Management Model : A Framework For Evaluation Of Alternative Mergers In The Wake Of Down-Turn

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INTRODUCTION

When two firms of equal size agree to form a new firm, this action is called as a merger. The new firm stock is issued to the existing shareholders. The merger of Glaxo Wellcome and Smith Kline Beecham into GlaxoSmithKline in 1999 is an example of a merger. On the other hand, when one company takes over or buys another company, it is known as an acquisition. The mergers and acquisitions ensure the competitive edge, increase the firm's value, achieve internal and external economies, upgrade technology, acquire major market share and develop a strong leadership in the industry. The guiding principle in mergers and acquisition is *'synergy'*, which is implied in the equation form as 2 + 2 = 5. In other words, this process of combination results in the creation of *'additional value'*.

WHY CROSS-BORDER MERGERS FAIL?

Though merging firms have a common vision, the barriers of language, working under different practices and understanding cultural differences are the major confronting issues in case of international mergers. The barriers crop up like this:

(i) There is a gap between perception and reality of the merging firms, which may crop up due to focus of firms on hard mechanics, instead of soft issues like selecting the right management team, and resolving cultural and communication misunderstandings.

(ii) Cultural clash of the merging firms as the challenge depends on the nature as well as the approach in mergers and acquisitions. If the merger firms integrate fully in terms of culture, the emerging company achieves the best business through the inherited cultural aspects as the good governing factor.

WHAT IS THE REASON FOR PURSUING DEALS DURING DOWN-TURN?

The basic governing principles for sound mergers and acquisitions have been derived from the Boston Consulting Group (BCG). It is a consultancy firm, which has been advising on business strategies by means of the market share matrix. This matrix has four quadrants - namely - *Question Marks, Dogs, Stars and Cash Cows*, which are explained as: A business which has a superior market position with invariably low costs takes the position of low growth rate in business, but high market share, and is referred to as Cash Cows. This leads to high generation of cash and profits, which can be used for maintaining a competitive demand. When both the business growth and market share are low, then the business is classified as the Dog. This leads to the solution to either liquidate or divest the business. A business with low market share, but high growth rate is termed as Questions Marks. Here, cash requirement is high due to low market share, resulting in low cash generation. A business with high business growth rate and high market share is termed as Stars. Such a business generates huge revenue due to generation of high profits. A prudent management invests in the Stars strategy. For example, a company may use the cash generated by Cash Cows to turn Question Marks into Stars, which in turn become Cash Cows of the future. This approach allows the managers to take decisions regarding investment decisions on the behalf of the investors. Here, a manager has to review the performance of different units or products and invest where the growth potential is maximum. The financial crisis has forced companies to shift their attention from Mergers and Acquisitions. However, for the companies who have the confidence to keep Mergers and Acquisitions dealings on their agendas, an economic down-turn can provide a window

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of opportunity (Figure 1).

Figure 1: Growth/Market Share Matrix

Growth Rate	Question Marks	Stars
	Dogs	Cash Cows
	Low	High
	Market Share	

MERGERS AND ACQUISITIONS CHECKLIST

The success or otherwise of a businessl can be known by the result achieved in the Post-Merger Integration (PMI). It requires specialized skills. The seeds of success are sown long before PMI, when a company is exploiting merger and acquisition options. There are several steps to be followed to ensure that the merger and acquisition is the best option for tuning growth, enhancing profitability and adding value for shareholders. They include:

(i) Ensure that the M & A is the only most suitable strategy for achieving defined goals, **(ii)** Identify alternative potential targets, **(iii)** Plan the current position of the target in the industry backdrop, **(iv)** Simulate the acquisition synergy effects on the financial, operational and market performance, **(v)** Ensure that the funds with internal capital base are available adequately and, **(vi)** Ensure that the process of the merger takes place on the right time, with the right integration.

THE PROCESS OF MERGERS AND ACQUISITIONS

This process of mergers and acquisition includes five phases, which are as follows:

☸ **Phase I : Pre-Acquisition Review :** Assess one's own situation - whether it can maintain core competencies like market share, return on capital, etc. in the future or not. Also, include the valuation of the company in assessment. How the company has to determine the achieved growth target? If not, a M & A team can be formed to set the criteria for achieving the determined growth.

☸ **Phase-II : Search and Screen Target :** Find out the alternative possible takeover of the firm. It must fulfill the set of criteria and formulate a strategic feasibility with the acquiring company.

☸ **Phase-III : Investigate and Value The Target**: Get to know about the target of the firm, which is truly a good fit for the acquiring firm. Then, the acquiring firm makes a thorough review about various value-drivers of the target , with a view to identify the degree of synergy which can be realized. This can be better explained as: Value of acquiring firm (US $) = $ 560 , value of target firm = $ 176 and Value of synergy = $ 38 ; the sum of these provide the value of the firm, which is equal to $ 774.

☸ **Phase-IV : Acquiring Through Negotiation**: The commonly followed approach in acquiring a firm is through negotiation, with which both the sides agree to the deal.

☸ **Phase-V : Post Merger Integration**: If everything goes well, the two firms will make an announcement regarding their merger. Since firms differ in many ways, hence, an extensive planning and design is to be followed throughout the process of the merger, which contains three levels, which are :

(i) Full : All functional areas will be combined into one new firm,

(ii) Moderate : Certain key functions will be merged together with the strategic decisions and,

(iii) Minimal : Only the selected personnel will be grouped together in order to improve the managerial performance without redundancy. Thus, if the PMI is surpassed, then the acquiring firm would certainly generate synergy value.

REVIEW OF LITERATURE

The knowledge on the topic of the subject is reviewed hereunder to appraise the need for the present study. Timothy J. Galpin and Mark Hendon expressed their view as: Synergies projected for M&As are not achieved in 70 per cent of the cases, only 23 percent of them earned the cost of capital in the first six months of a merger. Then, the productivity falls by as much as 50 per cent. The average financial performance of a newly merged firms is graded as 'C' by their respective managers. In the acquired firms, 47 percent of the executives left in the first year, and 75 percent left the firm within the first three years of the merger. Even in situations where the merging company is in the same line of business as the holding company, with enough time to allow for easy post-merger integration, the possibility of success is only about 50 per cent . Every big player operating today has grown leaps and bounds through merger and acquisition. A review of the international banking scenario over the past decade reveals that the consolidation has been a dominant feature of the banking sector in most of the countries like Malaysia, Singapore, Taiwan, Thailand, Indonesia and South Korea.

M & As are the easiest and the simplest means to achieve the defined objectives of the business in the shortest possible time frame. A reason for the consolidation emanates from the demand of the corporate sector. As Indian corporate sector is active on the international level too, they tend to acquire certain entities for business synergies. Porter in his study of 33 large diversified corporations ,between 1950 to 1986, found that the firms have formed, on an average, 80 new industries; 70 per cent of which through diversification, accomplished acquisition. This suggests growth via acquisition is popular.

OBJECTIVES OF THE STUDY

The specific objectives of the present study are:

1. To understand the concept of the mergers and acquisitions and the motives thereto;

2. To analyze the effect of mergers and acquisitions in the multi-facet analysis.

METHODOLOGY

The present study is confined to the process of mergers and acquisitions during 2005-06 to 2009-10, with a focus on why cross-border M & As fail. The tools used are the Present Value (PV), financial ratios - like Debt-Equity Ratio, Rate of Return, Earnings Per Share, Price-Earnings Ratio, Ownership Position (OP), Exchange Ratio (ER), and HH Index.

MANAGEMENT MODEL - A MULTIFACETED ANALYSIS

The success of a merger depends on the sound and healthy plan of a merger. The selection of the model/plan influences the long-range strategic planning process, which involves the elements as: **(i)** Possible mission and capabilities, **(ii)** Assessment of environment through interface, **(iii)** An emphasis on the process merger, **(iv)** Need of coordination and consistency among the individual divisions, **(v)** Need of appraisal effectively for the firm's changing environment and, **(vi)** integrating the planning process into a reward and incentive or penalty system in a long-term perspective.

❁ **Value Creation Framework:** The success of the merger depends on valuing the possible takeover firm by means of the value creation framework in terms of capital budgeting decision. So, this process of evaluating the acquisition consists of:

1. Determine cash flow (X), the equity-related post-tax cash flows of the acquiring firm 'X' prior to merging;

2. Determine PV (X), the present value of CF (X) by applying a suitable discount rate;

3. Determine CF (X^1), the equity-related post-tax cash flows of combined firm X^1 , which consists of acquiring firm X and the acquired firm Y after the merger;

4. Determine PV(X^1), the present value of CF(X^1);

5. Determine the ownership position (OP) of the shareholders of firm X in the combined firm X^1, with the help of the following formula :

1. $$OP = \frac{Nx}{Nx + ER\ (Ny)} \quad \ldots\ldots\ldots\ldots\ldots\ldots \quad (1)$$

Where N_x = No. of outstanding equity shares of firm X (before the merger), N_y = No. of outstanding equity shares of firm Y (before merger), ER = Exchange ratio representing number of shares of firm X exchanged for every share of

Table 1: Cash Flows of ADBP Limited					
Year	2005-06	2006-07	2007-08	2008-09	2009-10
CF(post-tax) ₹ in billions	0.711	2.021	2.382	1.002	5.631
Source: Religare Technova					

firm Y.

7. Calculate NPV of the merger proposal from the point view of X as follows:

1. $NPV(X) = OP[PV(X^1)] - PV(X)$ …………………(2)

Where; NPV(X) = Net Present Value of the merger proposal from the point view of shareholders of X, OP = Ownership position of the shareholders of firm X, $PV(X^1)$ = Present Value of the cash flows of the combined firm X^1, PV(X) = Present Value of the cash flows of firm X, before the merger.

DATA ANALYSIS

☸**Step 1:** The equity related post-tax cash flow of ADBP Limited is presented in the Table 1. After five years, CF $(ADBPL)_t$ grows at a compound rate of 5 per cent per annum.

☸**Step 2:** Find PV of cash flows using the discount rate of 10 percent, which is as:

$PV(ADBPL) = 0.0711/(1.10)^1 + 2.021/(1.10)^2 + 2.382/(1.10)^3 + 1.002/(1.10)^4 + 5.631/(1.10)^5 + 5.631(1.05)/[(0.10 - 0.05)(1.10)^5]$ = ₹ 81.76 billions.

☸**Step 3:** Equity- related cash flows of the combined firm ADBPL with RANBAXY is shown in Table 2.

Table 2: Cash Flows of Aurobindo- Ranbaxy					
Year	2005-06	2006-07	2007-08	2008-09	2009-10
CF(post-tax) ₹ in billions	4.517	8.191	-8.067	6.722	11.932
Source: Religare Technova					

After five years, cash flows of the combined firm is expected to grow at the compound rate of 6 per cent per year.

☸**Step 4:** Compute PV of expected cash flows of the combined firm.

$$PV(ADBPL\ with\ RANBAXY) = [4.517/(1.10)^1 + 8.191/(1.10)^2 - 8.067/(1.10)^3 + 6.772/(1.10)^4 + 11.932/(1.10)^5 + 11.932(1.06)/[(0.10 - 0.06)(1.10)^5]$$
$$= ₹\ 213.26\ billions$$

☸**Step 5:** After calculation, it was found that the ownership position of shareholders of ADBPL on the basis of the number of outstanding shares of it before merger is 58220000, and the number of outstanding shares of RANBAXY Laboratories Limited is 802921357; the proposed Exchange Ratio (ER) works out at 0.1. The ownership position of

Table 3: Financial Position of Firms			
Particulars	ADBPL	CIPLA	RANBAXY
Book value per share (₹)	329.01	65.83	94.16
P/E Ratio	10.30	48.946	42.10
No of shares	58220000	802921357	420369753
Debt/Equity ratio	1.3	0.22	0.85
Beta for existing leverage	1.3	1.15	1.55
Internal profitability(r)	0.05	0.14	0.18
Investment rate (b)	0.15	1.5	1.0
Growth Rate (g)	9.05	13.4	11.5
Source: Religare Technova			

the shareholders of firm ADBPL in the combined firm Aurobindo - Ranbaxy (AR) Limited is,

OP = 58220000/58220000+0.1(802921357) = 0.420.

☸**Step 6:** Determine NPV of the merger proposal from the point view of shareholders X. The NPV [(0.420) 213.26 - 81.76] is ₹ 7.81 billion. Since the NPV is positive, the new firm Aurobindo- Ranbaxy (AR) Limited should go ahead with the merger.

VALUE BASED PLANNING

This framework can be adopted when the firm expands its operations through the merger, with favorable growth and profitability opportunity. For which, the firm has to search and identify two firms as possible merger entities based on the number of characteristics - namely strong in research and marketing, high internal profitability, substantial investment opportunities, etc. The acquiring firm has to find out the value of the firm which it can merge with itself , compare itself with the chosen firm in terms of gain in value, and then plan an integration with the merger firm. This can be better understood with the following possible deal between ADBPL and CIPLA, and ADBPL and RANBAXY. Relevant data of the three firms is presented in Table 3.

Table 4: Key Financial Indicators

₹ in billion

Particulars	ADBPL	CIPLA	RANBAXY
Total assets	38.59	60.98	74.83
R (%)	0.05	0.14	0.18
Earnings rate (%)	0.214	0.219	0.132
Net operating income	8.28	13.41	9.90
Interest on debt	1.95	0.18	3.35
Profit before tax	7.54	13.250	9.510
Tax @ 25%	1.89	3.313	2.378
Net income	5.65	9.937	7.132
Number of shares	58220000	802921357	420369753
Earnings per share (₹)	100.27	13.47	13.61
Price Earning Ratio (₹)	10.30	48.946	42.10
Market price per share (₹)	1033	659.30	572.98
Total market value	60.14	529.37	240.86

Source: Religare Technova

Table 5: Effects of The Merger

Particulars	With CIPLA	With RANBAXY
Number of new shares	58220000	58220000
Existing shares	802921357	420369753
Total new shares	861141357	478589753
Earnings after taxes (₹ in billions)	9.937	7.130
A's Earnings after tax (₹ in billions)	5.658	5.658
Total new earnings (₹ in billions)	15.595	12.788
New Earnings Per Share (₹)	18.11	26.72
A's old EPS (₹)	100.27	100.27
Net effect (₹)	-82.16	-73.55
Per cent dilution (%)	-81.94	-73.35

Source: Religare Technova

Further insights into market parameters show that the risk-free rate is 5.5 percent, and the expected rate of return is 12 percent. Each firm pays 10 percent interest rate on the debt. The tax rate of each is 25 percent. A supernormal growth period will be 10 years. The capital structure of ADBPL, CIPLA and RANBAXY (₹ in billion) are 19.45, 1.84 and 33.48 in debt; 19.14, 59.14 and 41.35 in equity, which provide total assets of 38.59, 60.98 and 74.83 respectively. The calculated market price of share is presented in the Table 4.

Data on effects of merger on earnings per share is presented in the Table 5.

The qualitative capabilities of the new financial parameters of the combined firms would be as: net operating income (₹ In billions) is 22.50 and 18.00 in CIPLA and RANBAXY respectively, while the corresponding figures are 0.16 and 0.14 in internal profitability; 0.90 and 0.90 is the investment rate and 15 percent and 14 percent is the growth rate. Now, it can evaluate the two alternate acquisition prospects using valuation analysis, for which, calculation of beta for the merger company under two alternatives is required. The beta for the combined firms is the weighted average market value of the beta of the individual firms. Compute the cost of equity for each of the combined firms.

β_{Ac} = β (TMVE of ADBPL / (TMVE of ADBPL + TMVE of CIPLA**)** + β (TMVE of CIPLA / (TMVE of ADBPL + TMVE of CIPLA**)** …………………………………………...(3)

= 1.15 (60.14 / (60.14 +529.37) + 1.13 (529.37 / (60.14 + 529.37)

= 0.1173 + 1.1674 = 1.28

Where, TMVE of ADBPL is the Total market value of equity of ADBPL and TMVE of CIPLA = Total market value of equity of CIPLA.

$K_e = R_f + \beta (R_m - R_f)$ ……………………………………………………….…(4)

= 5.5 + 1.28 (12-5.5) = 13.82 per cent

β_{AR} = β (TMVE of ADBPL / (TMVE of ADBPL + TMVE of RANBAXY**)** + β (TMVE of RANBAXY / (TMVE of ADBPL+ TMVE of RANBAXY**)** ……………………..(5)

= 1.15 (60.14/ (60.14 + 240.86) + 1.55 (240.86/ (60.14 + 240.86)

= 0.2298 + 1.2403 = 1.47

Where, TMVE of RANBAXY is Total market value of equity of RANBAXY

$K_e = R_f + \beta (R_m - R_f)$ ……………………………………………………..........(6)

= 5.5 + 1.47(12-5.5) = 15.06 per cent or 15 per cent

The capital structure of the combined firms is that debt and equity are (₹ in billions) 21.29 and 1.897 in CIPLA and the corresponding figures in RANBAXY are 52.93 and 2.393 respectively, thus registering total assets of 23.187 and 55.323.

Weighted average cost of capital

$K_o = K_e (S/V) + K_d (1\text{-}t) (B/V)$ ……………………………………………….…….....(7)

K_{oAC} = 0.1382(1.897/23.187) + 0.10(1-0.25) (21.29/23.187)

= 0.0113+0.0688 = 0.0798 or 7.98 per cent

K_{oAR} = 0.15(2.393/55.323) + 0.10(1-.25) (52.93/55.323)

Table 6: Comparison of Two Merger Combination

(₹ in billions)

Particulars	With CIPLA	With RANBAXY
Post merger value	26.42	363.02
-Amount of debt	21.29	52.93
Value of equity	5.13	310.09
-A's pre-merger market value	60.14	60.14
Gain in equity value	-55.01	249.95
-Cost if acquired at market price	19.15	19.15
Gain in value	-74.16	230.81
Source: Religare Technova		

$= 0.00648+0.07175 = 0.0782$ or 7.82 per cent

Now, estimate the value of two alternative combinations with the cash flow approach.

$V_0 = X_0 (1\text{-}t) (1\text{-}b_s) \sum^{n}_{t=1}(1+g_s)/(1+k)^t + X_0 (1\text{-}T) (1\text{-}g_s)^{n+1}/k(1+k)^n$ ………… … … … ...(8)

$V_{AC} = 22.50(1\text{-}0.25) (1\text{-}0.90) \sum^{10}_{t=1} (1.15)^t/(1.0798)^t + 22.50(1\text{-}0.25) (1.15)^{11}/0.0798(1.0798)^{10}$

$= 1.6875 X \sum (1.0650)t + 3.64$

$= 1.6875(1.0650)$ FVIFA$_{6.5\%, 10years}$ $+3.64$

$= 1.6875 \;X\; 13.4944 + 3.64 =$ ₹ 26.42 billions

$V_{AR} = 18.00 (1\text{-}0.25) (1\text{-}0.90) \sum^{n}_{t=1} (1.14)^t/(1.0782)^t + 18.00 (1\text{-}0.25) (1.14)^{11}/0.0782 (1.0782)^{10}$

$= 1.35X \sum^{10}_{t=1}(1.0573)^t + 343.63$

$= 1.35 (1.0573)$ FVIFA5.7$_{\%, 10years}$ $+ 343.63$

$= 1.35 X 14.363 +343.63$

$= 19.39 + 343.63 =$ ₹ 363.02 billions

Data on comparison of the two merger firms is presented in the Table 6.

Table 7: Market Share of Six Pharmacy Firms

S.No	Name of the Pharmacy Company	Market Share (%)	% of Market share out of 27.6	Market share
1	Cipla	5.3	5.3/27.6X100	19.00
2	Ranbaxy	5.0	5.0/27.6X100	18.00
3	Glaxo Smithkline	4.3	4.3/27.6X100	16.00
4	Piramal Healthcare	3.9	3.9/27.6X100	14.00
5	Zydus Cadila	3.6	3.6/27.6X100	13.00
6	ADBPL	5.5	5.5/27.6X100	20.00
	Total	**27.6**		**100.00**

Source: Religare Technova

To find out the right organization for the merger, the prospective risk and return from various alternative merger combinations should be estimated. While the historical data is used as input, a forecast of the return and the risk in the future that may arise after the mergers should be estimated. It is inferred that ADBPL with RANBAXY combination is the most suitable solution for taking up the PMI, as it indicates gain value of the newly merged firm (₹ 230.81 billions) rather than ADBPL with CIPLA (₹ (-)74.16 billions) combination.

HERFINDAHL-HIRSCHMAN INDEX (HHI)

The size of the newly merged company in relation to the market is very important, which means that the merger cannot

Table 8: Market Share of Two Alternatives

Particulars	Alternative	
	1. Market Share for six firms	2. Market Share for six firms
Piramal Healthcare	14%	13%
Zydus Cadila	13%	14%
GLAXO Smithkline	16%	18%
ADBPL	20%	18%
RANBAXY	18%	17%
CIPLA	19%	20%
Total	**100**	**100**

Source: ORG IMS

Table 9: Pre-Merger HHI		
Particulars	**Market Share**	**Square the MS for six firms**
Piramal Healthcare	14X14	196
Zydus Cadila	13X13	169
GLAXO	16X16	256
ADBPL	20X20	400
RANBAXY	18X18	324
CIPLA	19X19	361
Pre-merger HHI		**1706**
Source: Religare Technova		

Table 10: Post-merger HHI	
Particulars	**Square the Market Share for six firms**
Piramal Healthcare	196
Zydus Cadila	169
GLAXO	256
ADBPL with RANBAXY	1444
CIPLA	361
Post-merger HHI	**2426**
Source: Religare Technova	

lessen competition or result in monopoly as per the federal set. If a merger is anti-competitive, federal agencies will look at the market and consider the factors like size of the market, number of competing firms, etc. In order to know whether the firm is anti-competitive or not, the HHI is used. It measures the impact of the merger on the increased concentration in the market share. The HHI is calculated by summing-up the squares of individual market share for all firms and classifying the market concentration into three categories namely :

(i) Less than 1000 : An un-concentrated market,

(ii) 1000 - 1800 : A moderate concentration, if the change in HHI exceeds 100 points.

(iii) Above 1800 : Denotes a highly concentrated market if the change in HHI exceeds 50 points. Assume that there are six firms competing with each other in manufacturing pharmaceuticals and their respective market share are present in two alternatives. Data on market share of six pharmacy firms is presented in the Table 7. Based on the availability of the data, the researchers have determined the percentage of market share of each company, considering the total market share of six sample pharmacy companies is 27.6 per cent as 100 per cent.

☸**Step 1:** Calculate the pre-merger HHI for six pharmacy companies;

☸**Step 2:** Calculate the post-merger HHI for AR Limited firm;

☸**Step 3:** Calculate the change in points and compare with HHI categories. Here, HHI is below 1800 points, and the points of change exceed 100 points, which indicates that there is a moderate anti-trust concern. AR Limited is not supposed to do anything to defend their merger as not reducing competition in the case when point changes exceed 50 points.

FINDINGS

On the basis of the above analysis, four interesting points pertaining to two alternative merger combinations of ADBPL with CIPLA, and ADBPL with RANBAXY were observed: synergy value of ₹ (-) 74.16 billion is derived from value based planning in Aurobindo-Cipla Limited, while the derived synergy value of ₹ 230.81 billion is significant from value based planning in Aurobindo- Ranbaxy Limited. The NPV is positive when the ADBPL is proposed to merge with RANBAXY. Hence, the former can merge with the latter and emerge as Aurobindo - Ranbaxy Limited. Herfindaahl Hirschman Index (HHI) of ADBPL with RANBAXY (post merger) is below 1800 points, and the increase exceeds 100, which mean there is a moderate antitrust concern.

SUGGESTIONS

The forecast variable measuring the prospective return and risk-free as alternative post-merger combination is very important in the evaluation of the merger alternative. Apart from this, the managers should also recognize the reality gaps and cultural clashes and act upon culture issues on a war footing basis, so that the post-merger integration process would become a grand success through which the objectives of the M & A would be attained. In the light of this study, a suggestion is that in the process of M & A , if the proposed model of this study is adopted in the process, the failure rate of cross-border mergers can be averted to a great extent.

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