

**A STUDY OF CORPORATE TAKEOVERS IN
INDIA**

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The Indian economy has undergone a major transformation and structural change during the past decade or so as a result of economic reforms introduced by the Government of India since 1991 in the wake of policy of economic liberalization and globalization. In this liberalized era, “size” and "core competence" have become the focus of every business enterprise. Naturally, this requires companies to grow and expand in businesses that they understand well. Thus, leading corporate houses have undertaken a massive restructuring exercise to create a formidable presence in their core areas of interest. Mergers and acquisitions (M&As) is one of the most effective methods of corporate restructuring and has, therefore, become an integral part of the long-term business strategy of corporates. The M&A activity has its impact on various diverse groups such as corporate management, shareholders and investors, investment bankers, regulators, stock markets, customers, government and taxation authorities, and society at large. Therefore, it is not surprising that it has received considerable attention at the hands of researchers world over.

A number of studies have been carried out abroad especially in the developed capital markets of Europe, Australia, Hong Kong, and US. These studies have largely focused on different aspects, viz., (a) the rationale of M&As, (b) allocational and redistributive role of M&As, (c) effect of takeovers on shareholders' wealth, (d) corporate financial performance, etc. Some studies have also been carried out to predict corporate takeovers using financial ratios. M&As, being a new phenomenon in India, has not received much attention of researchers. In fact, no comprehensive study has been undertaken to examine various aspects especially after the Takeover Code came into being in 1997. This study has been undertaken to fill this gap.

OBJECTIVES OF THE STUDY

The study has been aimed at examining the M&A activity in India during the post liberalization period, in general, and post Takeover Code period in specific. Another objective of the study has been to test the usefulness of select financial ratios to predict corporate takeovers in India. Further, the study has also evaluated the post-takeover corporate performance of sample companies.

RESEARCH METHODOLOGY

The study focuses on three main aspects viz.: (a) corporate takeovers in India, (b) financial ratios as predictors of corporate takeovers, and (c) post-takeover corporate performance. The methodology followed for each of these aspects is different. Therefore, the same has been discussed in three parts:

(A) THE SAMPLE SURVEY

Using convenient sampling method, a structured questionnaire was circulated amongst top M&A consultants of the country. Finally, a total number of 20 responses could be obtained. The survey provided data related to various aspects of M&A activity in India. The major aspects covered are: (a) reasons for takeovers, (b) sectors witnessing takeover activity, (c) takeover process, (d) methods of valuation, (e) a set of financial ratios useful for predicting corporate takeovers, and (f) takeovers and stock market activity, etc.

The respondents included middle and senior level executives from organizations such as DSP Merrill Lynch, Rabo India Finance, Ernst & Young, Arthur Andersen, Mc. Kinsey, Deloitte Haskins & Sells, Kotak Mahindra, Ambit Corporate Finance, SBI Caps, and others.

Method of Analysis

The responses so collected were classified and grouped according to several characteristics and were presented in the form of tables to draw meaningful conclusions.

(B) PREDICTING CORPORATE TAKEOVERS

The Sample

Using convenient sampling method again, a sample of 37 target companies were selected for which open offers were made during 1997- 98 to 2000- 01 with an intent to change the management. The sample comprised of those companies for which required financial information was available for three years immediately preceding

the year in which the takeover attempt was made. A set of 37 control companies were also selected using the following three criteria:

First, the companies in the control group were in the same business as that of the target companies.

Second, each of the control companies had a market capitalisation of ± 50 per cent of that of the corresponding target companies.

Thirdly, the same source of information was available for these companies.

Data and Study Period

A set of eight financial ratios for three years immediately preceding the takeover attempts were collected both for the target and control companies from SEBI's website and Prowess. The period for which target companies were selected was four years i.e., 1997- 98 to 2000-01.

Methods of Analysis

The discriminant analysis was used to discriminate between target and non-target firms. The discriminant function proposed by Fisher was used for this purpose.

(C) POST-TAKEOVER CORPORATE PERFORMANCE

The Sample

A sample of 20 companies targeted during the year 1997- 98 was selected for examining the post-takeover performance. The criteria used for selecting the sample was that necessary financial information for three years preceding and three years succeeding the takeover was available.

Data and Study Period

A set of financial ratios for three years preceding and three years succeeding the takeover was collected from SEBI's website and Prowess. The target companies were those, which were targeted in 1997- 98.

Methods of analysis

In order to know whether post take over performance of the target companies was better or worse, mean values of the set of financial ratios for pre and post takeovers were compared and tested for statistical significance using t-test.

HYPOTHESES

The study tested the following hypotheses:

- Financial ratios can be used to predict corporate takeovers.
- Some ratios are better predictors of corporate takeovers than others are.
- The financial performance of the target companies does not improve significantly in the post acquisition period.
- The provisions of the Takeover Code have been frequently abused by both, acquirers and incumbent managements and needs further fine-tuning.

MAIN FINDINGS

The concept of M&As was not very popular in India till as recently as 1990s mainly due to the existing regulatory provisions. However, with the policy of liberalization and economic reforms adopted by the government, the competition became international in character and the 'size' and 'core competence' became the buzzwords for the Corporate India. The corporate sector increasingly resorted to M&As due to significant gains they entail in terms of synergy, economies of scale, better financial and marketing advantages, diversification and reduced earnings volatility, improved inventory management, increase in domestic market share, and above all capturing fast growing markets abroad. Since such a restructuring exercise should promote fair competition for the overall benefits of shareholders and consumers, regulations were thought to be necessary to govern this exercise. The SEBI, therefore, notified the Takeover Code in February 1997, which laid down the rules, which govern corporate takeovers in India. The findings of the study are discussed under five major headings, viz.(a) overall trends in corporate takeovers, (b) findings of the survey, (c) predicting corporate takeovers, (d) post-takeover corporate performance, and (e) the need for revamping the takeover code.

(A) OVERALL TRENDS IN CORPORATE TAKEOVERS

Since the Code came into being, the number of open offers increased from a mere 43 in 1997-98 to 77 in 2000-01 with the amount involved increasing from Rs. 578.81 crore to Rs 1426.85 crore during the same period. These open offers were mainly made with the purpose of effecting a change in management as approximately 62 per cent of the offers were made with this purpose during 1997-98 to 2000-01. The other purposes included consolidation of stake and substantial acquisition. A number of foreign companies or MNCs made open offers to get their shares delisted from stock exchanges. The response to the open offers has, in general, been poor but for those made by foreign companies. The size of deals has increased over the years with mega deals becoming the order of the day. The increasing number of hostile takeovers have offered substantial gains to investors which has been estimated to be in the region of Rs. 5000 crore in the first three years of the Code coming into being.

The major reasons for increased M&A activity were: (a) legal reforms, (b) economic reforms, (c) economic slowdown and depressed stock markets, and (d) change in shareholders attitude specially those of FIIs. The deep-pocketed multinationals added another dimension to the already hot M&A scenario in the country.

(B) FINDINGS OF THE SURVEY

The survey revealed that achieving synergies, economies of scale, obtaining strategic benefits and elimination of competition were the main reasons for takeover of a company. It was found that though telecom, cement and IT sectors are likely to witness increased M&A activity, the ongoing process of consolidation is likely to continue in banking, pharmaceuticals, media, FMCG, biotechnology and health care sectors. The other major findings of the survey have been summarized under the following heads:

(i) The Acquisition Process

While short-listing a target, an acquirer usually looks at the strategic synergies it offers, low valuations with low P/E multiple, unused resources lying with the target, turnaround candidates in sunshine industries and transnational presence of the target.

Besides the targets themselves approaching the acquirer in some of the cases, merchant bankers of the acquirer, their own research team, and M&A consultants were the main sources of information used to identify potential takeover targets. Though NPV is the most frequently used method applied in valuing the targets, some of the consultants used enterprise valuation and P/E multiple approach.

(ii) Takeovers and Share Price Behavior

In general, the acquirers were using a combination of stock swap, cash, and other instruments as the methods of payment for acquisitions, which largely depend upon the state of the stock market. Though state of the stock market was not observed to have any major impact on takeover activity, the markets do take note of any such activity by discounting the same in the share price of the target and the acquiring company. Whereas, pre-acquisition the share price of the target company either rise generally or it depends upon the perception of investors, post-acquisition it presents a mixed picture. The pre-acquisition share price of acquirer company depends upon the perception of investors about the acquisition being beneficial or not, post-acquisition it generally depends upon the success or otherwise of the acquisition. Share prices of target companies defending themselves usually rise more sharply than those on whom the takeover bid goes uncontested. An investor can earn extra normal returns by having prior knowledge of a takeover.

(iii) Financial Ratios Useful for Predicting Corporate Takeovers

In terms of the survey results, it was found that the consultants were not using sophisticated techniques for predicting corporate takeovers. In their opinion, the following ratios have better predictive ability of corporate takeovers:

- Modified Net Profit Margin or Operating Margin (EBIT/ Sales).
- Return on Capital Employed (ROCE).
- Debt- Equity Ratio.
- Assets Turnover Ratio.
- Current Ratio.
- Cash Flow to Sales.
- EV/EBITDA

- Market Price to Book Value (MP/BV).

(C) PREDICTING CORPORATE TAKEOVERS

The study used multivariate discriminant analysis to test a model to classify firms into targets and non-targets. The discriminating variables in the classification test are the eight financial ratios as listed above.

The Model

The multidiscriminant model used in the study is based on Fisher's approach, which considers the problem of obtaining a discriminating function where there are k populations (the two group of companies i.e. k=2) by finding the linear decision rule with respect to which the k populations would vary to the maximum. It assumes that the k populations have the same variance-covariance matrices. The multidiscriminant model is provided in the following equation:

$$Y = b_1X_1 + b_2X_2 + \dots + b_8X_8$$

Where, Y is dependent variable i.e. sample or control group.

b_1, b_2, \dots, b_8 are discriminant coefficients

X_1 to X_8 are independent variables defined as under:

X_1	=	Operating Margin
X_2	=	Return on Capital Employed
X_3	=	Debt-Equity Ratio
X_4	=	Assets Turnover Ratio
X_5	=	Current Ratio
X_6	=	Cash Flow to Sales
X_7	=	Valuation Ratio or EV/EBITDA
X_8	=	Market Price to Book Value

Empirical Results

The multidiscriminant analysis applied to the target and control companies was based on the mean ratios for three years immediately preceding the takeover attempt. The model was able to discriminate correctly to the tune of 62.2 per cent, which may be taken as moderate rate of success. The reasons for the model not showing a very high discriminating power might be associated to measurement error, specification bias,

and other technical reasons. It is, therefore, suggested that the model might be used for screening companies for takeovers rather than as a decision tool. This would reduce the number of companies for possible takeover to a manageable size.

(D) POST-TAKEOVER CORPORATE PERFORMANCE

The study analyzed the post-takeover performance of the target firms in view of confusing results on the effects of takeovers on operating performance, efficiency, and stock market response yielded by the existing academic work. For a sample of 20 companies targeted during the financial year 1997-98, the study compared the pre and post-takeover performance of these companies. While doing so, the same set of eight financial ratios was used as used to predict corporate takeovers. It was felt that the corporate performance ultimately is reflected in the financial results of the company and these ratios were considered representative to reflect all the five major parameters viz. Profitability, Liquidity, Solvency, Efficiency and Market Conditions. The mean values of these ratios based on a period of three years each immediately preceding and succeeding the takeover attempt were calculated and compared.

The two profitability ratios viz. EBIT/Sales and ROCE declined significantly in the post-takeover period. With the assets turnover ratio also showing a decline, the study concluded that both profitability and efficiency of target companies decline in post-takeover period. Though market response to takeovers appear to be encouraging, the liquidity and solvency position of these companies as measured by current ratio, cash flow to sales and debt-equity ratio do not present an encouraging picture. However, a 't' test applied to each of the eight ratios indicated that the change in post-takeover performance was statistically not significant.

The present study therefore corroborates the wealth of research done abroad to suggest for a cautious approach to the use of the takeover mechanism and a lively awareness of the costs takeovers impose as well as its limitations as a tool for improving corporate performance. Takeovers do have a role to play in cases of proven management failure such as 'sick companies', but their widespread use in a relatively unsophisticated market such as ours is fraught with risks that are hardly justified by the ambiguous evidence elsewhere regarding the benefits of takeovers.

(E) NEED FOR REVAMPING THE TAKEOVER CODE

The study found that there are a number of problem areas that needs immediate attention of the regulators to make the Code more meaningful in the interest of investors at large. Certain exemptions such as preferential offers and stake transfer to co-promoters have been misused by the incumbent managements and should be brought under the purview of the Code. The terms such as 'change in control', 'persons acting in concert' and 'promoters' need to be clearly defined. Another area of concern for small investors is the provision relating to open offers mainly its size and pricing. There is an absence of simple and transparent regulations and a high degree of adhocism and confusion on how the changes in ownership stake at the global level affect the application of the Code. The present creeping acquisition limit of as high as 10 per cent hardly leaves any room for raiders to put the inefficient managements on their toes and should be reduced. However, special provisions should be made for professionally managed companies without any identified promoter group to protect them from hostile takeovers.

SEBI should also provide for better disclosure norms governing corporate M&As. The role of financial institutions in the case of a takeover should be well defined. The provisions for bailout takeovers should not limit competition and bring maximum benefits to financially weak companies thereby benefiting the economy. The issue of disinvestment of PSUs needs to be elaborately addressed in the Code

IMPLICATIONS OF THE STUDY

The study has important policy implications as far as the allocational and redistributive role of takeovers is concerned. The study can be used to the advantage of most of the diverse groups that are likely to be affected by a possible takeover. For instance, investors may be able to earn larger gains if they have prior knowledge of a takeover. Managements could identify potential acquisitions to plan their growth strategies or prepare a defense against possible future hostile takeovers. Regulators can be more alert in checking undesirable practices such as insider trading and can ask for more transparency in such deals.

SUGGESTIONS FOR FURTHER RESEARCH

The following are some of the areas that need to be explored further in the Indian corporate settings:

- Impact of takeovers on corporate governance.
- Impact of takeovers on competition.
- Analysis of managerial styles of corporate raiders.
- Takeovers and corporate disclosure practices.
- Takeovers and corporate restructuring.
- Takeovers and share price behavior.
- Takeovers and role of FIIs.
- Methods of financing takeovers and post-takeover performance.

CHAPTER SCHEME

CHAPTER 1: INTRODUCTION

CHAPTER 2: MERGERS & ACQUISITIONS: A THEORETICAL FRAMEWORK

CHAPTER 3: TAKEOVER CODE: A CRITIQUE

CHAPTER 4: TAKEOVERS IN INDIA: TRENDS & PROGRESS

CHAPTER 5: CORPORATE TAKEOVERS IN INDIA: THE SURVEY

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CHAPTER 7: POST-TAKEOVER CORPORATE PERFORMANCE: EMPIRICAL RESULTS

CHAPTER 8: SUMMARY AND CONCLUSIONS