FUTURE OF INORGANIC GROWTH

By Ashish Gupta

Growth is what all companies are craving for in this rapidly changing economy. It is no longer marked by a mere desire to expand but has become a necessity for survival and with the onset of the international competition post 1991, it is all the more applicable to the Indian scenario. As a result of globalization the private sector has become more aggressive every passing year and thus gradually shifted towards inorganic growth. Before delving further into the issue it is equally essential to understand the organic growth and why there has been a change in the trend.

While Inorganic growth is fast and more fulfilling, organic growth on the other hand is a slow and limiting process but a lot safer as it is a tried and tested model. The Indian economy has undergone a major transformation and structural change following the economic reforms, and “size and competence" have become the focus of business enterprises in India. Indian companies realised the need to grow and expand in businesses that they understood well, to face growing competition.

There are primarily three objectives behind every M&A transaction-Improving revenues and profitability, faster growth in scale and quicker time to market, acquisition of new technology or competence. As per the survey by Grand Thorton among Indian managers, 33% had the motive of increasing revenues, while 28% were banking on economies of scale and quicker time to market,22% wanted to acquire new technology,11% for increasing market share and 3% for tax shields and investment savings. Future of mergers and acquisitions will depend on the very fact that whether they actually fulfil the purpose or is it that our lack of significant research in the field has made us nonchalant towards the post merger effects. In US overall rate of failed mergers and acquisitions is estimated at between 74% and 83%.As per a study by Amie J Devero on why so many American acquisitions of Caribbean companies failed he talks about the two kinds of mentalities prevailing in the industry, namely the integration mentality and the deal mentality. For those with a deal mentality, the point of the exercise is to close the deal for the best price and generate the highest stock value in the shortest amount of time. Those with an integration mentality see the process of acquisition as a long-term project that starts with a due diligence and isn't over until the merger, including integration, is complete -a process that may take several years. Since deal is just the initial stage of an acquisition it is incomplete without an integration process which absorbs not only the operations of the acquired company but also the human resources and thus their culture which is a task even more daunting. When Yegen Associates, a fifty-year-old finance company was purchased, the acquiring company had a traditional, conservative banking culture. According to Louis Lorio, the VP of Yegen, the deal was made on the basis of analysis of historical data through which it was concluded that going national would grow the business, but Yegen dissolved in 5 years due to cultural clash. According to a study by American Management Association, one out of four executives leave within a quarter of merger and 47% of the seniors managers do so within a year. In addition to it, the acquirer adds on to its liabilities from the acquired company.

Now coming to the Indian scenario, very little research work has been done to study the post merger effects. As per a study done by Surjit Kaur (in ”A study of corporate takeovers in India”), using eight financial ratios on 20 companies and studying pre-merger and post-merger effects for three consecutive years, it was concluded that both profitability and efficiency of targeted companies declined in post- takeover period, but the change in post-takeover performance was statistically not significant. Beena (in 'Towards understanding the merger wave in the Indian corporate sector – a comparative perspective') analysed the pre and post-merger performance of a sample of 115 acquiring firms in the manufacturing sector in India, between 1995-2000, using a set of four financial ratios. The study could not find any evidence of improvement in the financial ratios during the post-merger period, as compared to the pre-Merger period, for the acquiring firms. Pawaskar ('Effect of Mergers on Corporate Performance in India') analysed the pre-merger and post-merger operating performance of 36 acquiring firms during 1992-95, using profitability, growth, leverage, and liquidity, and found that the acquiring firms performed better than industry average in terms of profitability. Regression Analysis however, showed that there was no increase in the post-merger profits compared to main competitors of the acquiring firms.

As per a recent research done by Pramod Mantravadi, Engagement Director, ISB and A Vidyadhar Reddy, Professor, Osmania University on pre and post merger effects across various sectors it was found that change in net profit margin was dependent on the type of industry. While Agri products, chemicals, textile, banking and finance, pharmaceutical companies registered a decline of 3.75%,2.09%,3.16%,7.97%,1.59% in net profit margin respectively, electrical equipment registered a meagre 0.09% increase. Overall there was a 2.73% decline in net profit margin. Although this data was taken only for a period of 3 years post and pre-merger but the slow rate of recovery in profit margins is evident and thus raises questions on the very fact that companies consider organic growth to be a slower process ignoring its zero risk aspect .Although there are exceptions like ICICI Bank and M&M which prefer organic growth over inorganic. Chanda Kochhar in one of the interviews said that their bank will prefer organic growth over inorganic one as many hidden liabilities could come in along with cheap valuations of the troubled foreign banks.

Taking into consideration the data from the research work and common belief in the industry, the credibility of acquisitions is yet to be proven and thus requires more research work. Quoting from the book “Black Swan” by Nassim Nicholas Taleb , “greatest achievements to worst disasters are unpredicted and undirected” and thus undue faith in inorganic growth may give rise to another black swan.