A Challenging Environment for Mergers & Acquisitions

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The past eighteen months have witnessed a precipitous decline in global merger & acquisition (M&A) activity, in sync with the world-wide economic slow-down. At the first half mark of 2002, the total value of global M&A deals had fallen 56% - from $1,020 billion in the first half of 2001 to $448 billion – reaching a level last seen in 1997. The decline has been across sectors and geographies, demonstrating that business confidence is the most important ingredient in deal making. Clearly challenging times turn CEO's to an inward cost focus - away from the world of aggressive revenue growth & geographical expansion.

From an Indian perspective however, the strategic need for M&A to lend greater focus to our most important industrial conglomerate groups remains unchanged. We can not afford to postpone M&A moves, unlike the western CEO's who have temporarily turned inward focussed. But despite the strategic aspect of M&A, things have been much worse locally. India M&A volumes in the first half of 2002 declined to $2.4 billion from $2.9 billion in 2001 first half. If related mergers are excluded the decline is much more steep.

FDI has always been a very important M&A driver in India and it is understandable that in the current global environment it has been adversely impacted by uncontrollable external factors. But the bigger issue in India is that we abound with several country specific aspects that are, to put it mildly, very unhelpful.

The foremost adverse local factor in India is the uncertain domestic policy environment. PSU dis-investment is the most visible economic reform program currently but continues to elude consensus within the government. Our inability to materially change our economic laws & rules and our constant refrain of shibboleths have become deep negatives; in optimistic times FDI investors suffered our ills but in bad times they are less patient. Every investor has cited our stultifying procedures as a grossly irritating aspect of doing business in India but this has not moved our bureaucrats to act. Likewise, unsustainable deficits constitute a real threat to our macroeconomic stability, but no solutions are being seriously pursued. Border tensions have been a concern but Law & order events in Gujarat did far more damage by enhancing the political risk perception of India.

It is not surprising that the proportion of cross border Indian M&A deals fell from 63% in 1998 to 35% in 2001.

Indian acquirors were also not as prolific. Local corporates continued to suffer from the effects of the decline in the domestic capital markets. Delayed acquisitions was an important theme of the market last year. Additionally, as a consequence of the weakness in equities and general illiquidity, stock as a form of consideration has lost favor with target company shareholders. Acquiring companies thus are being forced to make acquisitions for cash, which has always been difficult to raise in the form of mezzanine financing.

Corporate governance issues and accounting irregularities in the United States have had some impact here. A recent survey of Indian Chief Executives found that a large proportion of those surveyed felt that the problems were not limited to the United States. This environment of skepticism has proved challenging for merger & acquisition activity as potential acquirers question the financial reporting of target companies.

The prospects and timing of a broad-based economic recovery remain unclear. Certainly, a large number of economists are pointing to the elusiveness of an economic recovery as an indication that there may not actually be a significant rebound until 2003. As demand remains weak in most sectors, companies have been forced to rationalize their operating cost structures and are thus focussing internally at present before embarking on proactive consolidation strategies.

Despite the extremely challenging environment for M&A, there are some silver linings. First, the central Government has shown a sustained commitment to the privatization of state-owned companies. The last year was marked by several big-ticket privatizations such as those of IBP, VSNL, Maruti Udyog, and IPCL. The Department of Disinvestment also seems determined to push through the privatization of oil majors HPCL and BPCL, as well as partially monetize the cross-holdings between the oil majors.

Second, domestic valuation levels remain attractive for aggressive acquirers who view the current period as an opportunity to consolidate. Indian companies of comparable vintage across sectors continue to trade at significant discounts to their global peers. The sustained attractive pricing of potential targets should spur M&A activity.

Third, the current fundamentals in certain sectors necessitate consolidation in order to maximize shareholder value. We view the financial services, pharmaceuticals, and energy sectors as areas that should witness significant consolidation activity due to the capital-intensive nature of the industries and the derivative benefits of scale. Each of these sectors is still fragmented and we see attractive opportunities for consolidation in these sectors.

Figures: KPMG & IAP

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