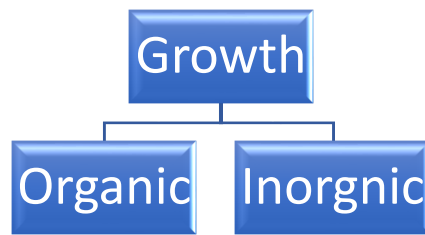


Ch. Funding of Merger and Takeover and Financial Restructuring



Organic Growth: through customer base, higher sales, increase revenue etc

Inorganic Growth: through M&A and other restructuring strategies

PROCESS OF FUNDING Mergers and takeovers may be funded by a company

(i) out of its own funds, comprising increase in paid up equity and preference share capital, for which shareholders are issued equity and preference shares or

(ii) out of borrowed funds, which may be raised by issuing various financial instruments.

(iii) A company may borrow funds through the issue of debentures, bonds, deposits from its directors, their relatives, business associates, shareholders and from public in the form of fixed deposits,

(iv) external commercial borrowings, issue of securities, loans from Central or State financial institutions, banks,

(v) rehabilitation finance provided to sick industrial companies under the Sick Industrial Companies (Special Provisions) Act, etc.

Form of payment may be selected out of any of the modes available such as

(a) cash payment, (b) issue of equity shares, (c) mix of equity and cash, (d) debt or loan stock, (e) preference shares, convertible securities, junk bonds etc.

Well-managed companies make sufficient profits and retain them in the form of free reserves, and as and when their Board of Director propose any form of restructuring, it is financed from reserves, i.e. internal accruals. Where available funds are inadequate, the acquirer may resort any one or more of the options available for the purpose of raising the required resources. The most prominent routes are the borrowing and issue of securities. The required funds could be raised from banks and financial institutions or from public by issue of debentures or by issue of shares depending upon the quantum and urgency of their requirements. Generally, a cash rich company use their surplus funds for taking over the control of other companies, often in the same line of business, to widen their product range and to increase market share.

FINANCIAL ALTERNATIVES: The acquirer/purchasing Co. can select a suitable financial package to make payment of purchase consideration to acquiree/vendor Co. Selection of financial package shall depend upon many factors as mentioned below:

- (i) It should suit to the financial structures of both the acquirer and the acquiree companies.
- (ii) It should provide a desirable gearing level which may suit to the financial structure of the acquirer.
- (iii) The package should be found acceptable by the vendors.
- (iv) The package should also prove economical to the acquirer.

Advantages

1. Financial alternatives provide access to many small business owners which were unavailable to them previously. Alternative financing is seen by many as being more balanced and fairer in terms of making loan decisions.
2. Low rate of interest
3. It helps to bring higher efficiency by providing required funds at right time to acquire company.
4. With Increase efficiency, a firm can reduce the additional cost and unwanted wasteful activities.
5. It provides way for diversification of business activity.

Disadvantages

1. Alternative financing is not clearly regulated in many jurisdictions.
2. Higher risk of loss.
3. Disadvantages of crowd funding.

Funding through various types of Financial Instruments

A. FUNDING THROUGH EQUITY SHARES: Equity share capital can be considered as the permanent capital of a company. Equity needs no servicing as a company is not required to pay to its equity shareholders any fixed amount return in the form of interest which would be the case if the company were to borrow issue of bonds or other debt instruments. In issue of shares, the commitment will be to declare dividends consistently if profits permit.

The process of issuing equity shares or bonds/debentures by the company takes a lot of time. It would require several things to be in place and several rounds of discussion would take place between the directors, and key promoters having the controlling stake, between the Board of Directors and consultants, analysts, experts, company secretaries, chartered accountants and lawyers. Moreover it requires several legal compliances.

B. PREFERENTIAL ALLOTMENT: Private placement in the form of a preferential allotment of shares is possible and such issues could be organized in a much easier way rather than an issue of shares to public.

C. FUNDING THROUGH PREFERENCE SHARES: Another source of funding a merger or a takeover may be through the issue of preference shares, but unlike equity capital, issue of preference share capital as purchase consideration to shareholder of merging company involves the payment of fixed preference dividend (like interest on debentures or bonds or) at a fixed rate. Therefore, before deciding to raise funds for this purpose, by issue of preference shares, the Board of directors of a company has to make sure that the merged company or the target company would be able to yield sufficient profits for covering discharging the additional liability in respect of payment of preference dividend.

D. FUNDING THROUGH OPTIONS OR SECURITIES WITH DIFFERENTIAL RIGHTS: Companies can restructure its capital through derivatives and options as a means of raising corporate funds. Indian companies are allowed to issue derivatives or options as well as shares and quasi-equity instruments with differential rights as to dividend and/or voting.

E. FUNDING THROUGH SWAPS OR STOCK TO STOCK MERGERS: In stock swap mergers, or stock-for-stock mergers, the holders of the target company's stock receive shares of the acquiring company's stock. The majority of mergers during the past few years have been stock-forstock deals. A merger arbitrage specialist will sell the acquiring company's stock short, and will purchase a long position in the target company, using the same ratio as that of the proposed transaction. As with all mergers, stock swap mergers may involve event risk. In addition to the normal event risks, stock swap mergers involve risks associated with fluctuations in the stock prices of the two companies.

F. FUNDING THROUGH EMPLOYEES STOCK OPTION SCHEME: This option may be used along with other options. The share capital that may be raised through a Scheme of Employees' Stock Option can only be a fraction of the entire issue. Hence no company can imagine of funding any scheme of merger or takeover entirely through this route. Merits and demerits of funding of merger or takeover through the equity issue have already been discussed earlier under the heading "Funding through equity issue". Employees' stock option scheme is a voluntary scheme on the part of a company to encourage its employees to have a higher participation in the company. Stock option is the right (but not an obligation) granted to an employee in pursuance of a scheme, to apply for the shares of the company at a pre-determined price.

G. FUNDING THROUGH EXTERNAL COMMERCIAL BORROWINGS (ECBs):

External Commercial Borrowings (ECB) refer to commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments (e.g. floating rate notes and fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares) availed of from non-resident lenders with a minimum average maturity of 3 years.

H. DEPOSITORY RECEIPTS (DRs): ADR is a foreign currency denominated instrument tradeable on a stock exchange generally in Europe or U.S.A. The major benefit that accrues to an investor from DRs is the collection of issue proceeds in foreign currency which may be utilized for meeting foreign exchange component of project cost, repayment of foreign currency loans, meeting commitments overseas and similar purposes.

I. FUNDING THROUGH FINANCIAL INSTITUTIONS AND BANKS: Funding of a merger or takeover with the help of loans from financial institutions, banks etc, has its own merits and demerits. Takeover of a company could be achieved in several ways and while deciding the takeover of a going concern, there are matters such as the capital gains tax, stamp duty on immovable properties and the facility for carrying forward of accumulated losses. With parameters playing a critical role, the takeover should be organized in such a way that best suits the facts and circumstances of the specific case and also it should meet the immediate needs and objectives of the management. While discussing modes of acquisition, certainly there would be a planning for organizing the necessary funding for the acquisition. If borrowings from domestic banks and financial institutions have been identified as the inevitable choice, all the financial and managerial information must be placed before the banks and financial institutions for the purpose of getting the necessary resources.

J. FUNDING THROUGH REHABILITATION FINANCE: Sick industries get merged through BIFR with healthy units with financial package to the acquirer from the financial institutions and banks having financial stakes in the acquiree company to ensure rehabilitation and recovery of dues from the acquirer. BIFR has been arranging such takeover from time to time in which creditor financial institutions and banks have been providing consortium financial packages in promoting mergers. Merger or takeover may be provided for in a scheme of rehabilitation under the Sick Industrial Companies (Special Provisions) Act, 1985.

The Sick Industrial Companies (Special Provisions) Act, 1985 provides for reference to the Board for Industrial and Financial Reconstruction (BIFR) of a sick industrial company. Once a reference is made, BIFR will cause an enquiry, appoint an operating agency for determination of measures necessary for rehabilitation of the sick company, direct the preparation of a rehabilitation scheme, which may provide, inter alia, for (i) rehabilitation finance for the sick

company; (ii) merger of the sick company with a healthy company or merger of a healthy company with the sick company; (iii) takeover of the sick company by a healthy company; (iv) such other preventive, ameliorative and remedial measures as may be appropriate.

K. FUNDING THROUGH LEVERAGED BUYOUTS: A leveraged buyout (LBO), is the acquisition of a company or division of another company, financed with a substantial portion of borrowed funds. The acquirer resorts to a combination of a small investment and a large loan to fund the acquisition. Typically, the loan capital is availed through a combination of repayable bank facilities and/or public or privately placed bonds, which may be classified as high-yield debt. The debt will appear on the acquiring company's balance sheet and the acquired company's free cash flow will be used to repay the debt.

Leverage Buy-Out (LBO)

A leveraged buyout, or LBO for short, is the process of buying another company using money from outside sources, such as loans and/or bonds, rather than from corporate earnings. Sometimes the assets of the company being acquired are also used as collateral for the loans (rather than, or in addition to, assets of the company doing the acquiring).

Following a LBO, the new owners often take the company private, rather than continuing to operate as a public entity.

LBOs by the Numbers

To be considered an LBO, the debt-to-equity ratio on an acquisition is typically between 70% to 30% to as much as 90% to 10%. That means the acquiring company invests 10-30% of the cost and borrows the remaining 70-90% to be able to make the purchase. That's a risky deal, mainly because the cost of the monthly loan payments, called debt service, on such a deal can be huge. Because of that, it can be difficult for some buyers to stay current.

Enormous loan payments are what caused the downfall of many firms engaged in LOBOs in the 1980s. Back then, LBOs were becoming so popular that in some cases, the debt-to-equity ratio was 100% to 0%, meaning companies were putting no money down and financing the entire deal. Yes, car dealers also offer those "no money down" opportunities, which can get buyers in trouble because the monthly payment is quite large.

These no-money-down offers also became popular in the mortgage industry and are what caused many homeowners to go bankrupt, many homes to be foreclosed on, and many banks to go under, after having financed too many homes that borrowers simply couldn't afford, thanks to the huge monthly payments.

Advantages of an LBO

Despite their risky nature, there are some pros to LBOs:

More control. Once the acquisition is converted to private ownership from public, the new owners can completely overhaul to company's operations and cost structure, making it easier for the venture to succeed.

Financial upside. Since, by definition, LBOs require acquiring companies to put up little to nothing of their own money, as long as the company being acquired can generate more than enough cash to fund its purchase, investors win.

Continued operation. Sometimes a company's financial situation becomes so dire that it is at risk of being shuttered altogether. When a buyer comes in, whether internal management or outsiders, the company at least has the opportunity to keep its doors open.

Disadvantages of an LBO

Of course, for every upside there is a downside. Here are some related to LBOs:

Poor morale. Especially in cases of a hostile takeover, where the company has no interest in being acquired, unhappy workers can convey their disappointment by slowing down or stopping work, further hampering the company's efforts to succeed.

Bankruptcy a big risk. If the acquired company's finances cannot, on their own, cover the cost of the loan payments needed to buy the company in the first place, it's possible the company will end up declaring bankruptcy. Weak finances are extremely risky.

Deeper cuts. While employees may hope that a new owner will help turn the acquired company around, in many cases, the cost-cutting required to return a company to profitability may involve serious job cuts and other unpopular measures. That means many employees will lose their jobs and the result could have a negative impact on the surrounding region.

Due to stricter banking laws introduced after the wild 1980s, LBOs are not nearly as popular as they once were, simply because it's very difficult to obtain financing.

Cost of various types of capital

- Equity capital is the permanent capital of the company, which does not require any servicing in the form of interest. However, the return to the equity capital is in the form of dividend paid to the equity shareholders out of the profits earned by the company. The ideal capital structure would be to raise money through the issue of equity capital.
- Debt is essentially an obligation, the terms of which are, inter alia, the repayment of the principal sum within a specific time together with periodic interest payments. Perhaps the easiest form of capital for a company to raise is, a loan from a bank. This form of loan capital may be comparatively expensive than equity.

However, as regards servicing of capital there are advantages of issuing debt instruments. Dividend is not a deductible expense when calculating a company's taxable profit; it is on the contrary an appropriation of profits. On the other hand, interest paid by a company on debt finance is an allowable expense when calculating a company's tax, thereby reducing its taxable profit.

A company may require any one or more of the above keeping in view its financial requirements at a particular point of time. A dynamic Board should constantly review the financial structure of the company and effect financial restructuring and reorganisation whenever the need arises.

NEED FOR FINANCIAL RESTRUCTURING A company is required to balance between its debt and equity in its capital structure and the funding of the resulting deficit. The targets a company sets in striking this balance are influenced by business conditions, which seldom remain constant. When, during the life time of a company, any of the following situations arise, the Board of Directors of a company is compelled to think and decide on the company's restructuring:

- (i) necessity for injecting more working capital to meet the market demand for the company's products or services;
- (ii) when the company is unable to meet its current commitments;
- (iii) when the company is unable to obtain further credit from suppliers of raw materials, consumable stores, bought-out components etc. and from other parties like those doing job work for the company.
- (iv) when the company is unable to utilise its full production capacity for lack of liquid funds. Financial restructuring of a company involves rearrangement of its financial structure so as to make the company's finances more balanced.

REORGANISATION OF CAPITAL In accordance with Section 390(b) Companies Act 1956, the expression “arrangement” includes a re-organisation of the share capital of the Company by the consolidation of shares of different classes or by division of shares of one class into shares of different classes or by both these methods. Accordingly, as per Section 390(b), the reorganization of share capital of a company may take place—

- (1) by the consolidation of shares of different classes, or
- (2) by the division of shares of one class into shares of different classes, or
- (3) by both these methods [Section 390(b)]. Besides, a company may reorganize its capital in different ways, such as – (a) reduction of paid-up share capital; (b) conversion of one type of shares into another etc.,

BUY BACK OF SHARE According to Section 68(1) of the Companies Act, 2013 a company whether public or private, may purchase its own shares or other specified securities (hereinafter referred to as “buy-back”) out of:

- (i) its free reserves; or
- (ii) the securities premium account; or
- (iii) the proceeds of any shares or other specified securities. However, no buy-back of any kind of shares or other specified securities can be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities. Thus, the company must have at the time of buy-back, sufficient balance in any one or more of these accounts to accommodate the total value of the buy-back. “Specified securities” as referred to in the explanation to the section includes employees’ stock option or other securities as may be notified by the Central Government from time to time. “Free reserves” as referred to in the explanation includes securities premium account.

- **Authorisation** The primary requirement is that the articles of association of the company should authorise buyback. In case, such a provision is not available, it would be necessary to alter the articles of association to authorise buy-back. Buy-back can be made with the approval of the Board of directors at a meeting and/or by a special resolution passed by shareholders in a general meeting, depending on the quantum of buy back. In case of a listed company, approval of shareholders shall be obtained only by postal ballot.

- Quantum of Buyback
 - (a) Board of directors can approve buy-back up to 10% of the total paid-up equity capital and free reserves of the company and such buy back has to be authorized by the board by means of a resolution passed at the meeting.
 - (b) Shareholders by a special resolution can approve buy-back up to 25% of the total paid-up capital and free reserves of the company. In respect of any financial year, the shareholders can approve by special resolution up to 25% of total equity capital in that year.
- Post buy-back debt-equity ratio The ratio of the aggregate of secured and unsecured debts owed by the company after buy-back is not more than twice the paid-up capital and its free reserves i.e the ratio shall not exceed 2:1. However, the Central Government may, by order, notify a higher ratio of the debt to capital and free reserves for a class or classes of companies; All the shares or other specified securities for buy-back are to be fully paid-up.
- **Effects of buyback: Following are the effects of buyback.**
 1. There is a reduction in capital of the company the extent of face value the shares bought back.
 2. There is an outflow of cash from the company.
 3. The shareholders whose Shares are bought back ceased to be owner of the company.
- **Objectives and importance of buyback.**
 1. Buyback leads to increase in EPS.
 2. It increases Intrinsic value of shares.
 3. Buyback reduces Excess share capital of the company.
 4. It reduces the chances of hostile takeover.
 5. Company can utilise surplus cash or idle cash balance for buyback.
 6. It Increase the shareholding of promoters of the company.
 7. share capital structure can be organised.