IMPACT OF TAKEOVER CODE 2011 ON M&A SCENARIO IN INDIA: A STUDY OF SHARE BUYBACK AS A TAKEOVER DEFENSE

Dr. B. K. R. Naik[1], Rameez Raja Shaik[2] and Ritesh Jain[3]

Abstract: *The paper aims at analyzing the takeover defenses adopted by Indian companies to avoid a hostile takeover. Hostile takeovers were rare in India as the M&A laws were stringent. Also, the Government and the financial institutions supported the promoter in the advent of a hostile takeover attempt. In 2011, a major amendment was done to the Takeover Code. We have analyzed the impact of this new regulation on the M&A scenario in India. The amendments in the takeover code have made hostile takeovers easy. Analysis of Promoter Shareholding pattern in 2154 listed Indian companies showed that promoters in most of the firms have increasing their stake to safeguard themselves against hostile takeovers. This was done in anticipation of the changes in the takeover code.*

Keywords: Mergers & Acquisitions (M&A), Hostile Takeovers, Takeover Defenses, Share buyback, Takeover Code 2011

[1] Assistant Professor, Department of Management Studies, National Institute of Technology Trichy, Tamil Nadu – 620 015, India

[2] Student, Indian Institute of Management, Kozhikode, Kerala- 673570, India

[3] Student, Indian Institute of Management, Kozhikode, Kerala- 673570, India

Introduction

Prior to 1991, Mergers and Acquisitions (M&A) activity in India was quite dormant (L.S. Patankar, S.R. Chavan, 2011). After the economic liberalization, Indian economy opened up to foreign players (Rabi Narayan, Amit Soni). Though India saw an increase in M&A deals, it was mostly friendly takeovers. The first hostile takeover attempt was in 1984, when Swaraj Paul tried to takeover Escorts and DCM (Shaun J. Mathew, 2007). The bid failed as the companies failed to register Paul's shares. In most of such takeover attempts, the promoters have the soft corner of the government and the financial institutions (Shaun J. Mathew, 2007). Moreover, the Foreign Direct Investment (FDI) laws in India were quite stringent. Hence, it becomes difficult for a foreign company to takeover an Indian company. Things are changing and the laws are amended periodically to match global standards and to bring about a competitive environment in Indian firms (Sandeep Parekh, 2009). The amendments to the Takeover code in 2011, has made it easy for acquirers to takeover Indian firms. Therefore firms need to adopt various takeover defense strategies to safeguard themselves.

Mergers and Acquisitions: When two or more firms combine or, when one firm takes over or buys a considerable stake in another firm, it is broadly called as merger and acquisition (M&A). Merger is the combination of two companies when one goes out of existence. Acquisition is the purchase of one company by another, in which no new company is formed. There are many reasons for M&A: Strategic, Financial and capability acquisition. Financial reasons may include tax savings, cost savings etc. Strategic reasons include economies of scale and scope, achieving growth, survival, focus on core competencies etc. Capability acquisition includes diversification and growth through inorganic route. Mostly M&A turns out to be beneficial to both the target and the acquirer as the synergy is shared by both. In such deals, the acquisition is mostly a friendly takeover. But, in certain scenarios the target is not willing to sell itself to the acquirer. In such scenarios, the acquirer's attempts to take over the target are known as **hostile takeover**.

Firms apply **defense strategies** against hostile takeover attempts to protect their independence and current management initiatives or to help ensure that hostile bidders are pressured to present their best offers. Hostile bids are unsolicited offers that challenge current management's strategic direction and leadership.

Preventive Anti-takeover Strategies: Preventive strategies are constructed when management believe that company is vulnerable to attack because of its depressed stock price, competitive weakness, market condition or financial exigencies. Such strategies are constructed prior to takeover attempts, are time consuming and signal that board and management are united to pursuit the goal of company autonomy.

Poison Pills: With the intent of making acquisition expensive by diluting the stock in case of takeover attempt this strategy involves offering stockholders preferred stock in the merged firm - at a highly attractive rate of exchange - as a mandatory consequence of a successful takeover.

Poison pill with flip-over rights - distributes rights rather than shares of preferred stock

Flip-in poison pills - provision that gives current shareholders (other than acquirer firm) right to purchase additional shares in targeted firm at discounted price.

Corporate charter amendments: This strategy involves staggering of election of members of board of directors of the firm so that all are not elected during the same year. It prevents installation of sympathetic directors to facilitate the strategic transition in the aftermath of the takeover by the acquiring firm.

Golden parachutes: If a pre specified threshold of outside stock ownership is acquired in a takeover bid this clause mandates distribution of lucrative compensation packages to a selected group of senior executives of firm usually paid in cash. This additional cost of paying off such obligation can inhibit some takeover attempts.

Shark Repellents: The company may include in loan agreements or some other agreements conditional covenants that in the event of the company passing under the control of a third party, the other party to the agreement has the right to accelerate the debt or terminate the contract.

Reactive anti-takeover defenses

Litigation: Usually used to stall hostile attempts by legal injunction and restraining orders against a pursuer to bar that company from acquiring additional shares of the target firm. It

gives buffer time to target firm for developing other strategies. The consequences of litigation defenses are more conclusive than those of other strategies because, according to Jarrell (1985), approximately one-third of all tender offers are challenged by the litigation defense.

Greenmail: Also referred as targeted repurchase this defense involve buy back of shares that have been acquired by aggressor at a premium in exchange of an agreement that aggressor will no longer target the firm for takeover. It is simple and effective strategy for fending off takeover attempts when aggressor's goal is short term profit than long term corporate control.

Standstill agreements: A contract between parties in which, pursuer agree not to acquire further stock of target firm in exchange of the target firm paying some fee.

Capital Structure Changes: A firm can restructure its capital to defend against hostile takeover by making firm unattractive or creating long term liabilities.

1. paying shareholders super dividend financed through additional debt
2. By issuing additional share to employees as ESOP to increase control of executives
3. Issuing additional shares keeping current level of debt forcing the bidder into a costlier battle to buy shares to gain control
4. Buy back shares from open market in attempt to ward off an attack.

Crown Jewels: A disinvestment strategy involves sale of parts of the target especially coveted by bidder. This makes the target less attractive to a bidder and encourages abandonment of the bid.

White Knights: Management of Target Company approaches another firm to place a rival bid. The desire to attract a rivalry bidder is shaped by takeover context with additional motive of increasing the takeover premium by encouraging a bidding contest.

Pac-Man Strategy: As a last resort, the target company can make a tender offer to acquire the stock of the hostile bidder. This is a very extreme type of anti-takeover defense and usually signals desperation

In India, the companies are able to access lesser anti-takeover defenses in comparison to the American companies. For the purpose of preventing a takeover effort, the Indian companies currently adopt the following anti-takeover defenses:

- Effecting creeping enhancement
- Making preferential allotment
- Selling the Crown Jewels
- Amalgamating group companies
- Searching for a White Knight

Table 1: Defense Strategy Analysis

Defense strategy	Category	Popularity among firms	Effectiveness as defense	Stockholder wealth effect
Poison pills—plus flip-over rights and flip-in options	Preventive	High	High	Positive
Corporate charter amendment	Preventive	Medium	Very low	Negative
Golden parachutes	Preventive	Medium	Low	Negligible
Litigation—antitrust, fraud, inadequate disclosure	Reactive	Medium	Low	Positive
Greenmail	Reactive	Very low	Medium	Negative
Standstill agreements	Reactive	Low	Low	Negative
Capital structure changes - recapitalization, new debt stock selling, share buybacks	Reactive	Medium	Medium	Inconclusive

Share Buy Back as defense strategy: Share buyback can be used as a credible signaling mechanism or as a defensive strategy against hostile takeover. As per Companies Act Section 77A: Buy Back may be used as a defense to a hostile takeover.

Reasons for Undertaking Share Buy-Backs: Leverage: Companies with additional debt capacity may buy back shares in order to move towards optimal capital structure.

1) Information signaling: It's a credible signaling mechanism by management of firm about their faith in well doing of firm in future. It can also represent management signal about possibly favorable information about future cash flows, or believe that company stock is undervalued.
2) Wealth transfer: A buy-back that is undertaken when shares are undervalued transfers wealth to non-participating from participating (selling) shareholders.

3) Free Cash Flow: This theory of buy-backs is based upon the work of Jensen (M C Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers" (1986) 76 American Economic Review 323.). Jensen analyses the problems that exist when a company generates substantial "free cash flow" (i.e., funds that cannot be efficiently invested on behalf of shareholders because of a lack of profitable investment opportunities). For such companies, share buy-backs are an efficient means of returning funds to shareholders who can make better use of these funds than can the company.
4) Earnings per Share: It can be an attempt to increase EPS of company stock by decreasing free floated equity.
5) Anti-takeover mechanism: A buy-back may be used as a defensive tactic in a hostile takeover by increasing the leverage of the company and reducing the liquidity and common stock available for acquisition.

Weather share buy back as a defense strategy is in interest of shareholders or not is a matter of debate in economic and legal literatures (E Bielawski, 1990). Economist typically evaluates two hypotheses. First is Management entrenchment hypothesis which suggest that management is working in self-interest of prevention of control by using share buy back as a takeover defense mechanism. In contrast, the shareholders' interest hypothesis states that when managers undertake share buybacks as a takeover defense they are acting in the interests of shareholders. This is because when managers are confronted by the threat of a hostile takeover they may adopt a short-term focus with respect to investment decisions (P F Drucker, 1986). This may not be in the interests of all shareholders. Therefore, defensive tactics, including buy-backs, by decreasing the threat of a hostile takeover, allow managers to make long-term investment decisions.

SEBI – TRAC – Takeover code: Securities and Exchange Board of India (SEBI) had formulated the Takeover Regulations in 1994. In 1995, SEBI appointed a committee to review the Takeover Regulations of 1994. Justice P.N. Bhagwati was appointed as the chairman of this committee. In 1997, SEBI repealed Takeover Regulations of 1994 and formed Takeover Regulations of 1997 by taking into consideration the recommendations of the Bhagwati committee. Bhagwati committee was reconstituted in 2001 and the Takeover Regulations of 1997 were reviewed in 2002. Since then it was continuously reviewed and

amended. Till date, the Takeover Regulations of 1997 have been reviewed 23 times (C. Achuthan, 2010).

Over the last decade, the M&A activity in India have surged. The number of takeovers of listed Indian companies has increased from an average of 69 per year during 1997-2005 to 99 a year during 2006-10 (C. Achuthan, 2010). Hence, SEBI once again decided to review its Takeover Regulations. It constituted the Takeover Regulations Advisory Committee (TRAC) on September 4th 2009 to review the Takeover Regulations of 1997 and to suggest amendments in it. Mr. C. Achuthan, the Former Presiding Officer of the Securities Appellate Tribunal was appointed as the Chairman of TRAC. TRAC came up with its recommendations in 2010. In 2011, SEBI formulated the Takeover Regulations of 2011 taking into consideration the recommendations of TRAC. The impact of the Regulations is enlisted in Table 2.

Table 2: Impact of Takeover Code 2011

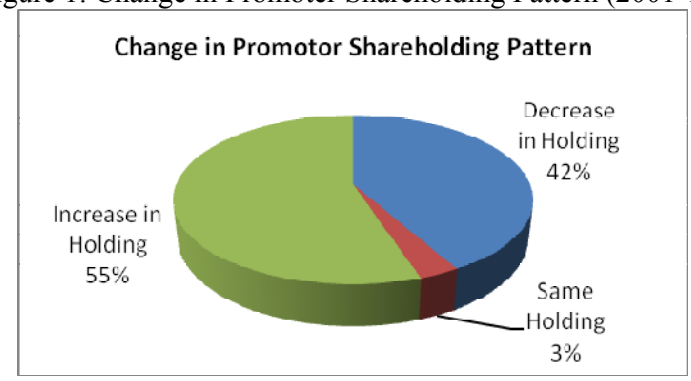
Existing Regulations	**New Changes to Takeover Code**	**Impact**
An acquisition of 15% or more shares/voting rights will trigger an open offer	15% has been raised to 25%. Hence, open offer is triggered when the shareholding/voting rights reach 25%	Limit has been increased to bring it in line with international markets. Increase in trigger limit will help the smaller firms to raise capital easily from external investors. Investors and financial institutions can invest more
Once the 15% trigger is reached, the acquirer has to make an open offer for acquisition of minimum 20% voting capital from public	Once the 25% trigger is reached, the acquirer has to make an open offer for acquisition of minimum 26% voting capital from public. Holdings due to the open offer has a cap of 75% and 90% depending on the firm	Makes it easy for hostile takeovers. Acquirers can increase stake upto 25% without triggering an open offer. After reaching 25%, they can acquire 26% additional stock through open offer and hence, they gain majority shareholding (51%)
Promoters can increase their holding by creeping acquisition of 5% per year, permissible for holders having 15% or more shares. They can increase their	The cap of 15% has been raised to 25%. Hence, promoters can increase their holding through creeping acquisition of 5% per year upto	Promoters can now increase their holding upto 75% of total equity compared to earlier 55%. Promoters will try to increase their holdings to 25% before

holding till 55%. Additional 5% (one time) can be acquired by promoters having 55-75% stake (upto a maximum of 75% stake)	maximum permissible limit under Securities Contract Regulation Rules ("SCRR"): i.e. 75% or 90%(public sector undertaking)	the new code is implemented.
Provides an outer limit of 25% premium for non-compete payments to promoters at the time of sale. This fee is excluded while calculating the minimum offer pricing	All payments, including the non-compete fee are considered while calculating the negotiated offer price for public shareholders	Brings all shareholders on the same level. Justice to minority shareholders. Promoters are at a loss, as they are not rewarded for their efforts and risk.
Board of Directors can send a recommendation letter to shareholders with their take on the current acquisition proposal	It's the obligation of the board of directors to send a reasoned recommendation letter to its shareholders about their take (if needed, they get experts' advice) on the current acquisition proposal	More power and responsibility to Board of directors. Removes asymmetry of information by making their recommendation letter as mandatory. Staggered Board of Directors can prove to be a good defensive strategy
Acquirer holding 25% or more shares to make a voluntary open offer, should atleast offer to buy atleast 20% shares	Acquirer holding 25% or more shares to make a voluntary open offer, should offer to buy atleast 10% shares subject to certain conditions	New voluntary code will keep the raiders away, as the conditions for a voluntary offer have become stringent
Change in control is exempted from an open offer if exempted by the shareholders	Irrespective of acquisition of shares, the acquisition of control will trigger an open offer	In terms with international standards
Common treatment for all indirect acquisitions irrespective of the size of target and acquirer	New code, prescribes certain parameters like revenue, asset value, market capitalization etc. for determining treatment of indirect acquisition	Brings more clarity and enables better scrutiny
Automatic exemption route in the open offer has many gaps	Overhaul of exemptions from open offer : made more stringent	Ensures that selected firms get the exemption from open offer

Data Analysis

Data was taken from Prowess Database (Release 3, CMIE). The promoter shareholding pattern in the year 2001 and 2011 were analyzed for a sample of 2145 listed Indian companies. In anticipation of changes in the Takeover code, promoters had started consolidating their stake in order to safeguard their ownership against hostile takeover attempts. This hypothesis has been proved by the analyzing the data in 2001 and 2010. Among the 2145 firms analyzed, promoters in 55.1% of the firms have increased their stake, whereas 41.82% of them have reduced their stake (figure 1). The reduction in stake in the 41.82% firms seems to be against our hypothesis.

Figure 1: Change in Promoter Shareholding Pattern (2001-11)



But further analysis of these firms show that the reduction of promoter's stake was less than 1% in all the cases. Infact 56.56% of the firms which showed reduction in stake in their trends, had actually reduced their stake by 0.25% or lesser (Table 3). Hence, we conclude that the reduction in stake among firms is very negligible and might be due to various factors affecting each company.

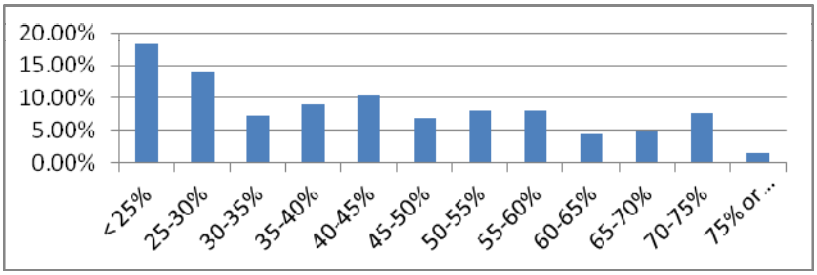
Table 3: Reduction in Promoter Shareholding (split-up)

Decrease in Holding (2001-11)	Number of Firms	Percentage of Firms
0-0.25%	487	56.56%
0.25-0.5%	190	22.07%
0.5-0.75%	96	11.15%
0.75-1%	88	10.22%
>=1%	0	0.00%
Total	861	100.00%

The data shows a whopping 55.1% of firms which have shown trends of increasing promoters share. This falls in line with our hypothesis. Due to the amendments in the criteria creeping increments in promoters stake, Indian promoters would have tried to increase their

stake to 25% before the implementation of the New Takeover Code in order to avoid triggering the open offer.

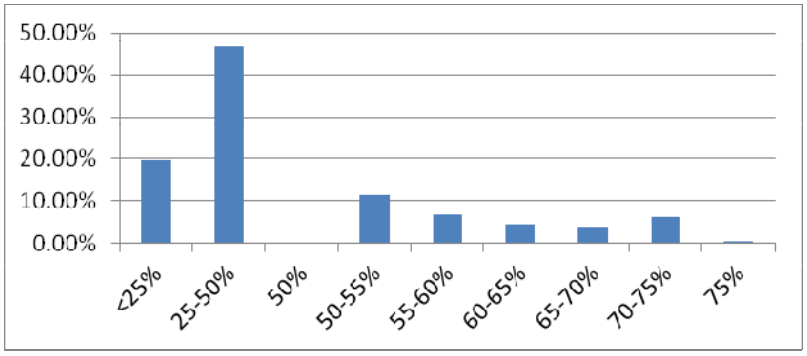
Figure 2: Promoter Stake of Firms in 2011 whose stake was <25% in 2001



Firms with promoter shareholding less than 25% in 2001 were analyzed. By 2011, only 18.39% of the firms remained less than 25%. Promoters in 81.61% of the firms have increased their stake to more than 25%, and 34.53% of them have increased it to more than 50%.

(figure 2).

Figure 3: Promoter Stake of Firms in 2011 whose stake was <50% in 2001



Firms with promoter shareholding less than 50% in 2001 were analyzed. By 2011, promoters in 33.6% of the firms increased their stake to more than 50%. This move completely eliminates hostile takeover threats (Figure 3).

Figure 4: Promoter Shareholding of firms that increased its holding

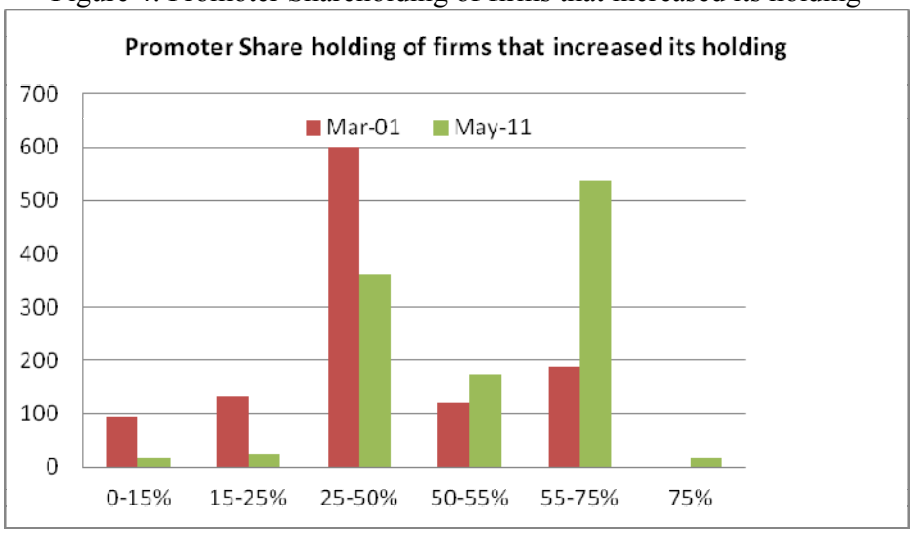


Figure 4 shows that overall there has been an increase in promoter shareholding percentage. The shift in ownership from low stake to high stake can be observed in the graph.

Conclusion

M&A trends in India have been changing. From a closed economy prior to 1991, India has opened up and has been amending its M&A laws to bring it on par with global laws. Though hostile takeovers were rare in India earlier, it can increase drastically after the introduction of the Takeover code 2011. The changes in the code have made acquisition of Indian companies relatively easy. In anticipation of such an amendment, the promoters have increased their stake over the years so as to ward of any potential takeover threats in future. Our analysis of 2154 listed firms in India showed that 55.1% of them have increased their promoter's stake by a decent margin. The increase in open offer trigger to 25% has resulted in promoters trying to increase their stake to more than 25% before the new code gets implemented. Analysis has shown that 81.6% of such firms have increased their promoter's stake to more than 25%. We conclude that the Takeover code is good for the Indian economy as it opens up avenues for new M&A's and hence makes the scenario competitive. Those promoters who wish to safeguard their firms need to adapt to takeover defense mechanisms like share buyback, shark repellent etc. to ward off potential takeover threats.

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