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MERGERS AND ACQUISITIONS: VALUATION IN A RECESSIONARY WORLD

Mergers and Acquisitions: Valuation in a Recessionary World

BACKGROUND

The present economic turmoil has not limited its impact to any specific country. Every business turf has been hit in some form or the other. Since July 30, 2008 till date, only five companies have filed their Red Herring Prospectus[1] with the Securities and Exchange Board of India ("**SEBI**") for listing on the stock exchange.[2] The situation is gloomy. A thought provoking question at such a time will perhaps be whether it is timely and appropriate to plan any mergers, takeovers, disinvestment, acquisitions etc. Needless to say, it is a buyers' market since the value of the business/asset is low, but then is it a good time to sell as well? How will companies determine the value of an asset and what is the legal impact of the valuation? These are a few questions that are considered by both the buyer and the seller before they enter into any negotiation.

This newsletter focuses on the impact of recession on Mergers and Acquisitions ("**M&A**") and valuation techniques which need to be fool-proof in order to mitigate future risks.

INTRODUCTION

The Companies Act, 1956 (the "**Act**") states that if the Articles of Association ("**AOA**") or the Memorandum of Association ("**MOA**") of a company provide that the company cannot merge or amalgamate with any other company, such provision will be deemed void.[3] Quite often a company's growth is achieved by utilizing the strengths of another company where common synergies exist and can be tapped. Post liberalization, India has experienced a remarkable increase in M&A activities. There are various conditions that need to be considered before any deal can be successfully closed but one of the most important conditions is the valuation. Unless there is consensus on the valuation of the target company, no transaction can be taken forward. Clearly, the question how to arrive at the price of the deal assumes crucial significance.

Listed and Unlisted Companies: regulatory framework

In case the target is a private company, the Act is applicable and the scheme of merger will have to be approved by the relevant court in India,[4] i.e. the High Court having jurisdiction. The merger scheme is first approved by the board of directors and then by the shareholders.[5] This scheme is then presented to the High Court in e-Form 21.[6] Once the order is received, it is filed with the Registrar of Companies ("**ROC**") in e-Form 61[7] and the scheme is deemed approved.[8]

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[1] It is a document submitted to SEBI by the company who plans on getting its stock listed in the stock market.

[2] http://www.sebi.gov.in/Index.jsp?contentDisp=SiteMap checked on February 11, 2009 at 11:49 am.

[3] Section 376 of the Act.

[4] Section 391 of the Act.

[5] Section 391(2) of the Act.

[6] e-Form 21 of the Companies (Central Government's) General Rules and Forms, 1956.

[7] e-Form 61 of the Companies (Central Government's) General Rules and Forms, 1956.

[8] Section 391(3) of the Act.

If a listed company has seen its stock rise up and down in a volatile market, its shareholders will be in two minds whether to sell during a recessionary phase or to retain their shares. Clearly, the power to negotiate and close a deal rests with all the parties to a transaction. If the target company is a limited company, it is governed by the relevant provisions of the Listing Agreement, SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997 ("**SEBI Regulations**") and other guidelines issued by SEBI. Any person who acquires more than 5%, 10% or 14% shares of a listed company will have to make a disclosure to the company and to the relevant stock exchange.[9] If the acquirer wishes to attain more than 15% shares, he will have to make a public announcement as per the SEBI Regulations within 21 days of the close of the financial year.[10]

Therefore, for a merger for listed and an acquisition for unlisted companies, the value at which each share is bought or transferred will go through the scrutiny of SEBI and the High Court respectively.

It is also pertinent to be aware that the Reserve Bank of India ("**RBI**") keeps a close watch on the price at which shares are either issued or transferred to a foreign entity. Each time fresh shares are issued to non-residents, the investment is to be reported to the RBI in the FC-GPR form and each time there is a transfer of shares to non-residents, it has to be reported in the FC-TRS form. Both these forms require a certificate from the statutory auditors or chartered accountant indicating the manner of arriving at the price of shares to be issued/transferred to the person resident outside India.[11] Therefore, no arbitrary valuation technique can be adopted to determine the face value of a share.

Methods of Valuation

All investment decisions are taken on the basis of the financial strength of a company. Warren Buffet once said "it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."[12] Therefore, realistic estimates are taken to derive at a value of a company based on its previous history and scope of profits and growth. Previously, the Controller of Capital Issues Guidelines ("**CCI Guidelines**") were relied upon to value shares but these guidelines have now been abolished. Despite abolition, unlisted companies still use them for valuing their share price for the purpose of reporting the transaction to the regulatory authorities. To arrive at the fair value of shares, some methods of valuation are as follows:

1. Net Asset Value ("NAV")

NAV is calculated with reference to the book value of assets and liabilities as they exist on the date of the proposed transfer. The basis of arriving at the NAV is usually the audited balance sheet of the year preceding the date of proposed transfer. Further, adjustments on the basis of the projected results till the last quarter (prior to closing) are also taken into account, including any prospective liabilities. However, the NAV does not factor contingent liabilities and non-tangible assets which are self generated.

2. Profit Earning Capacity Value ("PECV")

It is one of the most traditional methods of business valuation. Future net profits are ascertained on the basis of the past earnings of the company. These profits are then capitalized on the basis of a price earnings ratio.[13] The calculation is made as follows:

$$\text{Normal rate of return} \times \frac{\text{Rate of dividend}}{\text{Paid up value of share}}$$

The crux of estimating the PECV lies in the assessment of the future maintainable earnings of the business. While past trends in profit and profitability serve as a guide, it is important to remember that the valuation is for the future and the future stream of earning is of greater significance in the process of valuation. All relevant factors that have a bearing on the future earnings of the business must be given due consideration.[14]

[9] Regulation 7(2) of the SEBI Regulations.
[10] Regulation 8 of the SEBI Regulations.
[11] Vide Paragraph 9(1) (b) of Schedule 1 to Notification No. FEMA/20/2000-RB dated May 03, 2000.
[12] http://www.equitymaster.com/sfth/detail.asp?date=11/8/2008&story=3 checked at 12:25 pm on February 17, 2009.
[13] It is the ratio between the share price of the company and its earnings.
[14] Section 7.3 of the CCI Guidelines.

3. Market Price Basis ("MPB")

This method of valuation is used to determine the price offered to shareholders in a takeover bid of listed companies. The weighted average market value per share is calculated after considering the traded value and the traded volume of transactions in the previous 3 years.[15] Therefore, the stock market plays a very valuable role in arriving at such valuation. As mentioned above, listed companies will also have to conform to SEBI guidelines as well.

4. Discounted Cash Flow

Used in business valuations, this method is based on the hypothesis that the value of any business has a direct relation to its cash generating ability. The amount available for distribution to the capital providers, after considering cash which is reinvested into the business to sustain operation and growth, is discounted[16] for a pre-determined forecast period to the present at a discount factor.[17] It is quite apparent that this method of valuation is based on projections and estimations and, hence, a lot will depend on the quality of information available at the company level.

5. Earn-out Method ("EOM")

EOM is widely employed in a variety of industries and companies when the views of the parties on the value of the target business are too conflicting and divergent preventing an agreement on a price. During a recessionary phase, this method of valuation can be most effective since the "bargaining power" is with all the parties involved. Here, the valuation is not closed in one go but the buyer allows the seller to run its business and prove its projections with appropriate timelines (earn-out period). The buyer merely agrees to make future payments, in addition to the amount paid at closing, to the seller if certain pre-decided targets are accomplished after closing.

To avoid future disputes, it is absolutely essential to agree upon reasonable parameters for operation, functioning and control of the company during the earn-out period. For those companies who intend to follow this approach, and simultaneously wish to minimize and mitigate risks, it is prudent to consider a cap on the annual earn-out limit as it further reduces the risk associated with the earn-out structure. Another suggestion to curtail disputes is to attach budgets for the earn-out period with the agreement so that expectations are realistic.

As per the CCI Guidelines, the average of NAV and PECV was computed to determine the fair value of a share and MPB was used only for "fine tuning." In all the above methods of valuation, failure to get the details right can result in the deal from being accretive to disastrous. It is imperative that the method of valuation by the parties is similar, if not same, so that they can mutually negotiate with each other for a successful closing.

Due Diligence and its stringent compliance

The concept of a due diligence originates from the legal concept of "caveat emptor," i.e. let the buyer beware. Therefore, whenever a buyer wishes to acquire a company, he is expected to examine and scrutinize all records and documents of the target to evaluate the risks of the acquisition.

In relation to M&A, the scope of a due diligence is very wide and involves the investigation of a company's operations at various levels and not merely to consider its assets and liabilities. A due diligence has tremendous significance in any business environment since it leads to a clear understanding of the exposures, risks and benefits for an acquirer; however, in a world ridden with corporate scams, recession, market volatility, and with ever-tightening purse strings, it is essential that the level of questioning by the team conducting the diligence is exceedingly stringent, with a specific focus on behavioral patterns of the target in order to evaluate risks and prevent them.

The liquidity crunch and the lack of credit add to the risk of both, the buyer and the seller. The buyer may not have enough money to buy and the seller will want to gain as much as possible. In view of the recent economic downturns in the business world, the common objective of all parties is to do what is necessary to reduce risks and losses as much as possible. As a practical measure, it is prudent for

[15] Section 8.1(1) of the CCI Guidelines.
[16] It refers to deducting an account, charge and debt.
[17] It is the number which a future cash flow must be multiplied by in order to obtain the present value.

acquirers and their advisers to consider and implement the following while conducting a due diligence:

- Use expert consultants to check a company's references;
- Talk about future integration plans with the target;
- It is crucial that integration, planning and expectations must match;
- Verify who are the real partners and check their perceptions of the target;
- Acquirer to consider if they really want those partners/customers going forward;
- Determine if the potential transaction is a strategic fit or not; and
- Involve the operational team from day 1 so that projections are realistic.

Competition Act thresholds and valuations

No discussion of M&A will be complete without at least touching upon its impact on competition. Though there is no direct relation between valuation of shares and competition laws, the business strategy of a company may be impacted if it is not aware of the threshold limits provided under such laws. The Competition Act, 2002 ("**Competition Act**") was enacted to prevent and regulate practices that have an adverse effect on competition. Although provisions with respect to M&A are not yet in force, the legislation lays ground for transactions that may have a detrimental impact on competition in the market. Section 5 of the Competition Act defines combination by providing threshold limits in terms of assets and turnover. Any acquisition, merger or amalgamation falling within the ambit of the thresholds defined constitutes a "combination" and if such combination causes or is likely to cause any appreciable adverse effect on competition within India, it is deemed to be void.

According to the current regulatory thinking, M&A's within and outside India will be impacted (once the Competition Act is fully in force) provided either the assets or turnover exceeds the prescribed limits. Therefore, a merger or acquisition in India will be considered as a "combination" if (a) the **combined assets** of the parties exceed US$ 250 million or that of the acquiring group exceeds US$ 1 billion; (b) the **turnover** of the parties exceeds US$ 750 million or that of the acquiring group exceeds US$ 3 billion.

M&A outside India qualifies as a "combination" if (a) the **combined assets** of the parties exceed US$ 500 million (including at least US$ 125 million in India) or that of the acquiring group exceeds US$ 2 billion (including at least US$ 125 million in India); (b) the **turnover** of the parties exceed US$ 1.5 billion (including at least US$ 125 million in India) or that of the acquiring group exceeds US$ 15 billion (including at least US$ 375 million in India), the transaction qualifies as a "combination."

It will also be mandatory to notify all combinations to the Competition Commission of India ("**CCI**") within 30 days of the decision of the Board of directors of the parties to the combination or execution of any agreement for effecting the combination.[18] Mandatory reporting of combinations applies even in the case of a merger or acquisition taking place outside India having an Indian connection. Further, no combination will come into effect until 210 days have passed from the day on which the notice was given to the CCI unless the combination is approved by the CCI earlier.[19] This time period of 210 days will not only cause unnecessary delay but may also result in violation of the 90 day time period stipulated under the SEBI Regulations[20] and further delay the issuance/transfer of shares.

It is still not certain whether the provisions of the Competition Act will come into force retrospectively or prospectively. Therefore, it is important that companies are fully aware of the thresholds provided under the Competition Act to avoid any future hurdles that may surprise them in the course of their business activity in India. This does not imply that companies should not enter into any combination exceeding the thresholds but only that they should always try and keep a margin for the time and money that may be required to procure an approval from the CCI.

[18] Section 6(2) of the Competition Act.
[19] Section 2A of the Competition Act.
[20] Regulation 22(12) of SEBI Regulations.

CONCLUSION

Clearly, the world is experiencing rather challenging times that appear to be here to stay, at least in the foreseeable future. Many experts may feel that the recession and market conditions may actually trigger sector-specific consolidation. Companies performing poorly will need buyers to survive, while the rest will look to take advantage of the lower valuations and buy competitors at discounts. Timing, therefore, becomes critical while divesting or expanding. The price at which the transaction takes place invariably depends on the timing of valuation. With lack of credit in the market, tougher and expensive norms making financing difficult, a lot of risk aversion by corporations, decisions will be contingent upon when the acquirers feel that they are getting a "good deal." During these troubled times, the role of the advisers to acquirers and target companies will, increasingly, require a different level of diligence altogether. ***(Dhruv Suri)***

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