Reasons and Motives for Amalgamation, Merger and Acquisitions

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Abstract:
The liberalized economic policies have exposed Indian industry to several challenges. Time is evident of various economic activities that have grown over a period of time which led to various forms of business organizations. Initially as the transactions were limited the businesses used to be a one-man show. But the shortcomings of the sole trader business led to the development of small organizations known as 'partnerships' 1, later the use of the partnership form of business also suffered from various mistakes due to (a) lack of specialization of management and (b) large capital basis as it was not possible for partners to undertake various infrastructural activities. Even though mergers and acquisitions (M & A) have been an important element of corporate sector all over the world from several decades, research on mergers and acquisitions has not been able to provide the complete knowledge about legal framework of Amalgamation. There is no conclusive evidence on whether they enhance efficiency or destroy wealth. There is thus an ongoing global debate on the effects of mergers and acquisitions on industries.

Keywords: *Amalgamation, Merger, Acquisitions, Takeover, Motives and Reasons*

1. Meaning of Amalgamation, Merger, Acquisitions and Takeover

1.1 Amalgamation

When two or more companies carrying on similar business decide to combine, a new company is formed to take over their business. This process is known as Amalgamation. Amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders in company which is to carry on the blended undertakings. There may be amalgamation either by transfer of two or more undertakings to a new company or by the transfer of one or more undertakings to an existing company.

1.2 Merger

A merger is a corporate strategy of combining different companies into a single company in order to enhance the financial and operational strengths of both organizations. A merger usually involves combining two companies into a single larger company. The combination of the two companies involves a transfer of ownership, either through a stock swap or a cash payment between the two companies. In practice, both companies surrender their stock and issue new stock as a new company.

1.3 Acquisitions

An acquisition is the purchase of all or a portion of a corporate asset or target company. An acquisition is commonly mistaken with a merger – which occurs when the purchaser and the target both cease to exist and instead form a new, combined company. When a target company is acquired by another company, the target company ceases to exist in a legal sense and becomes part of the purchasing company. Acquisitions are commonly made by using cash or debt to purchase outstanding stock, but companies can also use their own stock by exchanging it for the target firm's stock. Acquisitions can be either hostile or friendly.

1.4 Takeover

A takeover is the purchase of a company. A takeover is different from a merger, which occurs when the purchaser and the target both cease to exist and instead form a new, combined company. Takeovers can create a bigger, more competitive, more cost-efficient entities. This synergy -- that is, the idea that the two companies together are more valuable to the shareholders than they are apart -- is elusive, but it is what justifies most takeovers.

2. Types of Mergers or Amalgamation and Acquisitions

2.1 Horizontal combination

This is a merger of two competing firms belonging to the same industry which are at the same stage of the industrial process. These mergers are carried out to obtain economies of scale in production by eliminating duplication of facilities and operation and broadening the product line, reducing investment in working capital, eliminating competition through product concentration, reducing advertising costs, increasing market segments and exercising a better control over the market. It is also an indirect route to achieving technical economies of a large scale.

2.2 Vertical combination

This is one where a company takes over or seeks a merger with another company in order to ensure backward integration or assimilation of the source of supply or forward integration towards market outlets. The acquirer company gains a strong position due to the imperfect market of its intermediary products and also through control over product specifications. However these gains must be weighed against the adverse effects of the merger.

2.3 Conglomerate Mergers

The conglomerated combination is in amalgamation of two companies engaged in unrelated industries. It enhances the overall stability of the acquired company and improves the balance in the company's total portfolio, the her quiet phone gives access to the existing proctor resources of the conglomerate which result in technical efficiency and furthermore it could have access to the greater financial strength of the present acquirer which provides a financial basis for further expansion by acquiring potential competition.

2.4 Within stream mergers

Such mergers take place when the subsidiary company mergers with the parent company or vice-versa. The former arrangement is called downstream and the latter is called the upstream merger. Recently ICICI Limited a parent company has merger with its subsidiary ICICI Bank signifying the downstream merger.

3. Reasons and Motives for Amalgamation, Merger and Acquisitions:

Companies undertake merger and acquisition to achieve certain strategic and financial objectives. In modern finance the shareholder wealth maximisation theory and managerial utility theory is being considered as a rational criterion as to what fundamentally derives acquisitions and mergers. The factors which motivate shareholders, managers and promoters to lend support to these combinations can be summarised as follows:

1. **Economics of scale:** This generally refers to a method in which the average cost per unit is decreased through increased production.
2. **Increased revenue / Increased Market share:** This motive assumes that the company will be absorbing the major competitor and thus increase it’s to set prices.
3. **Cross selling:** For example, a bank buying a stock broker can sign up the bank’ customers for brokerage account.
4. **Corporate synergy:** Better use of complimentary resources. It may take the form of revenue enhancement and cost savings.

5. **Taxes:** A profitable can buy a loss maker to use the target's tax right off i.e. wherein a sick company is bought by giants.
6. **Geographical or other diversification:** This is designed to smooth the earning results of a company, which over the long term smoothens the stock price of the company giving conservative investors more confidence in investing in the company. However, this does not always deliver value to shareholders.

3.1 From the viewpoint of the shareholders

It is based on the shareholders wealth maximisation theory that means a firm's decision or merger of acquisition should be based on the objective of maximising the wealth of shareholders of the firm. This approach hypotheses that managers try to pursue those mergers and acquisition activities which offer positive net present value. The basic pattern of merger and acquisition activities is that the divesting company moves from a diversifying strategy to concentrate on core activities in order to increase competitiveness. Both patterns are based on an attempt to create value for the shareholders. Management buyouts help to restructure the firms, resulting in a realignment of the interests of the shareholders and managers. Managements buyouts provide incentive to managers (who are shareholders themselves) to maximised shareholding. The shareholder wealth maximised criterion is satisfied when the added value created by acquisition exceeds the cost of acquisition.

Added value from acquisition = value of acquirer and acquired after acquisition – their aggregate value before

Increase in acquirer share value = added value – cost of acquisition

Cost of acquisition = acquisition transaction cast – acquisition premium

Acquisition transaction cost is incurred when an acquisition is made, in the form of various advisers' fees like the stock exchange fees, cost of underwriting, regulators fees. The acquisition premium is the excess of offer price paid to the target over the target pre-bid-price and is also known as the control premium. Then investment made by the shareholders in the companies subject to merger should enhance in value. Shareholders may gain from mergers in different ways viz. from the gains and achievements of the company through:

1. Realisation of monopoly profits
2. Economics of scale
3. Diversification of product line
4. Better investment opportunities in combination

3.2 From the Standpoint of Managers

In the modern corporate economy relation between shareholders and the managers is equivalent to that of principle and agents may not always act in the best interests of their principal. The cost to the shareholders of such behaviour is called the agency cost representing loss of value to the shareholder. Thus the managers act in disregard to their principles promoting their own self-interest. In acquisition context self-interest result in bad acquisition and loss of shareholder value and may be undertaken to satisfy managerial objectives. Managers may undertake acquisition for the following mentioned reasons:

- To pursue growth in size of their firm, since their remuneration status, prerequisites and power are functions of firm size (the empire building syndrome). Managers' compensation can be inter-related to firm size because it creates complexity of large firms. Managers may derive intangible benefits such as power and social statues when they run large firms.
- To deploy their currently underused managerial talents and skills. When a firm is in a mature industry/declining industry its survival depends on an orderly exit from that industry in to another with greater growth opportunities. The present industrial operations may not exhaust the managerial energies and talents available into the firm. Without moving into the growth industry, the firm may lose young managers and thus accelerate its own decline (self-fulfilment motive).

- To diversify risk minimize the cast of financial distress and bankruptcy (the job security motive). Risk diversification is achieved when the acquiring and the acquired firms' cash flows are not highly positively correlated thus reducing the overall variability of the combined entity's cash flows.
- Financial distress is a condition where the firm finds it difficult to meet its obligations and is forced to make suboptimal operating, investment and the financing decisions. Both firms' failure and the financial distress may have greater impact on the managers than shareholders. It is observed that managers hold highly undiversified portfolios overwhelmingly invested in their own firms. Thus total risk (including firm specific risk i.e. risk of failure) is more important to managers.
- To avoid being taken over (job security motive). Target manager often go to extraordinary lengths to defeats hostile takeover bids. To achieve immunity from the threat of takeover, managers undertake the acquisitions, assuming falsely, that increased from size confers such immunity.

3.3 Trade and other advantages

1. **Diversification and expansion** – merger and acquisition are motivated with the objectives to diversify the activities so as to avoid putting all eggs in one basket and obtain advantage of joining the resources for the enhanced debt, the financing, and the better service ability to shareholders.
2. **Taxation advantage** – a company may find it beneficial to accumulated losses for having benefits of tax laws that will shield income from taxation. Section 72A of Income Tax Act 1961 provides this incentive for reverse mergers for the survival of the sick units.
3. **Vertical integration** – it is profitable for a company to amalgamate with another company which supplies it with raw material and channels its products into market. Fusion of such two companies leads to reduction of overheads and thus creates trade advantage.
4. **Production capacity reduction** – amalgamation of two units manufacturing or dealing in the same product may lead to reducing the cost of research, production, advertisement and sale.
5. **Purchase of management/growth advantage** – the merger and acquisition are motivated with a view to sustain growth. To develop new areas becomes costly, risky and difficult than to acquire a company in the growth sector even though acquisition is on premium rather than investing in new assets.
6. **Financial advantage** – companies functioning in the same group are treated more favourable by its financers. Thus a company outside the group and facing difficulty in obtaining finance may be likely to join the group and thereby solve its tight financial position.

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