Revision

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STRATEGIC FINANCIAL MANAGEMENT

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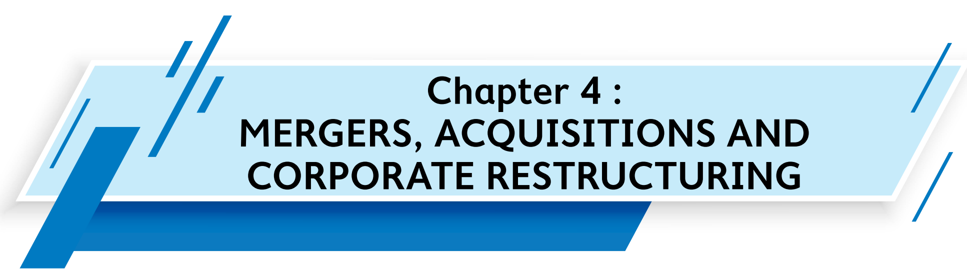
FINAL CA

MERGERS, ACQUISITIONS AND CORPORATE RESTRUCTURING

Head Office

Shraddha, 4th Floor, Old Nagardas Road,
Near Chinai College, Andheri (E), Mumbai - 400 069.

+91 8070 400 900



Chapter 4 : MERGERS, ACQUISITIONS AND CORPORATE RESTRUCTURING

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1. INTRODUCTION

1. Basics about Mergers, Acquisitions and Reconstruction:

1. Restructuring of business is an integral part of modern business enterprises. The globalization and liberalization of Control and Restrictions has generated new waves of competition and free trade. This requires Restructuring and Re-organisation of business organization to create new synergies to face the competitive environment and changed market conditions.

2. Restructuring usually involves major organizational changes such as shift in corporate strategies. Restructuring can be internally in the form of new investments in plant and machinery, Research and Development of products and processes, hiving off of non-core businesses, divestment, selloffs, de-merger etc. Restructuring can also take place externally through mergers and acquisition (M&A) and by forming joint-ventures and having strategic alliances with other firms.

3. Mergers, acquisitions and corporate restructuring business in India have grown by leaps and bounds in the last decade. From about $4.5 billion in 2004, the market for corporate control zoomed to $ 13 billion in 2005 and reached to record $56.2 billion in 2016. M & A activities in India has been buoyant from 2015 to 2019, with a steady pipeline of more than 3600 deals with an aggregate value of more than 3,600 deals with an aggregate value of more than $310 billion. M & A activity recorded a 70 percent growth in 2018, led by distressed deals enabled by the corporate insolvency resolution process under the Insolvency and Bankruptcy Code (IBC). This tremendous growth was attributed to the fact that the foreign investors were looking for an alternative destination, preferably a growing economy as their own country was reeling under the pressure of recession.

4. The report 'India M & A Report 2019' focused on 60% largest transactions by

strategic investors in India between 2015 to 2019, each valued at more than $250 million. The total value of these large deals during this period stood at $ 120 billion. The majority of investments were made in sectors including industrial goods, energy, technology, telecom and media which constitute more than 60 percent of deals in volume and value.

5. The terms 'mergers; 'acquisitions' and 'takeovers' are often used interchangeably in common parlance. However, there are differences. While merger means unification of two entities into one, acquisition involves one entity buying out another and absorbing the same. In India, in legal sense merger is known as 'Amalgamation'.

6. The amalgamations can be by merger of companies within the provisions of the Companies Act, and acquisition through takeovers. While takeovers are regulated by SEBI, Mergers and Acquisitions (M & A) deals fall under the Companies Act. In cross border transactions, international tax considerations also arise.

7. Many new companies are being incorporated as a result of the fast growing industrialisation of the country which is mainly dependent on agriculture. With the new trends of globalisation, not only in this country but also worldwide, there has been increasing interaction of companies and persons of one country with those of other countries. Today, corporate restructuring has gained momentum and undertakings and companies are merging, demerging, divesting and taking in or taking over companies and undertakings, both unregistered and registered, in India and outside.

8. Amalgamation signifies the transfer of all or some part of the assets and liabilities of one or more than one existing company to another existing company or of two or more existing companies or to a new company, of which transferee company or all the members of the transferor company or companies become, or have the right of becoming, members and generally, such amalgamation is accomplished by a voluntary winding-up of the transferor company or companies.

9. Under an amalgamation, merger or takeover, two (or more) companies are merged either de jure by a consolidation of their undertakings or de facto by the acquisition of a controlling interest in the share capital of one by the other

or of the capital of both by a new company. Amalgamation is a state of things under which either two companies are so joined to form a third entity or one is absorbed into or blended with another.

10. Generally, where only one company is involved in a scheme and the rights of the shareholders and creditors are varied, it amounts to reconstruction or reorganisation or scheme of arrangement. In an amalgamation, two or more companies are fused into one by merger or by one taking over the other. Amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company become substantially the shareholders of the company which is to carry on the blended undertaking. There may be amalgamation either by the transfer of two or more undertakings to a new company, or by the transfer of one or more undertaking to an existing company. Strictly, 'amalgamation' does not cover the mere acquisition by a company of the share capital of the other company which remains in existence and continues its undertaking but the context in which the term is used may show that it is intended to include such an acquisition.

2. Reasons for Mergers and Acquisitions:

1. **Synergy:** The combined value of the firm shall be more than the summation of the individual values. This may be the result of the economies of operations. Thus the merged firm will be more efficient as compared to individual values. The large scale of operations will definitely lead to lower average cost of production.

2. **Diversification:** In some situations unrelated parties in terms of its business may also join hands and a new firm is created. This increases the company's portfolio in terms of selling goods or providing services. This can increase the market value of the company.

3. **Taxation:** The provisions of set off and carry forward of losses as per Income Tax Act may be another strong season for the merger and acquisition. Thus, there will be Tax saving or reduction in tax liability of the merged firm. Similarly, in the case of acquisition the losses of the target company will be allowed to be set off against the profits of the acquiring company.

4. **Growth:** M & A can lead to faster growth in the company. If the company prefers

forward and backward integration then it can lead to complete control over selling goods or providing services. If end to end business model is adopted then it provides a comprehensive control over the business. This can result in reducing inefficiency and complete customer satisfaction.

2. CONCEPT OF EXCHANGE RATIOS

The purchase consideration decided by the management of the acquiring company can be settled in any of the following ways:

1. All Stock Deal
2. All Cash Deal
3. Partially stock and partially cash.

In case of an all – stock deal, the acquiring company will issue shares to the shareholders of the target company in exchange of the existing shares held. The ratio in which such shares are issued is called an exchange ratio. The exchange ratios can be decided on the basis of:

A) Earnings per share:

In such a situation, we need to calculate the EPS of both the companies and use the following formula to determine the exchange ratio:

$$\text{Exchange ratio} = \frac{\text{EPS of Target Company}}{\text{EPS of Acquiring Company}}$$

The basic objective is that exchange should be made in such a way that the EPS of shareholders of both the companies should not be affected due to merger.

B) Market price per share:

In such a situation, we need the current market price per share of both the companies and use the following formula to determine the exchange ratio:

$$\text{Exchange ratio} = \frac{\text{MPS of Target Company}}{\text{MPS of Acquiring Company}}$$

This exchange ratio is used when shareholders of the target company wants the exact value of shares from the acquiring company with regards to current market holdings.

C) Book Value per share.

In such a situation, we need calculate the book value per share for both the companies and use the following formula to determine the exchange ratio:

$$\text{Exchange ratio} = \frac{\text{BVPS of Target Company}}{\text{BVPS of Acquiring Company}}$$

As per this ratio, shares are exchanged as compared to the worth per share irrespective of the current market price and earnings. This method is used when the shares traded in the market are not correctly priced.

D) Intrinsic Value per share:

In such a situation, we need to compute intrinsic value per share using any of the valuation models for both the companies. Generally, intrinsic values are calculated by estimating future value cash inflows expected from the shares and discounting it into present value terms. We use the following formula to determine the exchange ratio:

$$\text{Exchange ratio} = \frac{\text{Intrinsic Value per Share of Target Company}}{\text{Intrinsic Value per Share of Acquiring Company}}$$

As per this ratio, shares are exchanged as compared to the worth per share similar to book value per share. The management of both the companies should agree to the values calculated by using this method.

E) Average of any or all of the above:

Exchange ratio can also be the average of any two or more than two exchange ratios determined by the above methods. Such an average can be simple or weighted average. If weights are assigned to exchange ratios, then weighted average concept will be used.

PRACTICAL PROBLEMS

Q.1 X Ltd. wants to take over Y Ltd. and the financial details of both are as follows :

	X Ltd.	Y Ltd.
Preference share capital	20,000	----
Equity share capital of ₹ 10 each	1,00,000	50,000
Share Premium	----	2,000
Profit and Loss A/c	38,000	4,000
10% Debentures	15,000	5,000
	1,73,000	61,000
Fixed assets	1,22,000	35,000
Current assets	51,000	26,000
	1,73,000	61,000
Profit after tax and preference dividend	24,000	15,000
Market price	24	27

What should be share exchange ratio should be offered to the shareholders of Y Ltd., if based on (i) net asset value, (ii) EPS, and (iii) market price. Which should be preferred from the point of view of X Ltd.

Q.2 A Ltd. is keen or reporting an earning per share of ₹6 after acquiring T Ltd. The following financial data are given :

Particulars	A Ltd	B Ltd
EPS	Rs. 5	Rs.5
Market Price Per share	Rs. 60	Rs. 50
No of shares	10,00,000	8,00,000

There is an expected synergy gain of 5%. What exchange ratio will result in post-merger EPS of ₹ 6 for A Ltd.?

Q.3 (MAY 18 - NEW COURSE - 8 MARKS)

Tatu Ltd. wants to takeover Mantu Ltd. and has offered a swap ratio of 1:2 (0.5 shares for everyone share of Mantu Ltd.). Following information is provided

	Tatu Ltd	Mantu Ltd
Profit after tax	₹ 24,00,000	₹ 4,80,000
Equity shares outstanding (Nos.)	8,00,000	2,40,000

EPS	₹ 3	₹ 2
PE Ratio	10 times	7 times
Market price per share	₹30	₹ 14

You are required to calculate:

(i) The number of equity shares to be issued by Tatu Ltd. for acquisition of Mantu Ltd.

(ii) What is the EPS of Tatu Ltd. after the acquisition?

(iii) Determine the equivalent earnings per share of Mantu Ltd.

(iv) What is the expected market price per share of Tatu Ltd. after the acquisition, assuming its PE multiple remains unchanged?

(v) Determine the market value of the merged firm.

Q.4 (NOV 17 – OLD COURSE – 8 MARKS)

EAST Co Ltd is studying the possible acquisition of FOST Co ltd. by way of merger. The following data is available in respect of the companies:

	EAST CO	FOST CO
Earnings after tax	200,000	60,000
Number of equity shares	40,000	10,000
Market value per share	15	12

a) If the merger goes by the change of equity share and the exchange ratio is based on the change in current market price, what are the new earning per share for East Co ltd. ?

b) Fost Co want to be sure that the merger will not diminish the earnings available to its shareholders. What should be the exchange ratio in that case?

Q.5 ABC Company is taking over XYZ Company. The shareholders of XYZ would receive 0.8 shares of ABC Co. for each shares held by them. The merger is not expected to yield in economies of scale and operating synergy. The relevant data for the two companies are as follows :

	ABC Company	XYZ Company
Net sales (₹ crore)	335	118
Profit after tax (₹ crore)	58	12
Number of shares (crore)	12	3
Earnings per share (₹)	4.83	4.00
Market value per share	30	20
Price earning ratio	6.21	5.00

For the combined company (after merger), you are required to calculate (a) EPS, (b) PE Ratio, (c) market value per share, (d) number of share, and (e) total market capitalization. Also calculate the premium paid by ABC Co. to the shareholders of XYZ Co.

Q.6 You have been provided the following financial data of two companies :

	T Ltd.	A Ltd.
Earnings after taxes	₹ 7,00,000	₹ 10,00,000
Equity shares outstanding	2,00,000	4,00,000
Earnings per share	3.50	2.50
Price - earnings (P / E) ratio	10 times	14 times
Market price per share	₹ 35	₹ 35

Company A is acquiring the Company T, exchanging its shares on a one to one basis for Company T's shares. The exchange ratio is based on the market prices of the shares of the two companies.

(i) What will be the EPS subsequent to merger ?

(ii) What is the change in EPS for the shareholders of companies A and T ?

(iii) Determine the market value of the post - merger firm.

(iv) Ascertain the profits accruing to shareholders of both the firms.

(v) T Ltd. wants to be sure that it's shareholders' earnings will not be dimished by the merger. What should be the exchange ratio in that case?

(vi) Determine gain (loss) for shareholders of the two companies after acquisition.

Q.7 AFC Ltd. wishes to acquire BCD Ltd. The shares issued by the two companies are 10,00,000 and 5,00,000 respectively :

(i) Calculate the increase in the total value of BCD Ltd. resulting from the acquisition on the basis of the following conditions :

Current expected growth rate of BCD Ltd.	7%
Expected growth rate under control of AFC Ltd. (without any additional capital investment and without any change in risk of operations)	8%
Current Market price per share of AFC Ltd.	₹ 100
Current Market price per share of BCD Ltd.	₹ 20
Current Dividend per share of BCD Ltd.	Re.0.60

(ii) On the basis of aforesaid conditions calculate the gain or loss to shareholders of both the companies, if AFC Ltd. were to offer one of its share for every four shares of BCD Ltd.

(iii) Calculate the gain to the shareholders of both the Companies, if AFC Ltd. pays 22 for each share of BCD Ltd., assuming the P/E Ratio of AFC Ltd. does not change after the merger. EPS of AFC Ltd. is 8 and that of BCD is 2.50. It is assumed that AFC Ltd. invests its cash to earn 10%.

Q.8 As Finance Director of BM Ltd. you are analysing the planned acquisition of WA Ltd. Following data is available to you.

Particulars	BM Ltd.	WA Ltd.
Expected Earning per share	₹ 10	₹ 3
Expected Dividend per share	₹ 6	₹ 1.60
Number of Shares	20,00,000	12,00,000
Current Market Price	₹ 180	₹ 40

Your estimate indicate expected steady growth of earnings and dividend to the tune of six percent per year. However, under the new Management the growth rate is likely to go up to 8 percent per year without additional investment.

Calculate :

(i) The cost of acquisition by BM Ltd. if ₹ 50 is paid for each share of WA Ltd.

(ii) The cost of acquisition if one share of BM Ltd. for every three shares of WA Ltd. is the agreed exchange ratio.

(iii) Compute gain from acquisition.

(iv) If the expected growth rate continues to be 6 percent how the new share price as well as cost will be different.

Q.9 Elrond Limited plans to acquire Doom Limited. The relevant financial details of the two firms prior to the merger announcement are:

	Elrond Limited	Doom Limited
Market Price per share	Rs. 50	Rs. 25
Number of outstanding shares	20 lakhs	10 lakhs

The merger is expected to generate gains, which have a present value of ₹200 lakhs. The exchange ratio agreed to is 0.5.

What is the true cost of the merger from the point of view of Elrond Limited?

Q.10 T Ltd. and E Ltd. are in the same industry. The former is in negotiation for acquisition of the latter. Important information about the two companies as per their latest financial statements is given below:

	T Ltd.	E Ltd.
₹ 10 Equity shares outstanding	12 Lakhs	6 Lakhs
Debt:		
10% Debentures (₹ Lakhs)	580	--
12.5% Institutional Loan (₹ Lakhs)	--	240
Earning before interest, depreciation and tax (EBIDAT) (₹ Lakhs)	400.86	115.71
Market Price/share (₹)	220.00	110.00

T Ltd. plans to offer a price for E Ltd., business as a whole which will be 7 times EBIDAT reduced by outstanding debt, to be discharged by own shares at market price. E Ltd. is planning to seek one share in T Ltd. for every 2 shares in E Ltd. based on the market price. Tax rate for the two companies may be assumed as 30%.

Calculate and show the following under both alternatives - T Ltd.'s offer and E Ltd.'s plan:

(i) Net consideration payable.

(ii) No. of shares to be issued by T Ltd.

(iii) EPS of T Ltd. after acquisition.

(iv) Expected market price per share of T Ltd. after acquisition.

(v) State briefly the advantages to T Ltd. from the acquisition. Calculations (except EPS) may be rounded off to 2 decimals in lakhs.

Q.11 The following information is relating to Fortune India Ltd., having two division, viz. Pharma Division and Fast Moving Consumer Goods Division (FMCG Division). Paid up share capital of Fortune India Ltd., is consisting of 3,000 Lakhs equity shares of Re. 1 each. Fortune India Ltd., decided to de - merge Pharma Division as Fortune Pharma Ltd., w.e.f. 1.4.2005. Details of Fortune India Ltd., as on 31.3.2005 and of Fortune Pharma Ltd., as on 1.4.2005 are given below :

Particulars	Fortune Pharma Ltd.	Fortune India Ltd.
	₹	₹
Outside Liabilities		
Secured Loans	400 lakh	3,000 lakh
Unsecured Loans	2,400 lakh	800 lakh
Current Liabilities & Provisions	1,300 lakh	21,200 lakh
Assets		
Fixed Assets	7,740 lakh	20,400 lakh
Investments	7,600 lakh	12,300 lakh
Current Assets	8,800 lakh	30,200 lakh
Loans & Advances	900 lakh	7,300 lakh
Deferred tax	60 lakh	(200) lakh

Board of Directors of the Company have decided to issue necessary equity shares of Fortune Pharma Ltd., of Re. 1 each, without any consideration to the shareholders of For- tune India Ltd. For that purpose following points are to be considered :

1. Transfer of Liabilities & Assets at Book value.
2. Estimated Profit for the year 2005-06 is ₹ 11,400 Lakh for Fortune India Ltd. & ₹1,470 lakhs for Fortune Pharma Ltd.
3. Estimated Market Price of Fortune Pharma Ltd. is ₹ 24.50 per share.
4. Average P/E Ratio of FMCG sector is 42 & Pharma sector is 25, which is to be expected for both the companies.

Calculate :

1. The Ratio in which shares of Fortune Pharma are to be issued to the shareholders of Fortune India Ltd.
2. Expected Market price of Fortune India Ltd.
3. Book Value per share of both the Companies immediately after Demerger.

Q.12 The following is the Balance-sheet of XYZ Company Ltd as on March 31st, 2013.

(₹in lakh)

Liabilities	Amount	Assets	Amount
6 lakh equity shares of ₹100/- each	600	Land & Building	200
2 lakh 14% Preference shares of ₹100/- Each	200	Plant & Machinery	300
		Furniture & Fixtures	50
13% Debentures	200	Inventory	150
Debenture Interest accrued and Payable	26	Sundry debtors	70
Loan from Bank	74	Cash at Bank	130
Trade Creditors	300	Preliminary Expenses	10
		Cost of Issue of debentures	5
		Profit & Loss A/c	485
	1,400		1,400

The XYZ Company did not perform well and has suffered sizable losses during the last few years.

However, it is now felt that the company can be nursed back to health by proper financial restructuring and consequently the following scheme of reconstruction has been devised:

(i) Equity shares are to be reduced to ₹ 25/- per share, fully paid up;

(ii) Preference shares are to be reduced (with coupon rate of 10%) to equal number of shares of ₹50 each, fully paid up.

(iii) Debenture holders have agreed to forego interest accrued to them. Beside this, they have agreed to accept new debentures carrying a coupon rate of 9%.

(iv) Trade creditors have agreed to forgo 25 per cent of their existing claim; for the balance sum they have agreed to convert their claims into equity shares of ₹ 25/- each.

(v) In order to make payment for bank loan and augment the working capital, the company issues 6 lakh equity shares at ₹ 25/- each; the entire sum is required to be paid on application.The existing shareholders have agreed to subscribe to the new issue.

(vi) While Land and Building is to be revalued at ₹250 lakh, Plant & Machinery is to be written down to ₹ 104 lakh. A provision amounting to ₹5 lakh is to be made for bad and doubtful debts.

You are required to show the impact of financial restructuring/re-construction. Also, prepare the new balance sheet assuming the scheme of re-construction is implemented in letter and spirit.