a legal scheme in which an insolvent debtor seeks relief.

Liquidation/Winding-up of a company is a process of putting an end to the life of a company. It is a proceeding by means of which a company is dissolved and in the course of such dissolution its assets are collected, its debts are paid off out of the assets of the company or from contributions by its members, if necessary. If any surplus is left, it is distributed among the members in accordance with their rights. Winding-up is the process by which management of a company's affairs is taken out of its directors' hands, its assets are realized by a liquidator and its debts are realized and liabilities are discharged out of proceeds of realization and any surplus of assets remaining is returned to its members or shareholders. At the end of the winding up the company will have no assets or liabilities and it will, therefore, be simply a formal step for it to be dissolved, that is, for its legal personality as a corporation to be brought to an end.

In finance and economics, liquidation is an event that usually occurs when a company is insolvent, meaning it cannot pay its obligations as and when they come due. The company's operations are brought to an end, and its assets are divvied up among creditors and shareholders, according to the priority of their claims.

Liquidation generally refers to the process of selling off a company's inventory, typically at a big discount, to generate cash. In most cases, a liquidation sale is a precursor to a business closing. Once all the assets have been sold, the business is shut down.

The main purpose of winding up of a company is to realize the assets and pay the debts of the company expeditiously and fairly in accordance with the law. However, the purpose must not be exploited for the benefit or advantage of any class or person entitled to submit petition for winding up of a company. It may be noted that on winding up, the company does not cease to exist as such except when it is dissolved. The administrative machinery of the company gets changed as the administration is transferred in the hands of the liquidator. Even after commencement of the winding-up, the property and assets of the company belong to the company until dissolution takes place. On dissolution the company ceases to exist as a separate entity and becomes incapable of keeping property, suing or being sued. Thus in between the winding up and dissolution, the legal status of the company continues and it can be sued in the court of law.

17.2 MODES OF LIQUIDATION

A company registered under the Companies Act, 1956 may be wound up in any of the following modes:

1. By the Court i.e. compulsory winding up;

2. Voluntary winding up, which may be either:

    (a) Members' voluntary winding up; or

    (b) Creditor's voluntary winding up;

Provisions relating to winding up subject to the supervision of the court has been omitted by the Companies (Second amendment Act) 2002 and the effective date is yet to be notified.

17.3 COMPULSORY WINDING UP

A company may be wound up by the Court if

(a) The company has passed a special resolution of its being wound up by the Court; or

(b) Default is made in delivering the statutory report to the Registrar or in holding the statutory meeting; or

(c) It does not commence business within a year from its incorporation or suspends business for a whole year; or

(d) The number of its members in the case of a public company is reduced below seven and in the case of a private company, below two; or

(e) It is unable to pay its debts; or

(f) The Court is of the opinion that it is just and equitable that it should be wound up; or

(g) If the company has made a default filing with the Registrar its balance sheet and profit and loss account or annual return for any five consecutive financial years; or

(h) If the company has acted against the interests of the sovereignty and integrity of India, the security of the state, friendly relations with foreign states, public order, decency or morality; or (It may be noted that the tribunal shall make an order for winding up of a company under clause (h) on application made by the Central Government or a State Government)

(i) If the tribunal is of opinion that the company should be wound up under the circumstances specified in Section 424 G (i.e winding up of a sick company) such as company has defaulted in filing statutory report or holding statutory meeting, Non-Commencement or Suspension of Business, Reduction of members below minimum, Inability to pay debts.

17.4 VOLUNTARY WINDING UP

The companies are usually wound up voluntarily as it is an easier process of winding up. It is altogether different from a compulsory winding up. In voluntary winding up the company and its creditors are left to settle their affairs without going to a Court, although they may apply to the Court for directions or orders, as and when necessary. One or more liquidators are to be appointed by the company in general meeting for the purpose of winding up the affairs and distributing the assets of the company. The remuneration of the liquidators is also required to be fixed by the company in general meeting. Unless the remuneration as aforesaid is fixed the liquidators shall not take charge of his/their offices (Section 490). The circumstances in which a company may be wound up voluntarily are:

(a) When the period fixed for the duration of the company as mentioned in its articles has expired;

(b) The event, on the happening of which the articles provide that the company is to be dissolved has occurred; and

(c) The company passes a special resolution that the company be wound up voluntarily.

17.5 KINDS OF VOLUNTARY WINDING UP

Section 488(5) divides voluntary winding up into two kinds:

(i) Members' voluntary winding up; and

(ii) Creditors' voluntary winding up.

1. Members' voluntary winding up - When the company is solvent and is able to pay its liabilities in full, it need not consult the creditors or call their meeting. Its directors, or where they are more than two, the majority of its directors may, at a meeting of the Board, make a declaration of solvency verified by an affidavit stating that they have made full enquiry into the affairs of the company and that having done so they have formed an opinion that the company has no debts or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration.

Members' Voluntary Winding Up (Section 489 – 498)

(i) When declaration of solvency is made and filed with the Registrar in e-form 62, the directors arrange to convene a meeting of the members of the company and pass the necessary resolution of winding up (Section 484).

(ii) The company shall appoint in general meeting one or more liquidators for the purpose of winding up the affairs and distributing the assets of the company and fix the remuneration to be paid. Any remuneration so fixed shall not be increased in any circumstances. The liquidators shall not take charge of his office unless the remuneration is fixed (Section 490).

(iii) On the appointment of liquidation, all the powers of the Board of directors, managing directors, or wholetime directors, and managers (if any) of the company cease except for the purpose of giving notice of the appointment of liquidator to the Registrar or so far as the company in general meeting or the liquidator may sanction their continuance.

(iv) If any vacancy occurs by death, resignation or otherwise in the office of any liquidator appointed by the company, the company in general meeting, subject to any arrangement with its creditors, can fill the vacancy. The general meeting for this purpose may be convened by the continuing liquidator or by any contributory and

must be held in the manner provided by the article or in any manner prescribed by the Court

(v) In the event of the winding up continuing for more than one year, the liquidator is required to call general meeting of the company at the end of the first year from the commencement of the winding up, and at the end of the each succeeding year, or as soon thereafter as may be convenient within three months from the end of the year or such longer period as the Central Government1 may allow, and must lay before the meeting an account of his acts and dealings and of the conduct of the winding up during the preceding year, together with a statement in the prescribed form containing the prescribed particulars with respect to the proceedings and position of liquidation.

(vi) As soon as the affairs of the company are fully wound up, the liquidator has to make an account of the winding up showing how the winding up has been conducted and the property of the company has been disposed of and is required to summon a general meeting of the company for the purpose of laying the account before it and giving any explanation thereof.

Creditors' Voluntary Winding Up (Sections 500 to 509)

The following provisions as contained in Sections 500 to 509 of the Companies Act, 1956 apply to a creditors' voluntary winding up:

(i) In this case the company must call a meeting of its creditors for the day or the day next following the day on which there is to be held the general meeting of the company at which the resolution for voluntary winding up is to be proposed and notices of the meeting of creditors be sent by post to the creditors simultaneously with the notices of the general meeting of the company.

(ii) The directors of the company shall prepare a full statement of the position of the company's affairs together with a list of the creditors of the company and an estimated amount of their claims to be laid before the meeting of the creditors to be held as aforesaid. They must also appoint one of their number to preside at the said meeting.

(iii) Notice of any resolution passed at a creditors meeting must be given by the company to the Registrar within ten days of the passing thereof.

(iv) The creditors and the company at their respective meetings mentioned in Section 500 may nominate a person to be liquidator, but the person nominated by the creditors shall become the liquidator subject to an application to the Court.

(v) The creditors may at the same or subsequent meeting appoint a Committee of Inspection consisting of not more than five members. If such a committee is appointed, the company may also at the same or any subsequent general meeting appoint such number of persons not exceeding five as they think fit to act as members of the committee. In any case, the creditors may resolve that all or any of the persons so appointed by the company ought not to be members of the committee of Inspection, whereupon the persons mentioned in the company's resolution shall not be qualified to act as members of the committee unless the Court otherwise directs.

(vi) The remuneration to be paid to the liquidator in creditors voluntary winding up is to be fixed either by the Committee of Inspection or by creditors. Where the remuneration is not so fixed, it shall be determined by the Court.

(vii) On the appointment of a liquidator, all the powers of the Board of directors shall cease, except in so far as the Committee of Inspection, or if there is no such committee, the creditors in general meeting may sanction the continuance thereof.

17.6 COMPANIES IN DISTRESS: EMERGING FROM BANKRUPTCY

A range of factors outside of management's control, such as macro-economic conditions and industry trends, can impact whether a company will successfully restructure and emerge out of bankruptcy as an economically viable entity. Proper planning and execution by management, with assistance from their advisors, is critical and can be the difference between successful emergence and succumbing to liquidation. The company finalizes its Plan of Reorganization ("the Plan"), which will set the stage for a number of events to occur. The Plan includes the resolution and settlement of creditor claims, which are typically stratified by class depending on priority and securitization. The Plan also outlines the company's post-emergence capital structure.

Reconciliation of creditor claims

Each claim that has been filed against the company by its creditors will need to be reconciled to the allowed claim amount for financial reporting purposes. The allowed claim is generally the gross amount allowed by the Court as a claim against the company. This will typically differ from the expected "cents on the dollar" settlement amount

envisioned in the Plan. Any adjustments to the allowed claim amount are recorded through reorganization expense in the statement of operations. There may also be claims that are not officially "settled" by the Court or specifically addressed in the Plan. Accordingly, it is common for the Plan to include estimated settlement amounts in order to facilitate emergence. The Plan typically specifies a reserve of equity or cash to be set aside for the resolution of claims that are not settled at emergence. Those creditors may continue to seek settlement post-emergence through mechanisms provided in the Plan.

Determining post-emergence capital structure

It is important to have a thorough understanding of the company's financial reporting requirements, both pre- and post emergence. Once the Court has confirmed the company's plan and it has emerged from bankruptcy, the company must determine if "fresh-start" reporting applies. Under fresh-start reporting, balance sheet items are adjusted to their fair values to reflect a "new" entity basis. In essence, the company has a new beginning, "starting fresh," which should be reflected in its financial statements. The starting point is the entity's Reorganization Value, which is usually determined through the Plan, and approximates the amount a willing buyer would pay for the assets of the Company immediately before emergence.

Companies that qualify for fresh start must meet two criteria at emergence ie., Reorganization Value and Holders of existing voting shares receive 50% of the voting shares of the emerging entity. Companies that fail to meet both of these criteria do not qualify for fresh–start and a new accounting entity is not created.

17.7 NOTES

17.8 SUMMARY

Insolvency describes a situation where the debtor is unable to meet his/her obligations. In such instances where companies cannot emerge from insolvent conditions, putting an end to the life of a company is considered by winding up or liquidating the assets of the company. A company registered under the Companies Act, 1956 may wind up in any of the following modes ie., by the Court i.e. compulsory winding up; Voluntary winding up, which may be either through Members' voluntary winding up; or Creditor's voluntary winding up. Depending upon macro-economic conditions and industry trends a few companies can emerge from distress through proper planning and reorganization.

17.9 KEY WORDS

Liquidation

Insolvent

Distress

Capital structure

Reconciliation

Creditors' claims

Compulsory winding up

Voluntary winding up

17.10 SELF ASSESSMENT QUESTIONS

1. What is bankruptcy? Explain different modes of liquidation
2. Write a note on Voluntary winding up
3. Explain in brief the ways companies can emerge from distress

17.11 REFERENCES

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UNIT-18 : FINANCIAL DISTRESS, TURNAROUND STRATEGIES

Structure :

18.0 Objectives

18.1 Introduction

18.2 Turnaround Strategies

18.3 Bankruptcy Liquidation and Reorganization

18.4 Formal bankruptcy or private workout

18.5 Prepackaged Bankruptcy

18.6 Bankruptcy Liquidation - Priority of Claims

18.7 Notes

18.8 Summary

18.9 Key Words

18.10 Self Assessment Questions

18.11 References

18.0 OBJECTIVES

After studying this unit, you will be able to;

- Understand the concept of financial distress
- Know the turnaround strategies of financial distress
- Study the pros and cons of bankruptcy

18.1 INTRODUCTION

Financial Distress refers to a situation where a firm's operating cash flows are not sufficient to satisfy current obligations and the firm is forced to take corrective action. Financial distress may lead a firm to default on a contract, and it may involve financial restructuring between the firm, its creditors, and its equity investors. Usually the firm is forced to take actions that it would not have taken if it had sufficient cash flow.

A firm that does not generate enough cash flow to make a **contractually required payment**, such as an interest payment, will experience financial distress. A firm that defaults on a required payment may be forced to liquidate its assets.

More often, a defaulting firm will reorganize its financial structure. Financial restructuring involves replacing old financial claims with new ones, and takes place with private workouts or legal bankruptcy.

Private workouts are voluntary arrangements to restructure a company's debt, such as postponing a payment or reducing the size of the payment. If a private workout is not possible, formal bankruptcy is usually required.

- Financial distress does not usually result in the firm's death.
- Firms deal with distress by
  - Selling major assets.
  - Merging with another firm.
  - Reducing capital spending and research and development.
  - Issuing new securities.
  - Negotiating with banks and other creditors.
  - Exchanging debt for equity.

– Filing for bankruptcy.

There are many **responses to financial distress** that a firm can make. These include one or more of the following turnaround strategies.

18.2 TURNAROUND STRATEGIES

1. Asset expansion policies
2. Operational contraction policies
3. Financial policies
4. External control activity
5. Changes in managerial control
6. Wind up company

1. Asset Expansion Policies - If a firm finds itself in difficulty, it may try to reduce the risk of its operations by increasing the size of its business or assets. Asset expansion policies include the full acquisition of another firm, a partial acquisition, setting up a new joint venture, increasing capital expenditure, higher levels of production, or expansion of existing facilities. The joint venture between Fiat and Chrysler is a good example of an asset expansion policy. In 2009 carmakers were facing a bleak prospect, with sales down across the world. The US and British governments had already bailed out their own automobile industries, and many carmakers had reduced production to only part of the year. By entering into a joint venture, Fiat and Chrysler were able to expand their sales revenue at a time when they needed it the most.

2. Operational Contraction Policies - The opposite of expansion is contraction, and many firms choose to focus on their most profitable businesses during a downturn. Operational contraction policies include asset sales, spin-offs and divestitures. Plants may also be closed, production can be cut, and employees made redundant. Honda is a good example of following a contraction policy. First quarter results for 2009 were absolutely dire. Car sales had dropped by 10 per cent, compared to the same period in 2008. There was also the very strong possibility that the company would make an annual loss for the first time since it was founded in 1948. In response, Honda cut global production by 420,000 units and closed its UK plant for four months in order to reduce inventory levels. The employees of the British plant were still paid during this period and, as a result, no redundancies were made.

3. Financial Policies - Financially distressed firms will definitely face some type of cash liquidity problem. Several remedies are available. One, the company can

reduce its annual dividend. Another option is to restructure existing debt facilities so that less interest is paid. The equity and debt markets may also be tapped to raise further funding. During the global credit crunch many banks had to be bailed out by their governments with loan guarantees and equity share issues. In addition, almost every bank slashed its dividends to zero.

4. External Control Activity - External control activity means that the firm has been taken over, or an outside investor takes a significant stake in the firm. A change in external control means that one or more major share-holders sell their shares to another investor with a larger capital base and greater access to capital. The European football industry has seen many deals of this type. One notable example is Glasgow Celtic, which was days away from bankruptcy when investor Fergus McCann purchased the shares of the club, imposed a very strict turnaround strategy, and reduced debt to almost zero. The team subsequently went on to dominate Scottish football, reached the UEFA cup final in 2003, and was one of only a few major British clubs to make a profit during the economic recession.

5. Changes in Managerial Control - The ultimate penalty for poor performance is losing your job, and many firms opt to remove their chairman, chief executive or other directors when they are in financial distress. This will normally go hand in hand with other forms of restructuring. Examples include Fred Goodwin, the former chief executive of Royal Bank of Scotland, who had to step down after the bank found itself in serious financial difficulty as a result of the acquisition of Dutch bank ABN AMRO in 2007.

6. Wind up Company - The final and least desirable strategy a financially distressed firm will follow is to wind up its operations and go into some form of bankruptcy. Bankruptcy laws differ on a country-by-country basis. Bankruptcy may not always end in the disappearance of a company, and firms may be split up, sold on to a new buyer, or restructured during the process.

18.3 BANKRUPTCY LIQUIDATION AND REORGANIZATION

Firms that cannot or choose not to make contractually required payments to creditors have two basic options: liquidation or reorganization.

- **Liquidation** means termination of the firm as a going concern. It involves selling the assets of the firm for salvage value. The proceeds, net of transactions costs, are distributed to creditors in order of established priority.

- **Reorganization** is the option of keeping the firm as a going concern; it sometimes involves issuing new securities to replace old securities.

Liquidation and formal reorganization may be done by bankruptcy. The firm will have two choices: formal bankruptcy or private workout.

Bankruptcy Reorganization

A typical sequence:

1. A voluntary petition or an involuntary petition is filed.
2. A federal judge either approves or denies the petition.
3. In most cases the debtor continues to run the business.
4. The firm is given 120 days to submit a reorganization plan.
5. Creditors and shareholders are divided into classes. Requires only approval by 1/2 of creditors owning 2/3 of outstanding debt
6. After acceptance by the creditors, the plan is confirmed by the court.
7. Payments in cash, property, and securities are made to creditors and shareholders.

18.4 FORMAL BANKRUPTCY OR PRIVATE WORKOUT

Bankruptcy is a legal proceeding, and can be done voluntarily, with the corporation filing the petition, or involuntarily, with the creditors filing the petition.

Private Workout or Bankruptcy - A firm that defaults on its debt payments will need to restructure its financial claims.

Both types of financial restructuring involve exchanging new financial claims for old financial claims. Usually senior debt is replaced with junior debt, and debt is replaced with equity.

Much recent academic research has described what happens in private workouts and formal bankruptcies. Historically, half of financial restructurings have been private, but recently formal bankruptcy has dominated. Firms that emerge from private workouts experience share price increases that are much greater than those for firms emerging from formal bankruptcies. The direct costs of private workouts are much less than the costs of formal bankruptcies.

Both formal bankruptcy and private workouts involve exchanging new financial claims for old financial claims. Usually senior debt is replaced with junior debt and debt is replaced with equity. When they work, private workouts are better than a formal bankruptcy. Complex capital structures and lack of information make private workouts less likely.

♦ **Advantages of Bankruptcy**

1. New credit is available - "debtor in possession" or "DIP" debt.
2. Discontinued accrual of interest on pre-bankruptcy unsecured debt.
3. An automatic stay provision.
4. Tax advantages.
5. Requires only approval by 1/2 of creditors owning 2/3 of outstanding debt.

♦ **Disadvantages of Bankruptcy**

1. A long and expensive process.
2. Judges are required to approve major business decisions.
3. Distraction to management.
4. "Hold out" by stockholders.

18.5 PREPACKAGED BANKRUPTCY

- Prepackaged Bankruptcy is a combination of a private workout and legal bankruptcy.
- The firm and most of its creditors agree to private reorganization outside the formal bankruptcy.
- After the private reorganization is put together (prepackaged) the firm files a formal bankruptcy under Chapter 11).
- The main benefit is that it forces holdouts to accept a bankruptcy reorganization.
- Offers many of the advantages of a formal bankruptcy, but is more efficient.

Bankruptcy Liquidation

Straight liquidation under Chapter 7 usually involves:

- A petition is filed in a federal court. The debtor firm could file a voluntary petition or the creditors could file an involuntary petition against the firm.

- A trustee-in-bankruptcy is elected by the creditors to take over the assets of the debtor firm. The trustee will attempt to liquidate the firm's assets.
- After the assets are sold, after payment of the costs of administration, money is distributed to the creditors.
- If any money is left over, the shareholders get it.

18.6 BANKRUPTCY LIQUIDATION - PRIORITY OF CLAIMS

The distribution of the proceeds of liquidation occurs according to the following priority (APR):

1. Administration expenses associated with liquidation.
2. Unsecured claims arising after the filing of an involuntary bankruptcy petition.
3. Wages earned within 90 days before the filing date, not to exceed $2,000 per claimant.
4. Contributions to employee benefit plans arising with 180 days before the filing date.
5. Consumer claims, not exceeding $900.
6. Tax claims.
7. Secured and unsecured creditors' claims.
8. Preferred stockholders' claims.
9. Common stockholders' claims.

18.7 NOTES

18.8 SUMMARY

Financial Distress refers to a situation where a firm's operating cash flows are not sufficient to satisfy current obligations and the firm is forced to take corrective action. Various turnaround strategies are developed for companies to emerge out of financial distress. Prepackaged Bankruptcy is a combination of a private workout and legal bankruptcy.

18.9 KEY WORDS

Financial restructuring

Private workout

Legal bankruptcy

Turnaround strategies

Prepackaged bankruptcy

18.10 SELF ASSESSMENT QUESTIONS

1. Define financial distress
2. Explain in detail the turnaround strategies
3. What is a private workout?
4. Discuss the pros and cons of bankruptcy
5. What do you mean by Prepackaged Bankruptcy?

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UNIT- 19 : CORPORATE AND DEBT RESTRUCTURING, LEVERAGED BUYOUTS, TENDER OFFERS, STRATEGIC ALLIANCE AND MLPS

Structure :

19.0 Objectives

19.1 Introduction

19.2 Purpose

19.3 Types and forms of Restructuring

19.4 Debt restructuring

19.5 Types of debt restructuring

19.6 Leveraged Buyouts

19.7 Tender Offer

19.8 Strategic Alliance

19.9 Master Limited Partnerships

19.10 Notes

19.11 Summary

19.12 Key Words

19.13 Self Assessment Questions

19.14 References

19.0 OBJECTIVES

After studying this unit, you will be able to:

- To know the concept of corporate and debt restructuring
- To understand the purpose of leverage buyouts
- To explain tender offer, strategic alliance and MLPs

19.1 INTRODUCTION

Corporate Restructuring refers to changes in ownership, business mix, asset mix and alliance with a view to enhance shareholders value. Restructuring is the act of dismantling and reorganizing/rebuilding areas within an organization that need special attention from the management. Restructuring is necessary when a company needs to improve efficiency and profitability and requires expert corporate management.

19.2 PURPOSE

- The basic purpose is to enhance the share holder value.
- To turnaround a sick unit
- To prevent a unit from becoming sick
- To improve performance of unit and organisation's efficiency
- To facilitate growth and expansion
- To influence management control
- Lack of resources
- Domestic/Overseas market opportunities

19.3 TYPES AND FORMS OF RESTRUCTURING

- ♦ **Operational Restructuring:** It involves a basic change in mode of operation, induction of technology, reduction in cost
- ♦ **Organizational Restructuring:** Organizational Restructuring hovers around the changes in organizational design. It brings about changes in decision making, information flow and management style. it requires the participation of all hierarchies of an organization, especially the employees.
- ♦ **Capital/Financial Restructuring:** Redesigning of loan & debt.

Forms of Corporate Restructuring

Corporate Restructuring encompasses three distinct, but related, groups of activities;

- **Expansions** – including mergers and consolidations, tender offers, joint ventures, and acquisitions;
- **Contraction** – including sell offs/divestitures, spin offs, equity carve outs, abandonment of assets, and liquidation; and
- **Ownership and control** – including the market for corporate control, stock repurchases program, ESOPs, exchange offers and going private (whether by leveraged buyout or other means).

19.4 DEBT RESTRUCTURING

It is a process that allows a private or public company, or a sovereign entity facing cash flow problems and financial distress to reduce and renegotiate its delinquent debts in order to improve or restore liquidity so that it can continue its operations.

Replacement of old debt by new debt when not under financial distress is called "refinancing". In other words, Debt restructuring is a method used by companies with outstanding debt obligations to alter the terms of the debt agreements in order to achieve some advantage.

A debt restructuring, which involves a reduction of debt and an extension of payment terms, is usually a less expensive alternative to bankruptcy. The main costs associated with debt restructuring are the time and effort negotiating with bankers, creditors, vendors, and tax authorities.

19.5 TYPES OF DEBT RESTRUCTURING

1. General Debt restructuring

Under the terms of general debt restructuring, the creditor incurs no losses from the process. The creditor decides to extend the loan period, or lowers the interest rate, to enable the debtor to recover from a temporary financial difficulty and pay the debt later.

2. Troubled Debt restructuring

Troubled debt restructuring refers to the process where the creditor incurs losses in the process. This happens when it leads to a reduction in the accrued interest, a dip in the value of the collateral, or conversions to equity.

19.6 LEVERAGED BUYOUTS

It is a strategy involving the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. It is nothing but takeover of a company using the acquired firm's assets and cash flow to obtain financing. In LBO, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company.

A LBO occurs when a financial sponsor gains control of a majority of a target company's equity through the use of borrowed money or debt. The purpose of leveraged buy outs is to allow companies to make large acquisitions without having to commit a lot of capital. Leveraged buy outs are risky for the buyers if the purchase is highly leveraged. An LBO can be protected from volatile interest rates by an Interest Rate Swap, locking in a fixed interest rate, or an interest rate Cap which prevents the borrowing cost from rising above a certain level. LBO's also have been financed with high yield debt or Junk Bonds and have also been done with the interest rate capped at a fixed level and interest costs above the cap added to the principal. For commercial banks, LBO's are attractive because these financings have large up-front fees.

In a LBO, there is usually a ratio of 90% debt to 10% equity. Because of this debt-equity ratio, the bonds usually are not investment grade and are referred to as junk bonds. The buyout is "Shock Therapy." The firm is taken private, managers make critical changes in operations, selling off assets, changing management and then reintroduces the firm to public ownership through a new (IPO) public offering.

Common characteristics

- The company has gone through a program of heavy capital expenditures (i.e., modern plant).
- There are subsidiary assets that can be sold without adversely impacting the core business, and the proceeds can be used to service the debt burden.
- Stable and predictable cash flows.
- A proven and established market position.
- Less cyclical product sales.
- Experienced and quality management.

The purpose of an LBO - The buyout improves operating efficiency through

- Reducing inefficient use of Free Cash Flow
- Provide additional incentives for management through higher ownership share and the necessity to make high debt coverage. Debt disciplines the firm and curtails the incentive to overinvest or be inefficient.
- Under the watchful eye of the buyout specialists.

19.7 TENDER OFFER

It is a formal offer to purchase some or all of the shareholders shares in a corporation. It can be done by the management or other investors, usually at a price higher than the current market price

Reasons:

- To reduce the number of outstanding shares in the market (To reduce dilution of ownership)
- It may be made by an outsider wishing to obtain control of the firm.
- A tender offer may be made by the company's management in a bid to prevent a hostile takeover

Types of Tender Offer

- Voluntary - A company can chose to make an offer on a voluntary basis.
- Mandatory - Mandatory Tender Offers are offers whereby the offerer is required (by law) to make an offer for the shares.
- Friendly Tender Offer - When an offer is made for the outstanding shares of a target company, the board of directors usually is being informed about the imminent bid by the offerer first. It can then advise it's own shareholders whether to accept the offer or to reject it. In case the board of the target company recommends it's shareholders to accept the offer, the offer is called a friendly offer.
- Hostile Tender Offer - In case the offerer does not inform the board of the target company of the imminent publication of its bid, or if the board thinks the offer price is too low and the offerer still continues to publicize the bid, the offer is called hostile.
- Creeping Tender Offer - In Creeping Tender offer the offerer will attempt to circumvent the legal requirements and quietly go about purchasing shares from

different shareholders. Only once a substantial number of shares have been acquired with the group do they comply with filing the proper documents with the regulatory. The result can be that the target company finds itself in a hostile takeover bid before there is a chance to prepare themselves.

- Mini Tender - An offer to purchase less than 5% of a company's stock directly from current investors.
- Partial Tender Offer - An offer to purchase shares of a company, but not all of the shares.
- Self Tender Offer - An offer from a firm to its own shareholders to buy some or all of the shares. Also known as a buy-back offer. Self Tenders are sometimes called in order to prevent a (hostile) Take Over or to make it more difficult.
- Two Tier Tender Offer - The acquiring company will make a Tender Offer to obtain voting control of the target company. In a second stage they will try to purchase the rest.

Cash or securities may be offered to the target company's shareholders, although a tender offer in which securities are offered as consideration is generally referred to as an "exchange offer."

19.8 STRATEGIC ALLIANCE

Strategic Alliance is a kind of partnership between two or more companies who jointly share resources, capabilities, distinctive competencies to achieve business goals. An arrangement between two companies, decided to share resources to undertake a specific, mutually beneficial project.

A strategic alliance is less involved and less permanent than a joint venture, in which two companies typically pool resources to create a separate business entity. In a strategic alliance, each company maintains its autonomy while gaining a new opportunity. A strategic alliance could help a company develop a more effective process, expand into a new market or develop an advantage over a competitor, among other possibilities.

Strategic alliances are critical to organizations for a number of key reasons:

1. Globalization of demand & supply
2. Rapid change in technology
3. Pressure on individual companies

4. Internal growth alone is insufficient for meeting most organizations' required rate of growth.
5. Organisation's need to tap the potential available first and Speed to market is of the essence
6. Complexity is increasing, and no one organization has the required total expertise to best serve the customer.
7. Partnerships can defray rising research and development costs.
8. Alliances facilitate access to global markets.

10 RULES FOR FORMING AN ALLIANCE

1. Develop a strategic foundation for all alliances, where you address the strategic gaps in your business.
2. Do not create an alliance unless you are strategically aligned with your partner.
3. Have a clear understanding of your own organizational culture and your potential partner, ensuring that you are compatible.
4. Create a win-win attitude in all partnerships.
5. Focus on creating greater opportunity than previously expected from forming an alliance; focus on creating "a bigger pie".
6. Develop your negotiating strategy at the very outset
7. Allocate outstanding resources to the alliance and ensure that your partner do the same.
8. Work to cultivate the relationship with your partner, as a legal agreement is never a substitute for a good relationship.
9. Develop an implementation plan before you sign the deal so that you can hit the ground running — and make it tougher for the competition to catch up.
10. Never lose sight of the reason for creating the alliance

ALLIANCE PITFALLS

There are common pitfalls in the alliance cycle.

1. Many organizations do not develop an explicit joint strategy with their partners. Consequently, the organization with the strong direction leads the alliance, while the other partner does not realize the full benefit.

2. Lack of ongoing commitment to the alliance by either party will derail it.
3. Lack of realistic or meaningful measurement is a common pitfall. In an attempt to quantify all results from the outset, employing meaningful qualitative metrics is often overlooked. Some of the most meaningful metrics which are predictors of success include things such as the level of trust between the parties.
4. Losing track of multiple relationships with a partner, This occurs when various alliances with this partner exist in different parts of the organization.
5. Finally, partnering with competitors requires particular attention. One of the common pitfalls occurs when insufficient boundaries are set around an alliance with a competitor. The risk is that their newly acquired knowledge of your organization makes them a more formidable competitor

These risks can be mitigated by creating an organizational competence in strategic alliances. To make alliances work, organizations must develop a systematic, structured and disciplined process that involves planning, implementation and evaluation.

19.9 MASTER LIMITED PARTNERSHIPS (MLPS)

MLP is a limited partnership in which the shares are publicly traded on a stock exchange. The partnership interests are divided unto units which are traded as shares of common stock. Shares of ownership are referred to as units.

MLPs generally operate in the natural resource, financial services, and real estate industries. Unlike a corporation, a master limited partnership is considered to be the aggregate of its partners rather than a separate entity.

There are two types of partners in this type of partnership. They are called as **general partners and limited partners.**

The general partner is the party

- Responsible for managing the business and bears unlimited liability.
- The general partner is typically the sponsor corporation or one of its operating subsidiaries.
- General partner receives compensation that is linked to the performance of the venture and
- Is responsible for the operations of the company and, in most cases, is liable for partnership debt.

The limited partner is the person or group of investors

- Who provide the capital to the MLP and receives periodic income distributions from the MLPs cash flow.
- The limited partners have no day-to-day management role in the partnership.
- Limited partners have the advantage of limited liability.

The advantage of MLPs is the combination of the tax benefits of a limited partnership with the liquidity of a publicly traded company. MLPs allow for pass-through income, meaning that they are not subject to corporate income taxes. The partnership does not pay taxes from the profit – the money is only taxed when unit holders receive distributions. The owners of an MLP are personally responsible for paying taxes on their individual portions of the MLP's income, gains, losses, and deductions. This eliminates the 'double taxation' generally applied to corporations (whereby the corporation pays taxes on its income and the corporation's shareholders also pay taxes on the corporation's dividends). That is, MLP is taxed as partnership avoids double taxation and the business achieves a lower effective tax rate. The lower cost of capital resulting from the reduced effective tax rate provides the partnership with a competitive advantage.

Different Types of MLPs

- **Roll Up MLP** – Formed by the combination of two or more partnership into one publicly traded partnership.
- **Liquidation MLP** – Formed by a complete liquidation of a corporation into an MLP.
- **Start Up MLP** – Formed by partnership that is initially privately held but later offers its interests to the public in order to finance internal growth .

19.10 NOTES

19.11 SUMMARY

Restructuring becomes a necessity when a company needs to improve efficiency and profitability and requires expert corporate management. Corporate restructuring happens through expansions, contractions and ownership control. Leverage buy out is another strategy that involves the acquisition of company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition.

19.12 KEY WORDS

Corporate Restructuring

Operational Restructuring

Organizational Restructuring

Capital/Financial Restructuring

Expansions

Contraction

Troubled Debt restructuring

Leveraged Buyouts

Tender Offer

Strategic Alliance

Master Limited Partnerships

19.13 SELF ASSESSMENT QUESTIONS

1. Define corporate restructuring and explain types of restructuring
2. Explain forms of corporate restructuring
3. What is debt restructuring? Explain different types of debt restructuring
4. What is leveraged buyout?
5. Define tender offer and explain its variants
6. What is strategic alliance?
7. What is an MLP? Explain different types

19.14 REFERENCES

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UNIT-20 : ACQUISITIONS / TAKEOVERS

Structure :

20.0 Objectives
20.1 Introduction
20.2 Types of acquisitions/takeovers
20.3 Categories of Takeover defense
20.4 Preventive measures/Precautionary measures
20.5 Active Antitakeover Defenses
20.6 Take Over Code: Securities And Exchange Board Of India
20.7 Notes
20.8 Summary
20.9 Key Words
20.10 Self Assessment Questions
20.11 References

20.0 OBJECTIVES

After studying this unit, you will be able to;

- Explain the concept of acquisition/takeover and buyout
- Understand the types of takeovers and motives behind takeovers
- Study the Preventive measures/Precautionary measures of takeover
- Identify and understand the Active Antitakeover Defenses
- Know the concept of leverage buyouts

20.1 INTRODUCTION

Acquisitions / Takeover

An acquisition or takeover is the purchase by one company the controlling interest in share capital, or all or substantially all of the assets and/or liabilities, of another company.

A takeover may be friendly or hostile, depending on the offerer company's approach, and may be affected through agreements between the offerer and the majority shareholders, purchase of shares from the open market, or by making an offer for acquisition of the offeree's shares to the entire body of shareholders.

20.2 TYPES OF ACQUISITIONS

a. Friendly takeover :

It involves an acquisition of firm, where the acquirer will purchase the controlling interest/shares through negotiations and agreements with the existing promoters and prospective investors. Hence, it is also called as 'negotiated takeover'. Purchase consideration is decided by having friendly negotiations**.** This kind of takeover is resorted to enhance some common objectives of both the parties. The takeover bid is finalized with the consent of majority shareholders of the target company; hence it is also referred to as "Consent Takeover". The acquirer here does not have to resort to aggressive tactics like Bear Hug, Proxy Contest, and tender Offer etc.

b. Hostile Takeover:

A hostile takeover can happen by way of any of the following actions: if the board rejects the offer, but the bidder continues to pursue it or the bidder makes the offer without informing the board beforehand. An unwanted offer/ surprise bid made by potential acquirer which is strongly opposed by the target firm. In this aggressive tactics are adopted by firms. Here, a person seeking control over a company, purchases the required number of shares from non-controlling shareholders in the open market. It is also called as "Violent Takeover".

Types of Hostile Takeover:

a) Bear Hug:

When friendly approach of takeover through negotiated settlement is not successful then the acquirer may contact Board of Directors by formal proposal to accept stating that if they don't accept they will be going for tender offer

b) Tender offer:

A formal offer by acquiring company to purchase some or all of the shareholders shares in a corporation. It can be done by the management or other investors, usually at a price higher than the current market price

c) Creeping Tender offer:

In Creeping Tender offer the acquirer will quietly go about purchasing shares from different shareholders in the open market, to effect a change in management

d) Proxy Fight:

Here, a group of shareholders are persuaded to join and gather enough shareholder proxies to win a corporate vote, which will replace the management with a new one which will approve the takeover. The famous proxy fight was Hewlett-Packard's takeover of Compaq. The deal was valued at $25 billion, but Hewlett-Packard reportedly spent huge sums on advertising to sway shareholders. HP wasn't fighting Compaq — they were fighting a group of investors that included founding members of the company who opposed the merge. About 51 per cent of shareholders voted in favour of the merger. Despite attempts to halt the deal on legal grounds, it went as planned. Proxy Fight.

e) Saturday night special:

is a slang term used to refer to a surprise takeover attempt, and it alludes to the fact that many takeover bids are announced over the weekend in order to avoid too much publicity.

f) Bailout Takeovers:

Another form of takeover is a 'bail out takeover' in which a profit making company acquires a sick company, i.e., to bailout the sick company. This kind of takeover is usually pursuant to a scheme of reconstruction/rehabilitation with the approval of lender banks/ financial institutions. One of the primary motives for a profit making company to acquire a sick/loss making company would be to set off of the losses of the sick company against the profits of the acquirer, thereby reducing the tax payable by the acquirer. This would be true in the case of a merger between such companies as well.

Acquisitions may be by way of

1. Acquisition of shares of the target, or
2. Acquisition of assets and liabilities of the target.

In the latter case it is usual for the business of the target to be acquired by the acquirer on a going concern basis, i.e. without attributing specific values to each asset / liability, but by arriving at a valuation for the business as a whole such an acquisition is referred to as a **'slump sale'**

Motives of Target Company:

1. **Management Entrenchment Theory:** Managers adopt various types of takeover defenses that are designed to ensure the longevity of the firm, but shareholders lose when managers are firm to protect by takeover.
2. **Shareholder interest theory:** Management resist takeover attempts to maximize shareholder value, shareholders gain when management resists takeover attempts which may be motivated to extract a higher offer from the initial bidder/attract competing bidders which results in shareholders gain by higher offer price by bidder.

20.3 CATEGORIES OF TAKEOVER DEFENSE

Preventive measures & Active measures

1. Preventive measures are designed to reduce the likelihood of a financially successful hostile takeover.
2. Active measures are employed after a hostile bid has been attempted.

20.4 PREVENTIVE MEASURES/PRECAUTIONARY MEASURES

a. Having a Early Warning Systems

b. Poison Pills

c. Back-End Plans

d. Voting Plans

e. Shadow pill

f. Chewable pill

g. Staggered terms of the board of directors

h. Supermajority provisions

i. Fair price provisions

j. Dual capitalization

k. Golden Parachutes

l. Down Raid

a. Having Early Warning System :

Having Early Warning System Analyze distribution of share ownership of the company, monitor the trading of its shares (trading patterns)

b. Poison Pills:

A strategy used by corporations to discourage hostile takeovers. With a poison pill, the target company attempts to make its stock less attractive to the acquirer.

- Make acquisition of control of target firm more costly
- Can be adopted by board without shareholders' approval

There are two types of poison pills:

Flip-in:

A "flip-in" allows existing shareholders (except the acquirer) to buy more shares at a discount. Management offers shares to investors at a discount if an acquirer merely purchases a certain percentage of the company. The discount is not available to the acquirer, and so it becomes extremely expensive for that acquirer to complete the takeover. Experts estimate that it would cost an unwanted bidder, on average, four to five times more to "swallow" a poison pill in order to acquire a target

Flip-over:

A “flip-over” allow stock holders to buy the acquirer’s shares at a discounted price after the merger. The holders of common stock of a company receive one right for each share held, bearing a set expiration date and no voting power. In the event of an unwelcome bid, the rights begin trading separately from the shares. If the bid is successful, all shareholders except the acquirer can exercise the right to purchase shares of the merged entity at discount. For instance, the shareholders have the right to purchase stock of the acquirer on a 2-for-1 basis in any subsequent merger. The significant dilution in the shareholdings of the acquirer makes the takeover expensive and sometimes frustrates it. If the takeover bid is abandoned, the company might redeem the rights.

c. Voting Plans:

This poison pill strategy is designed to dilute the controlling power of the acquirer. Under this plan, the target company issues a dividend of securities, conferring special voting privileges to its stockholders. For example, the target company might issue shares that do not have special voting privileges at the outset. When a potential hostile bid occurs, the stockholders, other than the acquiring party, receive super voting privileges. Alternately, the target company’s stockholders might receive securities with voting rights that increase in value over period. Voting plans were first developed in 1985. They are designed to prevent any out side entity from obtaining power of the company. Under this plan the company issues a dividend of preferred stock. If any outside entity acquires a substantial percentage of the company’s stock, holders of preferred stock become entitled to super voting rights.

d. Shadow pill:

A bidder cannot simply look at a target company and conclude from the fact that it may not have a poison pill in place that it will not have to face such a defense. Targets may simply adopt a pill after a bid has taken place A company may also have a poison pill which is not openly advertised.

e. Chewable pill:

Here, only the board of directors not shareholders has the right to redeem the pill. It limits the voting power to just the BOD. These are pills that disappear, or are brought to shareholders vote, if a company receives a certain type of offer such as a certain price or type of consideration E.g. If Company A wants to take over Company B it may have to pay minimum price set by the Board of Company B else poison pill will be triggered

f. Supermajority Provisions:

These provisions usually require that at least 80% of voting shareholders approve the takeover, as opposed to a simple 51% majority. Such a requirement can make it nearly impossible for an acquirer to obtain enough votes approving the takeover.

g. Fair Price Provisions:

Fair Price Provisions requires acquirer to pay a uniform price to be paid to all the shareholders including minority shareholders. This will avoid the two tier tender offer from the acquirer. It is a modification of corporations' charter that requires the acquirer to pay minority shareholders at least a fair market price for the company's stock. -it is usually in terms of company's P/E ratio -it's a weak takeover defense

h. Dual Capitalization:

It is used to create special voting rights by issuing preffered stocks to friendly parties to act as devices against hostile bids. Restructuring of equity into two classes of stock with different voting rights E.g.. Ford Motors Berkshire Hathaway Concept of Golden Shares

i. Golden Parachutes:

Golden Parachutes are special lucrative compensation agreements that the company provide to Top management. These are provisions in the employment contracts of key executives that provide them with sizable compensation if is the firm is taken over. Golden Parachutes deter hostile takeovers to the extent that the cash outflows required by these contracts are large enough to make the takeover unattractive to the acquirer. It may be used both as a preventive measure and as an active measure.

j. Dawn raid :

A 'dawn raid', i.e., a sudden entry into the stock market by the predator at a price above the previous market level, with a view to acquiring a major stake in a short space of time, in that it may lead to a further takeover offer a few days later.

20.5 ACTIVE ANTITAKEOVER DEFENSES

a. Greenmail

b. White Knight

c. Grey Knight

d. Yellow Knight

e. Lady MacBeth

f. White squire

g. Pac-man Defense

h. Crown Jewel Defense

i. People Mail

j. Jonestown Defense

k. Shark Repellent

l. Bank Mail

m. Capital Structure Changes

a. Greenmail:

It is a strategy by which firm repurchases/buys back large block of stock from specified shareholders/private negotiation at premium to end hostile takeover threat.

b. White Knight:

Target Company finding a more suitable acquirer (white Knight) / Target Company chooses another company with which it prefers to be combined. The white knight may offer to buy all or part of the target firm on more favorable terms than the original bidder and promise not to break up target or engage in massive restructuring, also they find Greater compatibility. The basic premise of this strategy is that if being taken over is certain; the target firm ought to attempt to be taken over by the firm that is deemed most acceptable to its management

c. Grey Knight:

A second, unsolicited bidder in a corporate takeover, A gray knight enters the scene in order to take advantage of any problems between the first bidder and the target company.

d. Yellow Knight:

A company that was once making a takeover attempt but ends up discussing a merger with the target company.

e. Lady Macbeth:

A corporate-takeover strategy with which a third party poses as a white knight to gain trust, but then turns around and joins with unfriendly bidders.

f. White Squire Defense:

The White Square is a modified form of a white knight. In a white square transaction, the target sells a block of its stock to a third party it considers to be friendly. The White Squire is typically not interested in acquiring management control of the target but either as an investment or representation in board of the target company which will be an advantage to Target Company as Large amount of Stock will be placed in hands of an investor which may not be tendered to hostile bidder.

g. Pac-Man Defense:

Best Defense is a Good Offence". It occurs when the Target makes an offer to buy the Hostile Company in response to Hostile bid for the Target. In other words, it aims at the target company making a counter bid for the raiders company, this would force the raider to defense himself and consequently call off his raid.

- Rarely used; usually designed not to be used
- Effective if target much larger than bidder
- Extremely costly

h. Crown Jewel Defense:

The precious assets in the company are called "Crown Jewel". Crown Jewel Defense is a strategy in which the target company sells off its most attractive assets to a friendly third party or spin off the valuable assets in a separate entity, so that the unfriendly bidder is less attracted to the company assets

i. People Mail:

People Mail It is kind of Black Mail where the top Management threatens to resign En-mass in the event of takeover, losing the team could seriously impact the company's performance

j. Jonestown Defense:

Jonestown Defense Jonestown defense is an extreme corporation defense against hostile takeovers. In this strategy, the target firm engages in tactics that might threaten the firm's existence to thwart an imposing acquirer's bids. This is also known as a "suicide pill", and is an extreme version of the poison pill.

k. Shark Repellent:

It is a measure taken by a company to defend an unwanted/hostile takeover attempt.

A Company will make special amendments to its charter/by laws that become active only when a takeover attempt is announced. These amendments when become active, it results into less attractive/profitable to the acquiring firm.

Elements of Shark Repellent are: Golden Parachutes, Poison Pills, Bank Mail etc.

l. Bank Mail:

It is an agreement between a bank and a firm which is about to experience a hostile takeover. Under the terms of this agreement, the bank refuses to provide financing a rival. In this instance of a hostile takeover, bank mail can prevent a hostile takeover by restricting the funds available to the rival firm.

m. Capital Structure Changes/ Recapitalization:

The Company borrows a large sum of money and pays it off in dividends, both raising the value of their stock and putting themselves into debt.

Other Post offer or post bid active defenses:

1. First response and pre emption letter: Inform shareholders not to accept.
2. Defense document: Praise own performance and share all the track records.
3. Profit report/forecast: Forecast improved profits to current year to make offer look cheap.
4. Promise higher returns

Financial defensive measures:

1. Debt should be increased
2. Large dividends
3. Use excess reserves to acquire other firms

20.6 TAKE OVER CODE: SECURITIES AND EXCHANGE BOARD OF INDIA

The Securities and Exchange Board of India (the 'SEBI') is the nodal authority regulating entities that are listed on stock exchanges in India. The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (the 'Takeover Code') restricts and regulates the acquisition of shares / control in listed companies. Generally, if an acquirer acquires 15% or more of the shares or voting rights

of a listed company, the acquirer would be required to make an offer to the public to acquire at least 20% of the voting capital of the company7. However, Regulation 3 (1) (j) of the Takeover Code provides that Regulations 108, 119 and 1210 would not apply to any transfer or acquisition of shares or voting rights pursuant to a scheme of arrangement or reconstruction, including amalgamation or merger or demerger, under any law or regulation, whether Indian or foreign. Therefore if a merger is sanctioned by the Court under the Merger Provisions, the above mentioned provisions of the Takeover Code would not be applicable.

Disclosure requirements under the Takeover Code: It must be noted that Regulations 7 and 8 of the Takeover Code would continue to be applicable to a merger involving a listed company.

Disclosures on certain acquisitions **:** Regulation 7 requires an acquirer to make disclosures of the aggregate of his shareholding if the acquirer acquires more than 5%, 10%, 14%, 54% or 74% of the shares/voting rights of a company. Such disclosures must be made at each stage of acquisition and are to be made to the company and to the stock exchanges on which the shares of the company are listed. Regulation 7 further provides that an acquirer, who has acquired shares/voting rights under Regulation 11 (Consolidation of holdings), must disclose purchase or sale of 2% or more of the share capital of the company, to the company and to the stock exchanges on which the shares of the company are listed. The disclosures mentioned above are to be made within 2 days of (i) the receipt of intimation of allotment of shares or (ii) the acquisition of shares or voting rights, as the case may be. The company whose shares are acquired must also disclose to the stock exchanges, the total number of shares held by the acquirers mentioned above.

Continual disclosures**:** Regulation 8 requires a person holding more than 15% of the shares / voting rights of a company to make annual disclosures to the company (within 21 days from the financial year ending March 31) in respect of his holdings as on March 31.

20.7 NOTES

20.8 SUMMARY

An acquisition or takeover refers to the purchase of controlling interest in share capital or substantially all of the assets and/or liabilities, of another company. Takeover can happen with the consent of the acquiring company or can be a hostile takeover. However, the target firm can use some of the preventive measures & active measures to shun acquisition.

20.8 KEY WORDS

Friendly takeover

Hostile takeover

Slump Sale

Bailout takeover

Poison pill

Golden Parachutes

Down Raid

Flip in

Flip over

Lady MacBeth

Pac-man Defense

Crown Jewel Defense

Shark Repellent

20.9 SELF ASSESSMENT QUESTIONS

1. Define acquisition/takeover and mention its types
2. Explain in brief different types of hostile takeovers
3. Elucidate in detail the precautionary measures of takeover defense
4. Write a note highlighting the active antitakeover defenses

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