Unit - V

Corporate Restructuring.

Corporate Restructuring refers to significant changes that occur in an org. This changes can be in the form of expansion or contraction of firms operations. The main purpose of this restructuring is to increase the shareholders value which ultimately increases the market price of the share & the corporate valuation.

Restructuring can take place in 3 different ways.

1. Restructure of Assets: When assets have to be purchased, replaced, sold etc.

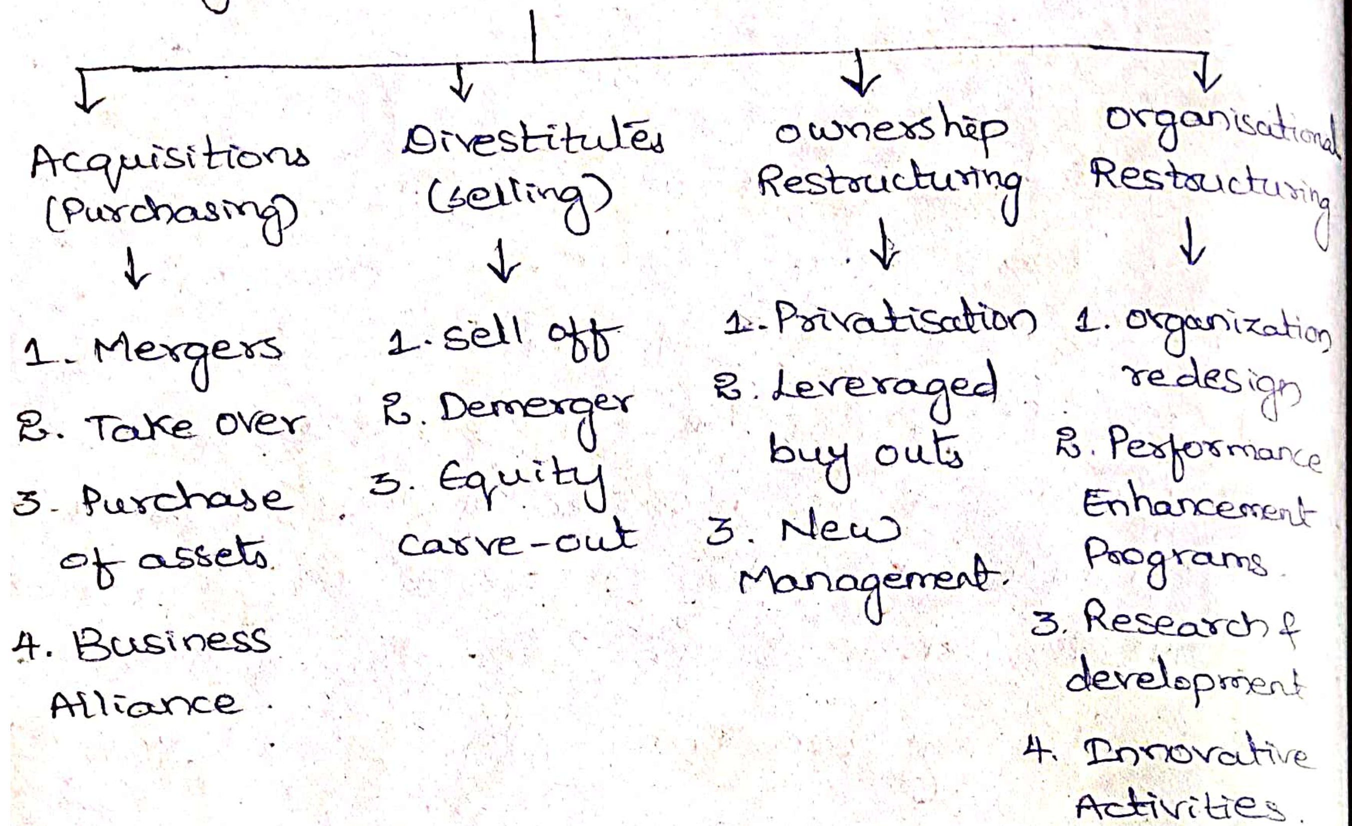
2. Restructure of ownership: When the existing firm wants to change the ownership or even the management by the way of joint ventures, mergers, acquisitions etc.

3. Restructure of business: When the business units, products, production line have to be organised differently, diversification etc.

~~Types~~ Categories of Corporate Restructuring

1. Financial Restructuring
2. Operational Restructuring
3. Organisational Restructuring
4. Strategic Restructuring

Types of Corporate Restructuring.



Corporate Mergers:

A merger refers to a combination of 2 or more companies to form one company or new company. There are different classifications of Mergers.

1. Absorption: one or more company taking an existing company.
For Eg: A, B, C are independent companies B is acquired by A & C.

2. Consolidation: Individual companies form a completely new company. For Eg: A & B from C.

3. Take over: A company is completely taken over by another company. For Eg: A & B are

independent Companies A takes over B. B no more exists.

4. **Liquidation**: It is also called winding up. It is a process by which the existence of a company comes to an end.

5. **Amalgamation**: All the assets & liabilities of amalgamated company & the share holders holding not less than 9/10th value of shares become the share holders of amalgamating company.

Types of Mergers:

1. **Horizontal Merger:**

Company operating & competing in the same line of business activity.

For Eg: 2 pharamaceutical companies starting a new pharmaceutical company.

2. **Conglomerate Merger:**

Firms engaged in unrelated type of business activities or products. It is opposite of horizontal Merger.

For Eg: firms in Software industry starting pharmaceutical company.

3. **Vertical Merger:**

Between firms in different stages of production operations.

For Eg: In an industry there will be different firms like research firm, production firm, marketing firm, product development firm etc where together to form a new company related to the same line of business

4. Cogeneric Merger:

It is one type of conglomerate merger where one firm acquires another firm of the same general industry but does not deal either in same line of business & is not a supplier customer.

For Eg: Reliance mobiles, reliance footware, reliance petrol, reliance hair dresses etc.

Economic Rationale for Mergers / Need for Mergers / Importance for Mergers:

1. Synergy of strategic benefit.
   - → Long term plans & implementation.
   - → Reduce competition.
   - → Prevent "
   - → Reduce risk & cost.
2. Synergy of Economies of scale.
   - → Availability of large scale Economies of production.
   - → Availability of external economies of scale.

→ Availability of internal economies of scale

3. Synergy of Economies of Scope.
→ To specialise in certain products.
→ To implement certain set of skills.
→ To procure assets of certain production.

4. Economies of vertical Integration.
→ Improve co-ordination.
→ Improve better control.
→ Value chain addition.

5. Complimentary Resources.
→ optimum utilisation of resources.
→ Specialised in certain activities.
→ Specialised in certain products.

6. Tax shield.
→ When accumulated losses, unabsorbed depreciation etc of a loss company can be set of against the profits of the purchasing company & can reduce the tax liability.

Exchange Ratio :

In a merger the acquiring firm offers its shares in exchange for the target firms shares. This offer is expressed in the form of ratio which is called exchange Ratio or swap ratio. It is the no. of shares the

acquiring company is willing to give in exchange for one share of the target firm.

For Eg: If the exchange ratio is 0.5 it means the acquiring firm is willing to give one shares for every two shares of the target firm.

The exchange ratio can be calculated based upon the following determinants

1. Book value Per share: If the book value per share of acquiring company is 25 & book value per share of target company is 15.

Exchange ratio will be $\frac{15}{25} = 0.6$.

2. Market Price Per share: If the market price of acquiring company is 50 & market price per share of target company is 10.

Exchange ratio is $\frac{10}{50} = 0.2$.

3. EPS: If the ~~ES~~ EPS of acquiring company is 5 & EPS of target company is 2. then the

Exchange ratio will be $\frac{2}{5} = 0.4$.

4. Dividend discounted value per share:

If the present value of dividend of acquiring firm is 40 & the target firms discounted dividend is 25.

Exchange ratio will be $\frac{25}{40} = 0.625$.

5. DCF value per share: If the acquiring company DCF value is 20 & the target company DCF value is 15.

Exchange ratio will be $\frac{15}{20} = 0.75$.

Corporate Good Governance.

It means the qualities of truthfulness, responsibility, faith, orientation, openness, accountability, mutual understanding, dedication, coordination, sincerity, & cooperation in work towards the success of the organization. It refers to allocation of ownership where it is necessary, power authority, direction & control.

Corporate governance means maximisation of the wealth of share holders. It can be possible if the company manager with care, responsibility, transparency & accountability towards the achievement of goals & responsibilities

The responsibility of the following contribute to corporate governance.

1. Management.
2. Board of directors.
3. Audit Committee.
4. Remuneration Committee.
5. Grievance Committee.
6. communication channel.

Principles of Good Corporate Governance.

1. Well, qualified & ethical CEO.
2. clear understanding of rules of board of directors, management, CEO etc.
3. CEO & senior management are responsible to run the day to day activities of the organization.
4. CEO should have high integrity.
5. Code of conduct should be implemented with effective reporting.
6. Audit committee should be conducted with outside auditors.
7. Audit Committee meetings should be conducted every quarterly.
8. All the share holders must be equal.
9. Directors should focus on long term planning of share holders value & wealth.
10. A central grievance committee should be formed with only directors & top level management.

11. Planning for departure of directors & formation of new board of director is essential regularly.

Corporate Valuation:

Value maximisation is an important aspect of financial management. Corporate valuation means a type of self appraisal & it helps to find out the total net worth of the organization.

It creates value for the shareholders & also to find out the credit worthiness of the shareholders.

It is responsibility of the management to increase the value of the company & the main purpose for valuing the corporation is to find out FMV – Fair Market Value.

FMV is defined as price to which the property would change hands between a willing buyer & a willing seller where both are not under computation to buy or sell but have reasonable knowledge of relevant facts.

There are 4 important methods of Corporate valuation.

1: Adjusted Book Value Method:

Under this method the value of the Corporation is based on two aspects called as investor claim.

(i) Algorithm Liability means share capital + Reserves + secured Loans + Unsecured loans.

(ii) Asset Liability Approach: Under this method

Corporate Valuation = Total Assets − Current Liabilities

2. Stock-debt Approach Method:

This method of corporate valuation helps to find out the total firms value by taking into consideration owner's equity & borrowed capital.

Total firms value = Market Value of Equity + Market value of debt.

3. Direct comparable Approach:

This approach is usually applied where two organizations or businesses are conducting similar operations. It is usually applied in real estate. For Eg: If there are two identical or near identical estates then if one of them sells at 1 lakh then the appraised value of the other estate will also be 1 lakh.

$$V_T = X_T \cdot \frac{V_C}{X_C}$$

Where V_T = Appraised value of target firm

X_T = observed variable for target firm

V_C = observed value of comparable firm

X_C = observed variable for comparable firm.

4. DCF Approach:

Value of the firm = Present value of cash flows during explicit forecast period + Present value of cash flows after the explicit forecast period.

Where explicit forecast period means a period of 5 to 15 years after the company was set up.

Steps:

1. Forecast the cash flows during explicit forecast period.
2. Establish cost of capital.
3. Determine the value at the end of explicit forecast period.
4. Calculate the firms value with the help of the above formula.
5. Interpret the results.

//

VBM – Value Based Management.

VBM is simply stated as management in which the entire organization is focused, measure, compensated for creating value for stake holders. Stake holders are all those people who are connected with the organization

1. Customers.
2. Share holders.
3. Employees.
4. Suppliers.
5. Bankers.
6. Government.
7. Community/society etc.

- VBM refers to integrate finance theory with strategic thinking & contribute for corporate planning. In simple words VBM means to create value for the organization which ultimately creates value for the share holders & also to all the stake holders.

Approaches to VBM:

1. Marakon Approach:

According to this approach the value of an organization can be measured by finding out the shareholders wealth. The share holders wealth can be calculated by using the formula.

Share holders wealth = Market value of equity − book value of equity.

It can be calculated by using the formula

$$\frac{M}{B} = \frac{r-g}{K-g}$$

Where, M = Market value of the equity.

B = Book value of the equity.

r = rate of return on equity.

K = Cost of capital.

g = growth rate.

2. Alcar Approach:

It is based on discounting cash flow analysis where share holders value depends up on value drivers.

Value drivers means

1. Rate of sales growth.
2. operating profit Margin.
3. Working capital Requirement.
4. Fixed capital Investment.
5. Cost of capital.
6. capital structure.
7. Rate of Taxation.
8. Value of the assets etc.

3. McKinsey Approach:

According to this method value of any particular organization can be calculated based up on 4 steps.

1. Ensure supremacy of value maximisation
2. Find out value drivers.
3. Establish appropriate managerial process
4. Implement value Based Management (VBM)

4. Stern Steward EVA:

According to this approach the value of any particular organization depends upon EVA – Economic value Addition. EVA can be calculated by applying the following formula

EVA = net operating profit after Taxes – Cost changes or fixed financial charges for Capital employed.

Where Net operating profit after Taxes = (PAT) Profit after Taxes + Interest (1–T)

5. BCG Approach:

Boston Consulting Group. According to BCG approach the value of the firm is an indicator for the total share holders returns.

Total share holders returns can be calculated with the help of the following formula.

$$P_0 = \frac{D_1}{1+r} + \frac{D_2}{(1+r)^2} + \cdots + \frac{D_n + P_n}{(1+r)^n}$$

Where P_0 = Price Per share.

D = Dividend per share.

r = rate of return on equity capital.

n = no. of years.

Financial Evaluation of Mergers

(1) You are given the following information of financial data of 2 companies A & B.

Particulars	Company A	Company B
PAT	7,00,000	10,00,000
Equity shares	2,00,000	4,00,000
EPS	3.5	2.5
PER	10 times	14 times
Market Price	35	35

Company B is acquiring company A at exchanging shares 1-1 basis. The exchange ratio is based on market price of the shares of the 2 companies.

(i) What will be EPS subsequent to merger.

(ii) What is the change in EPS for the share holders of both the companies.

(iii) Determine market value for post merger firm.

(iv) Ascertain gain from merger.

(V) Apportion the gains accruing to the share holders of both the companies.

Soln (i) **EPS After merger**

$$EPS = \frac{\text{Total Earnings}}{\text{No. of shares}}$$

$$= \frac{7,00,000 + 10,00,000}{2,00,000 + 4,00,000}$$

EPS = 2.83

(ii) **Change in EPS**

		A	B
Pre Merger EPS	—	3.5	2.5
Post Merger EPS	—	2.83	2.83
Change	→	-0.67	0.33

(iii) **Market Value of Post Merger**

Market price per share = EPS × PER

= 2.83 × 14

= 39.62.

Market Value = Total shares Post Merger × Market Price

= 6,00,000 × 39.62

= 2,37,72,000.

(iv) Ascertain Gain for Merger:

(a) Post Merger Market value of firm

= 2,37,72,000

(b) Pre Merger Market Value

A – 2,00,000 × 35 = 70,00,000

B – 4,00,000 × 35 = 1,40,00,000 = 2,10,00,000

∴ Gain → 27,72,000

(v) Apportionment of Gains:

A – $\frac{2}{6} \times 27,72,000$ = 9,24,000

B – $\frac{4}{6} \times 27,72,000$ = 1,84,8000

(2) A B company wishes to acquire CD company where exchange ratio is 0.8.

Particulars	AB	CD
PAT	1,00,000	20,000
ES	50,000	20,000
EPS	2	1
MP	20	8

(i) Determine the number of shares required to be issued by AB for acquistion of CD.

(ii) What will be the exchange ratio based up on market price of both the companies

(iii) What is PER currently.

(iv) Assuming the earnings of each firm remain same what is EPS after acquistion.

(v) What is equivalent EPS of shares of CD.

(vi) Ascertain gain from merger.

Sol:- (i) Shares required to be issued by AB = shares of CD × Exchange ratio

$= 20,000 \times 0.8$

$= 16,000$.

(ii) Exchange ratio based on market price

$$= \frac{\text{Market Price of CD}}{\text{Market Price of AB}}$$

$$= \frac{8}{20} = 0.4.$$

(iii) $PER = \frac{\text{Market Price}}{\text{EPS}}$

$AB = \frac{20}{2} = 10$ times.

$CD = \frac{8}{1} = 8$ times.

(iv) EPS after Merger

$$EPS = \frac{\text{Total Earnings}}{\text{No. of shares}}$$

Option 1 : When exchange ratio is 0.8.

$$EPS = \frac{1,00,000 + 20,000}{50,000 + 16,000} = 1.82.$$

option 2 : When exchange ratio is 0.4

$$EPS = \frac{1,00,000 + 20,000}{50,000 + 8000}$$

EPS = 2.07

(v) Equivalent EPS of shares of CD

= EPS after acquistion × Exchange Ratio

option 1 = 1.82 × 0.8 = 1.456

option 2 = 2.07 × 0.4 = 0.828

(vi) Ascertain Gain from Merger

Post Merger Market Value = Post Merger earnings × PER of acquiring company.

= 1,20,000 × 10 = 12,00,000

(−) Pre Merger Market Value of the firm

AB − 50,000 × 20 = 10,00,000

CD − 20,000 × 8 = 1,60,000 = 11,60,000

40,000

③ A company plans to acquire B company.

Particulars	A	B
Total current Earnings	50 cr	20 cr
No. of shares	20 cr	10 cr
Market price per share	30	20

(i) What is the maximum exchange ratio acceptable to share holders of A company if PER of both the companies is 12.

(ii) What is minimum exchange ratio acceptable to B company if PER of combined entity is 11.

(iii) At what levels do the exchange ratio of both companies intersect.

Sol:- (i) Maximum Exchange Ratio will be the choice of acquiring company which is denoted as ER_1 and it is calculated with the help of the following formula.

$$ER_1 = \frac{-S_1}{S_2} + \frac{PER(E_{12})}{P_1 S_2}$$

Where S stands for shares.

E – Earnings

P – Market Price.

$$ER_1 = \frac{-20}{10} + \frac{12(50+20)}{30 \times 10}$$

$$= -2 + \frac{840}{300}$$

$$= -2 + 2.8$$

$$ER_1 = \underline{0.8}.$$

(ii) Minimum Exchange Ratio will be the choice of Target company which will be denoted as ER_2 & is calculated as follows.

$$ER_2 = \frac{P_2 S_1}{PER(E_{12}) - (P_2 S_2)}$$

$$= \frac{20 \times 20}{11(50+20) - (20 \times 10)}$$

$$= \frac{400}{770 - 200}$$

$$= \frac{400}{570}$$

$$ER_2 = 0.70.$$

(iii) The exchange ratio ER_1, ER_2 intersect at the weighted average of 2 price earnings multiples. It is calculated as

$$PE_{12} = \frac{E_1}{E_1 + E_2}(PER_1) + \frac{E_2}{E_1 + E_2}(PER_2)$$

$$= \frac{50}{50+20}(12) + \frac{20}{50+20}(11)$$

$$= 8.57 + 3.14$$

$$PE_{12} = 11.71.$$

(4) From the following information where K ltd is acquiring S ltd.

Particulars	K	S
Earnings	3.6	1.2
Shares	1.2	0.8
EPS	3	1.5
MP	30	9

(i) What is maximum exchange ratio if PER is 8.

(ii) What is minimum exchange ratio if PER is 9.

(iii) What ratio do ER_1, ER_2 intersect.

Sol:- (i) Maximum Exchange Ratio will be the choice of acquiring company which is denoted as ER_1 & it is calculated with the help of the following formula.

$$ER_1 = \frac{-S_1}{S_2} + \frac{PER(E_{12})}{P_1 S_2}$$

$$ER_1 = \frac{-1.2}{0.8} + \frac{8(3.6+1.2)}{30 \times 0.8}$$

$$= -1.5 + \frac{8(4.8)}{24}$$

$$= -1.5 + \frac{38.4}{24}$$

$ER_1 = -1.5 + 1.6$

$= 0.1$

(ii) Minimum Exchange Ratio will be the choice of Target company which will be denoted as ER_2 & is calculated as follows

$$ER_2 = \frac{P_2 S_1}{PER(E_{12}) - (P_2 S_2)}$$

$$= \frac{9 \times 1.2}{9(3.6+1.2) - (9 \times 0.8)}$$

$$= \frac{10.8}{9(4.8) - 7.2}$$

$$ER_2 = \frac{10.8}{43.2 - 7.2} = \frac{10.8}{36} = 0.3$$

(iii) The exchange ratio ER_1, ER_2 intersect at the weighted average of 2 price earnings multiples. It is calculated as

$$PE_{12} = \frac{E_1}{E_1 + E_2}(PER_1) + \frac{E_2}{E_1 + E_2}(PER_2)$$

$$= \frac{3.6}{3.6+1.2}(8) + \frac{1.2}{3.6+1.2}(9)$$

$$PE_{12} = \frac{28.8}{4.8} + \frac{10.8}{4.8} = 6 + 2.25$$

$$PE_{12} = 8.25$$

Purchase consideration refers to the consideration or payment to be payable by the purchasing company to the vendor company for taking over the assets and liabilities of vendor company.

Methods.

1. Lumpsum method : The purchasing Co may agree to pay a lumpsum amount to the vendor company on the account of the purchase of its business. This method is not based on any scientific thoughts and techniques.

2. Net worth or Net Assets method.

3. Net payment method : The agreement between selling company and purchasing company may specify the amount payable to the shareholders of the selling company in the form of cash or shares or debentures.

4. Intrinsic value method (Shares Exchange method : Under this method, net value of assets is calculated according to net assets method and it is divided by the value of one share of transferee company which gives the total number of shares to be received

by the share holders of transfer or company from the transferee Co..