

Contd...

Value of Operations: The value of operations equals the discounted value of expected future free cash flow.

$$\text{Continuing Value} = \frac{\text{Net Operating Profit} - \text{Adjusted Taxes}}{\text{WACC}}$$

- Value of Debt
- Value of Equity

What Drives Cash Flow and Value?

- Fundamentally to increase its value a company must do one or more of the following:
 - . Increase the level of profits it earns on its existing capital in place (earn a higher return on invested capital).
 - . Increase the return on new capital investment.
 - . Increase its growth rate but only as long as the return on new capital exceeds WACC.
 - . Reduce its cost of capital.

Steps In Valuation

- Analyzing Historical Performance

$$\text{Return on Investment Capital} = \frac{\text{NOPLAT}}{\text{Invested Capital}}$$

Economic Profit = NOPLAT – (Invested Capital × WACC)
 FCF Cash Flow – Gross Investments

- Forecast Performance

Evaluate the company's strategic position, company's competitive advantages and disadvantages in the industry. This will help to understand the growth potential and ability to earn returns over WACC.

Develop performance scenarios for the company and the industry and critical events that are likely to impact the performance.

Forecast income statement and balance sheet line items based on the scenarios.

Check the forecast for reasonableness.

Estimating The Cost Of Capital

$$WACC = k_b(1-T_c)\frac{B}{V} + k_p\frac{P}{V} + k_s\frac{S}{V}$$

where

- k_b = the pretax market expected yield to maturity on non-callable, non convertible debt
- T_c = the marginal tax rate for the entity being valued
- B = the market value of interest-bearing debt
- k_p = the after-tax cost of capital for preferred stock
- P = market value of the preferred stock
- k_s = the market determined opportunity cost of equity capital
- S = the Develop Target Market Value Weights

Estimate The Cost of Non-equity Financing

Estimate The Cost Of Equity Financing

- Estimating The Cost Of Equity Financing- CAPM

$$k_s = r_f + [E(r_m) - r_f] \beta$$

- where r_f = the risk-free rate of return
- $E(r_m)$ = the expected rate of return on the overall market portfolio
- $E(r_m) - r_f$ = market risk premium
- β = the systematic risk of equity

Determining the Risk-free Rate (10-year bond rate)

Determining The Market Risk premium 5 to 6 percent rate is used for the US companies

Estimating The Beta

- The Arbitrage Pricing Model (APM)

$$k_s = r_f + [E(F_1) - r_f] \beta_1 + [E(F_2) - r_f] \beta_2 + \dots$$

where $E(F_k)$ = the expected rate of return on a portfolio that mimics the k^{th} factor and is independent of all others.

Beta k = the sensitivity of the stock return to the k^{th} factor.

Estimating The Continuing Value

Selecting an Appropriate Technique

- . Long explicit forecast approach
- . Growing free cash flow perpetuity formula
- . Economic profit technique

$$CV = \frac{\text{Economic Profit}_{T+1}}{WACC} + \frac{(\text{NOPLAT}_{T+1})(g / \text{ROIC})(\text{ROIC} - \text{WACC})}{\text{WACC}(\text{WACC} - g)}$$

where

Economic Profit T+1 = the normalized economic profit in the first year after the explicit forecast period.

NOPLAT T+1 = the normalized

- Calculating and Interpreting Results
- Calculating And Testing The Results
- Interpreting The Results Within The Decision Context

The way ahead

- How to achieve real consolidation and sustain it?
- Change in outlook, professionalism
- Cultural integration
- Budgeting for consolidation
- Due diligence
- Transparency and disclosure
- Risk management
- Safeguarding stakeholders interest and promoting value
- Good governance – corporate governance for better consolidation

Mr. Ram Mallar

Legal Issues Governing Consolidation

Mr. Ram Mallar highlighted the legal issues related with merger and acquisitions. In today's globalization, regulatory system is flexible for small to medium size organizations. 'Buyer' and 'Seller' both have to understand the process and needs at the same time.

It is expected that while the higher priority will be given to the operational challenges (such as integrating corporate cultures, merging IT systems and building solid management teams), it is also important to consider and address some of the legal issues. From a legal perspective, attention should be given to the following matters as part of the overall integration planning.

Due Diligence and Pre-Closing Period. The due diligence and pre-closing period can and should be used to assess, analyze, plan and address significant integration issues.

Exchange of Information. Competition law concerns surrounding the exchange of competitively sensitive information during the pre-closing period should be considered.

Human Resources. The retention of key employees, establishment of a key employee retention program, termination of non-essential personnel, pension plan and employee benefit harmonization and union/labour relations should also be reviewed.

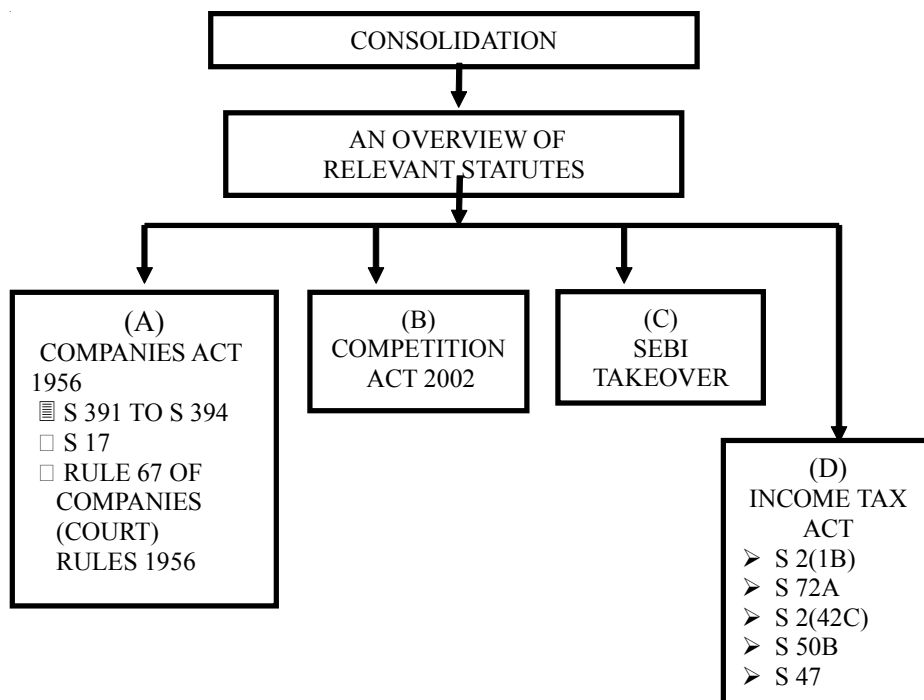
Information Technology and Systems. Integrating the numerous, complex and critical information and control systems will no doubt present challenges and must be addressed as soon as possible.

Organizational and Governance Structures. Organizational design changes and corporate governance issues that best suit the combined entities should be assessed.

Tax Planning. Pre-closing reorganizations that may optimize the combined entity's tax status, including any cross-border tax issues, should be analyzed.

Operational Matters. There are numerous operational matters that should also be analyzed to the extent applicable, including sales and marketing contracts, customer and supplier contracts, distribution and agency agreements, licenses, facility and equipment leases, transitional services agreements and shared facilities arrangements.

Source : *Frank Guarascio, Carolyn Naiman, Randy Bauslaugh, Richard Owens & Abdul-basit Khan, 'Legal Issues and Challenges for Integration Planning for M&A Transactions', <http://www.blakes.com>*



N.B.

(A) Companies Act

- 1) Section 391 to 394 provides for complete and comprehensive provisions and represents a single point of clearance. The said sections relate to arbitration, compromises, arrangements and reconstructions.
- 2) Buy back of shares is a provision introduced in the Companies Act through sections 77A, 77AA and 77B with effect from 31-10-1998

(B) Competition Act 2002

- 1) Competition Act 2002 has been introduced. This is a 'Paradigm Shift' in legislation — from controlled economy to an era of liberalization.

(C) Securities & Exchange Board of India (SEBI)

- 1) The SEBI takeover code applies to takeovers of any unlisted company in India or abroad when the acquirer of a company has control over a listed company.

(D) Income Tax Act

- 1) Section 72 A relates to carry forward and set off of accumulated loss and unabsorbed depreciation allowance in scheme of amalgamation of banking company in certain cases
- 2) Section 50B relates to special provision for computation of capital gains in case of slump sale
- 3) Section 47 relates to transactions not regarded as transfer

Company Law :

The current global financial meltdown has heightened this mantra of Consolidation.

The choices for Consolidation will include the following which has to be implemented under the Company law of India:

- ☞ Traditional proposals of merging two or more companies so as to transfer whole undertakings to one company called Transferee company proposed to be formed or to an existing company.
- ☞ Hiving off certain businesses to a Transferee company in consideration of allotment of shares or partly in cash or by way of allotment of mortgage bonds.
- ☞ Proposals so as to retain the core business with the Transferor company and sell other unconnected businesses to one or more companies already formed or proposed to be formed for appropriate considerations.

Considerations for the Shareholders of Transferor Company could be:

- ☞ innovative device to compensate them for their potential loss of earnings as a result of transfer of the businesses, or
- ☞ Could be allotment to them of shares in the transferee companies on an equitable basis or
- ☞ in case the transferor company is a listed company, provide in the scheme for the listing of the shares of the transferee company as provided in SEBI Rules.

Amalgamation / Merger

Amalgamation and merger: both words are used interchangeably to mean that a company (transferor company) amalgamate or merge with another (transferee company). It may also involve more than two companies.

Also mean two or more companies merge themselves to form a new company to take over business of all merging companies.

- ☞ The power under section 390 to 395 hitherto exercised by the High Court will henceforth be exercised by National Company Law Tribunal.
- ☞ The present jurisdiction of the High Courts will continue for the time being.

Widest discretion to the Courts (In future the Tribunal)

- ☞ Sections 391 to 394 provide a complete code as it is intended to be single window clearance.
- ☞ This is to ensure that the parties are not put to avoidable, unnecessary and cumbersome procedure of making separate applications to the court for various other alterations or changes which might be needed effectively to implement the sanctioned scheme whose overall fairness and feasibility has been judged by the court.
- ☞ The courts have recognized that it is the commercial wisdom of the parties to the scheme who have taken an informed decision about the usefulness of the scheme by supporting it by the requisite majority vote.
- ☞ The court would not, as a court of appeal, sit in judgment over the informed views of the concerned parties.
- ☞ The Court regards the Compromise as in the realm of corporate and commercial wisdom of the concerned parties.
- ☞ The court has neither the expertise nor jurisdiction to delve deep into the commercial wisdom exercised by the creditors and members of the company who are satisfied by the requisite majority.

Public Interest

- ☞ Section 394 casts an obligation on the court to be satisfied that the scheme for amalgamation or merger is not contrary to public interest.
- ☞ In amalgamation of companies, the courts have evolved the principle of “prudent business management test” or that the scheme should not be a device to evade law.
- ☞ Where the merger is with a subsidiary of a foreign company, then the economic interest of the country may have to be given precedence. The jurisdiction of the court in this regard is comprehensive.
- ☞ The provisions in section 391 to 393 apply to all companies registered under the Companies Act, 1956 and also unregistered and foreign companies.

Company already being wound-up can be revived under section 391–

- ☞ The provisions in section 391 can be availed of even to revive a company which is already in the process of winding-up.

Transferor Company shall first move the petition –

- ☞ It is the transferor company which should move the petition first under section 391

Object clause of Transferee company may or may not contain power to amalgamate

- ☞ The court did not accept that an amalgamation was possible only if object clause of Transferee and Transferor companies contained a power. It is held that the statute gave that power to the court to sanction an amalgamation.
- ☞ However, it would be desirable to alter the object clause of Transferee company by complying with the provisions section 17 of the Act when necessary.