SIMPLE IS BETTER

JIMIT ZAVERI 2/17/19 LUCKY IDIOT

SIMPLE IS BETTER – ISSUE -15 – MERGER

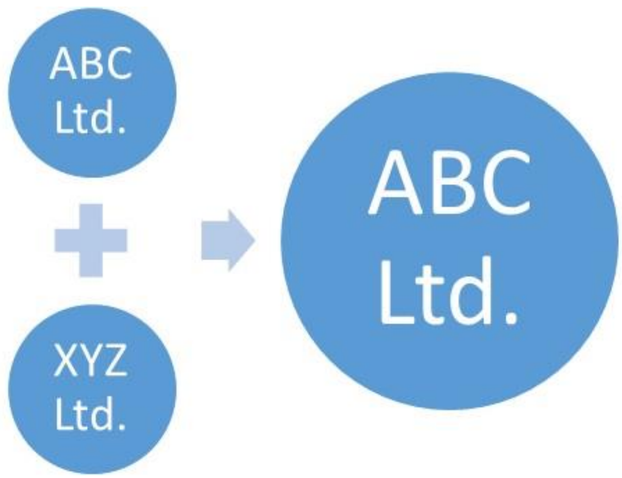
We have seen about the demerger into the last issue of the series. Now, I am going to explain similarly to the merger.

Merger-

"A merger is an agreement that unites two existing companies into one new company. Mergers and acquisitions are commonly done to expand a company's reach, expand into new segments, or gain market share. All of these are done to please shareholders and create value." – Investopedia

ABC Ltd XYZ Ltd.

ABC Ltd and XYZ Ltd both are different entities and both companies have decided to combine their business. Here, ABC Ltd. Will acquire the entire business of XYZ Ltd.



Here, XYZ Ltd. Got merged with the ABC Ltd.

Process of merger

- Both the company has to conduct a board meeting separately for approval of the merger and need to pass a resolution, fixed date for shareholder & creditor meeting
- The company need to publish a notice of the proposed scheme and send that copy to stock exchanges, registrar of the company
- Meeting with shareholders, members, and creditors
- Approval from shareholders, members, and creditors
- Both the Company has to file a scheme to the registrar of the company and official liquidator within seven days from the conclusion of meeting with shareholders, members and creditors
- If there is some kind of objection to the Registrar or Official Liquidator they shall communicate the same to the Regional Director within the period of 30 days

- After the Regional Director receives the objection by the Liquidator or Registrar and is of the opinion that the scheme is not in public interest or in the interest of creditors he shall within the period of 60days communicate the same to the tribunal and request to consider the same
- If the scheme is approved by the Regional Director and NCLT then both the companies shall within the period of 30 days from the date of confirmation of the scheme file the confirmation order with the Registrar

Why merger?

- Gaining market share
- Expansion to the new market or new segment
- Synergy

Impact of the merger to the financial aspects

1. **Dilution of capital**

If the company has decided to do a merger by a swap of equity shares then the company needs to issue new equity shares which will be resulted in the dilution of the equity. If a company makes an overvalued deal then the company needs to dilute more equity shares which will reduce the benefits of the merger.

Pre-Merger

	A	B	A+B
No. of Shares	100	100	—
Market Value	1000	500	—

Post-Merger

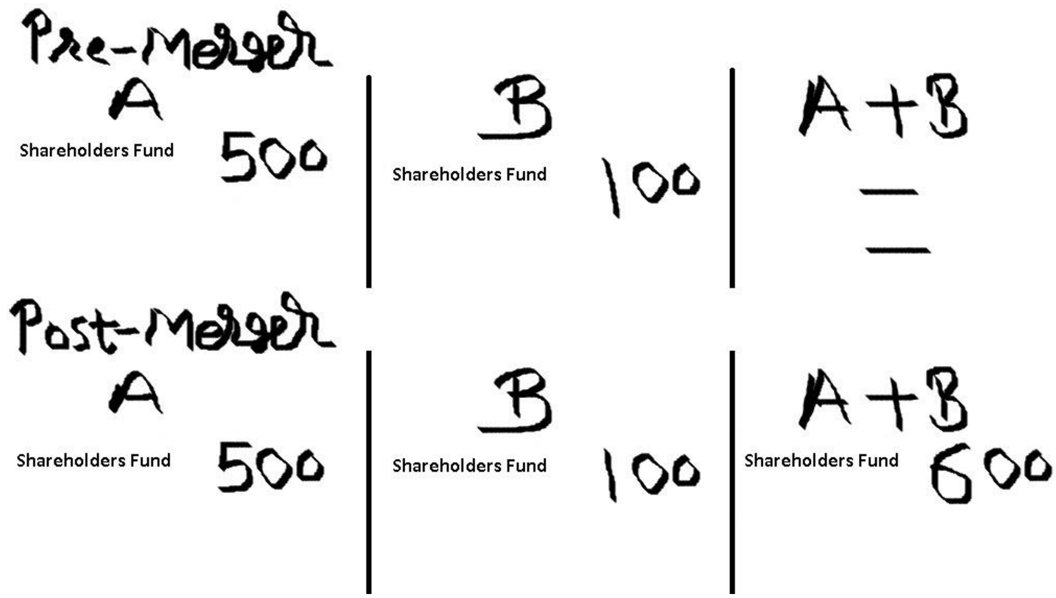
	A	B	A+B
No. of Shares	100	100	150
Market Value	1000	500	1500

Swap ratio of 1 share of company A for the 2 shares of company B.

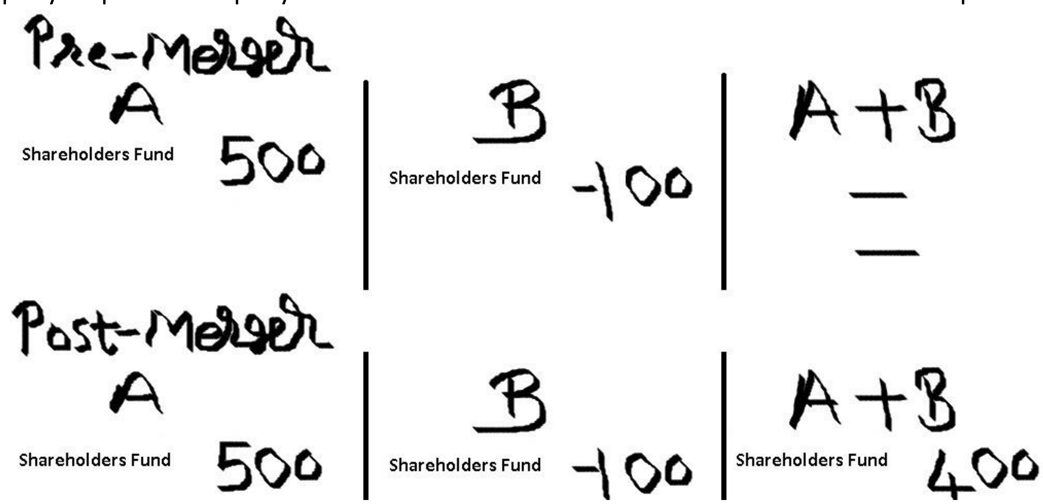
2. **Reserve and surplus**

If the merged entity is earning a profit then Reserve and surplus will be increased due to a combination of reserve of both the entity. And if the merged entity is not making profits/posting losses then Reserve and surplus will be reduced after combined entity.

If a company acquire a company which has a positive reserve and surplus



If a company acquire a company which has an accumulated losses to the reserve and surplus



3. Impact on borrowing

If the merged entity has a huge borrowing then borrowing at the combined entity will increase. And if the merged entity does not have a borrowing then level of borrowing proportion as a size of the total balance sheet will reduce.

4. Fixed Assets

When a company gets involve in the merger then fixed assets of the combined entity will be going to increase. As fixed assets of both the companies get to the combined entity.

Pre-Merger

A	B	A+B
Fixed Assets 500	Fixed Assets 200	=

Post-Merger

A	B	A+B
Fixed Assets 500	Fixed Assets 200	Fixed Assets 700

5. Investment

If the merged entity has an investment on the balance sheet, the investment on the balance sheet of the combined entity will be going to increase.

Pre-Merger

A	B	A+B
Investment 500	Investment 100	=

Post-Merger

A	B	A+B
Investment 500	Investment 100	Investment 600

And if the merged entity does not has any investment, then investment on the balance sheet of the combined entity will not get any changes.

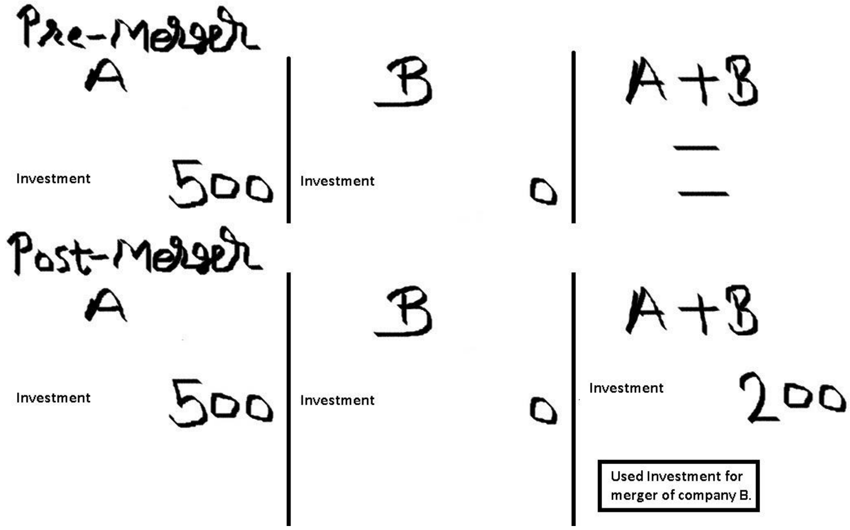
Pre-Merger

A	B	A+B
Investment 500	Investment 0	=

Post-Merger

A	B	A+B
Investment 500	Investment 0	Investment 500

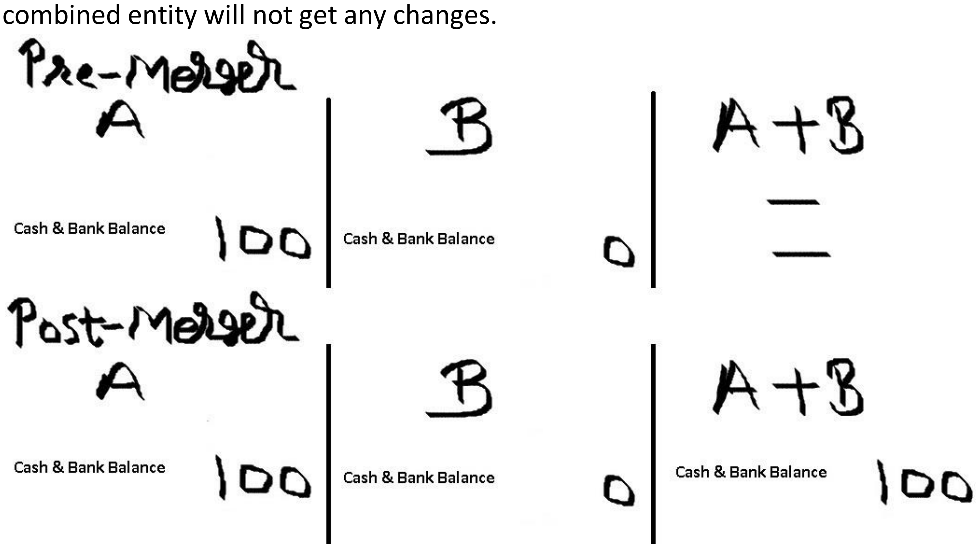
The company makes a cash deal to acquire another company then they might need to sell off their investment then investment, cash, and bank balance will get reduced.



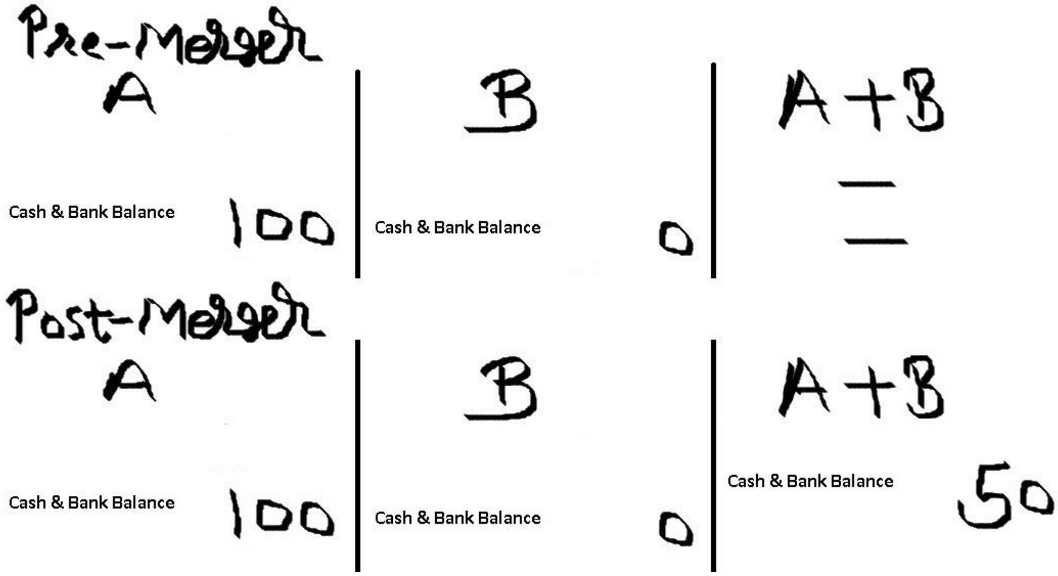
6. Cash & Bank Balance

If the merged entity has a cash and bank balance on the balance sheet, then cash and bank balance on the balance sheet of the combined entity will be going to increase.

And if the merged entity does not has any cash & bank balance, then cash & bank balance on the balance sheet of the combined entity will not get any changes.

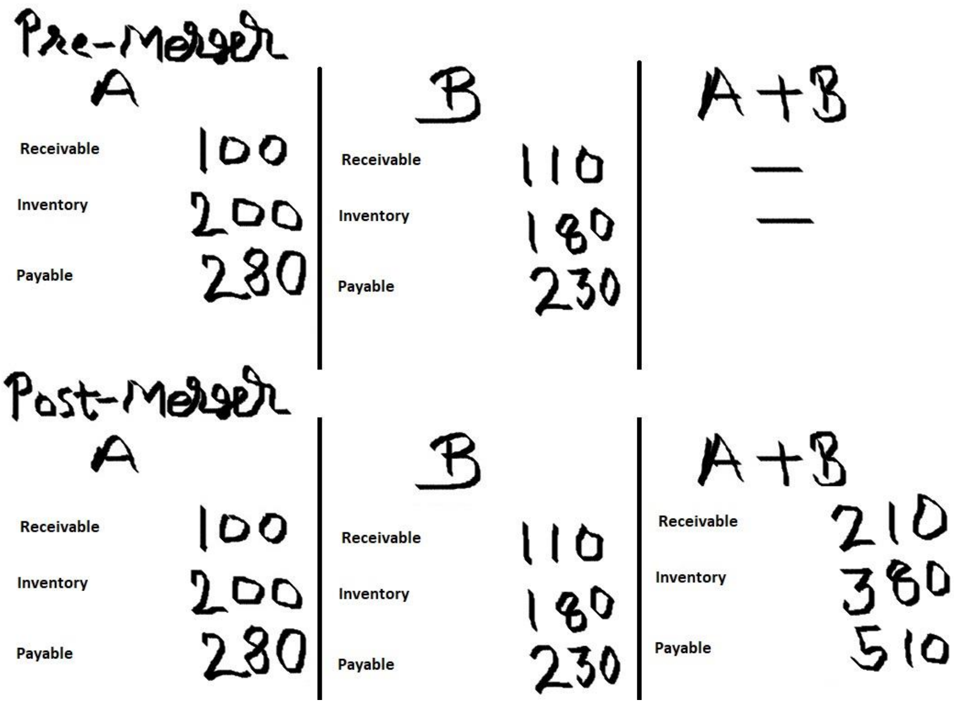


The company makes a cash deal to acquire another company then they might need to make payment through their cash and bank balance then cash and bank balance will get reduced.



7. Receivables and Inventories and Payables

When two company gets merged then Receivables and Inventories of the second company get added to the first company so that Receivables and Inventories get an increase of combined entity.



8. Cash conversion cycle

When two company gets merged then Payable, Receivables and Inventories of the second company get added to the first company so that Payable, Receivables and Inventories get an increase of combined entity. If the second company has a good cash conversion cycle then the cash conversion cycle of the combined entity will improve. And if the second company has the worst cash conversion cycle then the cash conversion cycle of the combined entity will deteriorate.

Pre-Merger				Post-Merger	
Debtor Days	49.946		56.982		68.039
Inventory Days	70.888		75.999		21.179
Payable Days	93.008		89.582		87.059
Cash Conversion Cycle	27.826		43.399		2.1598

9. Income Statement

a. Revenue

When two company gets merged then revenue of second company gets added to the first company so that revenue get an increase of combined entity.

Pre-Merger

A		B		A+B
Revenue	2000	Revenue	1000	=

Post-Merger

A		B		A+B	
Revenue	2000	Revenue	1000	Revenue	2500

b. Expenses

When two company gets merged then the expenses of the second company get added to the first company so that expenses get an increase of combined entity.

Pre-Merger

A		B		A+B
Expenses	1200	Expenses	700	=

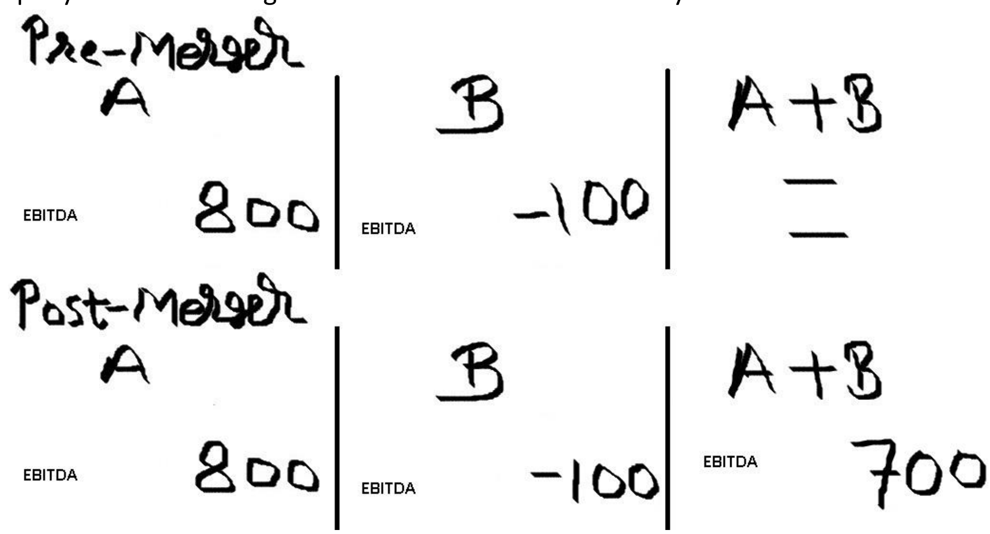
Post-Merger

A		B		A+B	
Expenses	1200	Expenses	700	Expenses	1900

c. EBITDA

When two company gets merged then EBITDA (Profit) of the second company gets added to the first company so that EBITDA get an increase of combined entity.

When two company gets merged then EBITDA (Loss) of the second company get subtracted to the first company so that EBITDA get reduced of the combined entity.



d. EBITDAM (%)

As we have seen that revenue and expenses of the combined entity get change due to the merger, so that EBITDAM% will get impacted (might get improve or reduce as per the merged entity).

Profit & Loss Account / Income Statement

Rs Cr	Mar-14		Rs Cr	Trailing		Mar-15
Sales	**16,080**	+	**Sales**	**10,762**	=	**27,392**
Expenses	9,367		Expenses	9,882		19,706
Operating Profit	**6,713**		**Operating Profit**	**880**		**7,686**
Operating Profit Margin	*42%*		*Operating Profit Margin*	*8%*		*28%*

e. Profit After Tax

When two company gets merged then PAT (Profit) of the second company gets added to the first company so that PAT get an increase of combined entity.

When two company gets merged then Net Loss of second company get subtracted to the first company so that PAT will get reduced of the combined entity.

f. PATM (%)

As we have seen that revenue and expenses of the combined entity get change due to the merger, so that PATM% will get impacted (might get improve or reduce as per the merged entity).

Profit & Loss Account / Income Statement

Rs Cr	Mar-14		Rs Cr	Trailing		Mar-15
Sales	16,080	+	Sales	10,762	=	27,392
Net profit	3,879		Net profit	-813		5,488
Net Profit Margin	24%		*Net Profit Margin*	-8%		20%

10. Per share value of the company

a. EPS

We have seen that if the merged company is generating profit then that profit will get added to the combined entity and profit of the company will increase. But if a company has diluted equity shares then will impact to the Earning per share.

And when two company gets merged then Net Loss of second company get subtracted to the first company so that PAT will get reduced of a combined entity so that EPS also will get reduced of the combined entity.

b. Book Value

As we have seen that assets of the second company get added to the first company during the merger which will increase assets based of the combined entity and if the second company does not have a higher level of debt then book value of the combined entity will improve. But if a company has diluted shares for the merger then book value per share has little improvements. Now, if the second company has a higher debt level then book value of the combined entity will not improve a much.

11. Return Ratio

a. ROA (%)

As we have seen that assets of the second company get added to the first company during the merger which will increase an assets based on the combined entity. Also, profitability gets change due to the merger of the companies, which has an impact on the return on assets %.

Net profit	3,879	**Net profit**	-813	5,488
Net Profit Margin	*24%*	*Net Profit Margin*	*-8%*	*20%*
EPS	18.7	EPS	-19.2	26.5
Total Assets	29,384	**Total Assets**	14,284	49,217
ROA %	13%	**ROA %**	-6%	11%

b. ROE (%)

As we have seen that share capital, reserve & surplus of the second company get added to the first company during the merger which will increases a shareholders fund (if second company is into the profit or else shareholders fund will reduce) based of the combined entity. Also, profitability gets change due to the merger of the companies, which has an impact on the return on equity %.

Net profit	3,879	**Net profit**	-813	5,488
Shareholders Fund	18,525	**Shareholders Fund**	3,298	25,586
ROE%	20.94%	**ROE%**	-24.64%	21.45%

c. ROCE (%)

As we have seen that share capital, reserve & surplus, borrowings of the second company get added to the first company during the merger which will increases a capital employed based on the combined entity. Also, profitability gets change due to the merger of the companies, which has an impact on the return on capital employed %.

EBIT	4,625	**EBIT**	805	6,982
Capital Employed	21,086	**Shareholders Fund**	9,896	34,582
ROCE%	21.94%	**ROCE%**	8.14%	20.19%

12. Other Ratio

a. Fixed assets turnover

Due to the merger, fixed assets and revenue of the combined entity will get change. So that fixed assets turnover of the combined entity will either improve or getting worst.

Sales	16080	10762	26843
Net Block	6817	3790	10607
Fixed Asset Turnover	2.36	2.84	2.53

b. Debt / Equity

As shareholders fund and borrowings both get change, due to the merger so that debt/equity of the combined entity will get change.

Pre-Merger

	A	B	A+B
Debt	100	300	—
Equity	1000	500	—
Debt / Equity	0.10x	0.60x	

Post-Merger

	A	B	A+B
Debt	100	300	400
Equity	1000	500	1500
Debt / Equity	0.10x	0.60x	0.27x

13. Cash Flow

a. Cash Flow from Operating Activities (CFO)

When the merger has happened then due to the changes in the profit, depreciation, working capital, CFO will also get change. It will improve or getting into trouble that will depend on the situation of another company which is getting merged.

b. Free Cash Flow (FCF)

If a combined entity has a good CFO but the other company which got merge has a huge Capex require to grow then FCF of the combined entity will getting worst. Similarly, if other company does not require a huge Capex with good CFO at combined entity then FCF of the combined entity will improve. If a combined entity has not a good CFO then FCF also suffers.

14. Valuation

Due to the changes into the balance sheet situation, income statement situation then it will affect the valuation of the company. If all the parameter of the company improves then valuation will also get improves but if the parameter of business get suffers due to merger then the valuation of the combined entity will also suffer.

Examples of Indian company

One of the Indian pharma company has acquired other Indian pharma company in the FY2014-15

Profit & Loss Account / Income Statement

Rs Cr	Mar-14	+	Rs Cr	Trailing	=	Mar-15
Sales	**16,080**		**Sales**	**10,762**		**27,392**
Expenses	9,367		Expenses	9,882		19,706
Operating Profit	**6,713**		**Operating Profit**	**880**		**7,686**
Operating Profit Margin	*42%*		*Operating Profit Margin*	*8%*		*28%*
Other Income	-1,679		Other Income	22		491
Depreciation	409		Depreciation	97		1,195
Interest	44		Interest	540		579
Interest Coverage(Times)	*105*		*Interest Coverage(Times)*	*1*		*12*
Profit before tax (PBT)	4,581		Profit before tax (PBT)	265		6,403
PBT Margin	*28%*		*PBT Margin*	*2%*		*23%*
Tax	702		Tax	1,078		915
Net profit	**3,879**		**Net profit**	**-813**		**5,488**
Net Profit Margin	*24%*		*Net Profit Margin*	*-8%*		*20%*
EPS	18.7		EPS	-19.2		26.5

*** Combined numbers not getting exactly matched due to further earning of the company one in FY15.**
**** EPS is get vary as PAT of combined entity get change.**

Balance Sheet Consolidated Figures in Rs. Crores

	Mar 2014	+	Sep 2014	=	Mar 2015
Share Capital +	207		212		207
Reserves	18,318		3,433		25,379
Borrowings	2,561		6,003		8,996
Other Liabilities +	8,298		4,410		14,636
Total Liabilities	**29,384**		**14,059**		**49,217**
Fixed Assets +	6,817		3,790		12,682
CWIP	842		0		2,039
Investments	2,786		74		2,716
Other Assets +	18,939		10,195		31,780
Total Assets	**29,384**		**14,059**		**49,217**

Love to read again and again

- Rajeev Thakkar discusses the business aspects of Asset Management
- Understanding the Diagnostics Lab Business

My Popular articles

- LEARNING INVESTMENT LESSONS FROM MOVIE CHAL MAN JEETVA JAIYE
- WHY CONSIDERING ROCE (RETURN ON CAPITAL EMPLOYED) WITH ROE (RETURN ON EQUITY) IS BETTER????
- WHAT IS ROE (RETURN ON EQUITY)? AND WHY ALWAYS CONSIDER DEBT WHEN CALCULATING ROE?

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Disclaimer

Above article is just my perception, and perception can be wrong. For me, my perception can be right but for others, it might be wrong.

I am Grateful to

I am really grateful to - Mr. Neeraj Marathe Sir, Prof. Sanjay Bakshi Sir, Mr. Vishal Khandelwal Sir, Dr. Vijay Malik Sir, Mr. Rajeev Thakkar Sir, Mr. Raunak Onkar Sir, Mr. Vijay Kedia Sir, Mr. Howard Marks, Mr. Warren Buffett, Mr. Charlie Munger, Mr. Benjamin Graham and Mr.Walter Schloss.

I am especially grateful to Mr. Vishal Khandelwal Sir for getting inspiration to start series of articles.

I am really grateful to my parents and almighty for providing me always support whenever I needed.

Please forgive me, if I forget to mention any person who has contributing value to my journey.

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As a founder of Lucky Idiot; My mission through "Lucky Idiot" is to educate novice investors and to distribute learning to more and more people in a simple manner.

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