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TOWARDS AN ORDERLY INDIAN MARKET FOR CORPORATE CONTROL

By

N. VENKITESWARAN

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TOWARDS AN ORDERLY INDIAN MARKET FOR CORPORATE CONTROL [1]

Abstract:

As the Indian economy is being modernised through dismantling of rigid controls and greater reliance on the interplay market forces, the Indian industry is likely to witness major restructuring through a spate of mergers and acquisitions. This paper begins with a short overview of the benefits and drawbacks of what is referred to a market for corporate control in the light of the developed country experience. It then examines the historical impediments against corporate restructuring through mergers and takeovers in India. The paper is of the view that given the economic compulsions, India is also about to witness significant spurt in mergers and acquisitions in the coming years. In this emerging scenario, importance of regulatory reforms covering a wide area such as competition, investor protection, taxation, corporate governance etc. is underscored so that the Indian market for corporate control is devoloped along orderly lines.

[1] May, 1992. Revised January 1993.

TOWARDS AN ORDERLY INDIAN MARKET FOR CORPORATE CONTROL [1]

The new economic policies ushered in by the Narasimha Rao government has placed the Indian economy on the unmistakeable road to the new order. A process has been set in motion that is bound to destroy the xenofobic insularity of Indian economy and integrate it with the rest of the world, bringing with it its own risks and rewards. One of the key links in the integration process will be complete when the Indian Rupee is made fully convertible, an event which may be ushered in sooner than later given the speed with partial convertibilty was announced in the 1992/93 budget. It is true that the shadow of the multi-billion rupees securities scam and the political processes may cause some delay and dilution; but the overall direction, philosophy and focus have come to stay.

One of the inevitable outcomes of the new economic order would be the large scale, market-driven restructuring of Indian industry through a spate of mergers, acquisitions, takeovers, divestments and demergers. An active mergers and acquisitions (M&A)/takeover market, otherwise referred to as the market for corporate control is clearly going to emerge, as companies begin to redefine and refocus their strategeies, as fragmented and uneconomic industry capacities get consolidated, as unviable units get busted up and as Non-resident Indians (NRIs) and multinationals look for Indian bridgeheads for speedy entry. Another factor that would stimulate the control market is the emergence of a new breed of aggressive institutional investors in the Indian scene, the private sector mutual funds and (hopefully) foreign mutual and pension funds. These institutional investors would demand superior performance from company managements in an environment of unprecedented competition. And they would not hesitate to vote out weak managements and would be only too happy to hawk their stakes in takeover bids for corporate control. In fact in the free, open US and UK economies, it is the insitutional investors with sole responsibility to their investors, who act as change agents in the takeover market. And investors who might have long put up with underperfoming managements would only be too happy to join the fray. Indian businessmen who have managed to enjoy the benefits of management control through generations despite minimal financial stakes by 'managing' the environment, are in for great shock and would spare no efforts to preserve the *status*

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quo. It may be recalled that not long ago, the entire Indian private industry stood as one man against the NRI 'raider' Swaraj Paul who bought into small stakes in DCM Limited (as it was then, before the celebrated four-way split in April 1990) and Escorts Limited.

This paper argues why it is desirable and even necessary to have an active market for corporate control. It then examines the view as to why India is likely to experience a takeover boom in the near future. The paper then goes on to discuss the broad contours of the regulatory framework required to make the functioning of the corporate control market orderly and fair in the light of experience in the Western countries. A broad set of recommendations towards the wide ranging reforms required in the Indian context is listed in the concluding section.

The Market for Corporate Control:

Following the seminal work of Manne (1965) it is generally recognised that control of corporations constitutes a valuable asset in its own right and a large number of mergers are the result of the successful working of this market. Corporate control, as defined by Jensen and Ruback (1983), refers to the rights to determine the management of corporate resources - that is the rights to hire, fire, and set the compensation of top level managers. And the market for corporate control is nothing but a market in which competing managements vie for the rights to manage corporate resources. Any takeover situation ultimately boils down to the transfer of the control rights relating to the management of the target's resources to the acquiring comapny's top management. Thus the term corporate control market is synonymous with takeover market. Since takeover can occur through mergers (amalgamation in the Indian context), tender offers, proxy contest, block acquisitions and buy outs, corporate control market covers these different types of transactions by which control rights change hands. While the clear distinction between these these different devices is explained in the following paragraph, terms *takeover, merger and acquisition* are often used interchangeably in a generic sense to signify transfer of control.

In mergers, the holdings of the ordinary shareholders of one company (target) are taken over through issuance of shares of another company (bidder).[2] Mergers are "friendly" in the sense

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[2] In India, the term merger is used to mean amalgamation in which the legal existence of the merging company is extinguished following the merger. In the Western countries, merger may not result in the obliteration of the legal person of the target. The target becomes a member of the bidder group (subsidiary) and loses its identity from a control and investor point of view.

that they are negotiated between the managements of the merging companies and blessed by the respective boards of directors before placed for shareholder approval. In tender offers, the bidding company directly approaches the target's shareholders with an offer to purchase their shareholdings in the target for cash and/or bidding company shares or bonds subject to certain conditions. Often, the incumbent management opposes the tender offer (for ostensible reasons of too low a price and/or reluctance to give up control) making the bid "hostile". In certain cases, the target management manages to negotiate a better price and recommends to the shareholders to accept the bid making it "friendly". In the Indian context, tender offer is a relatively new phenomenon; the successful examples being the acquisition (friendly) of Consolidated Coffee by Tata Tea and the takeover (hostile) of Wendt India by Carborundum Universal. In the case of proxy contests, the *voting rights* attached to the shares of the target rather than the *shares per se* are solicited to effect change in control. This is resorted to side-step the large financial outlay involved in the outright purchase of majority shareholdings and that too generally after the bidding group has already acquired a block of the target's shares. The well-known proxy battle by the Chhabrias to wrest control of Gammon India and the celebrated attempts of the Ambanis to take over the management of Larsen and Toubro (L&T) are recent examples of the use of proxy contests in the control market in India.

A more common and relatively less expensive mechanism for taking control of a company is to purchase the required number of shares directly - either from the market and/or privately from major shareholders. In India most of the takeovers of the Chhabrias and the R.P. Goenka (RPG) group are through acquisition of large blocks of shares in private deals. However where the target's shares are widely distributed, market purchases would still have to be resorted to. In actual practice a two or three stage process involving private acquisition, market purchases, followed by a tender offer and merger could be resorted to. (In most countries the acquirers are required to make some form of mandatory tender offers to protect the interests of minority shareholders; this aspect is discussed in a later section of the paper).

It may be noted that buy-outs by incumbent management (management buyouts - MBOs) or by specialised LBO outfits (who take recource to heavy debt to pay off the target shareholders - hence the term Leveraged buyout or LBOs) are only manifestations of the nature of the bidder or acquirer in the corporate control market. In actual practice, within the broad categories listed above, there may be a variety of *dramatis personae* and *modus operandi* in play to effect change of control as the celebrated US$ 24.7 billion leveraged buy-out of RJR Nabisco indicates.

For many decades now the Western economies led by the US and the UK have witnessed waves of takeover activity that were largely confined to their domestic frontiers. However in the eighties, cross-border mergers and acquisitions have emerged as major phenomena and have drastically changed the face of corporate control markets. The markets for corporate control have grown to transcend national boundaries to become global in the sense that the targets and the bidders are from different countries and the deals are finalised in board rooms and the offices of regulatory agencies subject to different jurisdictions. The factors that have contributed to this trend are as follows.

* Increasing globalisation of business from lowering of barriers to trade and capital movements. Thus the entire world is being perceived as one market demanding global manufacturing and sourcing. And companies whose operations are geographically concentrated are aggressively seeking to acquire companies in other countries to quicken the pace of their globalisation programmes. Thus many Japanese and European companies are acquiring in the US to strengthen their North American operations.

* The slow-down of growth in a number of sectors in the developed countries. This has forced the companies in these countries to seek non-traditional markets on the one hand, and restructure and refocus their operations, on the other. Consequently there is a significant spurt in cross-border M&A as part of industrial restructuring and consolidation.

* The single most important fillip to the active internationalisation of the corporate control market is establishment of a single common European market from 1993. This has prompted many European and non-European companies to merge with or acquire other companies in Europe both as defensive and offensive strategies.

* Free capial movements mean that investors anywhere are free to invest anywhere. And major companies are listed in different stock exchanges in the world to facilitate this process.

* Shift in the global balance of economic power on the one hand and increasing national concerns on local employment protection etc. on .other, have also contributed to this trend. Thus cash rich Japanese companies emerged as active acquirers of US companies.

Not surprisingly one sees international companies vying with each other and domestic companies and if necessary, even joining hands with competitors to control other companies. Thus the Agnellis of Italy and Nestle of Switzerland had lined up important members of the French business establishment on their respective sides in

their fight to wrest control over the French mineral water company, Source Perrier.[3] The significance of this international dimension is brought home in a recent study by Ingham, Kran and Lovestam (1992). They observed that in a sample of 1221 acquisitions by 102 leading UK companies over the period 1984-88, 53 per percent involved the acquisition of an overseas company.

A major new force in the corporate control market is privatisation. Privatisation is nothing but transfer of the right to control (of certain economic entities) from the state to the private sector. In the early stages of privatisation, this may be partial in the sense of part-transfer of ownership without involving transfer of management control (as the case of partial disinvestment of the state's shareholding in France and currently under way in India). Full scale privatisation, on the other hand, involves both transfer of ownership and control. The massive privatisations planned by the former Soviet Republics, countries in the Eastern Europe, Latin America and Asia close on the heels of rapid-fire privatisation of the East German companies undertaken by the German privatisation agency Truehand would make privatisation a key source of activity in the national and global markets for corporate control. Recent privatisation experiences confirm that very often multinational giants vie with each other and other domestic companies in bidding for the privatised enterprises. It is true that the privatisation process *per se*, with so many restrictions and conditons imposed by the privatising governments, may not be on a level playing field. But *after* the event, the privatised enterprises can be expected to add to the activity and participation in the control market in a variety of ways.

Why a Market for Corporate Control ?

In market-oriented economies mergers historically remained major corporate preoccupation. The US economy, for example, has witnessed a series of merger waves such as during 1895-1904, 1922-29, 1940-47, 1965-70 and again in the eighties. See Weston, Chung and Hoag (1990). While the first merger wave was characterised by horizontal mergers leading to concentration in a number of industries, the 1922-29 wave, continuing this trend, also led to product extension. The post-war merger boom was relatively smaller. The merger movement of the sixties was dominated by the diversification and conglomerate types. The merger boom of the recent times has been characterised by a return to specialisation and also for the sheer increase in the deal sizes. For example in the US during 1988 there were 2258

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[3] The Perrier takeover battle had all the drama of a *cause celebre* in the M&A field. The parties involved finally settled by agreeing to divide the various components of Perrier.

merger announcements valued at US$ 247 billion of which 369 transactions involved deals of US$ 100 million or more. In constant dollar terms the 1988 mergers represented four to six fold increase over the value of mergers in the early seventies. And the value of mergers which represented 10-15 per cent of the investments made in plant and equipment in the seventies rose to 40-45 per cent levels in the latter half of the eighties. While the US was and still remains the most active mergers market, other developed countries such as the UK, Canada, France, Germany and Japan have also been witnessing sharp rise in merger activity. For example, according to Benzie (1989), the UK industrial sector witnessed 568 takeovers valued at GB£ 5.5 billion in 1984 and these rose to 920 and GB£ 17.1 billion by 1987. However merger markets have seen a slow-down since 1990 due to the economic recession. This is in accordance with past trends and as these economies move out of recession, one may witness renewed stridency in takeover activity. It is important to recognise that these mergers of the eighties and beyond have been primarily driven by industrial restructuring considerations, despite the wide variations across countries in the structure of the market for corporate control. As less developed countries implement their industrialisation strategies in an era of global competition, the developed country experience of industrial restructuring and consolidation through mergers and acquisitions could be of great relevance to them.

The extensive academic research in the area points out to a number of motives behind mergers. They include increased profitability from synergy and efficiencies, greater market share and market power, speed of entry, geograhic diversification, enhanced debt capacity and access to cashflow, risk diversification, managerial growth and rewards and even outright ego trips. Empirical research further indicates that mergers may not turn out to be successful at all times; in many cases mergers may also end up as failures with disastrous consequences for both the biddng and the target firms. Like any other business ventures, mergers and takeovers also depend, for their success, on strategic logic, careful identification of the target, detailed planning and analysis, sustainable price and speedy execution and integration. When there is major default in one or more of these areas, mergers could turn out to be unsuccessful. On the other hand, successful mergers are extremely useful economic processes both from a corporate view point and a broader macro economic perspective. The beneficial effects of mergers and merger markets are summarised below.

1. Mergers are less expensive alternatives to bankruptcy. As is wellknown, bankruptcy of failed business is expensive, economically contracting and leads to socially undesirable consequences. Merger often results in the avoidance of bankruptcy of a weak unit and help in its revival, thanks to the managerial and financial inputs from the bidder. As

Manne (1965 *supra*) observes: "The function so wastefully performed by bankruptcies would be more economically performed by mergers at a much earlier stage of the firm's life." This factor is well appreciated by policy makers all over the world. Even in India section 72-A of the Income Tax Act, 1961 (ITA) and section 18 of the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) explicitly recognise role for mergers to rehabilitate the so-called sick units. The numerous mergers/acquisitions involving weak units and healthy ones in the corporate sector also support

this position. (It is recognised that even here there may be failed mergers; this could be due to failure in respect of any of the success factors noted above). From limited Indian experience, it would also appear that mergers provide a quicker and more acceptable route to rehabilitating sick units, as creditors and other stakeholders feel reassured by the entry of the healthy unit. In some cases, only part(s) of the businesses of the failed unit may be sustainable leading to disposal or retrenchment of the rest. Mergers thus provide the opportunity and time required for the assets to travel to their most economically desirable use or application. In the words of Dewey, quoted by Manne (1965 *supra*), merger is "merely a civilised alternative to bankruptcy or voluntary liquidation that transfers assets from falling to rising firms." In the era of rapid technological and competitive changes, mergers and takeovers permit organisational renewal before irretrievable decline sets in.

2. From a macroeconomic perspective mergers and acquisitions provide the wherewithal to restrucutre and revitalise an industry and thus restore the industry health and balance. As an industry matures and growth tapers of, industry health could be in jeopardy from low profitablity with competing firms jostling for market share. The weak players fall by the wayside; but even the stronger ones find it difficult to sustain. In such conditions, mergers lead to industry consolidation with a few strong and healthy units in place of a large number of weak or steadily weakening units. The restructuring takes place through the merger of the more efficient units in the industry and leaving the less efficient ones to wither away. This process is often not possible when industry is highly fragmented with capacity widely distributed over a large number of competitors. In such scenarios bad units often drive their good brotheren also out of business. The role of the government is to formulate broad industrial policies that would, *inter alia*, encourage consolidation through merger amongst the more efficient ones.

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A number of industries in the world over are undergoing such consolidation, in many cases even beyond national borders. Chemicals, electrical equipments, steel, airline and aircraft industries are some examples where such market specific restructuring is taking place in a big way. It is well known that Japan's MITI often takes the lead in actively promoting such domestic mergers to restore an industry's competitive balance at home. The 1987 merger of the electro-technical operations of ASEA of Sweden and BBC Brown Boveri of Switzerland and the 1989 merger of the packaging companies Groupe Carnaud of France and Metal Box plc. of UK are just two examples of cross border mergers aimed at industry restructuring. The world airline industry is perhaps on the threshold of major restructuring with the various airlines talking to each other on either strategic alliances or outright mergers. Recently, for example, the British Airways (BA) took stakes in the Australian airlines Quantas and is actively pursuing USAir. Similarly Alitalia, the Italian airliner, has picked up a 35% interest in Hungary's Malev, while KLM Royal Dutch Airlines (KLM) has bought into Northwest Airlines of the US; see the Economist (1992) for review of recent trends in this regard. The merger earlier proposed between BA and KLM was estimated to result in a combined *annual* savings of as much as GB£ 500 million through combining their central offices, maintenance and other operations. (The merger talks were suspended following disagreements over valuation; given the industrial logic and managements' keenness it would be a matter of time before the merger talks are resumed). Even automobile industry, often perceived as the symbol of national pride, would see large scale global restructuring; it is widely believed that Volvo of Sweden and Renault of France, may go far beyond their current strategic alliance to consummate a full merger. The merger proposed between the two leading German steel makers Krupps and Hoesch is once again aimed at continuing the process of restructuring the steel industry in the backdrop of the single European market. Lloyds Bank's counterbid for Midlands Bank (over the Hongkong and Shanghai Banking Corporation's bid in April 1992) was based on the argument that Britain is overbanked and that annual savings of GB£ 700 to 800 million could be effected through combining the branch networks and administrative management of the two banks and through the consequent reduction of manpower.[4] In the chemical industry restructuring and consolidation is taking place at a furious pace and a recent phenomena is swapping of assets and businesses leading to

[4] Lloyds Bank finally decided not to pursue the bid in view of the uncertainty and delay caused by regulatory reference in the UK. Lloyds management has rightly recognised the importance of speed in acquisition success.

greater specialisation. In recent months the UK chemical giant ICI has swapped its fibre business for Dupont's acrylic business and has also proposed to acquire the acrylic operations of BASF, this time, in exchange for its own European polypropylene business.

3. Mergers lead to increased efficiencies, beyond plant consolidation, through syergistic effects. In fact this is the most-touted justification of corporate managements for mergers. But evidence points out that such efficiency gains might be often exaggerated *before* mergers and thus fail to materialise *after* the event. In general, such efficiency gains are possible only if there is overlap in terms of product-markets, processes or costly inputs. This implies only horizontal and vertical mergers have efficiency-enhancing potential; conglomerate mergers often lack this. Such efficiencies and cost savings could flow from economies of scale and scope possible from the larger post-merger operations, greater control over key inputs, product rationalisation, combining marketing, advertisement and distribution or from cutting down overlapping research and development. The merger wave in the US in the eighties and beyond is characterised by the strong relatedness between the businesses of the merging firms, unlike the conglomerate mergers of the sixties and the seventies. (In fact one of the driving forces behind the recent merger boom is the urge to undo the excessive diversification of the sixties so as to stick to one's knitting).

4. An active market for corporate control benefits shareholders. Extensive empirical studies on the stock market responses to merger announcements, summarised by Jensen and Rubak (1983 *supra*), point out that the shareholders of target companies in general gain abnormal returns of 20 to 30 per cent from merger announcements while the shareholders of bidding firms record marginal gains at best or none at worst.[5] Jarrell, Brickly and Netter (1988) also reaffirm this finding; while the takeover premium paid to targets' shareholders were upwards of 20 per cent, the abnormal returns to bidder shareholders were about 1 to 2 per cent around the announcement days. In a study of UK acquisitions during 1955-85 involving a sample of 1814 targets and 1058 bidders, Franks and Harris (1989) report that targets' shareholders gain an abnormal return of as much as 23 per cent in the bid month against 1 per cent for the bidders' shareholders. It is also pertinent to note that

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[5] Jensen and Ruback (1983) have summarised the findings of sixteen earlier studies on stock market responses. Abnormal returns are computed from stock price movements around merger announcements after eliminating market wide movements.

anti-takeover defence measures adopted by incumbent company management have been found to be against the interests of the shareholders. A recent study by Mahoney and Mahoney (1993) covering a sample of 409 firms that adopted antitakeover amendments in the 1974-88 period indicates a strongly negative effect on stockholder wealth.

The sources of these takeover gains have also been subject of various studies. Bhagat *et al.* (1990) in their study of hostile takovers indicate that the main sources of the takeover gains are strategic factors involving firms in the same or closely related industry. Chatterjee (1992) also confirms that takeovers indeed create value for the economy. This value comes from synergy and restructuring, by "bringing into light unexplored opportunities within target firms which they have either ignored or were incapable of exploiting". It is true that a part of the takeover gains does flow from employees (redundancy)or the state (tax savings); but the evidence on these accounts are not overwhelming.

5. Often takeovers and its corollary divestitures are driven by industrial logic and provide opportunity to correct past decisions or to quickly reposition firms to fast-changing environment. Various estimates indicate that divestitures account for 30 to 40 per cent of the M&A transactions of the eighties and in a recent study, Kaplan and Weisbach (1992) report that acquirers have divested almost 44 per cent the target companies. It has been now argued - see Shleifer and Vishny (1991) - that the one of the main reasons for excessive conglomeration and unrelated diversification of US firms in the sixties has been the strict anti-trust enforcement by the regulatory agencies and when this became lenient in the eighties, companies were quick to disinvest to undo their past decisions. Similarly firms do redefine their product-market strategies in response to fast-changing environment. And the existence of a market for corporate control provide the medium through which the resultant acquisitions and disinvestment decisions are efficiently implemented. Thus the UK engineering company TI plc.has successfully implemented its strategy of concentrating on specialised engineering businesses with global potential through more than a dozen acquisitions and large scale disposals inclusive of its core domestic appliances business. In India, for example, the RPG group had, in its aggressive pursuit of growth, acquired a ragtag of businesses ranging from tyre and plantations to pharmaceuticals and gramaphone records and computers and chain stores mainly because of the severe restrictions on expansion imposed through the licencing and monopolies regulations. In the changed liberalised environment, one could expect such a group to sharply redefine its business

contours and pursue greater specialisation. This ought to result in certain amount of disinvestment and also, perhaps, focussed or strategic acquisitions. In all these cases, an orderly and well developed corporate control market would be an important contributory to the speedy implementation of the new strategies.

6. A dynamic control market is the best check shareholders have against managerial failures or complacency. It has been observed that managements do fail in their role as agents of stockholders and often take decisions that are not necessarily wealth-maximising. Thanks to the increasing institutionalisation of corporate shareholding, shareholder activism has lately gained currency. Company managements are called upon to give greater attention to shareholder value management. Continued failure on this score either through value destroying investments or from competitive decline would result in takeover bids. Time and again institutional shareholders have voted with their wallets in favour of management change proposed through takeover bids. As a takeover almost invariably results in unseating of incumbent management, a takeover threat acts as a major corrective force against managerial failures and excesses. For example, when the Hanson Group picked up a 2.8 per cent in the blue blooded UK company, Imperial Chemical Industries (ICI), threat of a looming full bid shook up the ICI management into forcing the pace of their restructuring strategies that have finally led to the recent demerger announcement. Similarly Sir James Goldsmith's bid on BAT Industries in 1989 prompted its restructuring and demerger as a takeover defence; a looming takeover threat was widely believed to be behind the restructuring of the Courtaulds by demerging Courtaulds Textiles in March 1990. Back home, it was quite likely that the Swaraj Paul raid on DCM did shake up its three managerial factions (the Bharat Rams, Charat Rams and Bansi Dhars) from complacency and set the stage for its eventual division. (The spinning off of four units from the old DCM, though along filial lines, has certainly helped the shareholders, as the different management's performance have become transparent and subject to sharp public scrutiny). In the US, the aggressive postures of LBO outfits like Kohlberg, Kravis, Roberts & Co.,and Forstmann Little & Co., and bust-up specialists like Carl Icahn have undoubtedly shaken up underperforming corporate managements from complacent lethargy and force them to refashion their companies' strategies and recapture value to their shareholders. Thus an active market for corporate control acts both as a correcting machanism as well as a check against managerial failure.

7. While horizontal mergers, in general, have potential anti-competitive effects arising from increased concentration and reduction in competition, in some cases mergers do lead to greater competitive vigour. This occurs in industries where the competitive structure consists of a few dominant firms and a number of weak players. Consolidation through merger amongst the weak firms could lead to emergence of stronger and bigger firms that could compete more effectively with the industry giants.[6]

8. Mergers helps in the efficient allocation of resources. By sorting out the industrial chaff from the wheat, a merger market ensures that funds do not go to support failing firms under weak managements. In a free corporate control market, only firms with reasonble business prospects would stand the chance of being acquired from a point of industrial logic. In those cases of hopelessly weak units, acquisition would be more likely to be motivated by the propects of release of funds through asset unbundling and disposal. The funds released in the latter case would most probably be redeployed in high-return investments and projects. Thus a merger market would help in the efficient resource allocation process in the economy.

When Mergers Spell Danger?

While the foregoing discussion highlights the useful and positive economic functions mergers perform, it must be understood that mergers also can lead to serious adverse and undesirable consequences. From very early days economists and governments have been concerned about the monopolistic and anti-competitive consequences of mergers. Almost all over the world there have been strong regulations against horizontal mergers. This stems from the fear that industry concentration and market power could lead to monopoly pricing and/or quality or servicing dilution - in short, raw deal for consumers. However as the structure and nature of competition have changed all over the world due to greater international trade and emergence of substitute products, the monopoly argument is losing much of its force.[7]

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[6] It is not intended to be construed that merger of weak units would, in all cases, lead to creation of stronger firms. This would depend on a host of factors such as complementarity amongst the units, their technological compatibility, potential for cost cutting through rationalisation, competitive responses of the larger units etc.

[7] As an example, while a merger of say Chrysler and General Motors would have strong monopolistic implications, say, in the seventies, this no longer should cause the same concern to-day in view of the strong competition from the Japanese cars.

Nonetheless, anti-competitive effects continue to remain a major regulatory concern. For example, European Community (EC),while recognising and even welcoming the role mergers would play in restructuring European industry in the context of the single market from 1993, has framed regulations to ensure that such Community scale mergers are not incompatible with the common market.

Similarly a free-for-all market for corporate control could also seriously jeopardise the interests of shareholders and investors and thus affect the efficient functioning of the capital market. This would happen when company managements enter into private 'deals' to transfer their stakes in and management control of companies to others leaving the minority shareholders in the lurch. In almost all the countries there are strict regulations to protect minority interests in takeover situations.

There have been strident criticism, especially in the academic and industrial circles in the US, of mergers and takeovers as being unproductive investments. They have also been widely criticised as contributing to competitive decline through neglect of productive capital investments and long term research and development (R&D). Mergers are also perceived to result in significant social costs through plant closings, lay off and employee dismissals following consolidation of merged firms. While there have been certain "excesses" during the boom run, especially in the eighties, much of the criticism is not valid as many studies indicate. Empirical research points out that in the US there was no clear evidence of either a decline in capital investment or on R&D spending. For example, Hall (1988) concludes: "existing data (through 1985) provide very litle evidence that acquisitions cause a reduction in R&D spending." Similarly, Welch and Bolster (1992) report that acquired firms experience increase rather than reduction in both R&D and long-term capital spending in the post-merger environment. Jensen (1984) and (1991) has forcefully rebutted much of the common fallacious criticisms and misconceptions regarding mergers.

As regards the criticism relating to plant closures and employee layoffs, it must be understood that this would be the inevitable short run price the society has to pay to achieve long run efficiency and sustainable employment. In the consolidation following mergers, the most efficient firms will remain consistent with demand-supply equilibrium and efficiencies would be achieved through reduction in excessive factor usage and corporate overheads.

Recent research by Healy *et al* (1992), for example, indicates that merged firms have "significant improvement in operating cash flow returns after the merger, resulting from increases in asset productivity.... .... Post-merger cash flow improvements do not come at the expense of long-term performance, since sample firms maintain their capital expenditure and R&D rates relative to their industries after the merger".

To sum up, in the words of Jensen (1984 *supra*), the takeover market "provides a unique, powerful, and impersonal mechanism to accomplish the major restructuring and redeployment of assets continuallu required by changes in technology and consumer preferences".

The Market for Corporate Control in India:

Thanks to the tightly regulated industrial environment, India never had much of a market for corporate control. The onerous provisions of the Monopolies and Restrictive Trade Practices Act, 1969 (MRTPA) and Foreign Exchange Regulation Act, 1973 (FERA) ensured that both domestic giants and multinationals were kept under tight leash. As a result there was no inbuilt mechanism to replace managements even in failed companies. Amalgamations were resorted to infrequently by managements, mainly, as salvage operation to resusciate failed group companies and/or to capture their tax losses. There have been other rare instances such as the formation through merger of the cement giant Associated Cement Companies Limited in the thirties and the amalgamation of the erstwhile Central Bank of India Limited with TELCO and Canara Bank Limited with L&T in the early seventies following bank nationalisation. It was perhaps not entirely accidental that in a study of company mergers in India by Kaveri (1986), 7 out of the 9 cases examined were between companies belonging to the *same* business group. In between, one also saw acquisitions by the Duncan (K.P. Goenka) and the RPG groups, Mallya and the NRI Manu Chhabria through private purchases of controlling blocks. The introduction of section 72-A of the ITA in 1979 and more importantly, the SICA in 1985 certainly gave a fillip to corporate restructuring through mergers/acquisitions. In the context of the structural changes ushered in through reforms since 1991, the restructuring of Indian industry assumes new importance and in this M&A would play a crucial role. There have been strong historical factors that prevented and still hampers the emergence of an active M&A market. These are listed below.

1. The peculiar ownership pattern of Indian industry under which the promoters (or foreign principals in the case of multinationals) and government owned financial institutions

hold large controlling blocks. As per a study carried in the Economic Times (1989), the shareholding pattern of 250 leading listed companies in India was as follows.

	Equity capital %
Resident promoters	21
Foreign collaborators	17
Non-resident Indians	3
Financial Institutions (FI)	23
Public	36
	100%

While this pattern would have undergone changes in the recent times, it is very unlikely that collective institutional shareholdings [@] would have dropped by any significant extent; in fact the emergence of the (public sector) banks-sponsored mutual funds in last four years would, if any, have led only to an increase in the holdings of the government-owned financial institutions. Thus with the majority stakes in a large number of Indian companies being held by the promoter-institutional combine, it was extremely difficult to effect change of control. It was far easier for the incumbent managements to manage institutional support through political and bureaucratic clout. With such a concentrated shareholding pattern, there was virtually no scope for open takeover bids.

2. Absence of objective criteria in the exercise of voting power by the public financial institutions. The overwhelming institutional shareholding means that their support is crucial in any takeover situation. The exercise of their voting power is, more often than not, dictated by the powers that are than by the respective managements in keeping with the institutional interests. In 1983-84, the institutions supported the NRI raider Swaraj Paul against the managements of DCM and Escorts. In a later episode they retracted from a move to turn over to the tobacco giant ITC, the management of the then underperforming Madras-based India Cements because of the warring promoter groups managing to raise a political storm over the issue. In more recent times, the institutional conduct in the Ambani-L&T saga was, to say the least, a puppet show utterly lacking in professionalism and

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[@] No distinction is made between the development financial institutions (IDBI, IFCI and ICICI), the investment institutions (LIC, UTI and GIC) and the public sector banks, as they generally only act in concert at the behest of New Delhi.

credibility. The Indian Supreme Court was openly critical of the conduct of at least one such institution.[9] In many other cases where internecine quarrels or outright mismanagement were seriously eroding performance of companies, the institutions have seldom called the shots in time to arrest the drift.

3. Extremely tight regulatory environment. As an inevitable byproduct of the prevailing economic doctrine, there was some sort of bigness-phobia and size of any form in the private sector, irrespective of industry characteristics, had monopolistic connotations and hence was considered bad. Thus under Chapter III (especially section 23) of the MRTPA virtually every merger or acquisition of shares needed *prior* government approval, a tall order even for the stout-hearted, given that speed is the essence of succesful acquisition. Similarly the rigorous provisions of the FERA were deterrent to any acquisition involving foreign controlled companies. The company law procedures on amalgamations and other arrangements under sections 391 to 394 of the Companies Act 1956 are also cumbersome and time-consuming and, given the pressure on the Indian legal system, often take more than a year to fructify. Consequently no restructuring of operations could proceed with the required sense of urgency as managements wait for the legal formalities to get completed. The recent amendments to the MRTPA and the FERA would have certainly ushered in a more benign regulatory regime.

4. Restrictions on registration/transfer of shares. The incumbent managements of many companies, through provisions in their articles of associations, retain the right to refuse register of transfer of shares. Similarly there are restrictions imposed by sections 108-A to 108-D of the

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[9] About the dubious role of Bob Fiscal, (a wholly owned subsidiary of the public sector Bank of Baroda) in the transfer of 3.90 million L&T shares to the Ambani (Reliance) outfit Trishna Investments, the Supreme Court had this to say:

> "..... ... It is no doubt correct that any person or company is lawfully entitled to purchase shares of another company in open market, but if the transaction is done surreptitiously with a malafide intention by making use of some public financial institutions as a conduit in a clandestine manner, such deal or transaction would be contrary to public policy and illegal. ... ..."

Per Justice N.M. Kasliwal in *re* Larsen and Toubro Ltd., delivered on April 16, 1991.

Companies Act requiring prior government approvals for certain types of acquisitions involving large blocks (ie., 25 per cent) of shares. Section 22-A(3)(c) of the Securities Contracts (Regulation) Act (SCRA)also grants wide leeway for company managements to refuse registration of transfers in favour of unwelcome transferees. A key valid ground for refusal in all these cases is whether the registration of the share transfer is likely to result in *such change in the composition of the Board of Directors as would be prejudical to the interests of the company or to the public interest.* (Emphasis supplied). It is almost impossible, therefore, to mount a bid on any company except with the blessings of its management and/or government. And a wait for a decision or government ruling could turn out to be long drawn-out and expensive. Given the uncertainties in the stock market, it would be extremely risky for a bidder to remain in suspended animation. The appellate authorities like the Company Law Board have time and again gone with the incumbent managements' decisions to refuse registration of transfers. Thus it would be impossible for a raider to bid for a company with the explicit objective of replacing management, as that would be, often, a legally valid ground for refusing to register the share transfer!

5. High entry barriers in terms of government licensing and approvals. Until the recent liberalisation measures, no industrial activity was possible without a plethora of government approvals - such as industrial licence and clearences for foreign collaboration and knowhow acquisition, capital goods and raw material imports and financing, whether institutional or through capital market. Blessed were those who managed to start business after such heroic efforts. Given such conditions, it was extremely difficult for companies to redefine their product-market portfolios. And managements stuck dearly to their companies which any way enjoyed reasonable returns, thanks to the high entry barriers. The end result was a certain amount of strategic rigidity in the Indian industry with hardly any incentive for buying or selling companies.

6. High exit barriers. Similarly there are high exit barriers in India with virtually no management freedom to retrench either surplus assets or surplus labour. While many old and sick companies have valuable property which could be disposed of and the proceeds redeployed in business, given the rigour of urban land legislation (the Urban Land Ceiling Act), it would be impossible to undertake speedy asset disposal. Similarly, thanks to the various legislation and the power of the organised labour, it would be tall order to retire or redeploy labour rendered suplus from any restructuring. The experience of various managements of the

Madras-based Binny Limited is a case in point. Thus while ideally under/non-performing companies should have contributed to an active market for control in India, this has not occured in view of the high exit barriers. The only exceptions have been the sick companies notified under the SICA that are open to mergers and takeovers under rehabilitation schemes sponsored by the Board for Industrial and Financial Reconstruction (BIFR).

7. Tax policy. The Indian tax laws positively discourage business consolidation as is evident from the following.

   a. Every company is a seperate tax entity and even wholly-owned subsidiaries are not consolidated with the parent company for tax purposes.

   b. Under section 72 of the ITA, the unabsorbed tax benefits of a loss making company would not be available to the company with whom the former is merged, making such a merger unviable.[10] However such merger is permitted with full tax benefits under section 72-A if the merger is pursuant to rehabilitation scheme involving yet another set of approvals. Thus far from being a matter of business judgement, the economic viability of a sick unit and its turnaround strategies need bureaucratic blessings. Also both sections 72 and 72-A require that the old (ie, the loss making) business is continued to enjoy the tax set off from the past loss!

   c. Under section 79 of the ITA, any change of ownership of a closely-held company involving not less than 51 per cent of the voting power disentitles it from enjoying the unabsorbed past losses.

The combined effect of all these was that the market for corporate control in India remained extremely narrow, opaque and inefficient. The few acquisitions that were done were private deals behind the back of public shareholders often clinched off-shore, sometimes involving government financial institutions for considerations unknown. Or one witnessed mergers strictly between group companies for tax, financial or less obvious reasons. It was not uncommon for mergers to take place as cover-up operations to bail out non-performing group companies. Even the so-called 72-A mergers for rehabiliting sick companies were, more often than not, with profit-making companies of the *same* promoter

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[10] This is in view of the fact that the unabsorbed tax benefits are available only to the *assessee* (in this case, the amalgamating company) and amalgamation results in the disappearance of the assessee as a tax entity.

group. In the end, it was not surprising that one witnessed major structural weaknesses in the industrial sector with a large number of sick and near sick units caused by policy rigidities and inefficient managements. And the absence of an effective market mechanism, that is, an active market for corporate control to discipline inefficient managements and facilitate shifting of assets to more efficient users has certainly aggravated the problem.

Emerging Scene In India:

We feel that following the irreversible measures at freeing the economy from policy inflexibilities and state dominance, the stage is getting set for major restructuring through an active control market. As featured in a recent issue of Business World (1992a), a merger boom is in the offing and we see the following reasons for this.

1. Virtual abolishing of the industrial licensing regime and the progressive withdrawal of import controls. In one stroke, the high, artificial entry barriers are being demolished. As a result, the entire Indian industry players are expected to redefine their product-market portfolios and reformulate their corporate and business strategies. This would call for quick entry into the chosen fields and equally quick retreat from the identified exit areas.

2. Increased competition both from newly entering domestic manufacturers and imports. A number of sectors of Indian industry have grown to become highly fragmented, thanks to the policies of capacity-restricting industrial licensing and reservation to small and public sectors; eg., black and white television and light commercial vehicle industries. Invariably many of these fragmented industry players are not doing well. With the prospect of competition from new players, better technology and in some cases even outright imports, there would be great pressure on the domestic industry to consolidate with fewer, healthier units. This process would be through mergers and acquisitions. Similarly consolidation through mergers may also be witnessed in industries such as two-wheelers that are characterised by the presence of one or two dominant players and a host of fledgeling competitors. We would also expect, in a life after the scam, the banking and financial services industries to be major candidates for mergers and acquisitions, where intensive competition and high fixed administrative costs promise tremendous opportunities for

cost cutting through consolidation and rationalisation.[11] This imperative would become immediate as they are called upon to undertake massive investments in information technology and automation. Thus the emergence of a competitive environment would force company managements to accord top priority to cost cutting and effiency improvements which did not matter in the earlier regimes of protection and low emphasis on profitability. Mergers and acquisitions are likely to be pursued for these efficency-enhancing reasons. The Narasimham Committee Report (1991) on restructuring the Indian financial system also recommends consolidation of public sector banks through mergers. In the words of the Committee, "There is clearly need for a degree of consolidation of the structure and this could be brought about essentially through a process of negotiated rather than imposed mergers, based .... on market-driven and *profitability considerations as well as for reasons of business strategy."* (Emphasis supplied).

3. Mergers and takeovers could emerge as major corporate armour to defend against unwelcome raiders. As the threat of takeover increases because of the emergence of more helpful environment, one would expect mergers among group companies to 'create size', as size is generally perceived to be a major deterrent against takeover. It is also likely that there would be an increase in the merger of privately-held companies with the public companies under the same management undertaken with a view to boost the shareholding of the controlling group in the latter. One may also witness more tender offers from existing management group for shares they *already do not own* in their group companies to defend against possible future raids, as one saw in the recent offer of Tata Tea for Rallis India's shares. (As may be known, both Tata Tea Ltd. and Rallis India Ltd. belong to the Darbari Seth branch of the Tatas).

4. Environmental changes affecting specific industries could force consolidation through mergers and acquisitions in those sectors. For example, if, as per reports, India were to accept the Dunkel draft on intellectual property rights, one would exepect a spate of mergers/acquisitions involving the pharmaceutical boutiques in India. The key to the success of many of these companies, it may be noted, is the low cost generic manufacture of foreign patented drugs. If these avenues get closed under a new dispensation, those drug manufacturers may seek to merge amongst themselves to

[11] It may not be out of place to point out that in the U.S., the largest 125 banks are expected to save $ 10 billion in operating expenses over the next ten years as a result of mergers. See *Fortune* (1992)

be able to spend on research and development or to save on selling and distribution expenses. Alternatively, they could be acquired by patent-owning multinationals as low cost production bases. Similarly in the financial services industry, higher capital adequacy norms are going to be the order of the day, whether it be banking, stock broking or underwriting. The entry of well-heeled Indian business houses, government owned banks and aggressive multinational banks and agencies in the various segments of the financial services industry would force some of the smaller brokerage and other outfits to undertake defensive mergers. The merger in 1991/92 of five small finance companies belonging to the same group to form Lloyds Finance Limited with a much stronger capital base could well a forerunner of this trend. It is also likey that some of the smaller firms like the ones in the stock broking industry may allow themselves acquired by the big brothers as was the case in the developed countries. One may see similar trends towards consolidation in the advertising industry as well. One sector where takeover action has already begun is the banking sector. The Narasimham Committee's proposal for greater private sector role in banking has resulted in a mad scramble to take over the small private sector banks operating in different parts of the country such as Karur Vysya Bank, Federal Bank and Catholic Syrian Bank. Industrial and financial houses keen to play a leading role in the restructured financial sector of to-morrow are conscious of the time and cost of building up new bank networks from the scratch and hence prefer takeover of the existing banks as entry strategy. The higher capital adequacy norms for these banks, reckoned to be beyond their small, local shareholder base, would come in as quite handy for the entry of these well endowed business houses. Thus groups like Kotak Mahindra and Bangurs have acquired important stakes in Bank of Madura Limited and Bank of Rajasthan Limited respectively. Other banks like Federal Bank Limited, Karnataka Bank Limited and Catholic Syrian Bank Limited are topics of hot takeover rumours involving Birlas, Tatas, Ambanis and ITC as possible acquirers as reported in the Business World (1992b).[12]

5. As Indian companies seek greater global visibility both for expanding their thin international operations and also for tapping foreign capital markets, they will be forced to seek size through margers and acquisitions. Even the largest amongst Indian companies are midgets by world standards, and

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[12] Once again the securites scam may delay the banking sector reforms and the entry of private sector in banking. This may lead to a temporary lull in the takeover interest.

they have to necessarily acquire a certain critical size-threshold to both effectively compete off-shore and attract investor interest. Reliance-Reliance Petrochemicals merger, *inter alia*, would have achieved this.

6. During the tight regulatory regime of yesteryears, some Indian business houses such as the RPG group, the Chhabrias and the UB group of Vijay Mallya, had managed to pursue growth through acquisitions and takeovers, often involving sick companies or companies with foreign shareholdings. Some of acquisitions have turned out to be unfocussed, perhaps without much of a strategic logic. While the takeovers may have been justifiable in an era of industrial licensing, these groups will have to redefine their respective strategic priorities in the emerging environment of competitive markets and open investment climate. As a result, some of the acquisitions of the past could be put up in the takeover market as disinvestment candidates.

7. The stock market is expected to recover from the declines following the securities scam and post-Ayodhya political fall out and may witness more orderly rise in the near term. With the rising interest cost of long term debt (thanks to interest deregulation) on the one hand and freeing of the pricing of share issues on the other, one has already witnessed sharp rise in rights/public issues by companies. Armed with strong cash position, many of them would be aggressively pursuing takeover as a key corporate strategy. No doubt the stock market boom since 1991 has resulted in phenomenal increase in the valuation of the potential targets across the board.[13] Nonetheless, steep increase in the capital cost of greenfield investments following the rupee devaluations and the ever-increasing cost of market development would make many acquisitions still attractive. If stock prices stay high, acquisition through all or high proportion paper (share) offer, as illustrated in the Tata Tea's bid for Consolidated Coffee in 1989 as also its recent offer to Rallis India's shareholders and so common in other countries, would be increasingly resorted to. Empirical evidence in other countries also point to a positive correlation between stock market behaviour and takeover activity.

8. There have been a flurry of international mergers and takeovers involving companies that have operations in India; eg., Warner Lambert and Parke-Davis (Indian operations:

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[13] It is true that the Indian stock markets have fallen by about 45% by January 1993 from the delirious peak reached in April 1992. But the market indices still are more than twice the levels of January 1991.

Warner Hindustan and Parke Davis), SmithKline Beckman Corporation and Beecham (Eskayef and HMM, since renamed Smithkline Beecham in India), Asea and Brown Boveri (in India, Asea and Hindustan Brown Boveri, since merged). The trend is likely to continue. Arising from this, there will also be consequential mergers and consolidation of their Indian operations to achieve greater product rationalisation, cost efficiencies and better tax planning. The merger of the four companies of the ICI stable (rather the amalgamations of Alkali and Chemical Corporation of India Limited, Chemicals and Fibres India Limited and Crescent Dyes and Chemicals Limited with Indian Explosives Limited, now rechristened as ICI India) in 1982 is already a case in point. Even those Indian affiliates that stayed seperate until recently would opt to merge their operations in the new liberalised environment. The recently announced merger of English Electric and General Electric to form GEC Alsthom India and the amalgamation of Doom Dooma Tea and Tea Estates India with Brooke Bond India are illustrative of this trend. Are we likely to see a further consolidation of the Unilever Group Companies in India (Hindustan Lever Limited, Ponds India Limited, Brooke Bond India Limited and Lipton India Limited) before long?

9. One may also see, not withstanding the scam blues, the emergence of less restrictive and more descretionary lending regime in due course. This would help the financially strong companies to have greater access to borrowed funds for takeover purposes. As Indian financial sector gets better integrated with the rest of the world following the expected full rupee convertibilty leading to greater presence of foreign banks in India, takeover and mezzanine finance may become available to acquirers. (No doubt the securities scam definitely has cast its shadow on the entire financial sector and these developments may take place later than sooner).

10. In very many cases especially in the consumer goods industry, there could be a spate of acquisitions of companies having well-known brands, as creation of new brands would be high-cost, high-risk, time consuming proposition. As the better known brands in India are owned largely by the multinationals, acquisition for brands is likely to follow the international lead. In the case of well-known Indian brands, brand acquisitions could also be through strategic alliance rather than through outright takeover, as the recently unveiled arrangement between Godrej Soaps and Proctor and Gamble India illustrates.

11. The series of liberalisation measures would have the desired effects of attracting overseas investments - both from Non-resident Indians (NRIs) and multinationals. Many of them may

be taking the acquisition route rather than green field projects to speed up the entry process. The example of Esab India Limited, the Indian arm of the Swedish multinational, though not involving acquisition of entire companies is a case in point. Esab India, a late entrant into India, hasmore than made up and strengthened its presence in the Indian welding industry overnight through acquistions of the the welding related businesses of Indian Oxygen and Peico Electronics (Philips India). Recently it has also been reported that another Swedish company Hoganas India Limited is acquiring Mahindra Sintered Products Limited from the Mahindras. Reports in the international financial press indicate that a number of multinationals such as Nestle, Unilever, General Electric etc. are expecting significant growth in markets such as India and China in contrast to the slow growth expected in the mature Western markets. It is quite possible that these companies with their vast hoards of cash would become active acquirers in India to beef up their position ahead of competition. Incidentally, some of them are active acquirers in East Europe, and thanks to their prior presence in India, many of them are in a much better position to actively pursue acquisitions. For example, it has been reported in the Business India (1993) that ABB in India is actively pursuing the takeover of the ailing boiler maker ACC Babcock Limited. The FERA amendment through an ordinance in January 1993 easing the restrictions on acquisitions by the FERA companies could lead to their emerging as aggressive acquirers.

12. In the continuing context of current economic philosophy, companies are likely to have greater freedom to retire and/or redeploy their redundant labour and assets. Thus emergence of exit routes and property disposal freedom could overnight make many underperforming companies attractive targets. Company managements themselves may pursue assets disposals aggressively to capture values hidden in their assets as well as part of major restructuring exercise. This process of value capturing could spur major activity in the takeover market. For example, the pharmaceutical company Hindustan Ciba Geigy (HCG) has recently (December 1992) proposed to dispose of its Bhandup (Bombay) plant's property and use the proceeds for extending an attractive voluntary retirement scheme for the plant employees. Through this restructuring exercise, it is planning to put an end to the plant's unviable operations. Given their clear-cut priorities, it is the multinationals that would take the lead in unlocking the values in urban properties. We would expect many more companies, especially in high-wage islands like Bombay, to follow the HCG example. (Some Indian companies such as the DCM rump belonging to the Bharat Ram

faction is already putting to best use the valuable real estate assets, ie., in property development). Thus aggressive takeover market for such asset rich companies could develop in due course.

13. Another significant force to speed up the emergence of an active control market is privatisation. Despite ideological and, more importantly, political compulsions, we feel that *full* privatisation of a large number of loss-making central and state government units is inevitable given the harsh economic realities of government finances. (It might still be possible to limit to *partial* privatisation in the case of profit-making companies, at least in the near term). It is quite possible that privatisation with the formulation of an exit policy stirs up significant interest from the private sector, NRIs and multinationals. As a result, one may see a fair amount of action involving these privatised companies. The disposal of Allwyn Nissan by the Andhra Pradesh government in 1988 to Mahindra and Mahindra and their recent move to sell Hyderabad Allwyn to Voltas and to the BPL group in parts may very well be precursors to the future trend. The BIFR model rehabilitation proposed for the sick public sector units, in our view, is a politically palatable way of speeding up the privatisation programme. Consequently there could be significant increase in mergers/acquisitions involving public sector units. If the recent press reports are true, the heavy electrical unit BHEL is already in 'play', with multinational giants such as Siemens, GEC Alsthom and ABB reportedly evincing interest to pick up stakes therein.

14. At the socio-cultural level, as the younger crop of industrialists and managers take over corporate reins they, unlike their predecessors, are likely to have a less sentimental and more hard-nosed approach to business. This could lead to greater willingness at asset and company disposals.

15. The new-found opportunities in the capital market and the financial services industry would have created a new breed of tough and aggressive financial wizards and India's own versions of bust-up specialists, who would move fast to take over undervalued, underperforming companies. One may be witnessing glimpses of this scenario already.

16. One would also expect a more aggressively competitive market emerging for the so-called BIFR companies - sick companies ending up with the Board of Industrial and Financial Reconstruction for restructuring. We feel that multinational companies, more precisely their Indian arms, will be the more aggressive acquirers of such companies given the tax benefits and other incentives that can be negotiated. The

Unilever group in India is already a quite active acquirer of the sick companies. The proposed introduction of a BIFR-type rehabilitating agency for the sick public sector units could be a major contributory force in the emerging takeover environment.

17. In a situation corresponding to Jensen's (1986) [14] freecashflow hypothesis, a number of cash rich companies may resort to takeovers and acquisitions as a means of using up their surplus cash, given the more favourable regulatory regime and aggressive environment. Today a number of companies such as Bajaj Auto and its stable mate Maharashtra Scooters and Tata Tea have their cash surpluses invested in financial assets; these could find their way into takeovers.

18. Another factor that may permit greater room for takeovers is the prospect of a wider distribution of company shareholding. We would expect the government financial institutions, in the context of their reported resource constraints and redefined priorities, to progressively off-load their large holding in the private corporate sector. As is known, these were acquired in the past at low cost through underwriting devolvements or through exercise of convertibilty options and a booming stock market would be certainly the attractive times to book profits and clean up their much window-dressed balance sheets. The control market implications of these disinvestments are that these disinvested stocks are likely to be widely distributed amongst public sector and private mutual funds and other individual investors who are expected to have a more short term orientation and would easily part with their holdings in any attractive bid. (It may be recalled that, even at less congenial times, the government institutions did *not* miss out to accept the Tata Tea offer of near 100% premium for Consolidated Coffee). Thus the takeover defence in the form of large institutional holdings may not be available to

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[14] Jensen has argued that managers endowed with free cash flow may tend to invest, even in wealth destroying, ie., negative net present value (NPV), projects rather than pay out in the form of dividends. "... ... firms with unused borrowing power and large free cash flows are more likely to undertake low-benefit or even value destroying mergers." He defines free cash flow as the cash flow in excess of that required to fund all projects with positive NPVs. See Jensen (1986). Despite (because of ?) the fact that the top management of Indian companies are also the principal shareholders, we would suspect, they tend to follow conservative dividend policies, and using the cash for inter-corporate investments.

the same extent in future. Given the implications for the incumbent managements and their lobbying power, this process could get delayed to a certain extent.

19. In the long run, the market corporate control would see a lot of action from *disinvestment* of past acquisitions turned sour. If experience in other countries is any indication, a freer market would definitely result in some excesses; but market itself has the necessary built-in mechanism to trigger off corrections. Considering that speed and secrecy would characterise most acquisitions and given the possibilty of competing bids, there may always be some instances of overpayments or less than perfect pre-acquisition screening. And the managements may often move to disinvest their acquisitions to stoploss. (One may be reminded of the Chhabria takeover of GENELEC - a classic case of overpayment and poor screening).

20. And finally, if some reports are any indication, the international merchant bankers are eyeing to set up shops in India [15]. Most of them have global reach and sophisticated expertise in mergers and acquistions, cross border deals, complex defences, acquisition financing and a host of other financial services. If the western experience is any guide, their fees-driven business orientation can lead to a number of 'deals' and proposals ending up in the laps of company managements. And the emergence of fierce competitors could also energise domestic investment bankers to play a more aggressive role in M&A. Thus competition for fees and business amongst investment bankers itself could put firms in 'play' leading to greater activity in the takeover market.

On the basis of this unfolding scenario, we feel convinced that Indian industry may be about to witness major restructuring through mergers and acquisitions and an active market for corporate control is clearly going to emerge. The process may be delayed in line with the pace of reforms, but given the economic compulsions and the trends across the world, the direction is irreversible. No doubt the economic reforms would cause major upheavel in the way Indian industry is structured, organised and managed. A vigorous and active takeover market would be both a product and a reinforcing agent of this process. Are the Indian industry and the environment prepared for these developments? May not be; but rather than managing by serendipity to unfolding events, both the industry and the government would do well to

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[15] Eg., according to a report in The Times (London Times) of April 4, 1992 Merril Lynch, Morgan Stanley and Goldman Sachs are planning to set up operations in India. The process may be somewhat delayed in the post-scam, post-Ayodhya environment.

work together towards a well-thought out industrial strategy in which mergers and acquisitions would play their rightful role. We next look at the contours of a sound M&A framework for India.

<u>A Framework for Regulatory Reform for India:</u>

That the government of India is waking up to the economic role of mergers and acquisitions is evident from the MRTP Act amendments proposed in 1991. Even otherwise, there has been realisation about the role of M&A in bailing out the so-called sick units; hence the facilty for tax benefits under section 72-A of ITA. The government also has time and again attempted to restructure the operations of some public sector units through mergers. Similarly recently the Securities and Exchange Board of India (SEBI) has released a draft takeover code; this is aimed to ensure a fair deal to minority shareholders in takeovers. Useful as these beginnings are, they are no subsitutes for a set of consistent and well integrated takeover norms that guarantees reasonable legal certainty and predictability to all the participants. The urgent need for a fair and rational framework assumes significance as the country is likely to witness major upheavels on this score when firms end up in a takeover frenzy to gain headstart in the newly deregulated environment. The government should also proactively encourage takeovers and mergers as important means of restructuring Indian industry. It is also important to encourage the creation of larger firms through mergers in many sectors to develop the domestic industrial R&D base and to compete effectively with global giants. This calls for appropriate reforms in areas such as taxation, labour legislation and asset disposal as well.

In formulating a set of merger/takeover guidelines, it is useful to draw on the experience of the Western nations which have over long years been privy to active control markets. Even in these countries, the takeover regulations are continuously evolving in response environmental changes and innovative takeover practices. At the generic level, the takeover regulations in these countries cover two broad areas: anti-competitive effects and capital market effects as can be seen from the following.

1. <u>USA:</u> Sections 14(d) to (e) of the Securities Exchange Act of 1934 spell out rules ragarding tender offers and section 13(d) specifies the disclosure requirements on purchase of securities above a 5 per cent threshold. Similarly the Antitrust Improvement Act of 1976 requires pre-acquisition notification to the Federal Trade Commission (FTC) and the Antitrust Division of the US Department of Justice and mandatory waiting period to facilitate antitrust analysis of

significant mergers and acquisitions. Often the FTC and the Justice Dept. seek divestitures to reduce the anti-competitive effects. In addition there are state laws that govern the formation of contracts governing and acquisition and the conduct of board of directors.

2. UK: The procedural and shareholder aspects of the UK takeover regulations are governed by the City Code on Takeovers and Mergers (the Code), while the competition angle is covered by the Fair Trading Act, 1973 (FTA), or the new EEC Merger Control Regulations. The Code is the basis of a self-regulatory system governing takeovers and is applicable both to tender offers and to court approved scheme of arrangement. The Code is administered by the Panel on Takeovers and Mergers, a non-statutory body. The Code deals with such factors as duration for which a bid shall remain open, effects of counter bids, disclosure requirements and duties and responsibillties of the directors, investment bankers etc. The FTA scheme of approval is based on referrals by the Secretary of State for Trade and Industry. Only those which meet 'the assets test' (value of asstes taken over above £30 million) or 'the market share test' (combined post-merger UK market share amounting to 25 per cent or more) qualify for investigation.

3. Virually every country such as France, Germany, Spain, Sweden, Australia or Canada has a merger control regime to examine mergers/takeovers both from the points of view of competition as well as investor protection and capital market and these are continuously being revised and harmonised. For example, only recently the French have approved a reform obliging companies to buy all the shares of companies they are bidding for instead of just 66 per cent, following investor complaints. The European Community has its own merger regulation for approving mergers that have implications for the community-wide competition in the context of the borderless Europe from January 1993. Similalry the European stock exchanges are also moving towards an agreed set of takeover regulations.

Many of these countries have had particularly stringent provisions in respect of foreign takeovers. Thanks to recent trends in globalisation both in industry and capital markets, these are being reviewed and relaxed.

In India while any regulatory framework for mergers/takeovers should draw on the experience of other countries, it would be necessary to go far beyond these. Given the useful role mergers can play in restructuring Indian industry, it is reiterated that a proactive environment needs to be created to encourage these. The regulatory changes required across a wide front are listed below.

1. A totally revamped approach to the anti-competitive effects of mergers in the light of the drastic changes emerging in the competitive environment. The emerging competitive environment is going to be characterised by competition from imports arising lowering of import barriers, greater threat from substitutes and absence of domestic entry barriers. The regulation also has to take into account the need for consolidating domestic industries in a number of highly fragmented sectors. It is doubtful whether agencies like the MRTP commission, given the their current research base, are geared to play the requisite role. The new regulatory framework also has to capture the global dimensions of consolidation that have significant bearing on India. The inadequacies on this score can be seen from the fact that the two packaged tea giants in India came to the Unilever fold because of overseas developments involving their parent companies. It is not known whether any regulatory agency in India had occasion to examine the potential effects of the event on the Indian tea producers and consumers.

2. An early disposal of institutional shareholding in the private sector. As discussed earlier, the government owned financial and investment institutions have come to hold a high proportion of the share capital of the private sector corporations through devolvement of underwriting obligations, exercise of covertibilty options, preferential allotment imposed by government and outright market operations favoured with insider information. As this has also contributed to the general shortage of liquidity of scrips in the market and a premium on politics, at least the development institutions should offload their holdings in a bouyant market. Alternatively they may be encouraged to sell to the public under an offer for sale to ensure wider dispersal. To be fair to the private sector managements, this *privatisation* of investments can be achieved in a phased manner over a three to five year period depending on stock market conditions and performance of individual units. Such disinvestment, besides ushering in an era of greater corporate democracy and opportunity for a freer play of corporate control market forces, should also significantly augment the resources of the funds-strapped development institutions. The resulting increase in liquidity of floating stocks would also lead to better pricing in the market.

It is recognised that the same private corporate sector which, in the past, criticised the dominant role of the government would cry foul at these developments - at the prospect of becoming targets of bids from market sweepers. Well-performing company managements may not have to worry as any hostile bid is unlikely attract investor response except at a steep premium over the prevailing market price. And if

and when a high premium bid does materialise, the incumbent corporate management should recommend its acceptance consistent with its key duty of achieving shareholder wealth maximisation. Underlying this is the assumption that the bidder is confident of generating greater efficiency gains to justify his premium - some thing, perhaps, beyond the present management.

3. Mandatory registration of all share purchases to safeguard the interests of the shareholders of the investing and the target companies. It is a fundamental principle of corporate governance that any buyer of shares is entitled to the voting rights attached to them and he is free to exercise his voting rights even if to achieve change of management. Thus provisions such as in section 22-A(3)(c) of the SCRA granting protection to incumbent management should be repealed. Also no authority should sit in judgement about the fitness of a given management to govern and grant divine rights to any management to perpetuate its existence. The time lag and uncertainty involved in the current practice of non-registration by company managements and the legal contest thereof by the buyers are highly damaging to the interests of the general shareholders. At the same time, the legality of purchases and compliance with due processes can be subject to challenge. This should, however, be *after* the registration of the shares in question. The remedy can be freezing of voting rights without, perhaps, affecting the dividend and other entitlements. Recently in the celebrated battle for Source Perrier, the French mineral water company, between the Agnellis of Italy and Nestle of Switzerland, a French commercial court just froze the voting rights of a block acquired by an Agnelli ally on grounds of impropriety. Similarly the power to stall a takeover or merger on grounds of being "prejudicial to the company's interests or to public interest", should be exercised by the government only in cases such as involving strong anti-competitive effects. By the same token, company managements must be explicitly required to act in the best in the interests of the larger body of shareholders in case of bids.

4. Exercise of voting power by mutual funds: As the mutual funds in India are allowed to operate only in the form of trusts, exercise of voting power in respect of their shareholdings vests with the public trustee (read as yet another nominee of the government) under Section 187-B of the Companies Act. This probably is an unintended consequence of this section which was enacted in an era when mutual funds were not in vogue. It may be noted these mutual funds are to be managed by knowledgeable asset management companies with the sole responsibility to the funds' investors. As the institutional investors such as mutual

funds are to play the role of activist shareholders against erring managements, voting rights in respect of the mutual fund investments should be reverted from the public trustee to the fund managers themselves.

5. Scrapping of regulatory restrictions, other than the usual shareholder related ones, on use of corporate resources and assets. A key area of reform is the one involving urban land – the Urban Land Ceiling Act. This will enable resources such as land finding their way to most optimal uses such as for housing and commercial purposes. In fact companies should be encouraged and even forced to unlock values embedded in such properties. This will lead to better pricing of the underlying company shares from greater transparency and recognition of opportunity costs.

6. Greater and more *legitimate* freedom for management to build takeover defences. For example, companies may be allowed to buy back its shares subject to pre-determined shareholder approved limits. Besides being a transparent takeover defence, buying back own shares for a company may even be a good business decision. An open publically announced buyback is preferable to clandestine cornering of shares. At the same time, it must be ensured that the moment a company's floating stock comes down to, say below 25% of its issued capital from the share buyback or otherwise, that company should be delisted along with a mandatory full scale buyback of all the minority holdings. This is because a company with a small holding with the public is likely to pursue management's interests that may be inconsistent with the policy of shareholder wealth maximisation.

   At the same time proposals such as introduction of non-voting shares etc. *should not* be pursued. Even in countries such as Italy, Sweden and Switzerland where companies historically have shares with disproportionate voting rights, the move is under way to convert into a one share-one vote regime, prompted by the European Community's regulations. This is aimed at, inter alia, to create a level playing field for the market for corporate control. Since the trend world over is towards a more open corporate democracy with few restrictions on shareholder voting rights, permitting non-voting rights would be a retrograde step. And investors would be robbed of the only weapon they have against the perpetuation of underperforming managements. Similarly, in view of the overwhelming evidence in the West of wealth-destructiong effects of anti-takeover defences, no *such* defences should be allowed to be created in India.

7. The takeover code proposed by SEBI providing for greater transparency and equality of treatment and opportunity to all the shareholders is a welcome first step in the area of takeovers. See Varma *et al* (1991) for a cricial review of the draft takeover code. While one expects that these regulations will undergo changes based on experience and in response to environmental changes, there is an imperative need to consider the imposition of fullscale bid wherever the promoter group ends up with super majority holdings. At least as of now, amalgamations under the Companies Act do not have to go through SEBI. While realising onerous responsibilties suddenly being imposed on a fledgeling organisation like SEBI, it is still considered appropriate to provide for a role to SEBI for mergers/amalgamations as well, to ensure greater coherence in policy administration.

8. Tax reforms: Once it is recognised that mergers do have positive economic role, it is useful to remove archaic tax restrictions. Some of the suggestions in this regard are:

   * Amendment to section 72 of the ITA that should permit setting off of unabsorbed tax losses etc. of the amalagamating company with the income of the amalgamated company in *all* cases. This would make the the special case of section 72-A redundant. It must be noted that even today companies are undertaking reverse mergers (followed by rechristening) to get over the problem of non-availabilty of carried forward benefits under section 72. What is sought is an acceptance by the government of a widely recognised business reality that unabsorbed tax reliefs are valuable assets(!) that somehow companies manage to avail of. The advantage of making this explicit tax amandment is to simplify life for the corporate management who any way structure a reverse merger or a 72-A merger so as not to miss the tax benefits. Additionally this would remove tax uncertainties and result in the market valuation of tax losses and thus a better deal for the minority shareholders of loss-making companies.

   * Corporate tax procedures should be amended to provide for consolidated assessment and taxation of wholly or substantially owned subsidiaries and their parent (holding) companies as in many other countries. Currently, these are assessed as seperate tax entities, a consideration more to their legal structure than to their underlying business and ownership realities. This would lead to a more realistic valuation in a merger context. It may be noted that already for purposes of capital gains, under section 47 of ITA, the transactions between holding and wholly owned subsidiaries are ignored.

* Section 79 of the ITA providing for the denial of carried forward losses to closely held companies due to changes in majority shareholding should be repealed.

9. The reporting requirements under section 211 and 212 (and Schedule VI) of Companies Act 1956 should be amended to provide for the consolidation of the financial statements of holding company and its subsidiaries. To facilitate greater transparency and managerial accountability, line of business reporting should also be introduced. These changes would lead to better appreciation of the quality of earnings, and thus to better valuation. At a more fundamental level, switch over to internationally accepted accounting standards is a long overdue requirement to improve the quality of reported financial statements.

10. Employee buyouts: In the West, buyouts by incumbent management/employees contributed significantly to the process of restructuring industry in the eighties. Considering the large number of sick units in the country, India too may offer a fertile ground for employee buyouts. There are, in India, a few successful instances of employee-run companies such as Jaipur Metal and Kamani Metal. With greater involvement of incumbent non-promter management groups and professionals, a number of units can be successfully taken over. And this may be a more desirable alternative than outright closure or third party sale. However to facilitate this, some supporting mechanisms would be required, such as, providing financial assistance (similar to venture capital) for employee share ownership, higher leveraging and a say, 15-20 % price preference for the buyout team, should a bidding war emerge for the unit in question.

11. India needs a bankruptcy policy. Artificial propping up of weak companies and their ineffective managements should stop. It should be left to the corporate control market to effect changes in management, failing which companies should be allowed to be wound up. Such a policy would also encourage the emergence of realistic and mature trade union leadership. Banks and financial institutions should be allowed to make full use of their loan covenants and their clout to straighten out erring managements or force hopeless companies into liquidation. Winding up and liquidation proceedings under the Companies Act need to be simplified and streamlined so as to cut down the time and quicken the entire process. This would, besides leading to quicker settlement of claims, also speed up the redeployment of the resources released. Perhaps the time has come to establish seperate commercial courts to handle such issues expeditiously and thus free the higher judiciary of these commercial matters.

12. Provident and pension funds in India should be allowed to invest in equities and bonds of blue chip companies. It may be that the history of provident fund (PF) defaults of yesteryears and the recent Maxwell scandal in Britain and India's own security scandal are still rankling in the memory. Currently, by restricting PF investments only to government instruments, government is, to say the least, denying the PF subscribers any choice based on their risk-return preferences. As the country is actively inviting foreign pension funds to invest in Indian equities, there is no reason bar such investment avenues for domestic pension funds. In any event, PF investments are currently handled by financial illiterates and greater investment choice will go a long way to professionalising the invest management activity. No doubt suitable limitations such as credit rating of the bonds, dividend record of equities and overall cap on investments in individual companies, groups or industries can be imposed while scrapping the current ban on PF investments in corporate securities. To begin with, such investments may be routed only through mutual funds. The emergence of a large breed of professional pension and mutual fund managers would introduce greater maturity and stability to the Indian stock market and greater strategic orientation among company managements.

13. Merger valuation: In the case of mergers involving exchange of shares, the share valuation and determination of exchange ratios have been traditionally the domain of professional accountants (auditors) in India. In this, they have been largely guided by the now discredited share valuation guidelines of the erstwhile Controller of Capital Issues. Such valuation, placing as it does undue emphasis on *past* accounting statements, is highly flawed and is inherently biased against a sick company (despite belonging to a growth industry and high asset replacement cost) as pointed out by Varma and Venkiteswaran (1990). Given this basis, it is quite likely that in a number of mergers involving sick companies their shareholders would have been subjected to a less than fair deal. As share value is a function of future performance and growth prospects, a drastic reorientation of the past-oriented accountant's approach is called for. Perhaps investment bankers with greater business orientation should also be involved in valuation along with the innately conservative accountant.

14. Quality of information in merger documents: The merger documents that the shareholders currently receive contain very little useful infomation. In general, these consists of the draft resolution, a benign explanatory statement under Section 173(2) of the Companies Act and the draft merger agreement - all to comply with a legal formality. The strategic logic of the proposed merger, the details of the

merger valuation, the shareholding pattern before and after the merger and financial statements - past and projected, with and without the merger - which are important inputs in any merger context are not made available to the investors. Similarly in the case of takeover also, the shareholders do not get vital information such as shareholding pattern, earnings forecasts etc. While there is some improvement in the quality of the information content in the public issue prospectus, thanks to SEBI, not much has been done in the merger area. It is extremely important to improve the quality of information about mergers/takeovers while the market is still evolving as it is far easier to implement changes at the trickle rather than at the torrent stage.

These are but some suggestions for ensuring that the market for corporate control develops in India along healthy and orderly lines. As discussed, reforms on a wider front involving corporate governance and even taxation are called for as part of comprehensive and integrated industrial strategy for the country.

CONCLUSION:

This paper looked at the emerging corporate control market in India, an inevitable byproduct of the new industrial environment dominated by a market economy. Rather than wishing away its emergence or indulging in knee-jerk responses to unfolding events in the takeover market, the industry and government should draw upon the experience of other countries to ensure a free and fair market. Despite its protestations and policies against concentration of economic power, industrial ownership in the private sector has tutrned out be highly concentrated along family lines. While the contribution of business houses in keeping private initiative alive cannot be gainsaid, the ownership and management structures have created their own problems in their wake. In market oriented economy, a certain amount of economic Darwinism is going to prevail and nothing should be done to interfere with the market process of replacing company managements on the basis of performance. And managements who have tended to expect managerial succession as a matter of birth right would be aghast at the developments and would go all out to halt a more favourable takeover environment from emerging. With the expected entry of a large number of aggressive institutional investors amongst their shareholders, company managements would have to give more explicit attention to shareholder value management, rendered doubly difficult in an open, competitive economy. It is quite likely that some managements not used to the market pressures may fail the test, but are quite unwilling to give up management rights. It is here that the government may have to take a proactive lead to create something of an M&A environment. Afterall when managements themselves demand an "exit policy" for their workers, can the shareholders be left behind?

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