Lesson Objectives

- To understand the process of terms mergers and amalgamation.
- Government and SEBI regulations related to M&A activity.

Introduction

Following the economic reforms in India in the post-1991 period, there is a discernible trend among promoters and established corporate groups towards consolidation of market share and diversification into new areas through acquisition/takeover of companies but in a more pronounced manner through mergers/amalgamations. Although the economic considerations in terms of motive and effect of these are similar, the legal procedures involved are different. The merger and amalgamation of corporate constitutes a subject matter of the Companies Act, the courts and law and there are well-laid down procedures for valuation of shares and rights of investors. The acquisition/takeover bids fall under the purview of SEBI. The terms mergers and amalgamations on the one hand and acquisitions and takeovers on the other are treated here synonymously/interchangeably. Section one of the chapter covers the framework of mergers/amalgamations including financial evaluation. The regulatory framework governing acquisition/takeovers is described in Section two. The main points are summarized in Section three.

Mergers/Amalgamations

The terms merger and amalgamation are used interchangeably as a form of business organization to seek external growth of business. A merger is a combination of two or more firms in which only one firm would survive and the other would cease to exist, its assets/liabilities being taken over by the surviving firm. An amalgamation is an arrangement in which the assets/liabilities being taken over by the surviving firm. An amalgamation is an arrangement in which the assets/liabilities of two or more firms become vested in another firm. As a legal process, it involves joining of two or more firms to form a new entity or absorption of one/more firms with another. The outcome of this arrangement is that the amalgamating firm is dissolved/ wound-up and loses its identity and its shareholders become shareholders of the amalgamated firm. Although the merger/amalgamation of firms in India is governed by the provisions of the Companies Act, 1956, it does not define these terms. The Income Tax Act, 1961, stipulates two pre-requisites for any amalgamation through which the amalgamated company seeks to avail the benefits of set-off/carry forward of losses and unabsorbed depreciation of the amalgamating company against its future profits under Section 72-A, namely:

i. all the property and liabilities of the amalgamated company/companies immediately before amalgamation should vest with/become the liabilities of the amalgamated company and

ii. the shareholders other than the amalgamated company/its subsidiary(ies) holding at least 90 percent value of shares/voting power in the amalgamating company should become shareholders of the amalgamated company by virtue of amalgamation. The scheme of merger, income tax implications of amalgamation and financial evaluation are discussed in this section.

Scheme of Merger/Amalgamation

Wherever two/more companies agree to merge with each other, they have to prepare a scheme of amalgamation. The acquiring company should prepare the scheme in consultation with its merchant banker(s)/financial consultants. The main contents of a model scheme, inter-alia, are as listed below.

- Description of the transfer and the transferee company and the business of the transferor.
- Their authorized, issued and subscribed/paid-up capital.
- Basis of scheme: Main terms of the scheme in self-contained paragraphs on the recommendation of valuation report, covering transfer of assets/liabilities, transfer date, reduction or consolidation of capital, application to financial institutions as lead institution for permission and so on.
- Change of name, object clause and accounting year.
- Protection of employment.
- Dividend position and prospects.
- Management: Board of directors, their number and participation of transferee company's directors on the board.
- Application under section 291 and 394 of the Companies Act, 1956, to obtain Higher Court's approval.
- Expenses of amalgamation.
- Conditions of the scheme to become effective and operative, effective date of amalgamation.

The basis of merger/amalgamation in the scheme should be the reports of the valuers of assets of both the merger partner companies. The scheme should be prepared on the basis of the valuer's report, reports of chartered accountants engaged for financial analysis and fixation of exchange ratio, report of auditors and audited accounts of both the companies prepared up to the appointed date. It should be ensured that the scheme is just and equitable to the shareholders, employees of each of the amalgamating company and to the public.

Essential Features of Scheme of Amalgamation: The essential features for pre-requisites for any scheme of amalgamation are as enumerated below.

Determination of Transfer Date (Appointed Date): This involves fixing of the cut-off date from which all properties, movable as well as immovable and rights attached thereto are sought to be transferred from amalgamating company to the
amalgamated company. This date is known as transfer date or the appointed date and is normally the first day of the financial year preceding the financial year for which the audited accounts are available with the company.

**Determination of Effective Date** by when all the required approvals under various statutes, viz, the Companies Act 1956, the Companies (Court) Rules 1959, Income Tax Act, 1961, Sick Industrial Companies (Special Provisions) Act, 1985, would be obtained and the transfer and vesting of the undertaking of amalgamating company with the amalgamated company would take effect. This date is called effective date. A scheme of amalgamation normally should also contain conditions to be satisfied for the scheme to become effective.

The effective date is important for income tax purposes the Companies Act does not provide for such a date but it is a practical necessity so that a court passing an order under Section 394(2) dealing with vesting of properties in the transferee company has before it a meaningful date contained in the scheme serving the purpose and in the contemplation of the applicant companies who are free to choose any date which will be binding one. While sanctioning the scheme the court also approves this date. The effective date may be either retrospective or prospective with reference to the application to the court. The effect of the requirement is that a mere order for the transfer of the properties / assets and liabilities to the transferee company would cause the vesting only from the date of that order. For tax considerations, the mention in the order of the date of vesting is of material consequence.

i. The scheme should state clearly the arrangements with secured and unsecured creditors including the debenture-holders.

ii. It should also state the exchange ratio, at which the shareholders of the amalgamating company would be offered shares in the amalgamated company. The ratio has to be worked out based on the valuation of shares of the respective companies as per the accepted methods of valuation, guidelines and the audited accounts of the company.

iii. The scheme should also provide for transfer of whole or part of the undertaking to the amalgamated company, continuation of level proceedings between the amalgamating and the amalgamated companies, absorption of employees of the amalgamating company, obtaining the consent of dissenting shareholders and so on.

**Approvals for the Scheme** The scheme of merger / amalgamation is governed by the provisions of Section 391-394 of the Companies Act. The legal process requires approval to the schemes as detailed below.

**Approvals from Shareholders** In terms of Section 391, shareholders of both the amalgamating and the amalgamated companies should hold their respective meetings under the directions of the respective high courts and consider the scheme of amalgamation. A separate meeting of both preference and equity share holders should be convened for this purpose. Further, in terms of Section 81(1A), the shareholders of the amalgamated company are required to pass a special resolution for issue of shares to the shareholders of the amalgamating company in terms of the scheme of amalgamation.

**Approval from Creditors / Financial Institutions / Banks** Approvals are required from the creditors, banks and financial institutions to the scheme of amalgamation in terms of their respective agreements / arrangements with each of the amalgamating and the amalgamated companies as also under Section 391.

**Approval from Respective High Court(s)** Approvals of the respective high court(s) in terms of Section 391-394, confirming the scheme of amalgamation are required. The courts issue orders for dissolving the amalgamating company without winding-up on receipt of the reports from the official liquidator and the regional director, Company Law Board, that the affairs of the amalgamating company have not been conducted in a manner prejudicial to the interests of its members or to public interests.

Now let us discuss step-wise procedure for amalgamation.

**Object Clause** The first step is to examine the objects clauses of the memorandum of association of the transferor and the transferee companies so as to ascertain whether the power of amalgamation exists or not. The objects clause of transferee company should allow for carrying on the business of the transferor company. If it is not so, it is necessary to amend the objects clause. Similarly, it should be ascertained whether the authorized capital of the transferee company would be sufficient after the merger / amalgamation. If is not so, this clause should also be amended. Suitable provisions for these could be incorporated in the scheme itself.

Preparation of a scheme of amalgamation on the lines explained earlier.

**Meetings / Information**

i. Holding of meeting of the board of directors of both the transferor and the transferee companies (a) to decide the appointed date and the effective date, (b) to approve the scheme of amalgamation and exchange ratio and (c) to authorize directors / officers to make applications to the appropriate high court for necessary action

ii. Inform the stock exchanges concerned about the proposed amalgamation immediately after the board meetings.

iii. The shareholders and other members of the companies should also be informed through press release.

iv. The transferor and the transferee companies should inform the financial institutions, bankers / debenture-trustees at least 45 days before the board meeting so that their approval is available to the proposed amalgamation at the time of board meeting.

**Application for Amalgamation** An application for amalgamation can be submitted by the company, members or even any of the creditors. A member, in this context means any person who has agreed to be a member and whose name appears on the register of members. A creditor includes all persons having pecuniary claims against the company for some amount whether present or future, definite or contingent. Even one member or one such creditor can make an application for amalgamation. Where the application is proposed to be made
by the company, only a person authorized by the company in this behalf can make an application for amalgamation. It is, therefore, essential that the company should authorize the director(s) or other officer(s) to make an application to the appropriate high courts and take necessary action as may be required from time to time. The directors can, however, apply for amalgamation only when requisite power appears in the articles of association originally or by way of amendment. Separate applications under Section 291 are required to be submitted to the appropriate high courts by the amalgamating and the amalgamated companies for the purpose of the respective high courts issuing directions to convene meetings of shareholders separately for preference and equity shareholders to approve the scheme of amalgamation. It is incumbent on both the transferor and the transferee companies to obtain sanction of high courts having jurisdiction over them. However, where both the companies are under the jurisdiction of the same high court, a joint-application may be made. Such an application can be moved even when an order for winding up has been made. However, the transferee company need not obtain approval under Section 291 when the transferor company is a wholly-owned subsidiary of the transferee company.

**Procedure for Application to the High Court** The procedure for making application to the high court has been laid down under the Companies (Court) Rules, 1959. An application under section 391 (1) for an order convening a meeting of creditors and/or members or any class of them should be by a judge’s summons supported by an affidavit. A copy of the proposed compromise or arrangement should be annexed to the affidavit as an exhibit. The summons should be moved ex parte. Where the company is not the applicant, a copy of the summons and of the affidavit should be served on the company, or where the company is being wound-up, on its liquidator; not less than 14 days before the date fixed for the hearing of the summons. On receipt of the application by the high court, a hearing takes place in the judge’s chamber, and after the hearing the judge may either dismiss the summons or order a meeting of the members or may give such directions as he may think necessary. But it is incumbent on the court to be satisfied that prima facie the scheme is genuine, bona fide and largely in the interest of company and its members. On being not satisfied with the scheme, the court may not even order the calling of meeting of creditors even if the consent of the creditors has been withheld or malafide or arbitrary even if the court considers the scheme reasonable and beneficial to the creditors. The court may dispense with the requirement of convening a meeting where all the members of a particular class have consented to the scheme and have entered into necessary agreement with the transferee company. Having known. Having known the proposed meeting the creditors may also move the court for rejection of the scheme and the court may entertain such an application and after reasonable scrutiny may call off the meeting.

**Holding of Meeting** The net step is to hold separate meetings of the shareholders and creditors of the company to seek approval to the scheme. The resolution approving the scheme may be passed by voting in person or by proxy as per the directions of the high court. At least three-fourth in value of the members or class of members or creditors must vote in favour of the resolution approving the scheme of amalgamation.

The members and the creditors are required to be classified into different classes for the purpose of convening meetings. This process has to be followed immediately on receipt of application under section 391 (1). If meetings of incorrect classification are convened and objection is taken with regard to any particular creditor of having interest competing with others, the company runs the risk of the scheme being dismissed. After classification, the court may order convening of the respective meetings of members and/or creditors.

For the purpose of convening meetings the court may give directions as it may deem fit regarding the following:

i. Fixing the time and place of such meetings(s);

ii. Determining the class or classes of creditors and/or members have to be held for considering the proposed compromise or arrangement;

iii. Appointing a chairman or chairmen for the meeting(s) to be held, as the case may be;

iv. Fixing the quorum and the procedure to be followed at the meeting(s) including voting by proxy;

v. Determining the values of creditors and/or the members of any class, as the case may be, whose meetings have to be held;

vi. Notice to be given of the meeting(s) and the advertisement of such notice;

vii. The time within which the chairman of the meeting is to report to the court the results of the meeting; and such other matters as the court may deem necessary.

The notice of the meetings of members and/or creditors, should be:

a. sent to the members/creditors;

b. sent to them individually by the chairman appointed for the meeting or if the court so directs, by the company or any other person as the court may direct, by post under certificate of posting to the last known address at least 21 clear days before the date of the meeting;

c. accompanied by a copy of the proposed scheme of compromise or arrangement and of the statement required to be furnished under section 393 and also a form of proxy.

The approval of the registrar of the appropriate high court should be obtained in respect of notice and explanatory statements, specifying the particulars prescribed under section 393 and in accordance with the directions issued by the court.

The notice of the meeting must be advertised in the prescribed form in such paper(s) as the court may direct, not less than 21 clear days before the date fixed for the meeting. In case of default, the summons should be posted before the court for such orders as it may think fit to make.

**Report of Chairman to the Court** The chairman of the meeting must within the time fixed by the court or where no time is fixed within 7 days of the date of the meeting, report the result of the meeting to the court. The report should state accurately the number of creditors or class of creditors or the
numbers of members or class of members, as the case may be, who were present and who voted at the meeting either in person or by proxy, their individual values and the way the voted.

Presenting Petition Before the Court After the proposed scheme is agreed to with or without modification in terms of section 391(2), the company must within seven days of the filing of the report by the chairman, present a petition to the court for confirmation of the compromise or arrangement. A copy of the petition should also be submitted to the regional director, company law board and others as directed by the court. The court would not sanction a scheme simply because it is recommended by the board of directors and approved by a statutory majority of the company. The court would have to see itself whether the scheme is reasonable and fair to all parties. A scheme which is proper on the face of it and in respect of which no fraud is alleged would not be rejected unless the objector shows any valid ground against it.

Under Section 394 (A), the court should give notice of every application made to it under Section 391 or 394 to the central government/ regional directors of company law board and take into consideration the representations, if any, made to it by the government before passing any order. However, the court is not bound to go by the opinion of the government / regional director as to the matters of public interest; rather it can form its independent opinion over the matte.

Where the company fails to present the petition for confirmation of the proposed scheme, it is open to any creditor or contributory, with the leave of the court, to present the petition and the company would be liable for cost. Where no such petition is presented for confirmation, the report of the chairman as to the result of the meeting must be placed for consideration before the judge for such orders as may be necessary. Such a petition must be moved within 7 days of the filing of the report by the chairman.

Once the scheme has been approved by the members of a company in a duly convened and held meeting, the petition filed for confirmation of the same cannot be withdrawn. The only course of action that may be followed is to appear before the court and raise the objections when the scheme comes up for consideration. In such a case, the scheme may not be sanctioned and the court may order for holding meetings of the members again. However, there is noting to prevent a company from requisitioning a meeting to consider a proposed modification in the scheme.

The court would fix a date for hearing the petition and a notice of the hearing must be advertised in the same newspapers in which the notice of the meeting was advertised or in such other papers as the court may direct not less than 10 days before the date fixed for the hearing.

The order of the court on the petition confirming the scheme should contain such directions in regard to any matter and such modifications in regard to compromise or arrangement as the judge may think fit to make for the proper working of the compromise or arrangement. The order must direct that a certified copy of the same should be filed with the registrar of companies within 14 days from the date of the order or such other time as may be fixed by the court.

The court while sanctioning the scheme should consider (i) that the provisions of the Act have been complied with; (ii) those who took part in the proceedings at the meetings are representatives of the class to which the meeting belongs and that the majority of them acted bonafide; and (iii) having regard to the object, background and other conditions of the scheme, the scheme on the whole is reasonable.

The high court may also direct the official liquidator for submission of reports after scrutiny of the books and papers of the amalgamating company. If the report indicates that the affairs of the company have not been conducted in a manner prejudicial to the interest of the public and the shareholders, the court may issue orders for winding up with dissolution.

Application for Direction If necessary, an application for direction of the court to provide for all or any matters indicated in Section 394(1) These are:

i. The transfer to the transferee company of the whole or any part of the undertaking, property or liabilities of any transferor company;

ii. The allotment or appropriation by the transferee company of any shares, debentures, policies, or other like interests in that company which, under the compromise or agreement, are to be allotted or appropriated by that company to or for any person;

iii. The continuation by or against the transferee company of any legal proceedings pending by or against any transferor company;

iv. The dissolution, without winding-up, of any transferor company;

v. The provision to be made for any persons who, within such time and in such manner as the court directs, dissent from the compromise or arrangement; and

vi. Such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation would be fully and effectively carried out.

The court would pass an order. Alternatively, by adding a suitable prayer in the main application, the court could be requested to give direction in regard to the above. In fact, such a course would provide for expeditious completion of amalgamation formalities.

Certificate A certified copy of the order of the court dissolving the amalgamating company or giving approval to the scheme of merger, should be filed with the Registrar of Companies concerned within 30 days of the date of the court's order.

Court Order A copy of the order of the court should be attached to the memorandum and articles of association of the transferee company [Section 39 391(4)].

As soon as the scheme of amalgamation has become effective, the members should be intimated through the press. Government authorities, banks, creditors, customers and others should also be informed.
Financial Framework

The financial framework of a merger decision covers three interrelated aspects: (i) determining the value of the amalgamating firm (ii) financing techniques in merger, and (iii) analysis of merger as a capital budgeting decision.

Determining the Firm’s Value

The first problem in analyzing a potential merger involves determining the value of the acquired firm. The value of a firm depends not only upon its earnings but also upon the operating and financial characteristics of the acquiring firm. It is, therefore, not possible to place a single value for the acquired firm. Instead, a range of values is determined that would be economically justifiable to the prospective acquirer. The final price within this range is negotiated by the two firms. To determine an acceptable price for a firm, a number of factors, quantitative as well as qualitative, are relevant. However, placing a value on qualitative factors such as managerial talent, strong, sales staff, excellent production department, and so on, is difficult. Therefore, the focus of determining the firm’s value is on several quantitative variables. The quantitative factors relate to (a) the value of the assets and 9b0 the earnings of the firm. Based on the assets values and earnings, these factors include book value, appraisal value, market value and earnings per share.

Book Value

The book of a firm is based on the balance sheet value of the owner’s equity. It si determined dividing net worth, by the number of equity shares outstanding. The book value, as the basis of determining a firm’s value, suffers from a serious limitation as it is based on the historical costs of the assets of the firm. Historical costs do not bear a relationship either to the value of the firm or to its ability to generate earnings. Nevertheless, it is relevant to the determination of a firm’s value for several reasons: (i) it can be used as a starting point to be compared and complemented by other analyses, (ii) in industries where the ability to generate earnings requires large investments in fixed assets, the book value could be critical factor where especially plant and equipment are relatively new, (iii) a study of firm’s working capital is particularly appropriate and necessary in mergers involving a business consisting primarily of liquid assets such as financial institutions.

Appraisal Value

Appraisal value as another measure of determining a firm’s value is acquired from an independent appraisal agency. This value is normally based on the replacement costs of assets. The appraisal value has several merits. In the first place, it is an important factor in special situations such as financial companies, natural resource enterprises or organisations that have been operating at a loss. For instance, the assets of a financial company largely consist of securities. The value of the individual securities has a direct bearing on the firm’s earning capacity. Similarly, a company operating at a loss may only be worth its liquidation value which would approximate the appraisal value. Secondly, the appraisal by independent appraisers may permit the reduction in accounting goodwill by increasing the recognised worth of specific assets. Goodwill results when the purchase price of a firm exceeds the value of the individual assets. Third, appraisal by an independent agency provides a test of the reasonableness of results obtained through methods based upon the going-concern concept. Further, the appraiser may identify strengths and weaknesses that otherwise might not be recognised such as in the valuation of patents, partially completed research and development expenditure. On the other hand, this method of analysis is not adequate by itself since the value of individual assets may have little relation to the firm’s over-all ability to generate earnings and thus the going concern value of the firm. In brief, the appraisal value procedure is useful if carried out in conjunction with other evaluation processes. In specific cases, it is an important instrument for valuing a firm.

Market Value

The market value as reflected in the stock market quotations comprises another approach for estimating the value of a business. The justification of market value as an approximation of true worth of a firm is derived from the fact that market quotations by and large indicate the consensus of investors as to the firm’s earning potentials and the corresponding risk. The market value approach is one of the most widely-used in determining value specially of large listed firms. The market value of a firm is determined by investment as well as speculative factors. This value can change abruptly as a result of change not only in the analytical factors but also purely speculative influences and is subject to market sentiments and personal decisions. Nevertheless, the market value provides a close approximation of the true value of a firm. In actual practice, a certain percentage premium above the market is often offered as an inducement for the current owners to sell their shares.

Earnings Per Share

Yet another basis to place a value on a firm is the earnings per share (EPS). According to this approach, the value of a prospective acquisition is considered to be a function of the impact of the merger on the EPS. In other words, the analysis would focus on whether the acquisition will have a positive impact on the EPS after merger or it will have the effect of diluting it. The future EPS will affect the firm’s share prices which is a function of price-earnings (PIE) ratio and EPS.

To summarize the discussion relating to earnings per share approach to determine the value of a firm, when the share exchange ratio is in proportion to the EPS, there is no effect on the EPS of the acquiring surviving firm as well as the acquired firm (Table 16.1). When, however, the exchange ratio is different, it may result into dilution in the EPS of the acquiring firm (Table 16.2) and accretion in the EPS of the acquired firm. For management of a firm considering to acquire another firm, a merger that results in dilutions in EPS should be avoided. However, the fact that the merger immediately dilutes a firm’s current EPS need not necessarily make the transaction undesirable. Such a criterion places undue emphasis upon the immediate effect of the prospective merger on the EPS. In examining the consequences of merger upon the surviving concern’s EPS, the analysis should be extended into future periods and the effect of the expected future growth rate in earnings should also be included in the analysis (Table 16.3).

Financing Techniques in Mergers

After the value of a firm has been determined on the basis of the preceding analysis, the next step is the choice of the method of payment to the acquired firm. The choice of financial instruments and tech-
techniques in acquiring a firm usually has an effect on the purchasing agreement. The payment may take the form of either cash or securities, that is, ordinary shares, convertible securities, deferred payment plans and tender-offers.

**Ordinary Shares Financing** When a company is considering to use common shares to finance a merger, the relative price-earnings (P/E) ratios of two firms are an important consideration. For instance, for a firm having a high P/E ratio, ordinary shares represent an ideal method for financing mergers and acquisitions. Similarly, the ordinary shares are more advantages for both companies when the firm to be acquired has low P/E ratio.

**Debt and Preference Shares Financing** From the foregoing it is clear that financing of mergers and acquisitions with equity shares is advantageous both to the acquiring firm and the acquired firm when the P/E ratio is high. Since, however, some firms may have a relatively lower P/E ratio as also the requirement of some investors might be different, the other types of securities, in conjunction with/ in lieu of equity shares may be used for the purpose. In an attempt to tailor a security to the requirement of investors who seek dividend/interest income in contrast to capital appreciation/growth, convertible debentures and preference shares might be used to finance merger. The use of such sources of financing has several advantages. namely, (i) Potential earning dilution may be partially minimised by issuing a convertible security. For example, suppose the current market price of the shares of an acquiring company is Rs 50 and the value of the acquired firm is Rs 50,00,000. If the merger proposal is to be financed with equity, 1,00,000 additional shares will be required to be issued. Alternatively, convertible debentures of the face value of Rs 100 with conversion ratio of 1.8, which would imply conversion value of Rs 90 (Rs 50 x 1.8) may be issued. To raise the required Rs 50,00,000, 50,000 debentures convertible into 90,000 equity shares would be issued. Thus, the number of shares to be issued would be reduced by 10,000, thereby reducing the dilution in EPS that could ultimately result, if convertible security in place of equity shares was not resorted to; (ii) A convertible issue might serve the income objective of the shareholders of target firm without changing the dividend policy of the acquiring firm; (iii) Convertible security represents a possible way of lowering the voting power of the target company; (iv) Convertible security may appear more attractive to the acquired firm as it combines the protection of fixed security with the growth potential of ordinary shares.

In brief, fixed income securities are compatible with the needs and purposes of mergers and acquisitions. The need for changing the financing leverage and for a variety of securities is partly resolved by the use of senior securities.

**Deferred Payment Plan** Under this method, the acquiring firm, besides making initial payment, also undertakes to make additional payment in future years to the target firm in the event of the former is able to increase earnings consequent to merger. Since the future payment is linked to the firm’s earnings, this plan is also known as earn-out plan. There are several advantages of adopting such a plan to the acquiring firm: (i) It emerges to be an appropriate outlet for adjusting the difference between the amount of shares the acquiring firm is willing to issue and the amount the target firm is agreeable to accept for the business; (ii) In view of the fact that fewer number of shares will be issued at the time of acquisition, the acquiring firm will be able to report higher EPS immediately; (iii) There is built-in cushion/protection to the acquiring firm as the total payment is not made at the time of acquisition; it is contingent to the realisation of the potential projected earnings after merger.

Notwithstanding the above benefits, there are certain problems of this mode of payment. The important ones are: (i) The target firm must be capable of being operated as an autonomous business entity so that its contribution to the total projects may be determined; (ii) There must be freedom of operation to the management of the newly acquired firm; (iii) On the part of the management of the acquiring firm, there must be willing co-operation to work towards the success and growth of the target firm, realising that only by this way the two firms can gain from merger.

There are various types of deferred payment plan in vogue. The arrangement eventually agreed upon depends on the imagination of the management of the two firms involved. One of the often-used plans for the purpose is base period earn-out. Under this plan the shareholders of the target firm are to receive additional shares for a specified number of future years, if the firm is able to improve its earnings vis-a-vis the earnings of the base period (the earnings in the previous year before the acquisition). The amount becoming due for payment in shares in future years will primarily be a function of excess earnings, price – earnings ratio and the market price of the share of the acquiring firm. The basis for determining the required number of shares to be issued in per following equation.

\[
\text{Excess earnings} \times \frac{P}{E \text{ ratio}} \\
\text{Share price (acquiring firm)}
\]

**Illustration**

Company A has purchased company B in the current year. Company B had its base year earnings of Rs 3,00,000. At the time of merger its shareholders received initial payment of 75,000 shares of Company A. The market value of Company A’s share is Rs 30 per share and the P/E ratio is 8. The Projected post-merger earnings of Company B for next three years are Rs 3,30,000, Rs 3,90,000, Rs 4,14,000. Assuming no changes in share prices and P/E ratio of Company A, determine the number of shares required to be issued to the shareholders of Company B during three years.

**Solution**

**Number of Shares**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Shares</th>
<th>Earnings</th>
<th>Price/E Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Rs 30,000 x 8 / Rs 30</td>
<td>8,000</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Rs 90,000 x 8 / Rs 30</td>
<td>24,000</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Rs 1,14,000 x 8 / Rs 30</td>
<td>30,400</td>
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Thus, the shareholders of company B will receive a total of 1,37,400 shares (75,000 initial + 62,400 in subsequent three years).

To conclude, the deferred-plan technique provides a useful means by which the acquiring firm can eliminate part of the
guess-work involved in purchasing a firm. In essence, it allows
the merging management the privilege of hindsight.

**Tender Offer** An alternative approach to acquire another firm is
the tender offer. A tender offer, as a method of acquiring firms,
involves a bid by the acquiring firm for controlling interest in
the acquired firm. The essence of this approach is that the
purchaser approaches the shareholders of the firm rather than
the management to encourage them to sell their shares generally
at a premium over the current market price.

Since the tender offer is a direct appeal to the shareholders, prior
approval of the management of the target firm is not required.
In case, the management of the target firm does not agree with
the merger move, a number of defensive tactics can be used to
counter tender offers. These defensive tactics include White
Knights and PAC-Mans. A white knight is a company that
comes to the rescue of a firm that is being targeted for a take-
over. Such a company makes its own tender offer at a higher
price. Under Pac-Mans form of tender offer the firm under
attack becomes the attacker.

As a form of acquiring firms, the tender offer has certain
advantages and disadvantages. The disadvantages are: (i) If the
target firm’s management attempts to block it, the cost of
executing offer may increase substantially; (ii) the purchasing
company may fail to acquire a sufficient number of shares to
meet the objective of controlling the firm. The major
advantages of acquisition through tender offer include: (i) If
the offer is not blocked, it may be less expensive than the
normal route of acquiring a company. This is so because it
permits control by purchasing a smaller proportion of the
firm’s shares; (ii) The fairness of the purchase price is not
questionable as each shareholder individually agrees to part with
his shares at the negotiated price.

**Merger As a Capital Budgeting Decision** Like capital
budgeting decision, merger decision requires comparison
between the expected benefits [measured in terms of the
present value of expected benefits/cash inflows (CFAT) from
the merger] with the cost of the acquisition of the target firm.
The acquisition costs include the payment made to the target
firm’s shareholders, payment to discharge the external liabilities
of the acquired firm less cash proceeds expected to be realised by
the acquiring firm from the sale of certain asset(s) of the target
firm. The decision criterion is ‘to go for the merger’ if net
present value (NPV) is positive; the decision would be ‘against
the merger’ in the event of the NPV being negative.