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Kalpataru Bandopadhyay

Farm Management Vidyasagar University, West Bengal, India., kalpataru.bandopadhyay@gmail.com

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Two Cases of Failure in Merger: Is it Over Confidence?

Dr. Kalpataru Bandopadhyay

Dept. of Commerce with Farm Management
Vidyasagar University, West Bengal, India.

Abstract - There were high rate of failure in mergers and acquisitions all over the world. Even after due diligence conducted by own qualified staffs and by expert consulting firm, the calculation may go wrong. Many researchers observed behavioural biasness during the decision making process of the deal as one of the causes of such failure. Here, the paper makes an attempt to identify human biasness in relation to decisions regarding mergers with the help of analysing two cases in Indian context. The said mergers could not succeed apparently due to the underestimation of risk by the acquirer probably arising out of the overconfidence

Keywords - Behavioural Finance, Merger, Overconfidence, Attribution Bias, Anchoring Bias

INTRODUCTION

The mergers & acquisitions are advocated generously at least at the conceptual level. Out of a merger, a firm could create synergy or could reduce risk by diversifying its activities. Sometimes the mergers are aimed at increasing the market share and to control the market. Thus mergers and acquisitions are supposed to improve value of the firm. Due to its estimated and assumed advantages, in 2015, there were 44,000 acquisitions around the world valuing over 4.5 trillion US dollar. Grand Thornton's 11 th. Annual deal tracker observed that there were 569 M&A transactions in India in 2015. However, the observations of empirical studies could not draw as rosy pictures as theory. Long back Kitching (1974), on the basis of self-reports of the managers of the acquirer company, observed that failure rate is around 50% in case of European companies. Even Rostand (1994) reported similar high rate of failure in mergers in early nineties. Later on Agarwal & Jaffe (2000) observed under performance in share price performance in the months following acquisition and also suggested that approximately 35-45% of the acquirers do not achieve positive returns in the two-three year period following acquisition. In the report of an extensive study, McKinsy in 2005 stated that in 70%

cases the revenue synergy could not be achieved after merger where as in 40% cases the expense synergy could not be achieved. In this paper, no distinction has been made between the term 'merger' and 'acquisition' and used interchangeably.

There might be several reasons for such failure in mergers. However, Moeller & Brady (2007) observed that human behavioural factors might be an important cause for high rate of failure in mergers and acquisition. In this context, the objective of the paper is to look into whether there is any possibility of behaviour induced decisions in general and overconfidence in particular as a cause for failure of merger.

The paper has four parts. First section above is to introduce the topic, second section deals with the merger related decisions and scope of human biases and third section is related to two short case studies in Indian context. The last part summarises the findings of two cases and concludes.

Scope of human biasness in merger related decisions:

All the merger related decisions are basically decision related to valuation: (A) valuation related to estimated benefits from target company and (B) valuation related to sacrifice of the acquirer company.

Valuation of estimated benefits from target company: These decisions of merger are related to (a) valuation of the assets of acquiring company including the valuation of intangible assets. There are several approaches to such valuation. Some are on the basis of intrinsic value and some are on the basis of market price. The book value of the assets of acquiring company may just be just a benchmark for tangible assets but the utility of all the assets may not be the same and such would be valued accordingly. Baker, Pan & Wurgler (2009) observed intrinsic value may not be the criteria for settlement of purchase consideration in merger. Further, it is really a complex job to evaluate the intangible assets like patents, control premium or

goodwill. (b) Change of risk profile: The risk profile of the acquirer company may change due to merger. If the acquirer assumes debt to finance the acquisition, then the risk may increase for the acquirer. Through the acquisition, a company can diversify its business and reduce risk. Further, by being market leader or enjoying monopoly even to a limited extent a company could reduce risk (c) Valuation of synergy: The synergies could be created out of merger. There are basically two types of synergies (1) operational synergy: arises out of utilisation of under-utilised capacity, commanding control over market as regards pricing or quality or availability etc. (2) cost synergy: arises out of utilisation of fixed facility by both, eliminating some expenditure e.g. research & development expenditure. The evaluation of synergies is a very subjective and complex exercise. So, the total evaluation of benefits in the event of merger is quite difficult to determine. In this respect, Doukas and Petmezas (2007) studied mergers of some companies in United Kingdom and observed that the overconfidence is prominent in managers who underestimate the risk and overestimate the synergy gain associated with the merger. He also observed in his study that poor long-term performance after the merger.

Valuation of sacrifice of the acquirer company: (d) determination of deal price and (e) mode of settling purchase consideration.

Pricing of the deal: The pricing of the deal is entirely dependent on valuation of benefits out of merger. Baker, Pan & Wurgler (2009) observed that the pricing of the deal is influenced by anchoring bias. The 52 week high price of the target company becomes a reference point, an anchor. When the share price is less than 52 week high, the shareholders' of the target company would be happy with higher price than the present. Further, the bidder think that the target was greatly valued some months' back, then the bidder themselves believed that with their ability to manage and creating synergy they can bring back the target into the same level or even at higher level than where it was. This phenomenon induces the bidder to be overconfident.

In many of the cases, the final bid value in a takeover is the outcome of auction like transactions. Roll (1986) observes the 'hubris hypothesis', in such cases. Hubris management relates to poor judgement. Any estimate related to future value may be aggressive, conservative or may even be realistic. However, bid value in an auction is the most optimistic value available. So, winning in a bid may be associated with some sort of 'curse' known as 'winner's curse'. The price is not realistic or not even rational.

Mode of purchase consideration: There may be different types of instrument for settling purchase consideration e.g. stock, cash or both etc. Graham & Harvey (2001) concluded that 67% of Chief Financial Officer of their survey stated that issuance of stock depends on overvaluation or undervaluation of their own shares vis-a-vis shares of the target company. When the share price is overvalued, the acquirer would tend to be interested in all-stock deal specially when the price of the shares of target company is undervalued comparatively. Shleifer & Vishny (2003) observed that when the shares of target company is overpriced because of enthusiasm, it is time for stock-for-stock deal. As the market price can hardly be rational, so existence of human biasness is prominent. Further, stock-for-stock deal all cash deal should not be better than all cash deal.

Now let us discuss two Indian cases in relation to the above the discussion.

Kingfisher – Air Deccan merger:

It was a case related to a merger in aviation industry. Kingfisher Airlines Limited (KAL) completed acquiring Air Deccan (Deccan Aviation) in 2008 (the process started in 2007). In this context, it is the objective of this discussion is to seek whether there is any human bias as discussed above in the decision of taking over Deccan Aviation by KAL.

Aviation Industry in 2006-07:

The aviation industry was a high growth industry during 2006-07. There were two types of airliners: (a) Full Service Airliner (b) Low Cost Carriers (LCC). The full service carriers used to offer usual services prevalent in aviation industry along with transport facility. The usual practice was to provide drinks, snacks and also magazines and news papers. The full service carrier also ensures due care and attention to the passengers by flight attendants. On the other hand, LCC charges low fares from passengers. Many a times the fare in LCC is even as low as 50% of the fare as charged by full service carriers. However, the LCC passengers were provided with basic transport service but no other usual service is provided not even a glass of water or a cup of tea. During that period of time, on an average, Indian aviation industry was growing at an annual growth rate of 30%. However, growth of LCC segment was much higher. In fact, LCC posed a threat to the business to full service carrier in a price sensitive place like India.

Kingfisher Airlines Limited (KAL):

KAL commenced aviation business in the year 2005. The company served the premium category of the sector offering full service possible with commensurate fare. But, the business of LCC was more lucrative as far as number of passengers, consequent load factor and future growth are concerned. In this context, KAL intended to expand its business by entering into LCC segment keeping the own premium brand intact. The market of KAL in 2006 was 11%. It was looking to become market leader inorganically through the route of merger and acquisition. Thus it planned to combat the price war prevalent in the industry at that point of time [Bandopadhyay (2007)]. Being market leader KAL could have dictated the fare as well to make the airlines profitable. KAL planned to have the synergy through sharing fixed infrastructure and common facility both of them enjoyed. Thus sharing of airport infrastructure, fleet sharing, airlines spares sharing and manpower sharing would have been possible. It was also possible to rationalise the routes of the airlines taken both the airlines together. Further, KAL wished to start international operation but lacking experience of running five years of domestic airlines services required as a prerequisite for availing license for the purpose. The merger with an airliner with necessary experience could have solved the problem. Further, a merger can yield synergy in the process.

Now let us note the financials of the KAL upto 2007-08, before the acquisition, and to examine whether the financial health of the company was in a position to afford any takeover decision.

Sales, Net Profit & BPS of Kingfisher Airlines before Merger

Year	Sales (in Rs. Cr.)	Net Profit (in Rs. Cr.)	Book Value Per Share (Rs.)
2004-05	305.55	-16.79	44
2005-06*	1285.42	-340.55	23
2006-07	1800.21	-419.58	28
2007-08**	1456.28	-188.14	14

Source: Ace equity Data base, 2015

* All figures are for a period of 15 months, as on June 2006

** All figures are for a period of 9 months ending on March 2008

TABLE- I

From the year 2004-05, i.e. since its inception, the Kingfisher Airlines was a loss making company. During the period, sales increased from Rs. 300 cr. to over Rs.

1800 cr. But, the loss shoots up from Rs. 16 cr. in 2004-05 to over Rs. 400 cr. in the year 2006-07. The net worth of the Kingfisher was eroding throughout the period i.e. from 2004-05 to 2007-08. As a result, book value per share was reduced from Rs. 44 to one third in four years of operation. Naturally, KAL had hardly any retained earnings to fund the acquisition.

Now let us have an idea amount of debt and contractual obligation as regards interest payment before the merger.

Kingfisher Airlines Limited: Debt & Interest

Year	Debt (in Rs. Cr.)	Interest (in Rs. Cr.)
2004-05	284.48	55.33
2005-06*	451.66	250.72
2006-07	916.71	466.05
2007-08**	934.38	434.44

Source: Ace equity data base, 2015

TABLE - II

The amount of debt of KAL kept increasing before the merger and in the year 2007-08, the company has a debt of around one thousand crore. Consequently total amount of interest has also increased from Rs. 55 cr. in 2004-05 to over Rs. 434 cr. in 2007-08. The chief reason of acquiring debt regularly was to finance for maintaining normal operation in the event of sustained loss.

However, the view of the management of KAL should be considered along with ground reality.

Expected Scenario of Airlines Industry in 2007-08:

We can understand that KAL was very much enthusiastic about acquisition and its future. However, the reality may have been something different. Krisnan (2009) surveyed the Indian airlines industry thoroughly upto 2006-07 and during 2007-08 and he observed the Indian airliners were in serious trouble. He observed several barriers to future growth. The airport landing and navigation charges are 50% higher than international bench mark. The price of aviation turbine fuel (ATF) was 70% higher than prices abroad. Further, air transport tax was also high India. All these cost only would increase passenger fare to discourage air travel. On the other hand, any attempt to absorb the cost by the airliners is not feasible since they are already incurring huge losses. Further Bandopadhyay (2007) also observed the vicious cycle of low fare mainly due to stiff competition.

Now let us discuss about the risk of KAL prevalent in this case. Firstly, risk already assumed by KAL and further risk to be assumed after the acquisition takes place.

Risk associated with Kingfisher Airlines Limited:

KAL is to bear ordinary business risk like any other business activities. However, aviation industry around 2006-07 was in a vicious cycle of low fare [Bandopadhyay (2007)] and characterised by price war initiated by LCCs which makes aviation industry even more riskier. KAL was not only a consistently loss making company since its inception but also the loss was with an increasing trend over the years. There was no sign of recovery in near term as per the industry forecast. As such, business risk is even higher for KAL. Further, the company was highly indebted company with a book debt of around rupees one thousand crore as on the period ended 2006-07.

Now the pertinent question is: should Kingfisher Airlines Limited, with the above risk profile, have gone for acquisition? Before that discussion let us discuss a few words about the target company, Deccan Aviation.

A brief account of Deccan Aviation: Deccan Aviation was pioneer in introducing the concept of low cost carrier in Indian domestic aviation industry in the brand name 'Air Deccan'. Air Deccan holds 14% market share of aviation industry in 2006-07. The company was a loss making company with huge debt burden. In the year 2004-05, the loss was around Rs. 60cr. However, the loss shoots upto to Rs. 341 cr. in fifteen months ending June, 2006. It is understood that financial figures of the company was in severe stress.

The KAL planned to acquire the control Deccan Aviation with a total investment of Rs. nine thousand and sixty eight crore in two tranches.

The risk profile of KAL was supposed to get adversely affected due to the proposed merger as stated above. After sustained loss year after year, KAL had no retained earnings to finance acquisition. The company is required to take fresh debt which would not only increase further finance risk but also put pressure on the margin instantaneously due to huge interest cost. Further, acquiring a loss making company with bleak prospect of the industry adds up business risk. Lastly, but very importantly, operational and cultural incompatibility out of a merger may also increase business risk.

Under this context, merger of KAL with Deccan Aviation would not have been recommendable. But, the fact is that, the KAL acquired 27% of Deccan Aviation at a total price of Rs. 550 cr. considering Rs. 155 for

each share of Deccan Aviation in 2007-08 and then acquired 20% with a sum of Rs. 418 Cr. afterwards. The process of merger started in 2007 and ended in the year 2008. Let us see the impact of some key financial figures of the KAL after merger with Deccan Aviation:

Kingfisher Airlines Limited After Merger with Deccan Aviation

Year	Debt (in Rs. Cr.)	Interest (in Rs. Cr.)	Net Profit (in Rs. Cr.)
2007-08**	934.38	434.44	-188.14
2008-09	5665.56	2029.33	-1608.83
2009-10	7922.60	2245.59	-1647.22
2010-11	7057.08	2340.32	-1027.40
2011-12	8030.00	1276.34	-2328.01
2012-13	8657.64	1436.15	-4301.12

[Source: <http://www.moneycontrol.com/>]

TABLE-III

As expected, the merger happens to be a total failure. After incorporating huge debt in 2008-09, the company faltered firstly due to huge interest payment and also for piling up of cumulative losses. The business plan of the company did not materialise as expected. Kingfisher Airlines could not pay their dues to its debtors and also could not pay salary to its staffs and eventually it has to stop its operation before being an irregular service for sometimes in 2011. Finally, Ministry of Civil Aviation has revoked the aviation license from Kingfisher Airlines in the year 2013 due to non-compliance of regulatory provisions.

Now, the most important question is why the company went for such a merger which lacks basic financial prudence. The reason behind such decision of acquisition may be traced to human bias of the decision makers.

In the year 2006-07 & also in 2007-08, KAL itself was assuming huge risk in its business operation as stated above. Further, there was even much higher risk to be accepted in the decision of the acquisition of Deccan Aviation. The risk is basically a perception and subjective in nature. It could be assessed only indirectly. However, there was no objective parameter to gauge the risk and thus to mark some level of risk as unbearable.

But, if subjective analysis is allowed, there is a sense of feeling that considering the financials of the company and the industry scenario during 2007-08, KAL itself was at high risk. The decision of acquisition of loss making Deccan Aviation by borrowing huge fund may be considered as self-defeating one. The reason behind such decision may be traced to the overconfidence of the managers. Doukas and Petmezas (2007) observed that the overconfidence is prominent in managers who underestimate the risk and overestimate the synergy gain associated with the merger. The influence of irrational overconfidence on the financial decisions including that of merger related decisions are not rare. Backer et. al. (2009) observed that irrational decisions are not rare. He noted, on an average, the managers are not overconfident. But overconfident managers are generally preferred by CEOs or Chairmen. Thus it is the overconfident managers who are placed at the top management of many of the companies. Naturally, many strategic business decisions and financial decisions are taken by such overconfident managers. There is another reason why managers do not seem to mind to be overconfident. In general, people has tendency to take greater responsibility for success. However, people has tendency to put blame on others for the failure causing attribution bias in decision making. This bias leads many managers to become overconfident and prompted them to take irrational decisions.

Now let us discuss another failure in merger.

Suzlon –RE Power Merger:

Suzlon was established in the year 1995. It was incorporated as a wind power turbine manufacturer with German collaboration. Suzlon is market leader in wind power generation in India almost since its inception. In the year 2000, it was world's fifth largest wind power company with presence in some Asian and European countries. Suzlon is engaged in all wind power related business like feasibility study, complex front-end engineering design, manufacturing wind power turbine. The company is also involved in construction, installation and commissioning of wind farms. Further, the company also deals in business of long term operation and maintenance contract business.

In the initial years, Suzlon was a high growth company. Its growth rate in turnover in the first five year of operation was stupendous. From the scratch the turnover of the company stood at around rupees two thousand crore with a net profit of over rupees three hundred and sixty in the year 2004-05 itself. By 2006-07, the company turnover shoots up to around rupees eight thousand cr. with a net profit of over rupees eight hundred and sixty crore.

Suzlon Energy: Financials Before acquisition

Year	Sales (in Rs. Cr.)	Net Profit (in Rs. Cr.)	BPS (on 31 st . March) Rs.
2004-05	1942.48	365.12	90.0
2005-06	3841.03	760.52	97.6
2006-07	7985.73	864.80	129.04

Source: Ace equity database, 2015]

TABLE-IV

The networth of the company has also increased during this period as demonstrated in Table- IV. Being enthusiast by its organic growth, Suzlon, dreamt bigger. It wished to be the world market leader in wind power generation. The company assessed that the convenient way to be market leader is to acquire established companies. In the year 2006-07, Suzlon acquired Hansen Transmission at euro 465 million. To expand in German market and other European countries the company targeted German company RE Power systems. The back to back acquisition required huge amount of financing. According to the agreement, out of the three tranches to be paid to RE Power, in 2007-08, Suzlon required to pay the largest tranche of 1.2 billion. In the subsequent years, Suzlon was to buy 30% stake of RE Power from Areva and finally according to the agreement of acquisition, Suzlon is also to buy the stakes of RE Power from its strategic Partner Matifar SGPS.

Motive behind merger with Suzlon: The reason behind acquiring RE Power is to expand the market specially to make itself more prominent in European Market and also to utilise its production facility. Another reason to acquire RE Power is to take the advantages of its excellent R&D capabilities. The Suzlon group CEO Andre Horbach commented 'with the help of highly integrated supply chain, Suzlon and REpower will provide an excellent platform for a strong growth in the wind industry with world class products and outstanding R&D capabilities'. There was another reason behind this merger. The operating profit margin of Suzlon was much higher than RE Power. Suzlon understands that with due restructuring of RE Power Systems by the experienced team of management of Suzlon, the operating margin could be improved significantly.

To assess its appetite for acquisition, the capital structure of the company need to be understood. We should also consider the amount of interest and operating profit

Suzlon Energy: Pre- Merger Debt and Interest

Year	Debt-equity	Debt (in Rs. Cr.)	Interest (in Rs. Cr.)	PBIT (in Rs. Cr.)
2004-05	0.65	395.81	45.83	410.95
2005-06	0.12	450.7	64.77	825.29
2006-07	0.31	5162.04	276.34	1141.14

Source: [http:// www.moneycontrol.com](http://www.moneycontrol.com)]

Table- V

From the Table-V, we understand that debt-equity ratio is not very high. But debt has increased over ten times. It implies that the company has increased its equity base during the period of study. The huge increase of debt in 2006-07 is due to the acquisition of Hansen Transmissions. However, the company has taken the loan may be sometimes during the year 2006-07. However, in the subsequent years the company would have to bear the interest for the full year. In this context, taking fresh loan to fund another acquisition would have been self-defeating. The Table-VI demonstrates the borrowing by Suzlon and its impact on profitability.

Debt and Interest on debt of Suzlon Energy: Post Merger

Year	Debt (Rs. Cr.)	Debt-equity ratio	Interest (Rs. Cr.)	PBIT (Rs. Cr.)
2007-08	9934.59	0.44	596.94	1668.09
2008-09	14869.51	1.13	1053.94	1482.81
2009-10	12667.94	1.36	1457.99	468.26
2010-11	11352.91	0.96	1268.18	-48.71
2011-12	10948.26	1.14	1529	-1056.41
2012-13	13692.35	3.39	1702.69	-3029.26
2013-14	15164.27	3.13	1998.48	-1549.7

[Source: *Ace Equity*, 2015 & www.moneycontrol.com]

Table-VI

The amount of borrowing has increased significantly. From over five thousand rupees in 2006-07, it went up almost double in the next year. The company increased its borrowing by almost another 50% in 2008-09. However, the debt-equity ratio was not alarming even upto 2011-12. This is because of increase of equity capital during this period. As a result without adequate increase in profit, the earning per share was shrinking. After struggling with huge debt burden and consequent interest after the acquisition, Suzlon even could not cover the interest cost in 2009-10 and had to

incur loss. The company could not pay a significant part of its due arising out of interest payment in 2009-10 onwards. With accumulated burden of interest due, the accumulated loss was spiralling up. Suzlon defaulted and had to renegotiate with lender with even harder terms.

There was another very important cause of such failure. From 2008 onwards, whole world was in the grip of recession. The priority of governments in different countries was to insulate the usual business from the world financial crisis. The encouragement towards alternative sources of energy took a back seat. It is needless to mention that due to higher cost involved the corporate in general is not interested in production of renewable energy without the government support ignoring the environmental issues. The figure of PBIT from Table VI shows that the company had to incur huge interest cost after acquisition and might be considered beyond its appetite. The total net assets of company were less than rupees three thousand crores as on 2006-07. However, with two consecutive acquisitions it had to arrange euro 1.665 billion or around rupees ten thousand crores, which was over three times than its total net asset. Chairman Tulsi Tanti conceded in an interview on 20th. December, 2007, that "we funded two large acquisitions by raising debt and that was a concern for our investors ". Due to huge debt already assumed and the company could not accept many orders which affected the profitability adversely. In another interview in 2015, Tanti admitted that "we have not been able to tap opportunities earlier because of liquidity crunch". It seems the concern is not only his shareholders' but also his own. It might be inferred with reservations that had Suzlon not taken such a huge risk by resorting to huge debt, there was possibility that company might have avoided the disaster. Before being a defaulter in 2009-10, Suzlon was earning decent operating profit. Due to spiralling amount of interest, the company falls in some sort of debt trap. The ultimate result of which could be observed from the following Table-VII:

Suzlon: After acquisition of RE Power

Year	Sales (in C Cr.)	Net Profit (in C Cr.)
2007-08	13679.43	1071.15
2008-09	26081.70	428.87
2009-10	20619.66	-989.73
2010-11	18090.23	-1316.89
2011-12	21359.21	-472.59
2012-13	18913.53	-4731.95
2013-14	20402.86	-3548.18

[Source: *Ace Equity*, 2015]

Table-VII

After the initial offer of Suzlon, Areva put counter offer for RE Power. Finally Suzlon offered 20% higher price than the offer price of Areva. The decision may have suffered by winners' curse. In case of an auction there may be there types of bidders. Generally, some are conservative in their valuation and offering bid, some may offer fair value and some even overestimate in offering their bid value. Even among the persons who overestimate, the bidder who offered the highest value wins the bid. So, in an auction a person may pay unreasonably high price for the bid and wins but ultimately may lose from economic point of view.

Suzlon changed the name of RE Power system to Senvion SE and hold to sell US Centre bridge at C 7,200 cr. (euro 1.1 billion). A part of the proceedings i.e. C 6,000 cr. would be utilised to retire old and the balance would be utilised to fund operation. In an interview in January, 2015, the Chairman of Suzlon commented, "We have not been able to tap opportunities because of the liquidity crunch and now we will be able to address it". It seemed that Suzlon was relived to sell RE Power not only to reduce yearly loss arising out of it but also to reduce the loss of Suzlon by reducing amount of interest by retiring a significant portion of debt.

CONCLUSION

After a theoretical discourse, this paper made an attempt to critically discuss the efficacy of mergers and acquisition through analysis of two cases. A company can certainly achieve its target objective out of merger and become successful in acquisition if undertakes decision rationally. The decision making is not a purely objective process but a subjective one which is easily vulnerable to personal biases. Thus a decision be it a financial decision or an organisational decision should consider all behavioural aspect including the issues of behavioural finance to control personal biasness in decision making. In this paper, it is observed that overconfidence bias of the top management of KAL might have played a spoilsport for Kingfisher Airlines and Deccan Aviation merger. Similar is the case of merger of Suzlon-RE Power merger. In cross section analysis of merger and acquisitions of different companies more generalised conclusion could be drawn. However, here the discussion of cases could show anatomy of the decisions more closely.

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