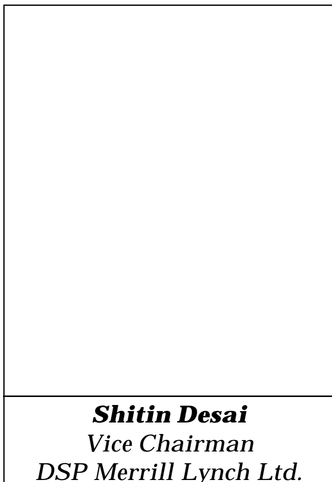
Emerging Trends in Mergers & Acquisitions



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Why has the corporate sector been looking to restructure by tapping the mergers and acquisitions (M&As) route? Survival of the fittest in the face of increasing competition and creation of shareholder value is the name of the game with increasing competition created through the increasing integration of markets. Excess capacity increases competition, drives down profits and reduces growth. As the dynamics of economics and government policies do not permit corporates to function in oligopoly set ups, the chosen route taken to maintain a competitive edge and achieve growth is through following the M&A route.

A variety of strategic imperatives have been driving companies toward mergers and acquisitions. They include consolidation, increasing integration of markets, capital market expectations, product differentiation in line with customer demands, vertical integration, technology requirements, strategic change in focus, and rehabilitation of loss-making units.

"Global M&A activity reached a record US$ 260 bn in the first quarter of 1999, exceeding the previous record of US$ 207 in the second quarter of 1998."[1]

India currently accounts for only a tiny fraction of this activity. But this is bound to change with mergers and acquisitions occurring from both ends, that is, on the part of Indian companies as well as multinational companies eager to enter the Indian market.

The key drivers of M&A activity shall be explained in brief before moving on to the emerging trends within the mergers and acquisitions scenario in India.

Key imperatives for corporates to take the M&A route:

Consolidation: The aim is to achieve cost savings through economies of scale and increased market power. For example, in the oil industry, the real rationale lies behind cost cutting, besides consolidation to create big firms that can survive in such a cyclical industry. "Research has shown that return on capital goes up as the concentration index rises. This has been especially proven in the cases of the pulping industry, air-compressors and pharmaceuticals."[2] The best way to improve return on capital is to expand outside mature markets, where competition is intense. Companies such as British Petroleum and Amoco, with an international presence, have clearly outperformed those with just a domestic focus.

Increasing integration of markets: The pressures of competition have intensified in recent years, due to the increase in global trade. A good example is the Renault and Nissan. With global overcapacity of 30% within this industry, the merger will facilitate Renault to tap the Japanese commercial vehicle market and Nissan to tap the European passenger car segment. With prices falling faster than productivity gains, volume producers will face massive gaps between revenues and costs; hence, consolidation of operations makes immense sense.

Capital market expectations: If a company believes that the market would look favourably at the prospect of a merger, then such a belief in itself becomes a justification for a merger. In a bullish market, as is in the mature Western markets currently, such a development would be received positively. The fact that chief executives enjoy stock options as part of managerial compensation is an added attraction.

Product differentiation in line with customer demands: The more product differentiation that is offered in line with customer demands, the greater the ability to fight retailers. The Grand Metropolitan and Guiness merger which created Diageo, now has 18 of the top 100 wine and spirits brands. Ciba and Sandoz that created Novartis and Hindustan Lever and Lakme may also be sighted are other such examples.

Vertical Integration: Nortel and Bay Networks that created Nortel Networks sights vertical integration as an imperative for M&A activity rather well. The deregulation of the telecom industry globally, has resulted in a considerable amount of M&A activity.

Technology requirements: In the global pharmaceutical industry this is one of the key motives for companies to tap the M&A route. Hoechst and Rhone Poulenc and Astra and Zeneca are some such

examples. Also within the global information technology industry, the inability to keep pace with the dynamism of technology was the key reason for the Digital and Compaq merger. Compaq's hold in the lower-end product segment and Digital's strengths in mini-computers were brought together by the merger.

Strategic shift in focus: By acquiring Polygram from Phillips, Seagram moved from the low-margin spirits business to the high margin media segment.

Rehabilitation of loss-making units: With the industry friendly proposal in the FY99 budget, permitting the offsetting of losses of a loss-making company with profits of a profit-making company, as business restructuring is proposed to be made fully tax neutral, might cause an increase in the number of M&As in India.

Having highlighted some of the key imperatives for corporates to turn to the M&A route and some of the big deals conducted, there are some questions that remain unanswered. How many of these will really add value? How many are really worth the price paid? How many would achieve the full benefits of integration?

The Indian Scenario:

Nearly 90% of M&A activity reported abroad is of the friendly variety. This is usually the result of an informal decision between the heads of the two companies to merge their operations into a consolidated organisation if they believed this would benefit both companies. This is a much easier process than would be the case with promoter-managed companies that exist within the Indian scenario. The latters' personal ownership stake should in the normal course inhibit any logical judgement on such a 'sensitive' issue. Hence, one would expect each one to carry on with their businesses until and unless mounting losses or pressures from financial institutions compels them to turn to the M&A route.

Indian corporates have settled M&A deals only through cash. Shareholders are still opposed to the idea of stock transactions, as opposed to that abroad, where lately around "51% of M&A transactions were settled through stock transactions, around 30% through stock and cash, and the balance through cash"[3] . Indian shareholders prefer cash to stock. M&A activity would multiply if stock transactions were acceptable to target company shareholders.

The 'capital market expectations' justification for M&As does not yet apply in the Indian scenario. There are only a few professional managers who enjoy stock options as part of managerial compensation. But most importantly, the Indian capital markets at present can hardly be described to be in a bull phase, vis-à-vis the US markets at present.

Mergers in the West have been aided by the attitude of institutional investors, made up largely of pension and mutual funds. They have generally preferred to vote with their feet, whereby, they could take up the offer of a hostile bid that is attractively priced. The Indian scenario does not inspire much confidence here, with the institutions being largely in the public sector. With fraudulent capitalism having developed between politicians and bureaucrats on the one hand, and promoters on the other, these institutions are not likely to encourage any hostile bids. This is the case until the company in question posts huge losses, if at all, which then becomes a BIFR case. However, this is slowly, but surely, changing as will be explained later.

As private mutual funds are now actively exercising their voting rights, they will be expected to influence the growth of the market for corporate control. This process should gather momentum once public institutions are privatised and the mutual funds sponsored by them vote independently on takeover bids.

Once Indian corporates realise that hostile bids become inevitable, friendly mergers would become a common phenomenon as in the West. But that seems unlikely in the near future.

Emerging Trends in M&A in India :

There are several distinct trends that are emerging which will decide the quantum of M&A activity in India in the near future.

1. There is ever increasing competition from local and foreign players. We have seen a large number of world multinationals come into the country either through joint ventures or through acquisitions. We have seen the case of Wipro-GE Medical Systems or Coke-Parle. There are a whole series of multinational companies that have come into India since liberalisation and there are a lot more waiting to get in. It is going to mean more competition for the domestic players.
2. Shareholders are organising themselves, by becoming more proactive in shareholders' meetings. The entry of foreign institutional investors (FIIs) has also placed corporate performance and corporate governance in focus. The cost of capital is being increasingly linked to management performance. No longer will large FIIs invest in companies that do not show performance and do not abide by the norms of corporate governance. FIIs are increasingly going to vote with their feet and constantly monitor management performance. With the privatisation of institutions, there would be even more pressure on companies to perform. Financial institutions and mutual funds are beginning to face the importance of corporate

governance and shareholder value. The case of India Cements acquiring Raasi Cements highlights this.

3. The depreciation of the rupee means that it is becoming cheaper for the international players to acquire Indian companies and that again may be viewed as an opportunity as well as a threat. There are also some attempts by Indian players to go global, for example, in the pharmaceutical industry, Ranbaxy, may be sighted as a key example.
4. Financing has now become less of a barrier for M&A activity. Macniel and Magor took over Union Carbide by making a public issue with the clear objective of acquiring another company. This was the first time that this has been done. India Cements too financed part of its takeover through part of a rights issue.
5. Another recently observed trend is the monopolisation of joint ventures by foreign partners. With liberalisation, though three routes were available for foreign participation - joint ventures, 100% subsidiaries, and technical collaborations, a number of multinational companies (MNCs) have tested the Indian industry through joint ventures. By now, volumes have been written about joint ventures in India. We have also observed that joint ventures need not be permanent, and can fall through after a while. But one major point that seems to have been missed is the growing preference amongst MNCs to ultimately survive on their own. This trend seems to have caught on in the automobile sector especially. The ongoing M&As, through constant restructuring, will have an impact on Indian industries in two ways. Firstly, large MNCs that have already entered India will change their plans as some of them will cease to be competitors due to acquisition of each others' stocks. Secondly, Indian firms will need to respond to the new situation and reformulate their strategies. Just at the beginning of 1999, the Mahindra Ford joint venture was called a perfect one. However, Ford wanted more money pumped in, which M&M could not or did not want to by wanting to focus on its core business.

   What compelled an end to the tie-up? Global majors normally do not have knowledge of local markets, contacts and established distribution systems. There are also Indian sensitivities towards MNCs. But as they grasp the 'know-how' of functioning in these markets, their intentions on joint ventures seem to undergo a revision. Strategic concerns such as assuming leadership of the company's business plans and strategy and maximisation of profits by expanding market share, take on prime importance. It is a well known fact that the MNCs are awash with funds, and a majority of them have long term goals and the financial muscle to sustain losses for some time during the initial stages, in view of the long term gains. MNC operations are normally large and directed by the attractiveness of opportunities in the domestic and, if necessary, export markets as part of their desire to develop their global operations and, thereby, create a global synergy. They are constantly searching for new markets and resource bases to maximise their profits and minimise their costs.

   Hence, even with news on Indian companies buying out their foreign partners (for example, Wipro buying out Acer's 45% stake, HCL buying out HP's stake, or Tata Telecom buying out a part of Bell-Canada's stake), it is true that at the moment there might be more instances of MNCs buying out their Indian partners rather than the other way round. The truth is that the corporate restructuring, an integral part of globalisation, has led to increased paranoia in Indian industry. The entry of MNCs, eager to get a 'foot-in-the-door' by riding piggy-back on Indian companies has made domestic companies understandably nervous. They are no longer safe from predators.
6. The takeover code has been made hostile bids easier, besides being investor friendly. Hence, some Indian companies are defending themselves by creating alliances, for example, with international financial investors. For example, George Soros is supposed to have allied himself with Elbee Couriers. Many other corporates are increasingly looking at tying up with international investors or mutual funds in order to have defense mechanisms.
7. India is slowly, but surely, becoming part of the global trend in terms of the correlation between foreign direct investment (FDI) inflows and M&As. "For the first three months of this year, about 34% of the total flows were a result of M&As. Prior to 1998, M&As accounted for less than 10% of the total FDI. This changed in 1998 when the M&A component crossed the 10% mark, and it is still rising. Out of total inflows of US$ 3.7 bn in 1998, about US$ 1.2 bn[1] came in through the acquisition route. In the current year where inflows are pegged at US$ 1.4 bn for January-March, M&As have accounted for about US$ 500 mn."[4]
8. "Worldwide, infrastructure and automobile sectors potentially seek investments. The case is no different in India, where about 45% of FDI flows have been in the infrastructure area."[5] However, for foreign investors most of these sectors may, for the short term at least, be close to the point of saturation. Foreign investors are not willing to invest in the various 'capital-hungry' infrastructure sectors, like power and telecom, until certain norms are followed. In the

power sector, all the big players have looked at India, and until an expansion plan is outlined they are unwilling to part with their funds. Similarly, in the telecom sector, instead of investing, some of the players are leaving after facing a raw deal. Foreign investors have been presenting to the government a need for corporate governance on par with international norms, which include transparency and an easier route for takeovers. While the Indian industry has been a bit apprehensive, a number of joint venture companies are believed to have accepted them. When powerful MNCs, like Enron, see a long-term opportunity, initial barriers are unlikely to dissuade them from pursuing their objectives. They are also able to restructure their strategies to cope with local sensitivities. This is one of the key attributes contributing to the unlikelihood of the sustainability of joint ventures in India.

Conclusion:

High growth sectors like pharmaceuticals, software, and services are likely targets for M&A activity amongst MNCs keen on entering these sectors in India. Many of these sectors have been driven by global M&As affecting the giant MNCs. The mergers of 1998 witnessed large transactions, where the aggregate stood at a record level of around US$ 2.4 tn. There were large deals like the merger of Exxon and Mobil of US$ 80 bn. This year larger deals seem to be in the offing. This could have an impact on current joint ventures in India. After reaching a level of comfort in the host country, MNCs might just prefer carrying on with their 'India' strategy on their own. For instance, 50% of the production of Daewoo's small car, Matiz, is earmarked for export to cover the shortfall in supply from the parent plant in Korea. Such quick decisions are possible when the MNC is in control of the venture.

The first wave of M&As, which was driven by the entry of MNCs, might be followed by a phase of consolidation by Indian companies. We are already beginning to see that happen. Indian companies need to be wary of joint ventures with MNCs, as it could be a very short-lived one. For example, it was a tough ride for Godrej to make up for the loss in market share in the toilet soaps and detergents market, after it ended its tie-up with Procter & Gamble.

The potential convertibility of the rupee, ease on regulatory controls, resource scarcity and a need for 'real' growth, call for a vigorous focus on corporate governance, with a dilution of promoter power. Hence, this calls for a need to get back to the grassroot level of delivering value to shareholders, employees, and customers.

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1 "Wipro Ltd", The Economic Times (Bangalore), 12th April, 1999
2 "A Mania with Meaning", by A. Srikanth, Business Line, 28th March, 1999
3 "A Mania with Meaning", by A. Srikanth, Business Line, 28th March, 1999
4 "Forex Inflows Look Up as M&As Rise", by Sharif D Rangnekar, The Economic Times (New Delhi), 20th May, 1999
5 Ibid