Unit II: Mergers and Acquisitions

- Motives behind M&A
- Theories of M&A,
- Process of M&A
- Fast track merger.
- Cross border M&A:
  - concept,
  - benefits &
  - difficulties.
- Due diligence process.
- **Methods of payment and financing options in M&A**
- Takeover defense tactics
- **Reasons for failure of M&A**

Due Diligence

Diligence: It means prudence; vigilant activity; attentiveness; or care, of which there are infinite shades, from the slightest momentary thought to the most vigilant anxiety.

Due diligence: Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case. Perry v. Cedar Falls, 87 Iowa, 315, 54 N.W. 225

Due diligence is a meaningful analysis of the collected information to arrive at some decision about the potential transaction. The due diligence exercise is a crucial task. In this process the financial and non-financial information of the target company is to be collected and analysed in order to derive profitability after acquiring the target company

Due diligence make tying the knot hassle free.

It refers to the investigating effort made to gather all relevant facts and information that can influence a decision to enter into a transaction or not. Exercising due diligence is not a privilege but an unsaid duty of every party to the transaction.

M&A due diligence helps to avoid legal hassles due to insufficient knowledge of important information.

Types of Due Diligence

- Legal Due Diligence:

Legal Due Diligence is used to ensure that there are no legal issues in buying a business or investing in it.

Potential purchaser will review the important legal documents of the target firm such as employment contracts, board meeting minutes, articles and memorandum of association and patents and copyrights or any other property related documents compliance status of the applicable laws etc.

Types of Due Diligence Contd.

- Tax Due Diligence:

This is aimed at ensuring that there are no past tax liabilities in the seller firm that might have materialized due to mistakes or deception and could hold the acquirer liable for it.

Types of Due Diligence Contd.

- IP Due Diligence:

IP due diligence is focused on establishing what rights the company may have in various intellectual property and where it might rely on the intellectual property of another entity.

Typical areas of interest are patent, copyright and trademark filings; descriptions of the company's IP protection processes; licensing agreements, IP Assignment document, etc.

Types of Due Diligence Contd.

- Operational Due Diligence:

Operational due diligence (ODD) is the process by which a potential purchaser reviews the operational aspects of a target company during mergers and acquisitions. The ODD review looks at the main operations of the target company and attempts to confirm (or not) that the business plan that has been provided is achievable with the existing operational facilities plus the capital expenditure that is outlined in the business plan.

Types of Due Diligence Contd.

- Commercial Due Diligence:

This aims at understanding the market the target business is operating in. This looks the current market status and the forecast of the market growth in future and the target's position in the market with relation to its competitors. This also involves interaction with the significant customers of the business to understand their opinion about the business.

Types of Due Diligence Contd.

- Information Technology (IT) Due Diligence:

This aims at identifying if there are any IT issues in the target business. This involves into matters such as scalability of systems, robustness of the processes, availability of ERP, IT base and infrastructure, capacity of server, the level of documentation of processes, compliance with the legislation and ability to integrate various systems.

Types of Due Diligence Contd.

- HR Due Diligence:

This aims at understanding the impact of human capital on the proposed deal. This involves review of number and type of manpower, skills, employment records, compensation schemes, HR processes, ongoing HR litigations, effectiveness of the sales force and cultural factors.

Due Diligence Process

The due diligence process should incorporate the following areas of the takeover to opt for or opt out of the takeover deal:

- 1. Industry Analysis Competition Growth Rate Future projections Barriers to entry / exit Mergers and acquisitions in industry and results Brand evaluation.

- 2. Management Analysis Company's HR Policies Assessment of Senior Level Management, resumes of key employees their qualifications and work exposures, previous background, etc. Summary Plan descriptions of qualified and non-qualified retirement plans Business Experience Union Contract, copies of collective bargaining agreements, description of all employees problems within last five years including the alleged wrongful termination, harassment discrimination, etc. Strike History Labour Relations/ Agreements, grievance procedures, labour disputes currently pending or settled within last five years. Workman's' compensation claim history / unemployment claim history Personnel Schemes, description of benefits of all employees' health and welfare insurance policies Profile of permanent employees Labour dues and settlement history Status of labour law compliances.

Due Diligence Process Contd.

- 3. Financial Analysis Audited Financial Statements along with auditor's reports for at least past five years or since inception. Auditor s letters and replies for the past five years or since inception The most recent unaudited statements, with comparable statements to the prior year. The company's credit report, if available Analyst reports, if available Budgets and forecasts and strategic plans Significant ratio analysis Revenue versus cost comparison.

- A description of depreciation and amortization methods and changes in accounting methods since inception Schedules of: { All indebtedness and contingent liabilities { Stock { Accounts receivable { Non-current investment { Cash in hand/Cash Equivalent { Type of ownership rights { Tax Liabilities { Accounts payable { Fixed Assets and its locations (including the land holdings, real estate leases, deeds, mortgages, titled deeds etc) { All leases of equipment { Sale and purchases of major capital equipments made during the last five years. Financial ratios { Return on Assets { Return on Net worth { Gross Profit to Net Profit Ratio { Debt Equity Ratio { Expense Ratio { Debt-Service Coverage Ratio. Analysis of { Fixed and variable expenses { Gross margins The company's general ledger Replacement cost data Valuation of Assets / Liabilities A description of the company's internal control procedures Internal audit/control reports for last five years Insurance coverage of all assets

Due Diligence Process Contd.

- 4. Intellectual Property Rights A list of domestic and foreign patents and patent applications A list of trademark and trade names A list of copyrights
- A description of important technical know-how A description of methods used to protect trade secrets and know-how Any work for hire agreements A list of and copies of all consulting agreements, agreements regarding inventions, licences, or assignments of intellectual property to or from the company Any patent clearance documents A list of and summary of any claims or threatened claims by or against the company regarding intellectual property

Due Diligence Process Contd.

- 5. Taxes Income-tax returns for the last five year or since inception States sales/VAT returns /GST returns Assessment orders Tax audit, where applicable Any tax settlement documents Other tax filing statements (State and Central Excise). Number of current tax litigations, if any.

- 6. Marketing Analysis Data on Past Sales and future trend Customer base and profile Major sales agreements, warranty agreements, distributorship/franchisee agreements, product development agreements. Trends Distribution channels Product Profile Development / Disclosure.

- 7. Manufacturing Location Technology Manufacturing process Quality Research & Development Sourcing of Raw Material.

Due Diligence Process Contd.

- 8. Compliance Status of various laws as applicable Companies Act 2013, Stock Exchange Compliances, SEBI/RBI Regulations Labour Laws Competition laws Environmental Protection laws.

- 9. Litigation A schedule of all pending litigations A description of any threatened litigations Copies of insurance policies providing coverage as to pending or threatened litigation Documents relating to any injunctions, consent decrees, or settlements to which the company is a party A list of unsatisfied judgments.

Managing the Due Diligence Process

During the due diligence process the following points are worth consideration:

- Constitute a due diligence team comprising of technical, legal, financial and taxation experts, etc.
- Assign the task to each of the member and the co-ordination among the members be supervised by a senior level officer.
- Collect the data of the target company with reference to the:
  - Corporate records
  - Promoter’s holding
  - Stockholder information
  - Important contracts including IP, Sales, Purchase, IT, etc.
  - Compliance record
  - HR record
  - Finance record including access of softwares/ERP, etc.
  - History of litigation
  - Insurance information
  - Financials and leases.
- Analyse the above information/ statistics, assess the future prospects and the benefit in acquiring with reference to the market size and cutting of the competition.
- If the proposal, found feasible, follow the regulatory requirements as mentioned in the Companies Act, 2013 and the SEBI Regulations, RBI regulations, FDI guidelines & competition laws as applicable.