A Legal Perspective on Mergers & Acquisitions for Indian BPO Industry

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In a merger, companies come together to combine and share their resources to achieve common objectives. The shareholders of the combining companies often remain as joint owners of the combined entity. An acquisition resembles more of an arm's-length deal, with one firm purchasing the assets or shares or both of another, and with the acquired firm's shareholders ceasing to be owners of that firm.

M&A offers tremendous opportunities for companies to grow and add value to shareholders' wealth. It is a strategy for growth and expansion.

This article aims to journey through, to a value creating destination which elucidates the scenario in the Indian Business Process Outsourcing (BPO) industry, existing and expanding due to M&As. Further, as amalgamations of companies are implemented through a scheme of an arrangement approved by shareholders and/or creditors of the company concerned, this article discusses the provisions under the Indian Companies Act, 1956 **("Act")** to be followed for such schemes. It becomes pertinent to trace the origin of BPOs in India and the reason for its explosive growth, before understanding highly charged developing condition in the Indian BPO industry.

1. Business Process Outsourcing (BPO) in India

India is at the centre of attention of businesses worldwide today, particularly for its information technology capability. Since 1996, the focus has moved to ITES (Information Technology Enabled Services). Through BPOs, a company relocates entire business functions to either captive or third party service providers; typically in low cost locations. The concept of ITES/BPO started with the drive of the global companies to become cost efficient. In an attempt to stay competitive, corporates restructured their business in such a way that they could concentrate on their competencies and outsource the processes that were non-core to their business. India with its large English speaking graduate workforce and low wage levels emerged as an attractive destination for ITES/BPO.

1.1 Route to BPOs

Primarily there are three ways in which a company could enter the BPO space - build, buy or outsource to a vendor. All the options are interesting, shouldering respective advantages and disadvantages.

A build-up situation would facilitate a company to scale the market needs as and when required, have absolute control over the management and the quality of the output, though, the main disadvantage to this avenue could prove to be a long wait before any profits are realized.

The buy-up option, which is preferred by companies, entails taking a stake in an existing BPO company. In this method, the acquired BPO player brings with it, best practices and trained manpower in addition to its customer base.

The third option is the most sought by those companies, who are keen on diverting their management time and resources solely on their core competencies. These companies are generally not interested in a captive BPO concept where the BPO unit is set up with the sole aim to service the company's clients as opposed to a third party client. The primary concern for these companies is to get best services for their non-core business operations. The company, therefore, enters the BPO space by outsourcing non-core business operations to third party vendors, specializing in business operations of its interest

Among the three options mentioned above, there are two methods, which are often resorted to. In case a company is keen on a captive BPO outsourcing then the buy-up option is most sought after. In such an arrangement the infrastructure of a BPO is already in place, which makes this method time and cost effective and, in addition, the company is able to bring best practices, trained manpower, customer base, all ensuring faster return on the capital invested. This method is most suitable for big companies, having a large client base and business operations spread in different parts of the world. The downside to this arrangement is that if the company wants the BPO unit to specifically cater to its customers, in that case it will have to ensure that the buy-up stakes in the existing BPO unit is high leading to management control.

The second method is advantageous for those companies who are more interested in concentrating on their core operations, but at the same time target best results for their non-core business operations. This is achieved by outsourcing non-core business operations to a vendor, who provides services to various third party clients. The main advantage in this method is that, a relatively small company, whose principal interest is in the end and not the means vis-à-vis their non-core business operations, have an option to achieve such results through outsourcing, without having to invest capital and time in building or buying-up a BPO unit. The downside to this method is that the vendor providing outsourcing services is not client specific vis-à-vis the company. Therefore, the company outsourcing its operations to a vendor, runs the risk that the vendor may provide services to its competitor raising potential confidentiality issues. .

1.2 A challenging road

Vantage and challenges are like two sides of a coin. There are tremendous benefits to the growing BPO sector in India - companies earning huge profits and experiencing rapid expansion, availability of job opportunities for the large number of human resource which, otherwise, would have remained unemployed and the profit and growth to the Indian economy at large.

At the same time there are certain challenges which the BPO industry faces. Many small players are finding it difficult to survive in this capital-intensive industry. The rapid growth and large profits attained initially by big companies in the BPO industry attracted many smaller players who lacked the necessary expertise and engineered a reckless start. Being caught in a dire situation, the small companies are resorting to huge cuts in their billing rates, which, in turn is portraying a negative picture of the BPO sector. The situation is threatening the stability of the BPO industry at large.[1]

Another issue which threatens the BPO industry is the fact that companies are loosing out on contracts because of high attrition and inability to demonstrate a competent team of good quality managerial talent. Therefore, this is an area which can be overcome by offering appropriate and consistent training to enhance the existing capabilities, according to the requirements of the business.

There is no doubt that service provider confidence is abundant in India and there are great expectations from the industry, but there are also many challenges facing India even as the optimism about growth in 2006 gains momentum. The need for a global delivery model was therefore, strongly felt. Various propositions are being considered by the BPO industry, but one key tool which has proved to be a clear value-enhancing method has been consolidation through M&A.

2. Opening up to M&A - key to value addition

2.1 Applicable Indian legal provisions in case of M&A

Mergers can be defined to mean unification of two players into a single entity. Acquisitions are situations where one player buys out the other to combine the bought entity with itself. It may be in form of a purchase, where one business buys another business or a management buys out a business from its owners[2]. There is no specific process defined or cut out for carrying out mergers and acquisitions. It is largely based on commercial decisions, which companies take keeping in view the impact of taxes and its profitability. Further, mergers and acquisitions can be carried out in many ways. For instance, an Indian company may go global and acquire shares of a foreign company or vice-versa, where a foreign company acquires shares of an Indian company or both companies create another company for merger purposes.

[1] With so many companies trying to wet their hands with outsourcing, there is a rise in competition which is being balanced, by dipping price margins. This level of dip in price is what has come under tremendous pressure, which seems to be the only tool being used to grab contracts by the companies.

[2] Report on Company Law by J.J. Irani Committee, http://dca.nic.in/report_expert_comt.htm#chap10.

In India, merger and acquisition activities may be classified either in the form amalgamations[3] including merger and de-merger or as acquisitions which could be either asset or stock purchase or both.

Securities and Exchange Board of India Act, 1992 (**SEBI**) governs acquisition of shares of an Indian listed company by another company. Scheme of mergers, amalgamations etc. falls within the jurisdiction of the Companies Act, 1956 and Indian courts. Lastly, another important law involving M&A is Foreign Exchange Management Act, 1999 (**FEMA).** The applicability of the above mentioned regulations are as follows:

SEBI provisions

Investment in a listed company is subject to strict norms, which have been imposed by SEBI to ensure fair dealings in capital markets. As per regulation 10 under SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (**Takeover Code**), acquisition of 15% or more of shares of a company listed on stock exchanges in India would attract SEBI Takeover Code and such investor is required to follow the route of 'Public offer'. Further, under regulation 12 of Takeover Code, international transactions involving merger/takeover of a company having a substantial shareholding in an Indian listed company requires acquirer of such company to make a public offer to the shareholders of the Indian listed company also.

Generally, the purpose of a takeover is to gain control of the management of the target company[4]. However, a takeover can involve either acquisition of majority shares, without management control or, it could involve acquiring majority shares with management control. In practice, management control ultimately manifests itself through control over the Board of the company, whatever be the manner in which such change of control may be achieved, i.e. direct or indirect[5].

Control has been defined as, "right to appoint majority of the directors or to control management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner."[6] However, exceptions exist in case of inter se transfer of shares amongst promoters of a company and

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3 Under section 2 (1B) of the Income Tax Act 1961, "amalgamation in relation to companies, means the merger of one or more companies with another company or merger of two or more companies to form one company.........."

4 Target company means a listed company whose shares or voting rights or control is directly or indirectly acquired or is being acquired.

5 A direct acquisition is one, wherein, the prime concern of an acquirer is to acquire shares of the target company directly either from the existing shareholders or by subscribing to shares of the target company. In contrast under indirect acquisition, by virtue of an acquisition a mother company (whether in India or overseas) which holds substantial shares of another listed company, an acquirer eventually acquires shares of such listed company.

6 Regulation 2 (1) (c).

foreign collaborators and promoters. In such cases, neither change in the quantum of control amongst the existing management nor a case where some persons cease control of management post merger/acquisition will fall under the purview of takeover regulations[7].

An acquirer is defined as, "any person who, directly or indirectly, acquires or agrees to acquire shares or voting rights in the target company, or acquires or agrees to acquire control over the target company, either by himself or with any person acting in concert with the acquirer".[8] The Takeover Code further clarifies that a person acting in concert will include, a company, its holding company, or subsidiary or a company under the same management, which either individually or together have an objective to acquire substantial shares or voting rights or gain control of management, directly or indirectly in the target company.[9]

Under regulation 12 of takeover code, a public announcement is made in the newspapers by the merchant banker of the acquirer within three months of consummation of such merger/acquisition or change in control or restructuring of the parent company holding shares or control over the target company in India[10] and in case of fresh acquisition under regulation 10, a public announcement is to be made by the merchant banker of acquirer within four working days of entering into an agreement for acquisition of shares or deciding to acquire shares exceeding 15% of the target company.

The disclosure in the public announcement includes the identity of acquirer, offer price, number of shares to be acquired from the public, purpose of acquisition, future plans of acquirer, if any, in respect of the target company, change in control over the target company, the procedure to be followed by the acquirer in accepting the shares tendered by the shareholders and the period within which all formalities pertaining to the offer would be completed. A public announcement is made to ensure that the shareholders of the target company are aware of the proposed transaction; they could then choose whether or not to exercise the exit opportunity available to them.

NASSCOM conducted a strategic review in the year 2005, on M&As of 2004[11], according to which, the year of 2004 has proved to be the year of M&As, encompassing wide range in the quantum of investments.[12]

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[7] Explanation and proviso to Regulation 2 (1) (c).
[8] Regulation 2 (1) (b).
[9] Regulation 2 (1) (e) (1).
[10] Regulation 14 (4).
[11] NASSCOM: The Strategic Review 2005, Chapter 3, Table 19, Page 94.
[12] Transactions of varied financial values have taken place, for example deals below five million US $ between IT&T and Hinduja TMT. There have been transactions ranging between five million and forty million US $ between USA Accounts Solutions Group (ASG) and ICICI OneSource; Aegis Communications Group (US) and Essar and many more. There have also been high stake deals ranging between100 million and 500 millon US $, between GECIS and Oak Hill; Daksh E-services and IBM.

In 2005 and 2006 there has been consistent growth in mergers and acquisition in both Indian and international outsourcing companies. Recently, a US based Information Technology (**IT**) services company Electronic Data Systems (**EDS**) made a public announcement under regulation 10 and 12 of SEBI Takeover Code on 4.4.2006 to the shareholders of Mphasis BFL Ltd, an Indian IT company, to acquire 83,000,000 shares (51.72% of total voting equity) of Mphasis BFL Ltd. Pursuant to above public announcement, EDS made a conditional open offer worth US$380 million to acquire a majority stake in Mphasis BFL Ltd.[13] The offer was conditional upon EDS being able to acquire above referred number of shares. Mphasis' management has backed the deal and recommended the offer to their shareholders. The offer by EDS received good response from the shareholders of Mphasis BFL Ltd. and has successfully acquired shares.

The bid by EDS of Plano, Texas is the latest attempt by multinational IT services companies to acquire Indian outsourcing companies, to ramp up their own operations in the country, and take advantage of India's low-cost manpower.

<u>Companies Act, 1956</u>

The scheme of arrangement of amalgamations of companies, wherein a foreign company is amalgamating into an Indian company is court driven and long drawn in India. The sanction of the High Court is required for bringing it into effect. Section 391-394 of the Act deals with schemes of compromise and arrangements. The entire process has to be to the satisfaction of the High Court, at the location where the companies have their respective registered office. This sometimes results in delays. Merger of an Indian company into a foreign company is not envisaged by the Companies Act, 1956.

An application seeking sanction of the scheme is to be made under Section 391 of the Act with the concerned High Court and court under Section 394 of the Act may, either sanction the scheme or may make provisions for following matters:

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

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

(iii) continuation by or against the transferee company of any legal proceedings pending by or against any transferor company;

[13] Mphasis of Bangalore is a company listed on Indian stock exchanges and has both an **IT** services and business process outsourcing business. It has more than 12,000 employees, including about 11,000 in India, and has clients in multiple industries, including financial services, transportation, technology and health care.

(iv) dissolution, without winding up, of any transferor company;

(v) 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 shall be fully and effectively carried out

As far as acquisition of shares by an Indian company in the shares of another company is concerned, section 372 A of the Act provides that Board of directors may invest up to 60% of its paid up share capital and free reserves, or 100% of free reserves, whichever is more and in cases, where such acquisition is more than 60%, then a special resolution authorizing such acquisition is to be passed in the general meeting of the shareholders of the company.

In the year 2005 two Indian listed companies, Tata Consultancy Limited (TCS) and Tata Infotech Limited (TIL)[14] initiated a process of amalgamation of TIL into TCS with a view to expand customer base and a deeper penetration to gain more efficient operations for both companies.

As per the scheme of amalgamation, shareholders of TIL received one equity share of INR 1 each of TCS for two equity shares of TIL of INR 10 each. Board of Directors of both companies passed resolutions[15] approving the scheme of amalgamation of TIL with TCS pursuant to section 391-394 of the Companies Act. Pursuant to passing of Board resolutions, petition was filed with the high court at Bombay to fix up the meetings of equity shareholders and unsecured creditors of both companies to approve the proposed scheme of amalgamation of TIL with TCS. The scheme of amalgamation was passed by the unsecured creditors shareholders of respective companies in meetings held on October 18, 2005. The scheme was approved by the Bombay high court on January 27, 2006 with retrospective date of April 1, 2005.

Foreign Exchange Management Act, 1999 (FEMA)

Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 deals with issue and acquisition of shares after merger or de-merger or amalgamation of Indian companies.

As per regulation 7 of the above stated regulations, where a scheme of merger or amalgamation of two or more Indian companies or a reconstruction by way of de-merger or otherwise of an Indian company has been approved by a court in India, the transferee or the

[14] Tata Sons Limited holds 80.64% of the paid up share capital of TCS and 74.18% of the paid up share capital of TIL.

[15] Both TCS BOD and TIL BOD passed resolutions on July, 15, 2005.

new company can issue shares to the shareholders of the transferor company i.e. the foreign company. However, this is subject to following conditions:

"a) the percentage of shareholding of persons resident outside India in the transferee or new company does not exceed the percentage specified in the approval granted by the Central Government or the Reserve Bank, or specified under the regulations stipulated under FEMA:-

Provided that where the percentage is likely to exceed the percentage specified in the approval or the Regulations, the transferor company or the transferee or new company may, after obtaining an approval from the Central Government, apply to the Reserve Bank for its approval.

b) the transferor company or the transferee or new company shall not engage in agriculture, plantation or real estate business or trading in transferable development rights and

c) the transferee or the new company files a report within 30 days with the Reserve Bank giving full details of the shares held by persons resident outside India in the transferor and the transferee or the new company, before and after the merger/amalgamation/reconstruction, and also a confirmation that all the terms and conditions stipulated in the scheme approved by the Court have been complied with."

3. Elements enhanced through M&A

Having witnessed series of M&As, it is evident that the Indian BPO industry has chosen its means, with an aim to enhance the following elements[16] within its domain, in order to ensure success and stability.

3.1 Importance of the size of the company

The primary aim of companies while considering M&A, is growth in size by adding manpower which facilitates overall expansion. The Polaris-OrbiTech merger added 1,400 employees to Polaris, taking the total employee strength to 4,000. For Bangalore-based vMoksha Technologies, the logic behind the acquisition of two US-based companies, Challenger Systems and X media, was to increase in size by widening its customer base. The acquisition of China-based Navion software helped Mphasis BFL increase its employee strength by 85 people and expand its business in the region. Similarly, when software services giant Wipro acquired BPO player Spectramind, it helped the company expand into the BPO space. Bangalore-based Mascot Systems' acquisition of US-based eJiva and Hyderabad-based Aqua Regia witnessed the total employee strength of Mascot Systems to increase from 1,700 to 2,000. Pawan Kumar, chairman and CEO of vMoksha Technologies stresses the importance of the size of the company while trying to attain being a lead player in the field. He says, "*The size of a company does matter when interacting with customers and clients.*"[17]

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[16] "Mergers and Acquisition-shaping up for a deal" Raghunath T.V., Executive Director and Co-Head, Investment Banking Services.
[17] Ibid foot note 21.

3.2 Efficient management

The need for skill set enhancement seems to be another major reason for companies to merge and make new acquisitions. Combining skill sets of both companies, leads to growth and expansion of the merged entity. M&A thus facilitates Indian companies to employ world class technology and efficient delivery mechanisms to ensure that clients get cost effective solutions for all their BPO needs.[18]

Wipro acquired GE Medical Systems Information Technology (India) to leverage its specialization in the health science domain. The intellectual property that Wipro acquired from the medical systems software company provided it with a platform to expand its offerings in the Indian and the Asia-Pacific healthcare IT market. Similarly, when Wipro acquired the global energy practice of American Management System and the R&D divisions of Ericsson, it acquired skilled professionals and a strong customer base in the areas of energy consultancy and telecom R&D.[19]

3.3 HR solutions[20]

Once companies are consolidated, the number of skilled human resources in various specialized fields generally increases. This, in turn, strengthens the position of the HR management to come up with better HR strategies which help in reducing costs and improving performance by enhancing processes and leveraging technology.

Polaris has had some recent post-merger wins, including ABN-AMRO Bank, Kuwait Commercial Bank and Deutsche Leasing. This has facilitated the HR management of Polaris to successfully develop a strategy to venture into a new field, i.e. banking. Polaris has, since the merger, become a large, specialized company in the banking, financial services and insurance space.

3.4 Improving infrastructure

M&A raises one's market value. The higher the market value, more monopoly a company holds in the industry. Such big entities have power and access to the legislators and Ministers of respective areas which enables them to have dialogue, lobby and contribute towards enhancement of the infrastructure of the country.

3.5 Smooth flow of finance

[18] Business Process Outsourcing by ITC, www.it-careernet.com/itc/present/ITC_BPO.ppt.
[19] Ibid foot note 21.
[20] "Measuring, valuig and managing information, people and IT capabilities: Pre and post global M&A", Managing Complex Mergers: Real world lessons in implementing successful cross-cultural M & As Don Marchand, IMD Faculty, Chapter 10.

M&A is primarily aimed at expanding a company's business and earning profits. Of late, Indian companies who had started out by clinching outsourcing contracts from developed countries are now indulging in acquiring BPO units overseas, in order to gain business from the firms who are reluctant to outsource business to an offshore location. The Polaris-OrbiTech merger saw a spurt in the merged entity's revenues from $60 million to $125 million.

3.6 Enhancement of professional skills

The need for skill set enhancement seems to be a major reason for companies to merge and make new acquisitions. The Polaris-OrbiTech merger helped in combining skill sets of both companies, which in turn led to growth and expansion of the merged entity. Also with increased infrastructure of the new entity, it becomes easy for the company to provide for training programmes, from time to time. While Polaris Software was looking for a specialized product suite, OrbiTech was looking forward to efficient marketing and service support for its products. Post-merger, Polaris got the Orbi suite framework and combined it with its service expertise to win more customers.

4. Conclusion

It is therefore quite clear that companies look at M&As due to the size factor or for expanding their market reach or as an entry strategy in the country or business segment. Acquisitions help in the inorganic and quicker growth of the business of a company. The decision to acquire or grow organically, however, depends on the business targets that the companies have set for themselves. In this scenario, M&As have emerged as key growth drivers in the Indian software services landscape. Apart from this, the importance, size, pricing pressures and global companies consolidating and building offshore capabilities have made M&A relevant for Indian IT enterprises. As companies have resorted to this tool only recently it is premature to set forth any drawbacks, which the entities face in India. It is, however, extremely necessary for an entity to be consistent in tackling challenges the industry is faces from time to time, failing which advantages of M&A may not deliver the desired results.

According to NASSCOM, the BPO Industry is expected to grow manifold in the financial year 2005-2006, which would enlist it as one of the fastest growing industries. This, it reports, is because India based organizations are able to deliver at levels comparable to their international counterparts on parameters such as quality, customer satisfaction, and people satisfaction.[21]

Working out values requires experience, good judgment and diligence as one is projecting the future growth of business which is unknown. Therefore, it would not be wrong to conclude that M&A is undoubtedly the golden spade with which Indian BPO

[21] NASSCOM–QAI ITES-BPO Report, http://www.nasscom.org/artdisplay.asp?Art_id=3610.

industry is ensuring its stability and profitability and will continue to do so for some time to come.