Working Paper

THE COMING RESTRUCTURING WAVE

By

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Abstract

Indian corporate sector is on the threshold of a major restructuring wave, with a new round of mergers, acquisitions and divestitures and demergers in the offing. This phase is likely to be qualitatively and quantitatively different from the earlier round in the first four years of economic reforms. This paper discusses some of the principal driving forces behind the new wave such as the continued low market valuation of a large number of companies, correction of managerial mistakes and cost pressures in several fragmented industries. This also examines the implications of recent regulatory changes for corporate restructuring in India.

The Coming Restructuring Wave

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N. Venkiteswaran

Corporate India is on the threshold of a restructuring wave. A new round of mergers, acquisitions, divestitures and de-mergers is set to radically alter the ownership and competitive structure of Indian industry. The pace may be typically Indian, but the process itself is inevitable. The new wave is likely to be significantly different - both qualitatively and quantitatively - from the earlier round witnessed in the first four years of economic reform. The earlier one was triggered off by the regulatory relaxation of the MRTP, FERA and implementation of various policy initiatives for attracting foreign direct investment, and consequently multinational corporations (MNCs, and their Indian arms) with their greater strategic focus and deep pockets were the prime players. The series of about ten mergers and acquisitions (M&A) involving the Unilever group of companies in India, Heinz's acquisition of Glaxo's family food division, Whirlpool's acquisitions of Kelvinator and TVS-Whirlpool and their subsequent merger, Colgate's acquisition of Cibaca from Hindustan Ciba Geigy, ABB's acquisition of ACC Babcock are some of the prominant transactions in this phase that comes to one's mind. Indian business houses were also not any less active. Besides mega-deals such as the opportunistic acquisition of Union Carbide by the Khaitans/Mcleod Russell and Ceat's tyrecord division by SRF, a number of groups did attempt to achieve consolidation and coherence through merger or amalgamation of the clutch of group companies. E.g., merger of Arvind Maftlal group's textile companies, merger of Polyolefine Industires Ltd. (PIL) with National Organic Chemical Industries Ltd. (NOCIL). Nonetheless the restructuring response of the Indian business houses in general has been somewhat halting and less forceful, partly because many of them were either still trying to figure out the depth and direction of reforms or chasing the so many new opportunities that were being thrown up by liberalisation.

A host of business, economic and regulatory developments in the last couple of years or so, we believe, strongly presage the new restructuring wave. These are discussed below.

Low valuation of companies

Nearly 3000 odd Indian companies are quoting stubbornly below par, some of them as low as 20 or 30 *paise* per share. Several companies belonging to larger groups even while quoting above par are still at extremely low multiples. Yet another dimension of the valuation problem is captured by the low market to book ratios for many of these companies; i.e., market price of the share being just a fraction of the book value. While there are a variety of (mostly) managerial, competitive and macroeconomic reasons for this, continued low valuation on such a large scale would be the major trigger for the next round of mergers, acquisitions and divestitures.

Low stock market valuation straightaway means that in several cases, wholesale acquisition of companies offer a cheaper alternative to new greenfield or even brownfield investment in a number of sectors. The companies which are able to sort out their liquidity problems first would be the ones to kick-start this process. We believe that sheer economic attractiveness would overwhelm the general reluctance and inexperience in effecting hostile bids in India. Since in most such companies promoters may not have absolute majority stakes, non-promoter shareholders would welcome with open arms any bidder who is willing to give them a profitable exit route. And the process would be helped by the facilitating legislations such as the new Take-over Code (discussed later).

Faced with the prospect of hostile take-overs, many Indian company managements themselves should initiate restructuring through divestitures or mergers. Since very often the biggest losers from low market valuation are the promoters themselves, they should find it worthwhile to salvage value through divestiture. One could see some parallel with the US and the UK in this regard. It is the success of the so-

called raiders like Hanson, Carl Ichan, James Goldsmith and leveraged buy-out outfits like the KKR in capturing value from the under-valued companies that forced company managements themselves to get their act together. Incumbent managements themselves soon began addressing the valuation problems through voluntary restructuring involving planned divestitures and focused acquisitions.

Correction of past managerial mistakes

The low valuation, in a large number of cases, certainly stemmed from seriously flawed managerial decisions. In the first flush of reforms and deregulation, most Indian groups rushed in just not to miss out a piece of the emerging action. Thus several groups

- diversified or attempted to diversify into exciting (?) new areas such as telecom, power, other infrastructure areas, oil exploration and refining, besides mundane areas like real estate and financial services, with access to neither technology nor deep pockets.

- invested heavily in financial instruments such shares of listed and even unlisted companies in bought-out deals.

- raised large funds through equity issues in domestic and international markets taking advantage of the freedom in issue pricing under the misconception that high premium equity is cheap money.

Unfortunately, they failed to realistically assess the entirely different risk profiles, gestation periods and cash flow patterns of the new investments. The consequence of the investment and financing misadventures has been wholesale destruction of shareholder value. Market valuation was further affected by lower profit/ cash flow generation by their mainstream or core businesses on account of severe and unprecedented competition particularly from cheaper imports, and newly entering

players. The problems were further compounded by the economy-wide liquidity crunch, and the high cost of funds of upwards of 20-25%

Having bitten more than they could chew, many companies should now be looking forward to correcting these mistakes and return to their core, quickly. This, needless to state, involves aggressive restructuring through divestitures, followed by bolt-on acquisitions. Here also one could see parallel with the US scenario. It is widely believed that the restructuring wave in the US in the second half of 80s was triggered off to an extent by the preceding period of high interest rates, forcing companies to divest their marginally performing units, often products of their diversification adventures of an earlier era, and return to the core.

Focus on shareholder value

The predominance of institutional investors - domestic and particularly foreign - and the emergence of a fastidious security analyst profession are forcing managerial attention explicitly on shareholder value management and shareholder value consequences of corporate decisions. The demand for delivering shareholder value could only become more strident in the coming days, with the generally loan recovery-focused domestic financial institutions joining the fray. This explicit attention to shareholder value would be a major dimension of the new M&A phenomenon. This would influence the manner in which the transactions are going to be structured.

It is being increasingly recognised that acquisition of companies, particularly through tender offer for or negotiated/market purchases of large block of shares that typically involve intercorporate investments and loans by other group companies would, more often than not, have adverse shareholder value consequences for the investing companies' shareholders. Consequently acquiring companies' share prices could experience significance price declines, particularly where this involves large premiums and in unrelated areas (in the absence of synergistic benefits). This

is because the returns the acquiring companies' shareholders can look forward to from the acquisition is only dividend, which in the normal course, can only give a measly financial return. This was precisely the problem which Mcleod Russell's shareholders experienced following its Rs. 300 plus crore acquisition of Union Carbide India Ltd (since renamed as Eveready Industries Ltd.). One way to resolve this problem is through a formal statutory merger or amalgamation of the acquired company and the acquiring company or companies, which inevitably Mcleod's Khaitans did. Given the implications for shareholder value, it is quite likely that a large number of future acquisitions are structured as merger or amalgamation of the companies involved or alternatively acquisition is quickly followed up with a statutory merger in which the full cash flow benefits flow directly to all the shareholders.

The growing emphasis on shareholder value should also see sharp increase in de-mergers or spin-offs of diversified Indian conglomerates, much as the same in other countries. It is widely recognised that most diversified companies suffer from conglomerate discounts in that the valuation of the whole (company) is less than the sum of its parts. This, *inter alia*, is on account of varying level of performance and potential of the individual businesses comprising the conglomerate and forced cross-subsidisation of underperforming businesses by diverting the resources generated by well-performing units. De-merger involves spining-off the individual businesses into stand alone companies and undertaking free distribution of their shares to the incumbent shareholders, thereby shfting the portfolio decision to the investor from company managements. Empirical evidence elsewhere indicates that such de-mergers do in deed help in delivering better value (E.g., the celebrated de-merger of the Imperial Chemical Industries PLC (ICI) into ICI and Zeneca). Limited Indian experience with de-merger such as Hoechst/Hoechst Schering AgRevo would appear to confirm this. With every one talking about focus and core competence, diversified companies like Larsen and Toubro, Grasim etc. could come under increasing investor pressure to effect de-merger.

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Resolving conflict of interest situations

This explicit attention to shareholder value would also call for consolidation of multiple group companies through merger or amalgamation. A number of Indian groups have multiple companies dealing in the same product-markets under the same stable, thus competing with each other for everything including strategic direction and investment. E.g., Nahar group, Bhilwara group, RPG in telecom cables, ICICI-SCICI, Piramal Healthcare-Nicholas Piramal etc. Needless to state, this does create serious conflict of interest., which can be resolved through merger. Already several groups (including the last three above) have proposed merger of the multiple companies to address the problem of conflict of interest. Besides this, such consolidation through merger could also be triggered by the pressure to slash costs (by avoiding duplication) imposed by the new competitive environment. The cement divisions of various Birla companies are candidates for such intra-group industry consolidation through merger. The MNC outfits in India have been fairly clear in this regard. E.g., the consolidation of the Unilever group in India, the merger of TVS-Whirlpool and Kelvinator under the Whirlpool management, the merger of the Wyeth group of companies with Cyanamid India, the merger of Sandoz with Hindustan Ciba-Geigy. Of course, the MNC consolidation moves are entirely dictated by their parents, but the mergers certainly avoids the conflict situation. It would be interesting to see how the new conflict problems being thrown up by the setting up of a number of new 100% MNC subsidiaries in India even as their old, listed subsidiaries continue, are resolved.

Industry consolidation

It is increasingly emerging that several Indian industries with highly fragmented structure are in for consolidation through mergers and acquisitions. The trend has already begun in pharmaceutical industry where there are far too many small players with narrow product-range. The inevitably weak R&D base, the impending move towards product patents, heavy interest costs on account of high leveraging and increasing competition in the bulk drug sector, all could mean that a large

number of Indian pharmaceutical companies could be gobbled up by the bigger players: both Indian and foreign. Ranbaxy's acquisition of Gufic and its acquisition through merger of Crossland, Piramal's acquisition (again through the merger route) of Sumitra Pharmaceuticals and Boehringer Manneheim), the proposed merger of Tamil Nadu Dadha Pharmaceuticals with Sun Pharma, its earlier acquisition of MJ Pharma are all pointers to this trend. Similarly Burroughs Wellcome (India) Ltd., has already passed the necessary enabling resolutions explicitly to pursue acquisitions opportunities in the economy.

Another sector which could experience significant consolidation is the cement industry with a very large number of players with widely varying sizes and capacities. The industry is forecast to experience excess capacity in the near term arising from bunching of capacity addition. With a highly fragmented industry structure that include several dominant players, the industry beckons for consolidation through mergers and acquisitions.

Similarly the consumer durable industry in India has become extremely competitive with the aggressive forays of the MNCs. Even with rising volumes, margins have become wafer-thin, increasingly weakening the financials of the industry players. Moreover most Indian companies dealing in refrigerators, air conditioners and colour TVs also suffer from serious technology gaps. It is a matter of time before they decide to sell out to the vertically integrated MNC competitors.

Encashing by promoter groups

It is also quite possible that a large number of entrepreneurs, particularly first generation, may decide to encash their entrepreneurial success by selling out early when the going is good rather than give up later from weakened positions in increasingly difficult market place. Many of them may prefer the merger route that would give them continued equity interest in larger companies and greater manoeuvrability for eventual exit, rather than a cash divestiture. The Crossland-Ranbaxy T.N. Dadha-Sun Pharmaceuticals typify this emerging trend.

While business and economic considerations as discussed above would be the major drivers behind the new restructuring wave, this would be facilitated by the more enabling regulatory environment. Similarly recent legal and tax changes (discussed below) would determine how the transactions are structured most optimally to meet the business goals of restructuring.

Amendment to SCRA and the new Takeover Code

Section 22A-3-c of the Securities Contracts Regulations Act (SCRA) that gave powers to company managements to refuse registration of shares lodged by an unwelcome acquirer has been deleted. Similarly Regulation 23 of the new SEBI Takeover Regulations (the new code) enjoins the target company managements to register shares lodged by the acquirer. Section 25 of the new code explicitly provides for the possibility of competitive bids, thus correcting the anomaly in the old take-over code, highlighted by the Bombay Dyeing counter-bid for Ahmedabad Electricity Company Ltd. in response to the Torrent's group's bid. Though company managements can still dilly-dally in registration, the room for this much more restricted. If the bidder offers a decent premium over market prices and an exit route, investors would only be too happy to tender their shares. It is quite likely that one could see a number of hostile bids.

Share buy-back

There is a widespread brouhaha that the proposal to permit buy back of shares (vide section 68 of the Working Draft of Companies Bill, 1997) can be an effective take-over defence. I do not believe so. There are very few Indian companies or groups with either the kind of cash generation or untapped borrowing capacity to finance large scale buy-backs necessary to avert hostile take-overs in the near term. Companies like Bajaj Auto or Reliance who have the resources are any way not that vulnerable to takeovers. The experience in other countries indicate that share buy back is resorted to by large free-cash flow generating companies to return cash to

shareholders rather than invest in sub-optimal projects. In that sense, they are viewed more as a variant of dividends. Nonetheless it is quite possible that vulnerable Indian companies could undertake large scale divestitures and use the proceeds for large share repurchase. Similarly buy-back could be resorted to by the many public sector companies (E.g. National Aluminium, India Tourism Development Corporation etc.) which have large overhang of equity.

Tax exemption of dividends

The provision introduced by the Finance Act, 1997 vide section 10 (33) of the income Tax Act, granting complete tax exemption for dividends would have wide implications for the corporate restructuring scenario in India. Since intercorporate dividends would be subject to the 10% dividend tax when paid out under the new section 115-O, the typical Indian corporate control structure involving shareholding by promoter-owned investment companies and by cascading chain of corporates may turn out to be tax-inefficient compared to direct holdings by non-corporate assesses. It is therefore on the cards that Indian industrial houses would be trying to unwind intercorporate holdings and distribute the same directly to the ultimate owners or resort to statutory mergers, subject of course to the control dilution consequences thereof.

Since dividends on preference shares also enjoy tax exemption under the aforesaid section 10 (33), an active market for preference shares and convertible preference is bound to develop. These instruments can be effectively used in acquisitions, and perhaps even in amalgamations that could satisfy the 90% shareholding test to make merger tax-free. Since a large number of potential M&A candidates are companies with languishing share prices, no dividend and no exit routes for their shareholders, offer of tax-free dividend yielding preference and convertible preference shares in exchange in M&A should find wide acceptance. For the acquirer-issuer, use of these instruments help in effecting merger/acquisition, at the same time minimising the dilution of control that an offer of pure equity alternative would have entailed.

Availability of finance

It has been the complaint of Indian industry that acquisition finance is not available in India which puts them at a disadvantage compared to the MNCs. This is likely to change. The restrictive minimum permissible bank finance (MPBF) concept is being quietly buried, and already several banks and financial institutions have expressed their intention to fund acquisitions. If the proposed Voluntary Disclosure of Income Scheme, 1997 succeeds in "whitening" large amount of black money, it is quite possible that many declarants could be emboldened to spend the money on acquisitions.

Thus it does appear that major restructuring wave is set to sweep Indian industry. This is going to be increasingly shareholder-value driven. With legal defensive walls tending to collapse, the only viable defence instrument open to company managements is sustained creation of shareholder value by itself. While giving full value may not necessarily save a company or its management, any thing less could spell their end.