FINANCE AND INVESTMENT CELL
SHRI RAM COLLEGE OF COMMERCE

MERGERS & ACQUISITIONS

VOLUME-3

1. STAKEHOLDERS IN M&A DEAL
2. WHY DO BIG COMPANIES ACQUIRE SMALL STARTUPS ?
3. WHAT DETERMINES THE FATE OF AN M&A DEAL ?
4. RECENT MERGERS AND ACQUISITIONS

CONTRIBUTORS:

Harsh Singh, Himanshu Chhabra, Jayesh Gautam, Parth Kulkarni, Raghav Laddha, Sarvesh Agarwal, Tanish Bansal and Vidhya Sriram

STAKEHOLDERS IN M&A DEAL

Generally acquisitions and mergers are seen like a one dimensional issue, purely for the purpose of solving problems faced by a business or to benefit from the synergy effect. Achieving synergy means the combined productivity of the firms would be greater than the sum of their individual productivity. The efforts of various groups of people must be co-ordinated with the view of achieving a single goal. Achieving this goal through synergy requires *clear communication of the implications of an acquisition to impacted groups*. It is here that we must realize the **importance of stakeholders**; they are *an essential element and must not be neglected at any point.* The decision to merge or acquire still remains a business one but it's impact on stakeholders and their reaction to the impact would determine whether the merger or acquisition was successful or not.

The stakeholder model:- It requires that *"all of the parties affected by management decisions, in addition to the shareholders themselves, management, employees, customers, suppliers, communities in which the business operates and the environment from local to global, all must be considered as fairly and justly possible ."*

So let us see which stakeholders we are talking about here.

1. **Employees**

   Perhaps the most important stakeholder of this process would be employees of the organization as *their reaction would determine whether the move would be a success or a failure.* Historically it has been observed that the employees of an organization always *panic during this process* (at least up until recent times), ***mainly because this process may lead do a mass scale downsizing to cut costs, optimize output production, etc***. This is generally seen as a positive sign for shareholders but not so much for the employees. *This ends up reducing the overall efficiency of employees.* The other side of it is that of the amount of workers are not brought done to the optimal amount the costs of the firm would be unnecessarily high.

   So where does this leave us? The general idea is for the organization to *take its employees into confidence before going for a merger or acquisition.* The panic is a lot less when they get to know about this move beforehand and preferably through some formal mean of communication by the top management. ***A popular example of these stakeholders affecting a merger/acquisition process would be that of Kraft and Cadbury.*** The companies witnessed a hostile reaction from its employees which gained further traction through media and resulted in a PR crisis for the companies. However, this was not enough to convince a separate group of stakeholders (namely the shareholders of Cadbury) to not go for the process.

2. **Customers**

Another important stakeholder would the customers of a business. One of the major reasons for M&A would be for gaining market share; *however during the process of an M&A the management may be busy with legal formalities, public image and other internal issues and might neglect their customers.* The competitors of the firm may see this as an advantage and try to increase their market share thereby defeating the purpose of the M&A itself.
Another issue is perhaps the image of the company that the other company is planning to merge or acquire. As seen in the ***case of Lóreal and Bodyshop***. The customers of Bodyshop were not happy with the company as Lóreal was infamous for animal testing and Bodyshop is a company which is proud to declare that they don't test their cosmetics on animals. In such a case the customer base would end up being dissatisfied and the M&A might prove to be very costly.

3. **Lenders**

Now let's look at the lenders, ***it should be noted that no debt could be forgone in an M&A process.*** The company acquiring would be liable for the debt in case of acquisition and both the companies would be liable in case of a merger. *From the lender's point of view, if the company is not doing well they would definitely want a larger company to acquire or merge with the company.* They would be interested in the growth projections post the M&A process to determine whether they would be able to service their debt. *Selection of lenders for the M&A process is also important as more prestigious underwriters are associated with positive outcomes, such as completing deals faster.* Banks as lenders may also be interested in marketing other services, *for example* ***Barclays Capital agreed to pay Del Monte shareholders*** *almost $90 Million following allegations of conflict of interest, they steered the sale of Del Monte to bidders using it for financing.*

4. **Competitors**

These are an ***external type of stakeholder***. One of the basic feature of an Oligopoly market is that ***the action of one of the market seller would have the other market leaders reacting to it.*** The same may be the case in a M&A process. Since M&A have to be announced publicly the competitors would be aware of it and would see this both as a threat and an opportunity. *The competitors could try to* ***capitalize on the inefficiencies*** *in an M&A process*, they may change their supply pattern or launch new products, come up with new marketing strategies. Additionally it has also been seen that the *competitors see this as an* ***opportunity to recruit the employees of the companies going through an M&A process*** *as generally there is fear of downsizing among the employees of the organization*. There have been cases where there have been a massive shift in workforce of a company going through an M&A.

5. **Vendor**

These are the supplier of raw materials or other resources required in a firm. The suppliers generally only care about timely payment of their dues *if they feel that the merger or acquisition could* ***put the payment of their dues in jeopardy****, they might object and go to the extent of cutting supplies which may pose further challenges for the companies.* It is not uncommon for the vendors to maintain updated credit data of the companies. However vendors would be looking for more information about the process and future growth projections of the concern. Communication with vendors is another key piece of the overall co-ordination of the entire progress.

6. **Shareholders**

Last but perhaps the most important stakeholder would be the shareholders. Why is it that they are so important? Well looking at the ***Kraft-Cadbury example we would realize that the final say for the M&A, at least to a certain extent remains that of the shareholders.*** The employees protested but the shareholders of Cadbury were not convinced and pushed the decision through. Every shareholder has some say in the management. Thus the final decision rests in their hands, *if they feel a certain decision could affect their wealth adversely they might go against other stakeholders to save their wealth. The voting power is also diluted for both the firms in case of a merger.* In case of acquisition the loss of power of the company being acquired is greater than that of the acquiring company.

Initially it was believed that M&A should be beneficial for the shareholders according to the perfect market hypothesis. However ***empirical evidence suggested otherwise***, it was observed in a research that *acquiring firm shareholders actually lost 10% of their wealth in the post 5 year period.* There are many other examples which suggest that in the long run the shareholders may end up losing the market value of their shareholding due to various factors such as problems in servicing new debt, problems with integration of various components of the target firm, cost of acquisition, etc. Let's look at the short run picture though. *In the short run, in most cases there are always gainers and losers.* In case of a merger the there is significant volatility in share price in that of the acquiring and that of the target firm too. ***Generally the acquiring firm sees a drop in its share price and the target firm sees a rise. The stock price of the new firm is always higher and beneficial for the target firm's shareholder (through stock price arbitrage).***

WHY DO BIG COMPANIES ACQUIRE SMALL STARTUPS?

We often hear the news of large companies acquiring smaller startups to fasten their growth. It's like the large fish occupying the colonies of the smaller fishes in the pond. But why would they do that? Why can't the big fish create its own colony? Why can't the big companies create the copies of the startups which they want to buy and not spend millions and billions to buy them?

Here is a look at some of the plausible reasons for the same:

1. Difficult to enter the market with a leader already

A new acquired product will create a new market. For example, MySpace. Before its immense success, there was no social media market to speak of. But after MySpace became a household name, it was very hard for newcomers (including media companies with other specializations) to cut out a niche in this market.

This is the reason why in 2005 Rupert Murdoch thought it was feasible to buy MySpace for $580 million instead of building his own platform. Of course, now we know that at that time, one-year-old Facebook would have been a better acquisition, *but hindsight is 20/20*. (That is another lesson to be learned: you are never sure what the future will bring for an acquired startup.)

2. To make their foes(competitors), friends

One is aware of the fact that you have to keep your friends close, and your enemies closer. Translated to the world of business, the acquisition of a promising new business can be *killing two birds with one stone*: corporations add to their portfolio with a great new product, and they take their competition out of the market at the same time.

3. They Want the Talent

One of the most valuable factors of a company is the talent pool. A big company can afford company can attempt to buy out the best people of an emerging business, but that can cost a lot of time and money. Furthermore, chances are that these employees work perfectly together, so it can be risky to disrupt the equilibrium that they have established among themselves. Hence, buying the whole startup in one fell swoop may be the most inexpensive and efficient method to get great talent on board.

4. To acquire the start ups' clients

It's a well-known fact in the business world that **65 percent of a company's business comes from existing customers**. Especially *when we are talking about niche markets, acquiring a startup can be the most cost-efficient method* for a big company to get their hands on a high-end customer list.

5. Simple

Sometimes it is very simple: the big player has the money; the small startup has the talent and the ideas. **By teaming up, both parties gain something.** It is the same reason why you don't grow your own food,

but you go to the grocery. It is just how the economy functions in the most efficient and elegant way.
Other reasons why companies would acquire startups are *Financial synergy for lower cost of capital, Diversification for higher growth products or markets, Strategic realignment and technological change, Tax considerations, Undervalued target, Diversification of risk.*

Principle behind any M&A is 2+2=5

There is always synergy value created by the joining or merger of two companies. The synergy value can be seen either through the Revenues (higher revenues), Expenses (lowering of expenses) or the cost of capital (lowering of overall cost of capital).

Google and Android

For instance, In 2005, Google acquired Android for an estimated $50 million. At the time of the deal, Android was an unknown mobile startup company. The move made it possible for Google to compete in a market owned by Microsoft with Windows Mobile and Apple's iPhone. This deal is a successful acquisition example, 54.5 percent of U.S. smart-phone subscribers use a Google Android device as of May 2018

The Downside

But, Mergers and Acquisitions, inherently, have a failure percentage too. Similar to a marriage, there can be many reasons why it can fail. *Like a person, every company has its own distinct personality: its policies, work culture, marketing and advertising strategy, strengths and weaknesses, employees, etc.*

A disaster gone completely wrong, this is one of the classic cases of a failed marketing strategy. In 1993, ***Quaker bought Snapple*** for almost USD 1.7 billion. Quaker was backed by its success from the 'Gatorade' drink. When they took over Snapple, they employed a marketing strategy that could have worked good for big brands. Snapple, though popular, was a local brand, and people liked it in small bottles. On the other hand, Quaker introduced the new Snapple in bigger bottles, which failed miserably. Their Ads also did not feature Wendy Kaufman, popularly known as the Snapple Lady. ***Quaker finally sold Snapple to Triarc Companies for $300 million.***

Conclusion

When a company is looking to expand, one way many business owners consider doing so is through the acquisition of another similar business. An acquisition is a great way for a company to achieve rapid growth over a short period of time.

While an acquisition can create substantial and rapid growth for a company, it can also cause some problematic issues along the way. Several things can go wrong even when there is a well-laid plan. There may be a clash between the different corporate cultures, synergies may not match, some key employees may be forced to leave, assets may have a lower value than perceived, or company objectives may conflict.

Before putting the acquisition of another business into consideration, it is essential to analyze the advantages and disadvantages that will be presented by the business deal. A well-executed strategic acquisition that takes advantage of potential synergies can be one of the best ways for a company to achieve growth.

WHAT DETERMINES THE FATE OF AN M&A DEAL?

REASONS FOR SUCCESS

With increasing number of businesses aiming to diversify its portfolios off late, mergers and acquisitions have turned out to be a masterstroke for quite a few of them. In this section, we examine some of the key factors in the success of a merger or an acquisition:

1) **Cultural compatibility**: The key to a successful merger is determining which culture to merge into which. *Co-creating a brand new culture from scratch is a lot of hard work with a relatively low probability of success.* Corporate culture is the only truly sustainable competitive advantage and the root cause of any merger's failure or success. This entails making clear choices about the new, combined entity's behaviors, relationships, attitudes, values and environment and then insisting on embracing those choices as a condition for staying on board.

2) **Due diligence**: After having done the strategic planning, intending acquirers should conduct a thorough due diligence exercise of the target covering its financial statements, strategies, business plans, resources and operations of the entity to ensure the compatibility of the target company and an assessment of any risks associated with the deal. For instance, *analyzing the business connections of the principals or political risks involved in making the acquisition, especially in cross border acquisitions*

REASONS FOR FAILURE

Technically Mergers and Acquisition are intended to unify the individual strengths and create a strong market presence. However, data says that minimum 60-70% of all M&A's is a failure. Of the many reasons, this article explores key few factors:

1) **Mismatch of Culture:** An organization's culture and values get established over many years of being together and growing together. Each shall have its own set of values, focus areas and beliefs. When *organizations that have radically different working culture unite, the first effect is huge attrition of prominent human capital.* ***Sprint's acquisition of Nextel Communications*** in 2005 is a classic example of this. Sprint was bureaucratic, while Nextel was more entrepreneurial.

2) **Financial Failings and high cost of M&A process:** How much ever all business aspects are checked before a merger, the actual situation is evident only after the M&A. *The financial strength depicted in the books and the actual numbers might completely different.* ***Bank of America's acquisition of Countrywide*** is a classic exampl

3) **Integration planning**: Having done the deal the integration process needs to run smoothly for the merger to take place and to reap the benefits from the synergy. This involves finalizing a common strategy for the new organization, consolidating duplicative services such as human resource, consolidating compensation plans and corporate policies, deciding on what level of integration should take place, who will govern the organization, what authority people will have etc.

4) **Value creation**: The fundamental premise of any merger is that the merging entities will be more valuable together than they are separately. *The combination of the two companies needs to produce synergy.* If this was a math equation, it wouldn't necessarily look like the typical 1 + 1 = 2. ***With a merger and acquisition what is required is synergy in the form of 1 + 1 = 3*** or more. When you merge cultures well, value is created. When you don't, value is destroyed.

From the above we can surmise that the key to a successful M&A exercise is when the strategy of the management is strong enough to ensure that there is synergy benefits in such merger and acquisition along with the cultural compatibility between the entities involved. It is also important that the plan is executed with enough speed to ensure that the momentum is maintained and that the business and operation of the new entity is not disrupted and attention not distracted by rumors and uncertainties

3) **Leadership and undervaluing the importance of Human Capital:** An efficient leadership that can stand the biggest challenge of change management and synergise the strengths of the individual organizations involved is a very crucial requirement which misses out in most of the M&A cases. At the foundation all functions and entities is the human capital, without which every other strategy fails and fades out. *Careful analysis of individual strength and role allotment is a laborious but imperative process which gets overlooked in the Mergers.*

4) **Customer Focus:** When organizations fail to look at the merger from the customer's point of view and to their comfort level and benefit of the impending merger, the entire Customer focus is lost. *The unification should be a smooth process for the customer too in relation to access to data, clear communication and continued service*. ***20% customers of First Union Bank were lost after it acquired CoreStates Financial in 1997.***

RECENT MERGERS AND ACQUISITIONS: SECTOR-WISE LARGE M&A's IN INDIA

BANKING: Bandhan Bank and Gruh Finance Ltd.

Gruh Finance Ltd, an HDFC promoted NBFC was acquired by Bandhan Bank in October 2019

REASONS:

1. Gruh Finance is one of the only non banking entities with strong financials and a consistent AAA rating
2. Bandhan Bank seeks to diversify lending and can effectively do so through a readymade home finance entity, with a strong deposit and infrastructure base.

SIZE:

1. The deal was made at 13.3 times the book value, for 84000 crore
2. The new combined entity will have a net worth of Rs 11800 crore (up from 10200) and a combined loan book of Rs 50000 Crore (up from 33000)

IMPLICATIONS:

1. The merger creates a very large suburban and rural lending platform in the country – with Bandhan bank having a strong base in the east, and Gruh Finance in the west
2. Bandhan Bank will now provide credit in diversified segments as its unsecured loans will go down from 85% to 57%, although its return on assets is expected to contract.
3. HDFC earns a very good premium on a much smaller book value

MEDIA AND ENTERTAINMENT: Disney and Star TV

Walt Disney Ltd acquired a controlling stake in 21st Century Fox in a deal finalized in early 2019. The procedural aspects of the acquisition are underway.

REASONS:

1. Disney's response to the streaming war started by Netflix, Amazon Prime, and other platforms was to consolidate its position and launch its own streaming service Disney +. As a result it acquired control of Fox, and consequently Hulu, Sky TV, and the Indian Star TV to create content for the platform

SIZE:

1. The deal was finalized for a whopping $71 billion

IMPLICATIONS:

1. Disney is now the world's largest content creator, surpassing Netflix's capacity
2. Disney also enjoys a share of 35% in box office revenues in Hollywood
3. Disney now controls the Star Network, which entails a viewership of 790 million over 60 channels in the subcontinent

E-COMMERCE: Walmart and Flipkart

Walmart acquired a 77% stake in Flipkart in 2018.

REASONS:

1. Walmart wanted to enter Indian markets to compete against E-commerce giant Amazon, a strong global competitor

SIZE:

1. Flipkart, which was then India's largest E – commerce platform and was valued at around $20 Billion, sold 77% stake to Walmart for $16 Billion

IMPLICATIONS:

1. The acquisition signals the exit of the founder- promoters of Flipkart
2. Flipkart has 40% market share, and Amazon.in is very closely behind, so now there is intense competition resulting in low prices
3. The formal entry of two American retail giants signifies a revolution in the e – commerce industry, indicating cut – throat competition for small suppliers and other platforms.

OIL AND GAS: ONGC and HPCL

Oil and Natural Gas Corporation acquired a controlling stake in Hindustan Petroleum Corporation Ltd in late 2018, and the final procedures were completed in August 2019

REASONS:

1. On the government repealing the acts that nationalized HPCL and BPCL, ONGC acquired a 51% stake in HPCL in order to benefit from synergies and common business models, andincrease crucial traction in oil and gas.

SIZE:

1. The deal was finalized for Rs 37000 Crore

IMPLICATIONS:

1. ONGC was listed as a Fortune 500 company after the acquisition
2. ONGC now controls around 65% market share, and runs around 18000 kilometres of pipelines in the country

However, ONGC went from being debt free and relatively clean to now debt ridden, and seems to have reaped no tangible benefits from the merger. It is rumoured ONGC plans to sell a share of its stake in HPCL, after conflicts about shareholding pattern and the board of directors arose between the two giants.

STEEL: TATA Steel and Bhushan Steel

Tata Steel's subsidiary Bamnipal Steel acquired a 72% stake in Bhushan Steel in May 2018

REASONS:

1. Bhushan Steel had declared insolvency, and Tata Steel sought to acquire the bankrupt unit to strategically up its steel production game

SIZE:

1. The total payout amounted to Rs 35,200 Crore after IBC requirements were met by Bamnipal Steel

IMPLICATIONS:

1. Tata Steel increased steel production from Bhushan Steel's largest plant in Odisha from its earlier level of 3.5 million tonnes to 4.5 million tonnes
2. Among a few other factors, control of Bhushan Steel assets was a major contributor to the 17% increase in Tata Steel's annual steel production in the last fiscal year

FMCG (*Pharma*): HUL and GSK

Pharmaceutical manufacturer GlaxoSmithKline Consumer Healthcare decided to merge into Hindustan Unilever Ltd in a deal finalized in January 2019.

REASONS:

1. GSK Consumer Healthcare was the leader in the Health Food Drinks category, with brands like Boost and Horlicks, and HUL sought to expand and consolidate its leading position in the FMCG sector

SIZE:

1. The deal was finalized for Rs 31700 Crore

IMPLICATIONS:

1. HUL, which is a giant in the consumer goods industry with a total average market share of 39% amassed through 35 brands, gained control of Horlicks and Boost in the Health Food Drinks category, along with Sensodyne, Eno, and Crocin in Over the Counter and Oral Care Medicines.
2. GSK gained a stake of 5% in HUL, which it is free to offload to any other investor as well.