# Strategic Management for Competitive Advantage
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**Lecture - 18**
**Merger and Acquisitions - II**

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Welcome to the course strategic management for competitive advantage. In the last class, we are discussing mergers and acquisitions and to further continue the merger and acquisitions, we will cover in this lecture the rest of the topics under merger and acquisitions. The valuations for mergers and acquisitions and managing after acquisitions these two are very important, we will be covering this in today's lecture.

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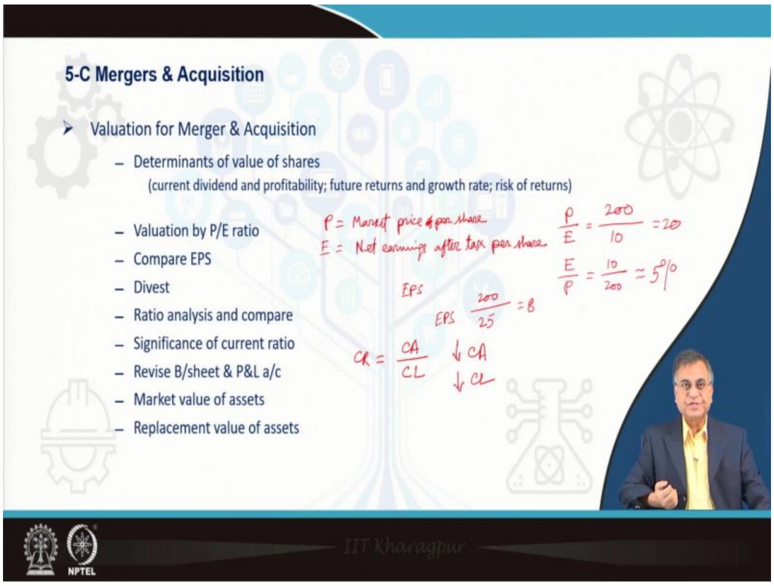


In the last lectures, we have covered what is the merger and definitions of mergers and acquisitions, what are the drivers for mergers and acquisitions, what are the screening steps in screening processes for M&A then, and the fund's availability. Now, you have to do the due diligence of, not only the financial due diligence.

But in all spheres say, HR due diligence, IT due diligence, operational due diligence, marketing due diligence, and every area you do it. So, financial due diligence is one of the main activities. So, what is this due diligence for finance, like in merger and acquisition what do you do? We are taking over the other company. So, you buy the company shares to take the controlling position.

So, for that, what do you have to do? You have to determine the values of the shares of the companies you are targeting to acquire. So, what are the determinants of the values of shares? Share determinants are the current dividend paid by that company, the current dividend of that target company and the current profitability, and profitability of the target company also. you look at the future returns, the future growth rate of those markets and also the risk of returns. So, all these are the determinants to find out the valuation of the shares of that target company. these will help you.

Now, we will be talking about the valuation, you have to do the valuations of the shares. So, because you have to pay a 100 per cent premium generally is paid for a takeover. So, valuations by P E ratio, what is P E ratio? I suppose all of you know what is P E ratio, what is

P and E?   So, P is the market price per share and E is net earnings after tax per share. So, what is the P E ratio gives you?

Suppose the market price of the share is, say, rupees 200.  So, earnings per share suppose are 10, so, what is the P E ratio? The PE ratio is 20. So, what does it mean, and what does it indicate? It indicates that if you invest 200 rupees today, then it will take 20 years for you to recover that money, and you will recover that money in 20 years.

Now, tell me if it does, if the shareholder has to wait for 20 years to recover that money. will anyone invest in that? Generally, people will not wait for that long. why do they invest? They invest with the hope that the growth of the companies will be much faster it will take 20 years that is assuming then the earnings per share remains at 10 rupees for the next 20 years, but it is a shareholder(investor) always invest with the hope the growth rate will be much faster so you will be recovering your money much earlier than 20 years that is one.

Another way investors look at it is that if the price of the market share goes above 200 rupees, he can sell and get his return, get the money back for that they invest. So, this is the P E ratio is one of the target companies. PE ratios, you look at it now, if you reverse the P/E ratio that is called E/P that is called earnings yields. what does it indicate? What will be the earning yields of this E/P? What are the earning yields? EP is 10/200*100 means 5 per cent. So, earning yields is 5 per cent.

Now, if you see that, what is the fixed deposit in the bank?  if you put this money that is a 6.5 per cent fixed deposit you are getting, then why should you put it in the market? in these companies whose P/E earning this is 5 per cent, it will not be a lucrative return. So, it has to be more than the fixed deposits in the bank. So, if it had not been 10 per cent, it would have been a lucrative investment option. So, they also look for the earnings yield. this is the valuation of the PE ratio you look for that company.

Another is that you compare EPS, what is EPS? EPS is earnings per share. You compare the earnings per share of your target companies, the target that is your target be acquired companies. Now, then you find out what is EPS earnings per share of your company and after the mergers and all or acquisitions take place, what will be the earnings per share of the new entity company? So, if you compare all three, if it standing per share is lucrative for the combined companies, then only you go for those mergers and acquisitions, so you come to compare.

What is EPS? Earnings per share, say 200 rupees the market price. Now, suppose your P/E ratio is 25, then what will be the EPS? EPS will be then, in that case, your market price, this is P/E ratio, earnings per share will be how much? 8 rupees per share. So, you compare this figure with your acquiring company, acquired company, and the new entity newly merged companies, whichever is looked at if it is prospective, then only you go for it that compares the earning per share.

Then, another thing is you divest, what is divest? Before mergers and acquisitions and all that, especially acquisitions, you will look for the target companies. what are the financial draining businesses which are draining the capital, draining the finance, and those loopholes? you must identify with it even before going for acquisition.

And the first thing you do after acquisitions is try to divest those loopholes, plug those you're syphoning. Those are the syphoning your assets, and syphoning your money. So, you plug those and try to divest those, say the non-attractive businesses, non-attractive assets, non-attractive products and all. you should very first divest it, then you can get that leverage off your capital.

So, you identify those even before the acquisitions and try to divest them as fast as possible, then another is ratio analysis and compare it. You do various ratio analyses that you do it, and you compare that ratio analysis with the acquiring company, then the acquired company and the new company, and after the merging or taking over those new companies, you do the ratio analysis.

Say one of the ratios is said the current ratio, and what is the significance of the current ratio? It gives you many things to ponder like the current ratio, what is the current ratio? I suppose, all of you know it, the current ratio is a current asset by current liability. So, usually, what should be the current ratio? Should be the industry average of that industry, or you compare your current ratio with your competitors or the industries in that sector where you are operating. If the current ratio is high, what to do? You identify each component of the current assets and current liabilities; you study them separately. Each component of CA and CL. So, in that way, you can find out ways to reduce this current asset.

So, one of the current assets is composed of the inventory, stocks that constitute a good number. So, you have to reduce those stocks or the inventory. How do you do that? So, you are more focused on that, and there are means to do that. Like suppose, your inventory or stock says 10 months you have to give because of your lead time. It will take you 10 months to arrive at your material. So, you keep your stock for 10 months.

Now, if you can further focus on it, improve your processes and supplier relationships. There are many ways, so if you can reduce that lead time and your stock also will reduce. If you from 10 months reduce by 3 or 4 months, say 7 months. You are liquidating the stocks for 3 months. So, that is huge, and these three months, you are reducing your current asset, and as a result, current liabilities like the debtors and all those liabilities also will come down.

So, in this way, the effort should be to reduce current assets and reduce your current liability that way, you can improve your organization's efficiency and efficacy and financial health. So, this is the significance of the current ratio, but this ratio analysis, when you do it, this ratio analysis is nothing, but it gives you some numbers, it is a static number it does not mean anything unless you put that ratio and connect it with your balance sheet and profit and loss account it has to be integrated, it has to be connected then only it gives.

So, you revise your balance sheet. you have the balance sheet of your acquired company and acquiring company. now the combined company's revised balance sheet has to prepare. You have to see the current ratio and other ratio analyses with that revised balance sheet and revised profit and loss accounts that will give you the actual valuations(picture) whether you should go for those mergers or acquisitions, which will give you the financial advantages, competitive advantages or not. So, these are the valuations for mergers and acquisitions. These ways you go for it.

Then further, you also look for the market value of assets like buildings, land, plant, and machinery. Those are your assets and all you also have to consider. Suppose your factory or your plant is in a DRA urban city and all it has huge value, that value may be for other sectors also, like if we have seen it, Bombay. All the Bombay that the textile mills, were in the heart of Bombay, but the textile industry, when it went for modernization, could not be slid down.

So, those companies used to have huge market value for their land and plant. So, those are the market value of assets you must also consider the replacement values of assets. These are some of the important parameters one should look for when valuations are done for mergers and acquisitions. So, these are the valuations.

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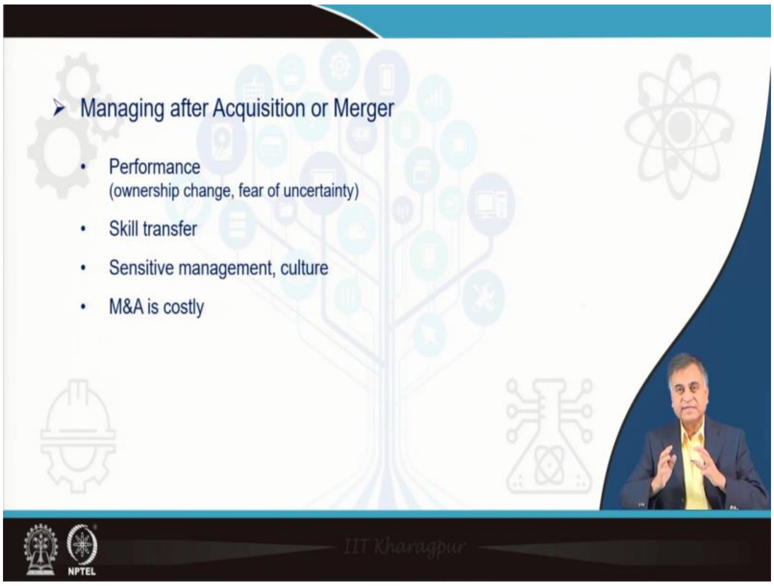


Now next, we will proceed to manage after acquisitions or mergers. What do you think mergers and acquisitions are being made for with the hope of you improved the performance of the combined company? those mergers and acquisitions have been made after studying the economies of scale further in your market supremacy, financial advantage, and marketing advantage. All these advantages you have studied, synergic effect. so it is supposed that your financial performance of the combined company should be more attractive.

So, what do you think the performance of a merger or acquisition becomes after the M&A activities are done? So, performance should theoretically improve, but it has been observed that the performance does not improve immediately after the merger or acquisition is done. Say if you say for the next two years it is in turbulence or a state of flux, and not only for two years even it is found after five years also performance is not up to the expected and if you compare it with the performance of before the merger.

In this case, when you measure the performance. You always take three years average like before the merger also performance you take for a few years as three years' average, and after the mergers or acquisitions also you take the performance of three years' average that will give you a smoother result. But why does this performance not improve? Theoretically, it should have improved because all the synergic effects were there, but even then, it deteriorates not only two years after five years also, it does not get the expected result.

This is because some of the reasons for this deterioration of performances are ownership change and fear of uncertainty. whenever these acquisitions or merger takes place and all from both sides, both companies people feel secure because in any acquisitions or merger there will be the company will go for the rationalizations of their resources. When one of the resources is human resources, usually the downsizing or right-sizing is done.

So, people are in a state of flux, before the acquisitions and after the acquisitions also. There will be some managers or people who will oppose these acquisitions, especially from the acquired company and generally, they are fired very fast after the deal is made. So, this ownership change, fear of uncertainty. both parties acquired the company, and acquiring company tried to manipulate their systems and all. All these cancel out the synergic effect. So, this is one of the reasons for deteriorating performance after the acquisitions take place.

So, another is the skills transfer. Like after the merger or the acquisition, you have to transfer the skills of the big company. Acquiring a company has abundant skills, and those skills have to be transferred to the acquired company. so, they are harmonized. There are some skills which are easy to transfer and some skills that are very difficult to transfer.

So, you go first for the transferring the easy skills. what are the easy skills that come to your mind? Say this financial skill can be easily transferred. Similarly, marketing skills also and some technical skills can be easily transferred, but some technical skills are difficult to transfer, like R&D skills, then design skills, and product innovation skills, these cannot be easily transferred to some engineering skills, so, these are difficult to transfer. So, you try to transfer the skills, so that the activities of the joint entity become harmonized. So, this is skill transfer.

Then another thing is that you should have sensitive management and conducive management culture. what does it mean for sensitive management? As I told you in the last lecture, the management there should not of the acquiring company not act as a Victor and the acquired company as a victim, they should not look for that, they are the masters.

So, here to be a successful acquisition or merger, so you have to put yourself in the shoes of the acquired companies. You have to feel their emotion and their anxiety. So, you have to be sensitive to all these issues, and the culture should also be conducive. There must be a culture of cooperation, not a culture of competition. It is that culture you have to do it, and to inculcate it cannot be said autocratic sort of things. So, some sensitive management is required for harmonizing the activities of acquired companies.

Then all of us know, that merger and acquisition is a costly affair because when you are acquiring a company, you have to pay a 100 per cent premium. So, it is a very costly thing, and not only are you doing valuations, you are finding out the cost of acquisitions, but there is another cost that is the cost of integrations, you have to also keep in mind that and take into account the cost of integrations and cost of acquisitions. The executives take time to make these acquisitions and mergers successful.

So, these are some of the very important parameters you have to look into so that because you have paid a lot merger as I told you, it is a costly affair. So, to make it significant you have to recover and improve your performance for that. you have to harmonies the activities of the new entity with new companies very fast. So, you have to take all the measures for that, this is merger and acquisition. These are some of the parameter factors you must keep in mind for a successful acquisition and merger.

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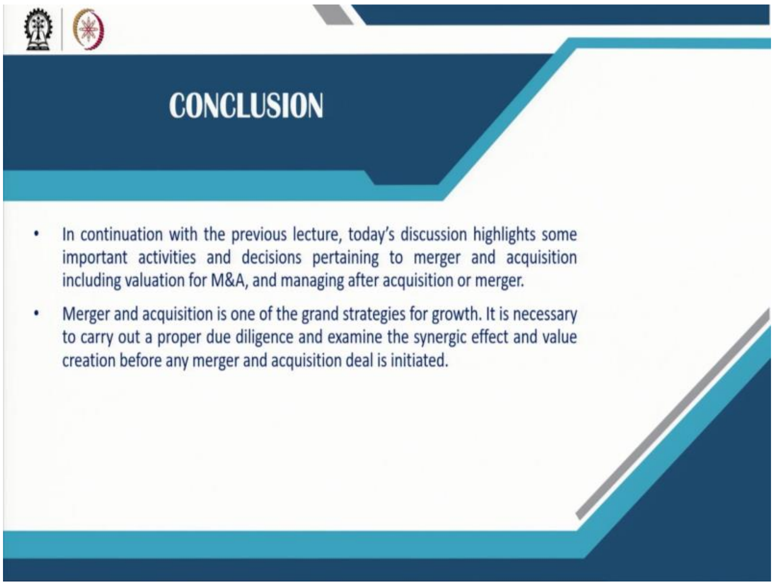


So, to sum up, today's discussion, what have we discussed? We discussed that, in continuation with our last lecture, we have discussed some important activities and decisions pertaining to mergers and acquisitions. So, we have discussed the valuations for mergers and acquisitions. what are the factors you look for it and the management after acquisitions or mergers, which is a very important aspect to make your merger and acquisition successful?

So, we also know that merger and acquisition is one of the grand strategies for growth, it is an inorganic growth strategy, and it is one grand strategy. So, you must do the proper due diligence and examine the synergic effect and value creation before any merger and acquisition deal is initiated, and how much value you can create for that. So, you have to look for all those before any merger and acquisition deal you sign, or you go for it.

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These are some of the references, books, you can go through it and for the merger and acquisition that will enrich your knowledge. So, that is all for the merger and acquisitions in this chapter. Thank you very much for attending.