Strategic Management for Competitive Advantage
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Lecture: 17
Mergers and Acquisition - I

Welcome to the course strategic management for competitive advantage.

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Today, we will continue the strategic formulations and strategic choices in Part C, in that we will be covering mergers and acquisitions.

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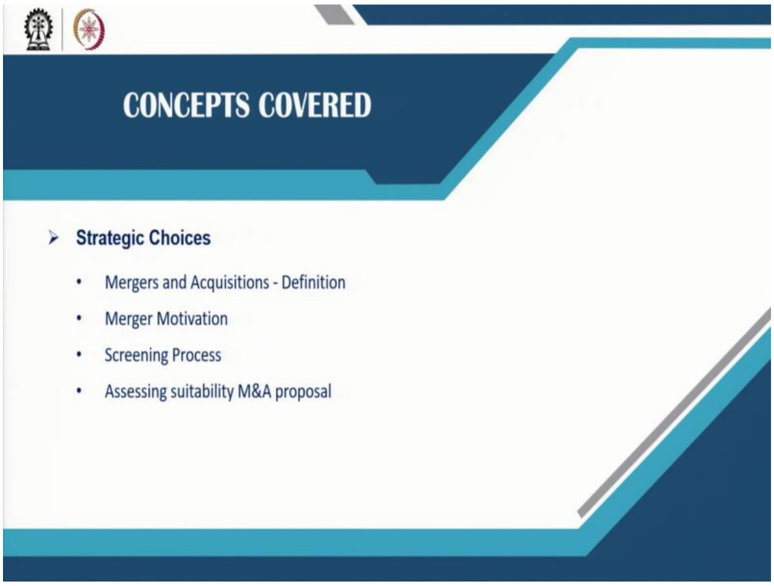

So, the concepts that will be covered in today's lecture are strategic choices, mergers and acquisitions. what are their definitions? What are the motivations or drivers for mergers?

what are the screening processes for mergers? All you have to select some candidates and some companies? So, screening processes for that and assessing the suitability of merger and acquisition proposal.

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These are the things we will be covering in this lecture. So, first of all, we have to define what is mergers and acquisitions. All of you, I understand, have the knowledge and are acquainted with what is mergers. what are acquisitions? Now, what is the definition of a merger? How do you define a merger? A merger is actually when two or more companies roughly of equal size or strength submerge their corporate identity in a friendly manner and develop a new corporate identity that is called a merger.

Usually, a holding company is created, and the shares of the new company are exchanged with the shareholders of the merged companies. So, in effect here, you just notice that mergers are generally successful when the companies are rough of equal size or strength, and they submerge their corporate identity in a friendly manner. Generally, before that, they do the synergic exercise and both companies then only take a decision this is a merger.

Acquisitions are also known as takeovers. what is that? Here a big company that takes over is usually a smaller company. The thumb rule is generally that the big company acquiesces in most cases for 5 to 10 per cent of the size of the acquired company, that is being acquired. Now, the definition of acquisition is when a company takes over the control of another company in exchange for cash or securities and takes over the maximum controlling share of the acquired company. So, control comes to them, that is called acquisitions.

Usually, some of time it has been seen, when the merger set out in a failure, then the beat for acquiring the company acquisitions and all that route is also followed. Now, as I told as a thumb rule, the big companies acquire the smaller companies, but that is not necessarily always the case. Rare instances there when a small company can also take over a big company, but those cases are very rare.

Recently, can you cite any example that smaller companies taking over a big company? our own TISCO, the Tata iron and steel company that is the Tata sons, they have taken over Corus, Corus is much bigger in revenue, assets and size. Maybe that more than three times and all but that Tata sons have taken over the Corus. So, the other things also might happen, these are the merger definitions.

Now next, I will be coming, what are the motivations for the merger? why do mergers and acquisitions take place, and what are the drivers for it? So, to explain that there are many factors that may be the reasons one is to improve the economies of scale. All of you have an understanding, of what is economies of scale. we have discussed it in our previous lectures.

So, when a merger or acquisition takes place, what happens? The combined entity increases its capacity to supply capacity to produce, so, they get that volume that the cost advantage. So, that is the unit cost advantage because they use the common resources and all. they have a synergetic effect and also advantages on all finance, advertising, and marketing. So, all those advantages you get, so, those it improves their economies of scale, that is one of the reasons.

Another is market supremacy if your capability to produce or supply increases, what happens to suppose you are merging with another company, say one automobile company is merging with another company. So, the combined market share will be more so, they suppose, one company's market share was set 25 per cent and other companies maybe that is 20 or 18 per cent. So as a total, your combined market share is becoming 40 to 43 per cent. So, the company is in a position to manipulate the market and also in a position to control the prices of the market.

So, it gives you market supremacy, of course, this merger and acquisition are made within the framework of the companies act or the entity that computations act. You have to obey all those comply all those rules. So, it gives you market supremacy. So, that is another motivation for mergers you can see most mergers are for consolidating their market share so, that they can control the market in a better way. They have control all over the market which is market supremacy.

Then you get it to acquire a new product or brand name. Suppose some of the companies may require a new product or a brand name, but that company does not have very strong product lines or that several segments. A big company they have a brand, but what do they do? they can go and acquire a smaller company which does not have any brand, but they can produce the product at a much cheaper rate. And this company can sell that with its brand like Bata. Bata also does many of its product lines they acquire from the smaller companies and put a brand name.

Similarly, many companies are doing that. So, this is to acquire a new product or in the reverse may be also true. Some smaller companies may require that they do not have a brand name they can go for a bigger company for that brand. So, it is acquiring a new product or brand name and then is the diversifying portfolio. Why do you diversify your portfolio? We have already discussed in the last lecture diversification because if you have different products, different businesses, and different markets.

Then what you have, you can balance not only the risk and also you can balance the different stages of the business because different stages of the business require different cash flow. So, you balance that cash flow also. supposes, if you go for a different market like international markets in some countries and some continents, there may be some says demand is stagnation, then the other countries the economic prosperity is going on. So, it balances your portfolio.

Then reduce risk, as I told you that diversification one of the reasons is you spread your risk. Similarly, if you have a diversified portfolio, for the merger and acquisitions, you are spreading your risk, which is one of the reasons. Another reason is gaining managerial expertise, what is it? some small companies or the acquired target companies which we are going to acquire may have a good management system that managers are very competent or maybe very talented.

So, if a company buys that company (acquires that company) with the hope that managerial expertise can be transferred to the parent company and they can get the advantage of it, so, that may be also the reason for mergers and acquisitions.

Then, some other reasons may be unused debt and the capacity of another company. what does it mean? Suppose, a company running at a loss had unused debt, you know, the unused debt they have because they do not know or do not have the plan for expansions and all for the market? So, some big companies, which are in expansion mode or they wanted to get some debt from the market, can take over that company and can absorb that unused debt. So, this may be also a cause for your merger and acquisitions.

Then lastly, there are taxation and investment incentives. you know Indian companies act, and many countries act the loss-making company, the losses can be allowed to accumulate, so, that in the future, when the company turns around and earns profit, then these losses can be absorbed. So, now, a failing company which are not getting in a profit, so they are accumulating losses are there and now, a big company which has a lot of profit can absorb those losses.

So, they take over that company and absorb the losses, so, that they do not have to pay the higher corporate taxes. So, they get that tax benefit with that taxation money, they are acquiring another company that is the assets, and all this is the taxation benefit. Similarly, investment in incentives they like when a company goes on say modernization or buy new equipment, new machinery and all. there are some rebates are given by the acts and all. So, that company can take that rebate and that opportunity. So, the investment incentives for that may also be the reasons for merger and acquisition motivation. These are some of the drivers for the merger.

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Next, we will be coming to what are the steps in the screening processes for mergers and acquisitions. So, how do you start? how do you go about it? So, the steps I will explain now, the first is you have to identify an industry and sector where you want to invest your money to go for a merger or acquisition. So “identifying the industry.”

So, whether you want to go for an automobile industry or energy sector, say oil and gas industry or a steel industry or cement industry or software industry or banking industry financial services, so, all options are open. So, it is a very general, from general you have to be more specific suppose if you wanted to go for an automobile or then after that what you do whether you want you to have to find a specific sector of automobile whether you want it to go for a light commercial vehicle or you want it to for heavy vehicle like bus like passenger car like trucks, you have to identify your sector.

Similarly, if you go for the oil and gas industry, you have to find whether you want it to go upstream or downstream sector or midstream sector, whether you want it to go petroleum petrochemicals or refinery or oil exploration of productions or the supply of oil and gas. So, these are the sectors you will be doing it. after you select that, then you have to choose the number of companies which you wanted to take over, he wanted to acquire.

So, this is becoming more specific and also, this depends on your pocket, how deep your pocket is, and how much you are able to acquire that because some of the acquisitions are some sectors or some industries are very capital intensive. So, it also depends on that, then you choose the companies that are the top companies, and all good companies are the good candidates, you choose those you so, you narrow down.

What you do after that, you have to look for the cost of acquisitions and likely retunes and for that acquisition, like what is the cost of acquisition, how will you determine the cost of acquisition. The cost of acquisitions generally depends on the size of the company you are going to acquire. what the size of the company is defined in terms of its sales volume or in terms of its asset level, or terms of it any other measure you want it to do. So, that is that cost of acquisition, and there are many other associated costs I will come to that later on.

Then after that, when your acquisition cost is not enough, then you have to make a likely return on what will be your future returns from those funds you have invested. So, that investment to that economic returns also you have to calculate. So, you have to find out, say, economic like NPV (Net Present Value), IRR (Internal Rate of Return). you have to find a Payback Period Profitability so many other things are like ROI. So, all those things, you have to determine that is the cost of acquisitions and returns.

After that, what do you do? You compare and rank candidates. how do you compare, and you have to develop some criteria for comparing the relative worth or net worth of those companies, relative attractiveness of your candidates, that is, the companies and you rank them generally? how do they do it? Generally, the strategist or the financial due diligence, who does it?

So, usually, they engage the concept of fit, what is this concept of fit? they have every company have some financial parameters in those parameters, they give a certain weightage to each parameter. and against that weightage, those parameters are assessed for different candidates or different companies. So, in that, you can make a composite index against the company that measures the relative attractiveness of different companies or candidates. So, that is why they compare and rank the candidates.

So, after ranking the candidates, what do they do? you have to identify who are the good (potential candidates) that you will be interested in taking over. So, what are the good candidates? The characteristics of good candidates are: that they must have a high market share, they are in a growing market business, their business has large sales volume and a good management system and should also have a diversified portfolio, and above all, it should have above average return on investment, it will be above the industry average?

So, these are the good candidates, people look for. It is just like if you go to interviewing some candidates and all you look for some attributes, they should have good experience and skill set that matches your job requirement. it should have a good education, a good personality and good as a team member. So, all those attributes you look at it similarly, these identifying up the good candidates, these are the attributes which are generally the people look for it.

But here is a catch, what is the catch? if a company has all these attributes, the high market shares, growing market, then the large sales volume, good management system, diversified portfolio, above average ROI, why will that company want to get taken over by the others? why the company will agree to that? they generally will resist it, and also, if all these candidates are there, the demand for other companies also taking over will intensify.

So, there will be intense competition among the competitors to take over that, and as a result, what happened, the share prices of this company will go sky high, and it goes above the roof. So, if so, it becomes difficult to acquire that company. So, you must have noticed it, but having said that, even then, there are people who are successful in taking over such companies, this is our call the experience and the tricks and all, these cannot be taught in what are those tricks and all that are those competencies it cannot be taught in any business schools and all that comes with experience and that is why they are paid so heavily. So, these are the steps in the screening process. after the screening processes are done.

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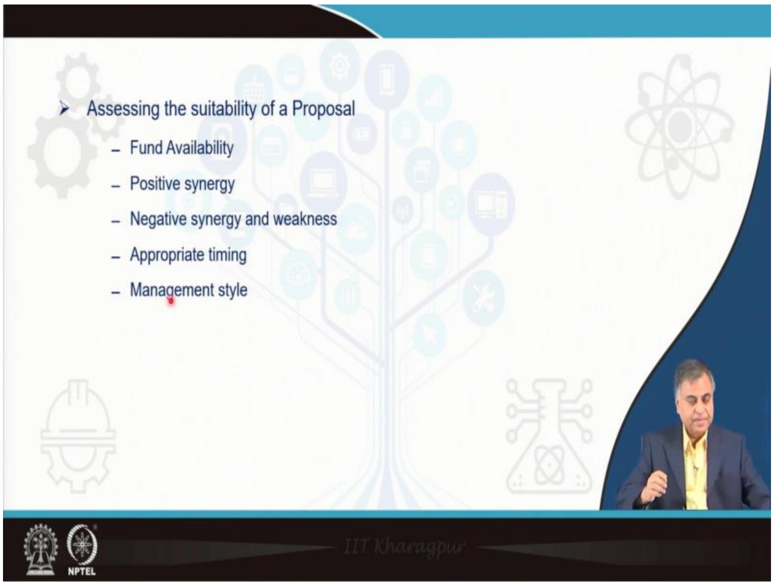

Next, after identifying your target candidates and you have to assess the suitability of the proposal. This proposal generally comes from a middleman or the agent or in-house also people, who are closely watching the market. So, everything in many routes is there.

So how do you assess the suitability? The first thing is fund availability because the merger and acquisition cost is very high because you have to take the control of the acquired company, and for that, you have to pay a 100 per cent premium for that company. So, whether you have that fund or not. And if you do not have an internal fund, you have to borrow it. So, how much do you have to borrow debt equity financing, all those things are involved in finding out your fund availability.

Then the positive synergy, every merger and acquisition is being made first thing, there is a synergetic effect. So, what is the positive synergy, like suppose it can be operational synergy, it can be marketing synergy, logistics synergy, R&D synergy, financial synergy etc. So, it must have a positive synergy for the example, that recently you have seen the many Indian banks have been merged, three four banks, public sector banks, they have merged in all.

So, what were the reasons for merging there must have been some positive synergy, what are the reasons? what is the positive synergy, you can come to your mind that for the reasons that the banks were merged? Any idea? Some of the synergic effects that were responsible for that is one is the market reach suppose say Bank of Baroda that has merged with some Dena Bank and other syndicate banks and all. this then the bank of Indian, Indian bank was merged with Allahabad bank and some other banks, so the market reach.

Indian bank and all they might be very strong network in western India, Allahabad bank in eastern India. So, the market reach increases, and another is the nowadays banking industry is always run for the banking software, it is now that computerized and all software and all. This computerization and software that compatibility. those packages are very costly, and those packages that compatibility with those packages, maybe another synergy these are positive synergy.

Similarly, if you see the merger of Daimler Benz and Chrysler. two mobile giants that had all the positive synergy, like technical synergy, operational synergy, R&D synergy and all. So, that was a positive synergy you look for similarly, you must look for the negative synergy and weaknesses, there may be some negative synergy, like the company you are going to acquire may have very industrial relations problem, they may have to say toxic IR relations, the pay packages of the smaller company to be accurate company may be much higher than the bigger company the acquiring company.

So, if you do that merging, it will create a problem for the parent company, the bigger company because toxics IR culture, then your pay packages are our differential like it happened in Daimler Benz and, this Chrysler, Chrysler was an American company. And Daimler Benz is a German company. They are totally two different cultures. Culturally they did not match the Working, working also they did not match.

Germans are very methodical, precision-oriented, and bureaucratic way they go for it, whereas the American culture is more informal. They are more creative. Their meetings used to be done in say 15-20 Half an hour, whereas the German's meeting continued for 3, 4, 5, and 6 hours. So, these are the contrast, and the pay packages of Americans were much higher than those of the German staff and all. even the top CEO of German Daimler Benz was much less than a merger of Chrysler. So, these are the negative synergy, and, in fact, that merger was not successful because of this negative synergy.

Then there is appropriate timing, what is this appropriate timing? appropriate timing is every merger and acquisition, the management should have spare time to look after, after the acquisitions and the merger, you have to be focused on the smaller companies, and you have to groom them to fit in your system. So, it requires a lot of management timing, if you cannot give it will not be very successful.

And another thing for appropriate timing is in terms of the business cycle like some business cycles go in our growth stage, then some are in the mature, or the seasonality also is there. So, that thing has to be matched. So, these are in terms of the business, the state of development, and also the seasonal, cyclical things and all that is called appropriate timing.

And lastly, it is the management style, like when you are acquiring a company, then the parent company or (the acquiring company) should not treat the smaller company or the acquired company like a master and the slave or the victor or the victims that should not be there, because they are your people now, you have to harmonize those people. they are harmonizing, they are methodical, they are working and all, into your system and culture. So, there is the best way do that you put yourself in their shoes and try to understand their things because they are emotional, and the cultures of the two companies are different. They are emotionally when it is merged, and all emotionally, they are in a very shaky position.

So, it is you should not act like a big brother, and you should nurture it very attentively and nurture it very carefully. So, your merger and acquisition have become successful, because, after all, it is a costly affair. So, these are some of the points for assessing the suitability of a proposal.

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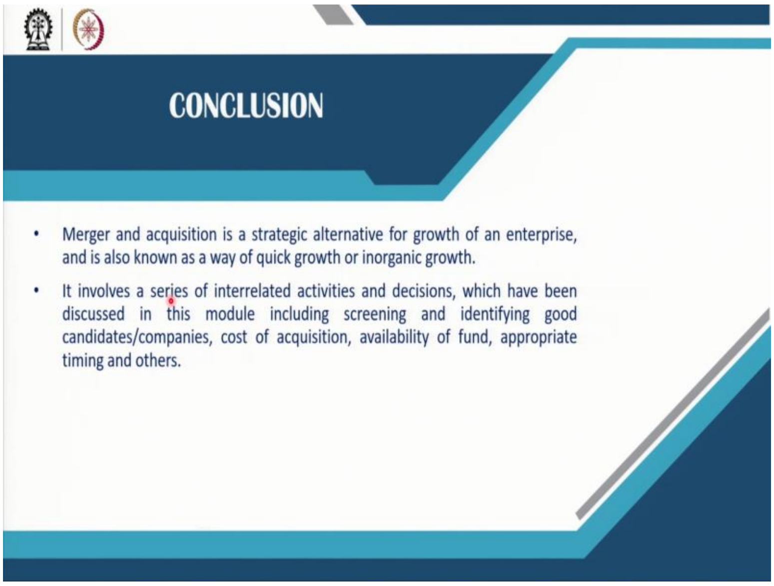

Now, to end with this, I will talk about what is the conclusion to summarize today's lecture, I may go through those mergers and acquisitions is a strategic alternative for the growth of an organization or enterprise. It is also known as inorganic growth, and generally, it is a way of quick growth for an organization. this merger and acquisition involve a series of interrelated activities and decisions.

This we have discussed in this module, and we have discussed how the screening processes there, how to identify a good candidate and how the cost of acquisition, availability of funds and appropriate timing and the management style and issues. we have discussed in this lecture. Further on this, we will be discussing mergers and acquisitions we will be discussing in the next lecture.

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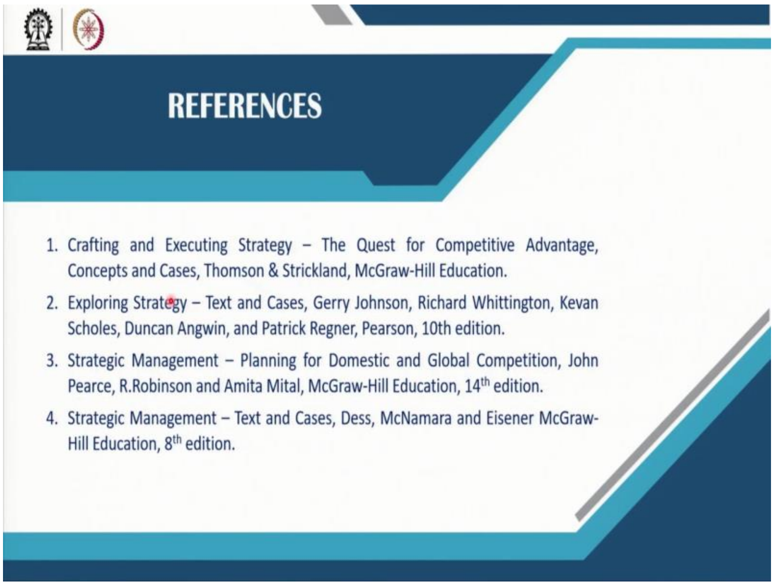

And these are some of the references, and books you can go through to enrich yourself further on this topic. Thank you very much for attending.