CORPORATE RESTRUCTURING

LEADS TO INCREASE IN SHAREHOLDER VALUE

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ABSTRACT

Corporate Restructuring has become a major component in the financial and economic environment all over the world. Industrial restructuring has raised important issues for business decisions as well as for public policy formulation. Since 1991, Indian industries have been increasingly exposed to both domestic and international competition and competitiveness. Hence, in recent times, companies have started restructuring their operations around their core business activities through mergers and acquisitions. The basic purpose of corporate restructuring is to enhance the shareholder value. A company should continuously evaluate its portfolio of businesses, capital mix and ownership and assets arrangements to find opportunities for increasing the shareholder value.

KEY WORDS: Merger, acquisition, shareholder value, corporate restructuring, portfolio.

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1.1 INTRODUCTION

Almost from the last two decades the global industrial landscape had been completely redrawn by the forces of globalization, deregulation and unprecedented technological development. Companies have responded to the competitive pressures unleashed by these forces through extensive corporate restructuring.

In the words of Justice Dhananjaya Y.Chandrachud, "**Corporate restructuring is one of the means that can be employed to meet the challenges which confront business".**

Corporate restructuring refers to changes in ownership, business mix, assets mix and alliances with a view to enhance the shareholders value. Hence, corporate restructuring may involve ownership restructuring, business restructuring and assets restructuring. A company can affect **ownership restructuring** through mergers and acquisition, leveraged buy-out, buyback of shares, spin-offs, joint ventures and strategic alliances. **Business restructuring** involves the reorganization of business units or divisions. It includes diversification into businesses, out-sourcing, divestment, brand acquisitions etc. **Asset restructuring** involves the acquisition or sale of assets and their ownership structure. The examples of asset restructuring are sale and leaseback of assets, securitization of debt, receivable factoring, etc.

It should focus on asset utilization and profitable investment opportunities, and reorganize or divest less profitable or loss making businesses/products. The company can also enhance value through capital restructuring: it can design innovative securities that help to reduce cost of capital. Merger and acquisition is the most popular means of corporate restructuring.

1.2 Merger or Amalgamation

A **merger** is said to occur when two or more companies combine into one company. One or more companies may merge with an existing company or they may merge to form a new company. In merger, there is complete amalgamation of the assets and liabilities as well as shareholder's interests and businesses of the merging companies. There is yet another mode of merger. Here one company can purchase another company without giving proportionate

ownership to the shareholder's of the acquired company or without continuing the business of the acquired company. Laws in India use the term **amalgamation** for merger.

For example **section 2(1A) of the Income Tax Act, 1961**defines amalgamation as the merger of one or more companies (called **amalgamating company** or companies) with another company (called **amalgamated company**) or the merger of two or more companies to form a new company in such a way that all assets and liabilities of the amalgamated company and shareholders holding not less than nine-tenth in value of the shares in the amalgamating company or companies become shareholders of the amalgamated company.

A merger may take the legal form of either a statutory merger or a purchase of assets (and often assumption) of the target firm.

1) <u>Statutory merger</u>: In statutory merger, so called because it is executed under the statutes of the state of incorporation, the stock of the target firm is directly exchanged for stock of acquiring firm and the legal existence of the target firm automatically ceases. Although the legal form implies a stock –for-stock exchange, the acquiring firm may purchases the stock of the target for cash or by exchanging other securities and then, as the sole stockholder of the target, exchange the stock in a statutory merger.

2) <u>Purchase of assets</u>: The acquiring firm might purchase the assets and usually, assume the liabilities of the target firm. The purchase may be for cash or securities of the acquiring firm. After the purchase, the sole assets of the acquired firm are the cash and/or securities received in the exchange. After any liabilities not assumed by the acquiring firm are paid, the acquired firm is liquidated by distributing its assets (cash and/or securities of the acquiring firm) to its stock holders in liquidating dividend. Then the acquired corporation is formally dissolved.

Regardless of the legal form used, holders of a stipulated majority of the equity of the acquired firm must approve the merger. Depending on its character, approval of holders of a majority of the stock of the acquiring firm may or may not be required. Merger or amalgamation may take two forms:

(i) Merger through absorption

(ii) Merger through consolidation

- **Absorption:** Absorption is a combination of two or more companies into an existing company. All companies except one lose their identity in a merger through absorption.
- **Consolidation:** Consolidation is a combination of two or more companies into a new company. In this form of merger, all companies are legally dissolved and a new entity is created.

1.2.1 Categories of Merger

Merger types can be broadly classified into the following five subheads as described below.

(i) Horizontal Merger refers to the merger of two companies who are direct competitors of one another. They serve the same market and sell the same product. An example would be the merger of two machine-tool manufacturers. This form of merger results in the expansion of a firm's operations in a given product line and at the same time eliminates a competitor.

(ii) Conglomeration Merger refers to the merger of companies, which do not either sell any related products or cater to any related markets. Here, the two companies entering the merger process do not possess any common business ties. For example the merger of a machine-tool manufacturer with a chain of fast-food restaurants

(iii)Vertical Merger is affected either between a company and a customer or between a company and a supplier. For example, the merger of a machine-tool manufacturer with its supplier of castings would be a vertical merger. The economic benefit of this type of merger systems from the form's increased control over the acquisition of raw materials or the distribution of finished goods.

(iv)Product-Extension Merger is executed among companies, which sell different products of a related category. They also seek to serve a common market. This type of merger enables the new

company to go in for a pooling in of their products so as to serve a common market which was earlier fragmented among them.

(v) Market-Extension Merger occurs between two companies that sell identical products in different markets. It basically expands the market base of the product.

Mergers may further be categorized as:

1) Cash Merger: A merger in which certain shareholders are required to accept cash for their shares while other shareholders receive shares in the continuing enterprise.

2) Down Stream Merger: The merger of parent company into its subsidiary is called down stream merger.

3) Up Stream Merger: The merger of subsidiary company into its parent company is called an up stream merger.

4) Short-form Merger: A number of statues provide special company rules for the merger of a subsidiary into its parent where the parent owns substantially all of the shares of the subsidiary. This is known as a short form merger. Short form mergers generally may be effected by adoption of a resolution of merger by the parent company, and mailing a copy of plan of merger to all shareholders of subsidiary and filing the executed documents with the prescribed authority under the statue. This type of merger is less expensive and time consuming than the normal type of merger.

5) Triangular Merger: Triangular merger means the amalgamation of two companies by which the disappearing company is merged into subsidiary of surviving company and shareholders of the disappearing company receive shares of the surviving company.

1.3 ACQUISITION

An essential feature of merger through absorption as well as consolidation is the combination of the companies. The acquiring companies takeover the ownership of one or more other companies and combines their operations. However, an acquisition does not involve combination of companies. It is simply an act of acquiring control over management of other companies. The control over management of other company can be acquired through either a ‘friendly take-over’ or through ‘forced’ or ‘unwilling acquisition’. When a company takes over the control of another company through mutual agreement, it is called **acquisition or friendly take-over**. On the other

hand, if the control is acquired through unwilling acquisition, i.e., when the take-over is opposed by the 'target' company it is known as **hostile take-over**.

1.4 FINANCING MERGER AND ACQUISITION

Mergers are generally differentiated from acquisitions partly by the way in which they are financed and partly by the relative size of the companies. Various methods of financing an M&A deal exist:

1) **Cash Offer:** After the value of the firm to be acquired has been determined, the most straight forward method of making payment could be by way of offer for cash payment. The major advantage of cash offer is that it will not cause any dilution in the ownership as well as earning per share of the company. However, the shareholders of the acquired company will be liable to pay tax on any gains made by them. Another important consideration could be the adverse effect on the liquidity position of the company. Thus, only a company having very sound liquidity position may offer cash for financing the merger.

2) **Equity Share Financing or Exchange of Shares:** It is one of the most common methods of financing mergers. Under this method, shareholders of the acquired company are given shares of the acquiring company. It results into sharing of benefits and earnings of merger between shareholders of the acquired companies and the acquiring companies. The determination of the rational exchange ratio is the most important factor in this form of financing a merger.

3) **Debt and Preference Share Financing:** A company may also finance a merger through issue of fixed interest bearing convertible debentures and convertible preference shares bearing a fixed rate of dividend. The shareholders of the acquired company sometimes prefer such a mode of payment because of security of income along with an option of conversion into equity within a stated period. The acquiring company is also benefited on account of lesser or no dilution of earning per share as well as voting/controlling power of its existing shareholders.

4) **Deferred Payment or Earn-Out Plan:** Deferred payment also known as earn-out plan is a method of making payment to the target firm which is being acquired in such a manner that only a part of the payment is made initially either in cash or securities. In addition to the initial

payment, the acquiring company undertakes to make additional payment in future years if it is able to increase the earnings after the merger or acquisition. It is known as earn-out plan because the future payments are linked with the firm's future earnings. This method enables the acquiring company to negotiate successfully with the target company and also helps in increasing the earning per share because of lesser number of shares being issued in the initial years. However, to make it successful, the acquiring company should be prepared to co-operate towards the growth and success of the target firm.

5) **Leveraged Buy-Out:** A merger of a company which is substantially financed through debt is known as leveraged buy-out. Debt, usually, forms than 70 percent of the purchase price. The shares of such a firm are concentrated in the hands of a few investors and are not generally, traded in the stock exchange. It is known as leveraged buy-out because of the leverage provided by debt source of financing over equity. A leveraged buy-out is also called **Management Buy-Out (MBO)**. However, a leveraged buy-out may be possible only in a case of a financially sound acquiring company which is viewed by the lenders as risk-free.

6) **Tender Offer:** Under this method, the purchaser, who is interested in acquisition of some company, approaches the shareholders of the target firm directly and offers them a price (which is usually more than the market price) to encourage them sell their shares to him. It is method that results into holistic or forced take-over. The management of the target firm may also tender a counter offer at still a higher price to avoid the takeover. It may also educate the shareholders by informing them that the acquisition offer is not in the interest of the shareholders in the long-run.

1.5 MOTIVES BEHIND MERGER AND ACQUISITION

The dominant rationale used to explain M&A activity is that acquiring firms seek improved financial performance. The following motives are considered to improve financial performance:

1) **Synergy**: Synergy refers to the greater combine value of the merged firms than the sum of values of individual units. It is something like one plus one more that two. It results from benefits other than those related to economies of scale. Operating economies are one of the various synergy benefits of merger or consolidation. The other instances which may result into synergy benefits include, strong R & D facilities of one firm merged with better organised

production facilities of another unit, enhanced managerial capacity, the substantial financial resources of one being combined with profitable investment opportunities of the other, etc.

2) **Increased Revenue or Market Share**: This assumes that the buyer will be absorbing a major competitor and thus increase its market power (by capturing increased market share) to set prices.

3) **Economies of Scale:** The amalgamated company will have more resources at its command than the individual companies. This will help in increasing the scale of operations and the economies of large scale will be availed. These economies will occur because of more intensive utilization of production facilities, distribution network, research and development facilities, etc. These economies will be available in horizontal mergers (companies dealing in the same line of products) where scope of more intensive use of resources is greater.

4) **Operating Economies:** A number of operating economies will be available with the merger of two or more companies. Duplicating facilities in accounting, purchasing, marketing, etc. will be eliminated. Operating inefficiencies of small concerns will be controlled by the superior management emerging from the amalgamation. The amalgamated companies will be in a better position to operate than the amalgamating companies individually.

5) **Growth:** A company may not grow rapidly through internal expansion. Merger or amalgamation enables satisfactory or balanced growth of a company. It can cross many stages of growth at one time through amalgamation. Growth through merger or amalgamation is also cheaper and less risky. A number of cost and risk of expansion and taking of new product lines are avoided by the acquisition of a going concern. By acquiring other companies a desired level of growth can be maintained by an enterprise.

6) **Diversification:** Two or more companies operating in different lines can diversify their activities through amalgamation. Since different companies are already dealing in their respective lines their will be less risk in diversification. When a company tries to enter new lines of activities then it may face a number of problems in production, marketing etc. when some concerns are already operating in different lines, they must have crossed many obstacles and difficulties. Amalgamation will bring together the experience of different persons in varied activities. So amalgamation will be the best way of diversification.

7) **Utilisation of Tax shields:** When a company with accumulated losses merges with a profit making company it is able to utilize tax shields. A company having losses will not be able to set

off losses against future profits, because it is not a profit earning unit. On the other hand if it merges with the concern earnings profit then the accumulated losses of one unit will be offset against the future profits of the other unit. In this way the merger or amalgamation will enable the concern to avail tax benefits.

8) **Increase in Value:** One of the main reasons for merger or amalgamation is the increase in value of the merged company. The value of the merged company is greater than the sum of values of the independent companies. For example, if X Ltd. and Y Ltd. merge and form Z Ltd., the value of Z Ltd. is expected to be greater than the sum of the independent of X Ltd. and Y Ltd.

9) **Elimination of competition:** The merger or amalgamation of two or more companies will eliminate competition among them. The companies will be able to save their advertising expenses thus enabling them to reduce their prices. The consumers will also benefit in the form of cheap or goods being made available to them.

10) **Better Financial Planning:** The merged companies will be able to plan their resources in a better way. The collective finances of merged companies will be more and their utilisation may be better than in the separate concerns. It may happen that one of the merging companies has short gestation period while the other has long gestation period. The profits of the company with short gestation period will be utilized to finance the other company. When the company with longer gestation period starts earning profits then it will financial position as a whole.

11) **Economic Necessity:** Economic necessity may force the merger of some units. If there are two sick units, government may force their merger to improve their financial position and overall working. A sick unit may be required to merge with a healthy unit to ensure better utilization of resources, improve returns and better management. Rehabilitation of sick units is a social necessity because their closure may result in unemployment etc.

CONCLUSION

The purpose behind mergers and acquisition is that it provides a productive platform for the companies to grow, though much of it depends on the way the deal is implemented. It is a way to increase market penetration in a particular area with the help of an established base few reasons for M&A's are:

1. Accessing new markets.
2. Maintaining growth momentum.

3. Acquiring visibility and international brands.
4. Buying cutting edge technology rather than importing it.
5. Taking on global competition.
6. Improving operating margins and efficiencies.
7. Developing new product mix.
8. Eliminating the financial constraint.
9. Deploying surplus cash.
10. Enhancing debt capacity.
11. Lowering the financing costs.

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