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Turnaround *or* Contract Merger: A conceptual model to protect sick and government companies

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Turnaround *or* Contract Merger: A conceptual model to protect sick and government companies

ABSTRACT

The prolific competition and unanticipated customer loyalty gave the ideological thought to craft combat strategies among firms, now it became a warriors' battle. To achieve this, global firms are designing tactics to become a gladiator by choosing merger & acquisition as a synergistic choice. M&A is an opportunity for target firm shareholders in a high premium, on the other hand escalating monopoly by an acquirer in the respective market. These inorganic options will increase the capitalism in mixed economy countries that result in the loss of government control on public sector enterprises and sick industries. Availing this gap, the present conceptual study is aimed to introduce a new weapon for emerging market nations to protect state control and keep public belief. Exclusively, we try to accommodate and suggest a new financial arrangement or scheme against the existing model, i.e. Leveraged buyout (LBO). Finally, this array is supported by the Indian sick industries as case examples which were disappearing now. It also ensures that the economic sustainability and progress of nation would be achieved by the proposed 'Contract Merger' model.

Keywords: Corporate restructuring, turnaround, merger, acquisition, LBO, disinvestment

Important notes to Readers:

Thank you very much for reading my academic work.

This draft was prepared as part of my doctoral thesis carried out at the IIT Roorkee, India during the period Dec 2009 – Sept 2014. Due to several rounds of revisions after my doctoral presentation, I have finally published the part of this draft with significant improvements in a referred international journal published by InderScience Ltd. Therefore, if you consider citing this draft, you may have to consider citing the following article.

Reddy, K. S., Xie, E., & Huang, Y. (2016). Contractual buyout-a legitimate growth model in the enterprise development: foundations and implications. ***International Journal of Management and Enterprise Development***, *15*(1), 1-23. *Scopus, ABDC Ranked*.

Also, see http://econpapers.repec.org/RAS/pko531.htm

INTRODUCTION

Augmentation is a fundamental to sustain the practicality, vitality and value enhancing capability of a company. Further, corporate restructuring refers to the change in ownership, business mix, asset mix and alliances to enhance the shareholder's value (Kumar and Rajib, 2007; Pandey, 2009). Merger, acquisition and diversification have become in touch-pads of great importance in the global business arena. From the review, we observe that firms engage in joint ventures, enter management contracts, buy other firms, divest segments and restructure in many different ways for firm enlargement and enrichment (Weston, Chung and Hoag, 1998; Pandey, 2009; Reddy, 2014; Chandra, 2008). The term M&A is often confused or used interchangeably by the business media. A merger typically refers that two companies coming together to become one (Sherman, 1998). To protect state control and sick companies in this global competition, we aim to introduce a model that can sustain the economic life of industries and reduce the monopoly power. The model is illustrated by the Indian cases and recommends the government to enact a new regulation through concerned division. Neither the case, we suggest the state to put up a committee for ensuring good economic health and corporate control on government companies.

Historically, M&A was born in the timeline of Kings. After advancement in human living life and social studies, the true pinpointed first wave of mergers consisted primarily of horizontal mergers, the second wave transfer to vertical and the third wave publicized by conglomerate mergers (Weston, Chung and Hoag, 1998). There are several motives or reasons behind the M&A deal (Srinivasan and Mishra, 2007; Kumar and Rajib, 2007). Generally, the most common motive is expanding: horizontally or vertically and in related or unrelated businesses. In general, acquiring a company in the line of business or geographical area in which the firm may want to expand can be a quick way to expand than internal expansion (Ray, 2010). M&A serve managerial motives that do not maximize shareholder returns, i.e. Sales – increasing the sales team prefers to acquire even at high prices (Muller, 1969). During 80s, virtually half of all US companies were acquired or merged and over 700000 sought bankruptcy protection to continue their operations. The global village has forced many companies to explore M&A as a mean to develop an international platform and expanded market share (Sherman, 1998).

The general drivers of M&A especially in Russia, includes continuing concentration of capital, globalization of company activity and liberalized access to national markets (Kasparova, 2007). All these factors ease the free movement of investment flows among cross-borders. During 2007-financial crisis, volume and value of international M&A had been falling down in both western and developing nations and it has been continued up to 2009-10 (Rao & Reddy, 2015; UNCTAD, 2009). From 2007, the M&A waves spur at a superior growth rate in almost all the nations. It evidences that the transactions have become more widespread in energy, oil & gas, chemicals, automobiles, steels, telecommunications, financial services and other allied industries.

The remaining paper is articulated in the following conduct. Section 2 presents the review of select & relevant past studies, section 3 describes the conceptual foundation to propose a financial array, section 4 illustrates the model with case approach and conclusions cum future scope of research depict in section 5.

REVIEW OF EXISTING STUDIES

Leveraged buyouts (LBOs) and leveraged cash-outs (LCOs) are the next wave after the end of conglomerate mergers in 1980s. Mergers had been proving to significant increases in financial leverage by controlling the firm size and industry effects (Shrieves and Pashley, 1984). In the context of buyouts, during the 1980s merger wave, corporate sector of the American economy was left with an enormous increase in its debt/equity ratio (Jensen, 1984). To add this 'Going Private' refers to the transmission of a public corporation into a privately held firm. On the other hand, LBO has become an increasingly frequent form of business streamlining. *LBO is the acquisition financed largely by borrowing of all the stock or assets of a hitherto public company by a small group of investors* (Ray, 2010).

In its earlier versions, an LBO was a practice by which the owner/founder seeking to cash out his investment transferred the firm to manage or younger family members, who can put up a small amount of capital and borrow the rest (Kosedag, Mehran and Qian, 2009). Further LBO is an acquisition of a company in which the acquisition is substantially financed through debt. There are relevant studies on LBOs, the most prominent ones are cost savings, exchange listing, tax savings, agency costs, free cash flow and informational advantages of managers. LBO is deemed the most efficient in enhancing the oversight of the public firm while without

effective administrative control on firm operations (Bowman, *et al.,* 1999). Braun and Latham (2009) examine the governance structure of the firm undergoing a complete reverse leveraged buyout cycle.

Generally, buyouts mostly funded by the investment bankers as debt. In an LBO, debt financing typically represents 50 percent or more of the purchase price. The debt is secured by the assets of an acquired firm find typically amortized over a period of less than ten years (Kasparova, 2007). The debt is scheduled to be paid off as operations generated funds or from the sale of the assets of the acquired firm. Figure 1 represents the existing model of the LBO and participation of the parties/transactions involved.

Insert Figure 1 about here

Literature evidences that LBO was a financing technique through, which a public company is bought mostly with debt making the public company as private. LBO means that borrowed funds are used to pay for all or most of the purchase price of the acquisition of a company as a whole or any of its divisions. Traditionally in more than 90 per cent of the LBO transactions, the purchase price of an acquisition has been financed with debt and the tangible assets of the target firm that have been used as collateral for the loans (Ray, 2010; Machiraju, 2010). The essence of LBO consists in the acquisition of a controlling share of a company using borrowed funds. In Russia so far, there have been only a handful of LBOs and these are financed 100 percent by bank credit using the property of the purchased asset collateral. Transparent LBO transactions in the Russian market are quite rare. But the problem lies in finding suitable targets for LBOs. Banks are often unwilling to finance such a deal in full and assume the risks of the collateralized asset. Another type of deal in Russia is that finance by accumulating the debts of the company to be taken over and then converting them into company shares in the bankruptcy process (Kasparova, 2007).

The financial arrangement is an art of structured and mechanized framework which is done by strategic board members and the array can be linked with virtual common sense. It is a major concern for bidders who are anxious to clinch their bid that consummate with the acquisition strategy in terms of tempo and price. Information asymmetry and valuation risk are important determinants of the choice between cash and share exchange offers (Ray,

2010). The cash offer is made by bidders, who attach a high value to the target of their bid and signal their confidence that the target firm will remain to be a high value company under their control (Fishman, 1989). The range of options available to a buyer to finance an acquisition range from the very simple to the very complex and designing deal model will vary with each transaction (Damodaran, 2002). There are common sources of finance an acquisition in the capital market, which they include seller as a source of financing, debt finance (includes asset based lending, senior debt, convertible debt and subordinated debt) and equity finance includes venture capital, private placement offerings, strategic investors and buyout funds (Sherman, 1998; Pandey, 2009).

Most of the early studies found that mergers increase leverage and that the argument is due to increased debt capacity rather than utilization of latent debt capacity (Weston, Chung and Hoag, 1998). It observes that financing M&A transaction in Russia concerns assorted frameworks for the transfer of corporate control. The majority of Russian companies was formed in the process of privatization and conversion into joint-stock companies (Kasparova, 2007). Further the relation between bidder gains and the source of financing funds available. Bidder announcement period abnormal returns are positively and significantly related to the amount of ex ante equity financing. Further, it reports a negative and significant relation between bidder gains and free cash flow. Though, the amount of debt financing before a takeover announcement is not related to bidder gains (Schlingemann, 2004).

Interestingly in the milieu of corporate laws and governance, Braun and Latham (2007) discover the board of directors in leveraged buyouts as a distinct source of value creation and to conceptually investigate the going private transaction via LBO as a response to deficient to governance structures. Though there are factors influencing the decision to go private via buyout in UK public firms (Weir, *et al.*, 2005). Board independence and CEO duality take part as predictors in their study. In case of reverse LBOs, Gertner and Kaplan (1996) compare 59 reverse LBO board structures to industry and size matched public firms over the course of two years following their secondary initial public offers. In the US economic context, Krause (1989) describes that LBOs have achieved remarkable success in return on investment and value creation despite the fact that their borrowing costs are very high on a comparative basis. Though, they have also injected new life into the economy by creating lean competitors out of tired, family-run firms and bloated corporate subsidiaries.

In the case of sick company's turnaround strategy, Khandwalla (1992) suggest seven sets of activities to develop four typologies of a turnaround strategy based on retrenchment of people and technology up-gradation. Conversely, Robbins and Pearce (1992) divide turnaround strategy into an efficiency driven and competition driven. Most of the studies in turnaround administration conclude that all typology efforts have been a manpower reduction to orbit organizations. Further, the market for corporate control appears to be developing in India through the enforcement of managerial discipline after merger incidences (Ramakrishnan, 2010).

Since the focus part, M&A had more than 120 years of vast literature in the corporate finance as well as management cosmos. Though, all the glorious existing studies had written and published in western economies which are developed nations in the economic context. Even most of the theories, concepts, valuation practices and integration approaches have not fit or overly loaded while applying the same in developing nations, India. One gold ring does not suit every ones finger and every finger, likewise all fingers are not equal. To grasp this opportunity and achieve the objective of the study, the new model/theory would be added to M&A history for the benefit of third world countries/emerging nations. In the next section, we present the proposed model as a theoretical base. In the next section, we present the conceptual model which is the main motto behind our study.

CONTRACT MERGER

Contract Merger (CM) is an extension of leveraged buyout (LBO), which would be a part of the inorganic growth strategy. Further, it seems to be a 'Futures Contract' in the derivatives market. The merger agreement will be taken place before the true mix of balance sheets of both the companies, i.e. acquirer and target firm. After the agreement, the acquirer firm will create a subsidiary unit for joint management & control operations with the target firm corporate board. It means that the acquirer will share their expertise, technology, manpower and operational activities with the target firm to strengthen the financial position, employee belongings and corporate responsibility in their respective industry. In addition to this, it is protecting the public interest through the virtual acquisition of the target firm by investing the required amount with the financial courtesy of an investment banker or leveraged banker in the form debt. Specifically, the acquirer firm would be giving an acknowledgement of guarantee for the amount of debt funded by the lender.

Definition of Contract Merger

Three or more parties agree to form a combined entity or living like a single entity after the immediate collapse of CM Deed/MoU/Agreement, after settlement of agreed financial arrangements among the involved parties which usually occur on the premises of the court is called a contract merger.

Mandatory Parties

Acquire, Target firm and Investment banker/Lender

Insert Box 1 about here

Elements of the Agreement

1) CM should have three parties namely, Acquirer, Target firm and Lender
2) Acquirer company should be or more than 2.5 times of target firm business value
3) It is not necessary that the parties should be on the same business line. It can be a conglomerate
4) Reasons for merging the target firm balance sheet with acquirer balance sheet should be on the following primary/border line of the CM model.
   a) Disinvestment
   b) Turnaround strategy
   c) Corporate restructuring
   d) Looking for expansion
   e) Entry of new markets
   f) Diversification as a choice
   g) Party's interest in the context of law
5) Parties should express their utmost belief, interest and law of concern to enter CM
6) They should explicit their issues and contingencies if any, before CM negotiations/deed
7) Parties should appoint their financial and legal advisors as a proxy evidence
8) Parties should satisfy the leverage norms, guidelines and requirements for grant of debt by the select investment banker
9) After financial arrangement, the acquirer will be signing a deed/MoU/agreement with the target firm, which contains the following information and signed by both the parties, as well as authentication by a bank on the deed document is called "Contract Merger".
   a) Date of contract

b) Date of writing/signing the document
c) Name and address of the parties
d) Name and address of the lender
e) The amount of financial arrangement
f) The rate of interest
g) Payment options & pay procedure
h) Sharing of technology, manpower, expertise and resource allocation, etc.

10) Acquirer will get a certain percent of commission on future sales of the target firm from the half of the agreed time. The agreement time ranges from five to seven years.
11) The target firm will pay the interest amount from third year onwards until the agreed time completed. From 5th year onwards, the target firm will pay both interest and principal amount. If any principal amount left in the deed, that amount will be partially paid by an acquirer through its subsidiary company.
12) If target firms do not want to continue like a single entity after the collapse of an agreement, it should merge with the acquirer. Further the two balance sheets will merge after paying the debt obligations of the target firm by subsidiary firm of the acquirer.
13) If a target firm wants to continue like a single entity, first the CM deed should wind up along with financial arrangements, which was funded by investment bankers.
14) Next, obtaining 'No Objection Certificate' from all the parties with seal in the premises of court, later target firm can continue their own life. From the first year closing of agreement time, the target firm should not merge or acquire or takeover with, or by any other company.
15) The following conditions should satisfy while the deed (CM) turns on
    a) No party shall try to void the contract
    b) If an acquirer wants to break up or not to continue the corporate life with the target firm, the acquirer should repay the commission which was received earlier and clear the remaining amount of debt. Even it before one day to complete the CM deed.
    c) If a target firm wants to break up their deed with acquirer before the completion date, simply it has to merge with the acquirer and the remaining debt amount with interest will be paid by the acquirer.
    d) During the agreement time, an acquirer can buy any other assets or business units or equity stake in the global market. Or it can sell its own stake to some other party, but the other party should consider a CM deed as a contingent liability.

e) During the agreed time, target firm can’t sell its equity or asset stake or control to someone or enter any agreement without the board approval of the acquirer firm.
f) Further no company/no person to buy the target company during the CM deed.

Insert Box 2 about here

Contract Merger Model

The proposed contract merger model is depicted in Figure 2 below. This model explains the involvement of parties, actions which take place between the parties and finally how the merger will occur from the new CM model. Further it also explains various issues related to participation in the contract merger.

Insert Figure 2 about here

Further, the model or theory depicts in the Figure 3 below. This presentation portrays three phases namely the contract merger period, simple merger and single entity, which are the main streams of contract merger. The following illustration contrary the model ‘contract merger’ and how it could be executed (see my full paper, Reddy et al., 2016; also how I developed a model based on Test-Tube method, Reddy, 2015a; Reddy, 2015b).

Illustration: Company A’ is a registered and public listed entity has been resulting losses since five consecutive years. Though, the peers in the industry showed dropdown in their profits for the last two years. At this juncture, diversified & profit making company B entered ‘contract merger deed’ with company A. The agreement/deed had written for the period of five years. After the windup of deed, company A’ show relative profit and it represents as contract merger period with turnaround curve (see Figure 3). From this point, if company A wants to be living their presence as a single entity or it may simply merge with company B.

Insert Figure 3 about here

CASE ILLUSTRATIONS

The study believes that contract merger model would be fit for the emerging economies (BRICS: Brazil, Russia, India, China and South Africa) and other third world nations. Economic reforms and liberalization of policies on the Indian economy has brought in more domestic as well as international players in the Indian industries. The first wave of M&A in India took place towards the end of 1990s (Machiraju, 2010; Reddy, 2016; Reddy et al., 2013a; Reddy et al., 2013b; Reddy et al., 2015). However, we present some of the realistic case examples in sick industries and suggest PSUs that should be taken control over by the government through the proposed model.

Sick industries in India

Sinha (1998) expresses that companies are getting a tax advantage by acquiring sick companies and evidences that Universal Steel & Alloys Ltd (USAL) had declared a sick company by the Board for Industrial & Financial Reconstruction (BIFR), and merged with Bharat Gears Ltd. Bharat Gears proposes to raise foreign currency loans and/or rupee loan for Rs.100 crore from banks, financial institutions, investment institutions, etc., to part finance its expansion plans. To secure the loan, the company intends to mortgage its movable and/or immovable assets at its factories in India. Apart from getting hold of the USAL properties, the merger would have made Bharat Gears eligible for tax benefits under Section 72A of the Income Tax (IT) Act, 1961, as USAL has a large amount of carry-forward losses.

In the cement industry, Gujarat Ambuja Cements Ltd acquired Modi Cements, which was declared as a BIFR company, and got tax exemptions. Further, it amalgamated with Ambuja Cements Rajasthan then received tax benefits under Section 72A and Section 115JB of the IT Act, 1961. Interestingly, Grasim Industries Ltd had taken over Dharani Cement for getting sales tax benefits over six years; in other cases India Cements Ltd also acquired the public sector undertakings, Cement Corporation of India. The tax shelter benefits would provide an added incentive for bigger companies to target sick units (Sasi and Mishra, 2004).

Indian Public Sector Undertakings

Exclusively, the literature on the proposed model recommends Govt. of India and other emerging nations to be executed in the select public sector undertakings (PSUs). This model keeps the state control with utmost belief and promises the public governance for smooth

functioning of the democratic system. The list of suggest PSUs include MMTC, NNMDC, Hindustan Copper Limited, HMT Limited, Ircon International Limited and Scooters India Limited, etc. (*Refer: Appendix-I*). We suggest 16 out of 39 PSUs that are suitable to execute the CM model on the recommended grounds and in the context of law. Though, the government/state is essential to alter their laws related to disinvestment and privatization. To confirm the model, authorities can carry out in any select sick unit on trial and error basis.

CONCLUSIONS

Surging M&A and private equity (PE) deals in the emerging economies, like India and other BRICS countries would require keeping their public administrative control in the key areas such as the public system, public administration and focused industries/PSUs for the sake of public interest. Since India is a young country in many discoveries, inventions and developments. Going for internationalization might promises economic growth but associated risks is involved. The study concludes that suggest a contract merger model would benefit the states in developing countries as a fit framework for government control as well as a strategic advantage like inorganic growth opportunities. As a contribution and advancement of theory in the M&A area, the propose contract merger framework will open the doors for future research contributors by raising various issues related to that how far the suggest model fit to protect state control, beneficial to sick industries, does it produce favorable results compare to other models or it suits by altering some provisions in the model.

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<table>
<tr><th colspan="2">Box 1: Eligible Criteria for Contract Merger</th></tr>
<tr><td>Eligible Criteria of Acquirer</td><td>Eligible Criteria of the Target firm</td></tr>
<tr><td>a. Registered in India under the Companies Act, 1956
b. Good report on Corporate governance
c. It can be private/publicly listed entity but should not be a subsidiary of any group
d. Sound financial backdrop during the last five years
e. Prove 2/3 majority of the board of directors
f. The net worth of acquirer should be thrice, what actually the loan amount funded by investment bankers
g. If a target firm becomes insolvent, the acquirer is legally liable to pay both interest and principal amount</td><td>a. Poor financial backdrop
b. Corporate restructuring & business process reengineering
c. Turnaround strategy
d. Sick or proposed to disinvest</td></tr>
<tr><td colspan="2">Eligible Criteria of Investment Banker</td></tr>
<tr><td colspan="2">a. The banks should be registered under the RBI guidelines and the entity may be a public sector bank or private bank or investment bank or established MNC banks or an Indian subsidiary of an International bank.
b. Agree to fund the agreed amount before the CM deed takes place between the parties
c. Collect/receive at time of payment of the interest / principal amount
d. Should be liable and binding for the rules</td></tr>
</table>

Box 2: Fundamentals of Contract Merger	
Benefits of CM	*Benefits for the Acquirer*
a. Stop the monopoly player in the market b. Regulate one man control in the industry c. Independence to live in the business d. Free flow of transparency e. Public interest and public governance	a. Building reputation and brand image b. Social responsibility in the business context, specifically in sick segments/units c. Acquirer will get a certain percent of commission on sales of the target firm d. Acquirer will get an advanced experience in the unrelated businesses e. Acquirer can excise his option to buy the target firm like a forward contract by taking a written concern from the board of directors f. It can rise free cash flows and reserves & surpluses
Benefits for a Target firm	*Benefits for the Lender*
a. Giving new birth to old firm b. Protect the employee and customer belongings of the target firm c. Public and social interest d. The existence of the market	a. Mortgage of acquirer and target firm assets & securities b. Timely payment of interest and principal amount c. Reengagement of the loan amount with other firms d. Corporate customer portfolio
Pre- CM period	*Post – CM period*
a. Gather all the parties along with financial and legal advisors at one place b. The negotiation talks should lead to deal structure c. Valuation of both the entities by financial advisors d. Decide the required amount which will be funded by the investment bank e. Plan of action and strategies will be developed by both the acquirer and target firm f. Documents to be ready for authentication and it are mandatory g. There are 5 copies – acquirer copy, target firm copy, lender copy, state legislative copy and company registration copy	a. Implementation of program/plan of action b. Integrating the subsidiary company operations with the target firm c. Pay interest/collect commission/manage

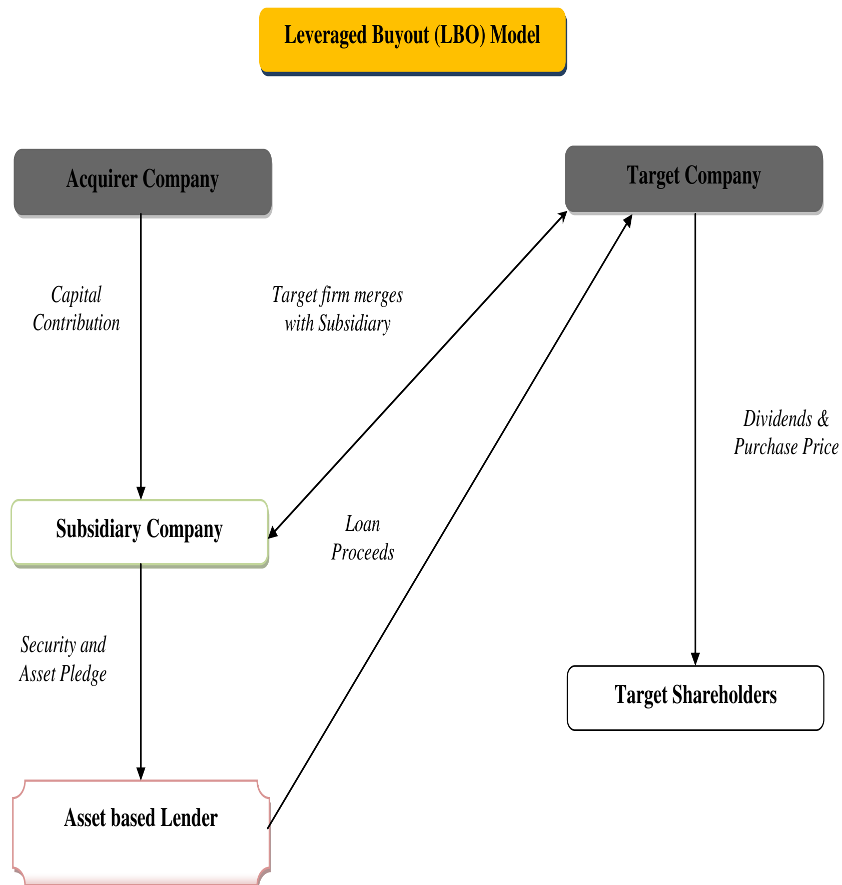

Figure 1: LBO Model (Ray, 2010)

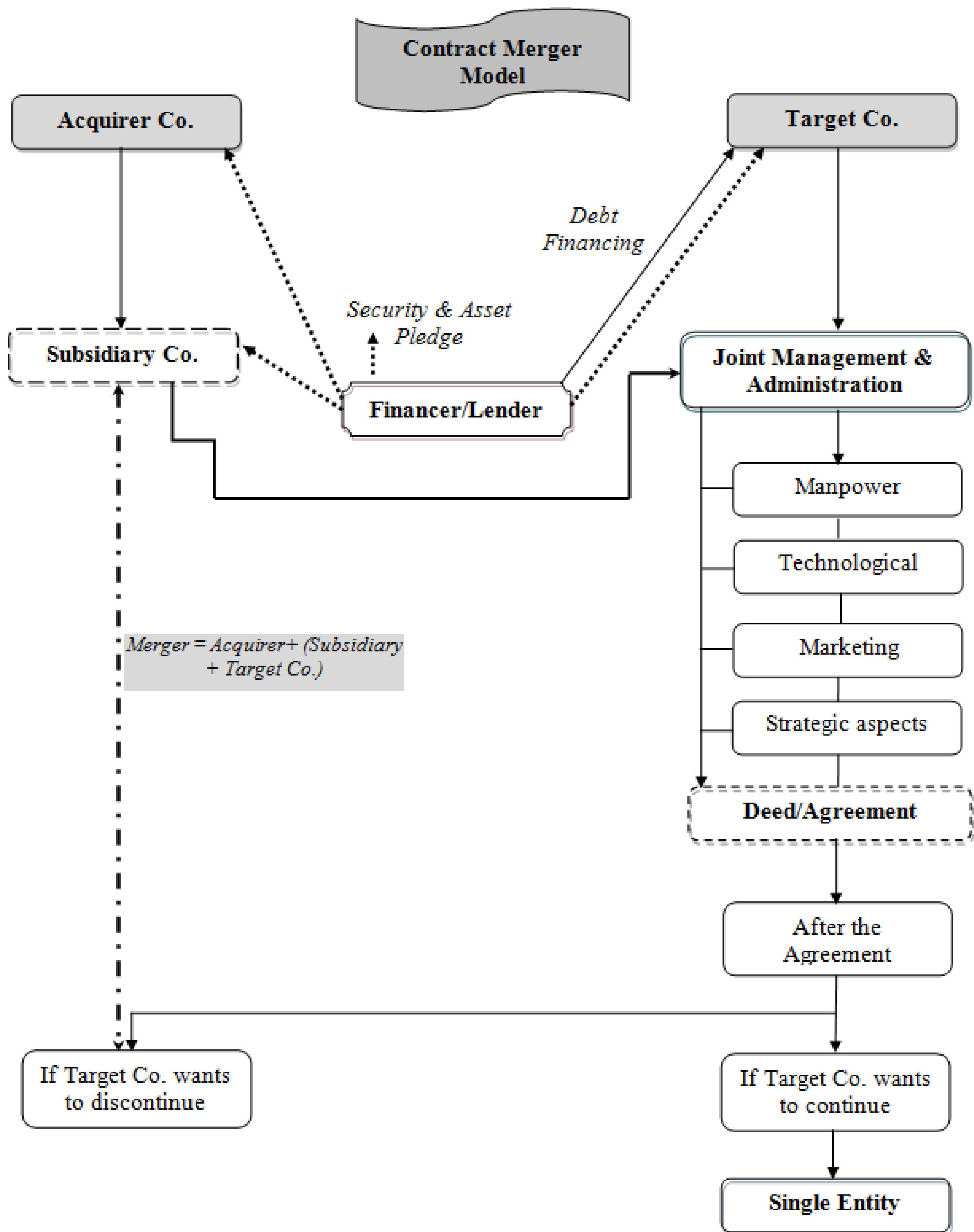

Figure 2: Contract Merger Model (CM)

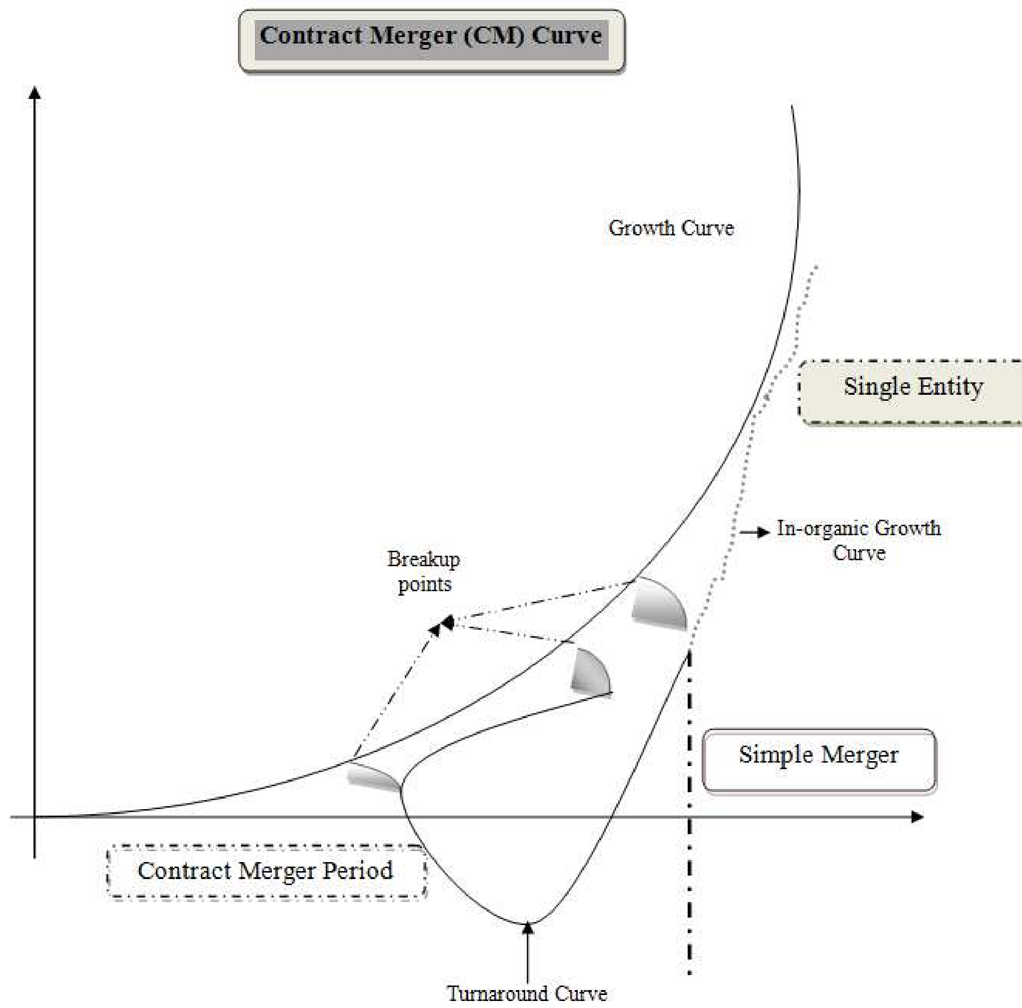

Figure 3: Contract Merger - Merger/Single Entity Curve

Appendix I: Proposed Disinvestment of Public Sector Undertakings (PSUs) in India				
S.No	Name of the PSU	Market Cap (US$ MM)	Govt. Holding (%)	Stake that can be divested (%)
1	ONGC Limited	44,486	74	23
2	NTPC Limited	33,351	89	38
3	MMTC Limited	28,812	99	48
4	NMDC Limited	27,146	98	47
5	BHEL Limited	20,624	68	17
6	Indian Oil Corporation Limited	14,365	79	28
7	Steel Authority of India Limited	13,166	86	35
8	Power Grid Corporation of India Limited	9,023	86	35
9	Gas Authority of India Limited	8,578	57	6
10	Hindustan Copper Limited	4,676	100	49
11	Power Finance Corporation	4,602	90	39
12	Neyveli Lignite Corporation	4,109	94	43
13	National Aluminium Company Limited	3,774	87	36
14	Bharat Petroleum Corporation Limited	3,559	55	4
15	Rural Electrification Corporation	2,796	82	31
16	Container Corporation of India Limited	2,588	63	12
17	Mangalore Refinery & Petro-chemicals Limited	2,569	89	38
18	Hindustan Petroleum Corporation Limited	2,356	51	0
19	Bharat Electronics Limited	2,315	76	25
20	Mahanagar Telephone Nigam Limited	1,191	56	5
21	Engineers India Limited	1,071	90	39
22	Shipping Corporation of India Limited	1,043	80	29
23	BEML Limited	905	54	3
24	Rashtriya Chemicals & Fertilizers Limited	709	93	42
25	HMT Limited	573	99	48
26	Chennai Petroleum Corporation Limited	522	52	1
27	National Fertilizers Limited	500	98	47
28	State Trading Corporation of India Limited	402	91	40
29	Andrew Yule & Company Limited	304	94	43
30	Dredging Corporation of India Limited	252	79	28
31	ITI Limited	239	93	42
32	Indian Tourism Development	140	90	39
33	Hindustan Photo Films Manufacturing Limited	123	91	40
34	Ircon International Limited	63	100	49
35	Hindustan Organic Chemicals Limited	43	59	8
36	Balmer Lawrie Investments	41	60	9
37	Madras Fertilizers Limited	32	60	9
38	Scooters India Limited	21	95	44
39	Bharat Immunologicals & Bio Limited	20	59	8

Source: Dalal Street. Biz, 10 July, 2009