

Are Mergers and Acquisitions Beneficial? The Case of Tata's Corus Buy

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Abstract

Mergers and acquisitions in the recent times have emerged as the top strategic moves of companies world over in the face of globalization. Not only survival and growth, such strategies have now been the preferred options even for establishing and/or expanding international presence of the forward looking corporate giants.

India witnessed the largest ever overseas acquisition in April 2007 when Tata Steels Limited acquired the Anglo Dutch steel producer Corus Group Plc (Corus) for US\$ 12.11 billion. After this acquisition Tata Steel emerged as the fifth largest steel producer in the world. However, there have been serious doubts and apprehensions regarding whether the acquisition has been beneficial for TATA or not. Since TATA has already lived the acquisition for around three years by now, one is tempted to discover the hidden truth. In the present paper, an attempt has been made to see how TATA has been affected by its acquiring of Corus group. For this purpose the authors have analyzed the pre and post acquisition performance of TATA with the help of the various financial ratios of the company. The paper concludes that TATA is apparently in benefit of its buying of Corus and still to benefit in the long run from capital and technology of Corus.

Keywords: merger, acquisition, financial ratio.

JEL Classification: G34

1. Introduction

The Indian steel industry has come a long way since its humble beginnings. It entered into a new development stage in 2005-06 and has been riding high on the resurgent economy and rising demand for steel. Rapid increase in production has resulted in India becoming the 5th largest producer of steel. It has to be said that the global recession has affected the Indian steel industry especially stainless steel, but the steel industry is trying to offset the negative effect of the recession by focusing on transportation and construction projects which are usually funded by the government. India is the only country globally to record a positive overall growth in crude steel production at 1.01 percent for the period January-March 2009. It is estimated that India's steel consumption will grow at nearly 16% annually till 2012. The National Steel Policy has forecasted the demand for steel would reach 110 million tons by 2019-2020.

2. The Tata-Corus Deal

On April, 2007, Tata Steel Limited (Tata Steel), acquired the Anglo Dutch steel producer Corus Group Plc (Corus) for US\$ 12.11 billion (€ 8.5 billion) (around Rs 55,000 crore). The process of acquisition concluded after nine rounds of bidding against the other bidder for Corus - the Brazil based Companhia Siderurgica Nacional (CSN). This acquisition was the biggest overseas acquisition by an Indian company. Tata Steel emerged as the fifth largest steel producer in the world after the acquisition. This event signifies the fact that the Indian steel industry has acquired a global identity. Tata's acquisition of Corus is

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notable not only for creating a new steel giant, but also because this deal was a private sector venture far from Indian government influence.

The acquisition by Tata amounted to a total of 608 pence per ordinary share or £6.2 billion (US \$ 12 billion) which was paid in cash. First of all, the general assumption is that the acquisition was not cheap for Tata. The price that they paid represents a very high 49% premium over the closing mid market share price of Corus on 4 October, 2006 and a premium of over 68% over the average closing market share price over the twelve month period. Moreover, since the deal was paid for in cash automatically makes it more expensive, implying a cash outflow from Tata Steel in the amount of £1.84 billion. Tata has reportedly financed only \$4 billion of the Corus purchase from internal company resources, meaning that more than two-thirds of the deal had to be financed through loans from major banks. The day after the acquisition was officially announced Tata Steel's share fell by 10.7 percent on the Bombay stock market. Despite its four times smaller size and smaller capacity, Tata steel's operating profit for 2006, earning \$840 million on sales of 5.3 million tones, were very close in amount to those generated by Corus (\$860 million in profits on sales of 18.6 millions tons). Tata's new debt amounting to \$8 billion due to the acquisition, financed with Corus' cash flows, is expected to generate up to \$640 million in annual interest charges (8% annual interest cost). This combined with Corus' existing interest debt charges of \$400 million on an annual basis implies that the combined entity's interest obligation will amount to approximately \$725 million after the acquisition. The debate whether Tata steel has overpaid for acquiring Corus is most likely to be certain, since just based on the numbers alone it turns out that at the end of the bidding conflict with CSN Tata ended up with paying approximately 68% above the average price of Corus' Shares. In view of the above it is interesting to find out whether Tata's buy of Corus was a wise decision.

3. Review of Literature

A study conducted by Mantrawadi and Reddy (2007) regarding the post-merger operating performance of the acquiring firms in the Indian industry reveals the following important facts.

The analysis of pre- and post-merger operating performance of the acquiring firms in the sample seems to indicate that relative size makes some difference to

the post-merger operating performance of the acquiring firms. For cases where the relative size was between 0.11 and 0.70, there has been a decline in net profit margin and return on capital employed along with an increase in financial leverage after mergers. For cases where the relative size was between 0.71 and 1.00, there was no significance in the pre-merger and post-merger operating performance ratios. For cases where the relative size of the target firm was more than that of the acquiring firm, there has been a significant decline in returns on net worth and capital employed and a marginal increase in financial leverage.

The study on multi-mergers in India (Kumar and Rajib, 2007) shows that the average sales, profits and cash flow for a period of ten years were higher for the merger firms as compared to a control group matched by industry and size. With respect to profits, the multiple merger firms' mean of profits was about 200% higher than that of control firms. The study also finds evidence which is consistent with the market power and size hypothesis of merger theories. The variable of return on capital employed was statistically significant and positively related to multiple mergers.

Mishra and Goel (2005) studied the returns to shareholders from mergers by taking the case of RIL and RPL merger. The purpose of the study was to examine the financial applications of RIL and RPL merger on the shareholder's wealth. The profitability for shareholders was investigated by examining the daily excess returns that accrue to the shareholders around the date of announcement of the merger. The study shows that positive excess return occurred to shareholders of the target firm RPL and negative excess returns to the shareholders of the acquiring company. However, one thing is clear from the study that RIL and RPL, being the members of the same family, their merger is a step towards concentration of economic power.

The study conducted by Shrimali, Vijay and Karunesh Saxena (2004) established that mergers and acquisitions as business strategies have been gathering momentum for advantages such as synergy, diversification motive, price reduction, securing latest product technology etc.

Nayar (2008) study analyses the growing outflows of FDI from India and the spurt in foreign acquisitions by Indian firms due to reforms induced greater access to financial markets.

The study of Ramakrishnan (2008) shows that mergers in India have helped the operating performance of the firms in terms of improvement in their operating performance. Enhanced efficiency of utilization of their assets by the merged firms appears to have led to the generation of higher operating cash flows.

4. Objective

The objectives of the present study are as follows:

- To know the pre-acquisition financial performance of TATA.
- To know the post-acquisition financial performance of TATA
- To compare the pre and post acquisition ratios of TATA Steel in order to find out whether the acquisition has been beneficial

5. Research Methodology

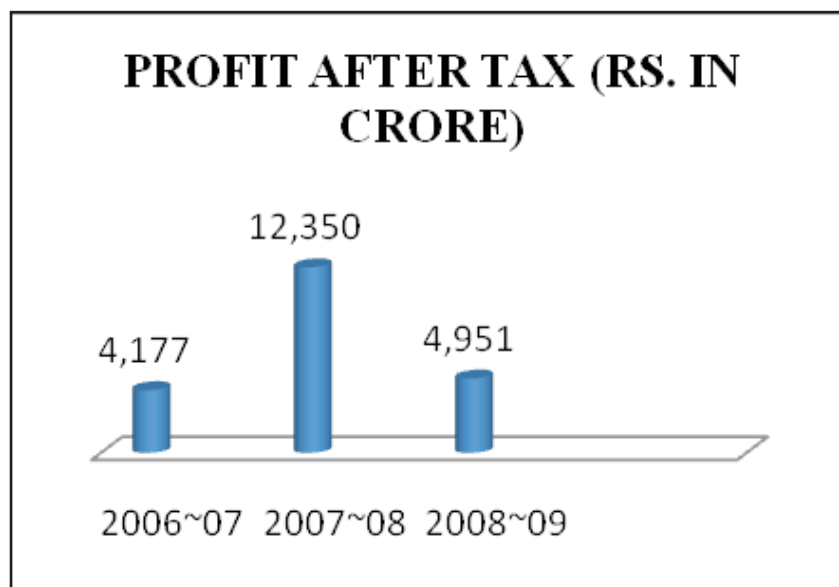
As stated above, the basic objective of the study is to find out whether TATA's acquiring of Corus has been a financially viable decision. Hence, the authors have selected the financial ratios to make a comparison between the company's pre and post acquisition performance. The ratios which have been used for the purpose of analysis

are: profit after tax (PAT) as percentage of total revenue (TR), earning per share (EPS), EBITDTA, asset turnover, current ratio, debt-equity ratio, p/e ratio, interest coverage ratio, inventory turnover ratio and debtor turnover ratio. For analysis purpose data on required financial variables were collected from Annual Reports of Tata Steel for 2006-07, 2007-08 and 2008-09

6. Data Analysis

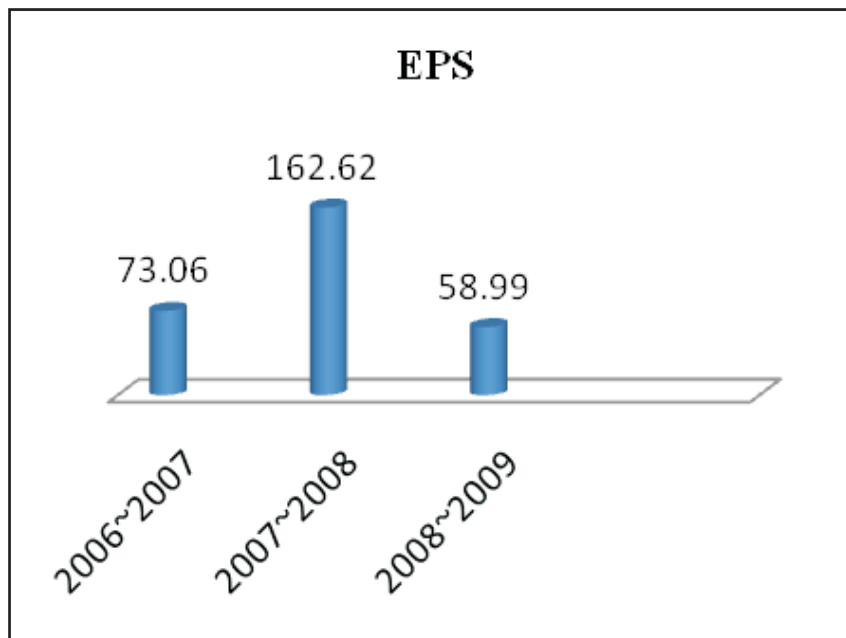
It is evident from Chart-1 that in 2006-07 i.e., before TATA acquired Corus, TATA's PAT as a percentage of Revenue was 16.28%. The same, after acquisition, came down to 9.36% in 2007-08 and further to 3.35% in 2008-09. Further, the amount of PAT in 2006-07, 2007-08, 2008-09 were 4,177 crores, 12,350 crores and 4,951 crores respectively. As compared to 2006-07 the amount of PAT was very high in 2007-08 i.e. in post acquisition. However, in spite of increasing revenue in 2008-09 which was 1,47,595 as compared to 1,32,110 in the year 2007-08, there was decline in PAT. The important factor responsible for such a state of affairs was increase in finance/interest charges. It was merely 411 crore in 2006-07, but increased to 3,290 crore in 2007-08 and further to 4085 crores in 2008-09. Undoubtedly, such spurt in interest charges was because for the acquisition of Corus Tata Steel had borrowed huge fund from outside.

Chart-1 Tata's profit after tax during year 2006-2009



Source; Tata Steel Annual Reports

Chart-2 Tata's EPS During Year 2006-2009

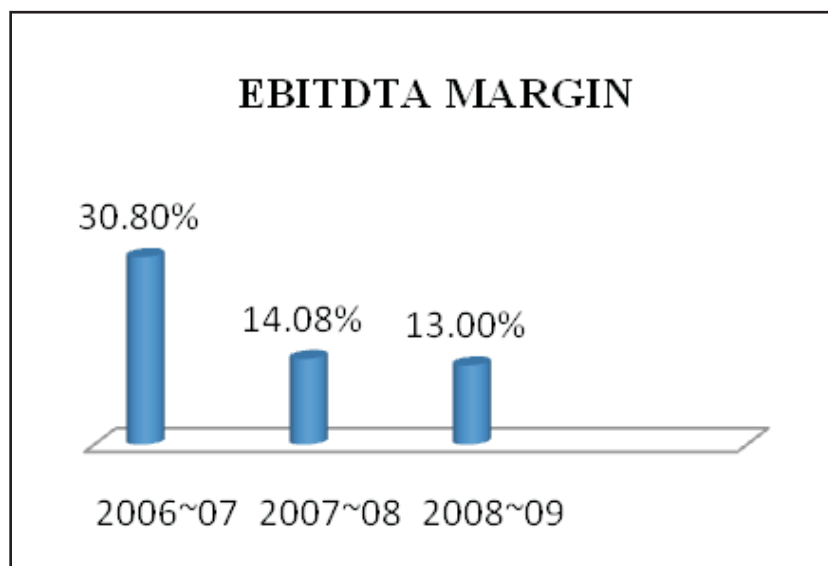


Source: Same as Chart-1

Chart-2 shows that the pre-Corus EPS of TATA i.e., in the year 2006-07 was 73.06 which turned out to be 162.62 and 58.99 in 2007-08 and 2008-09 respectively i.e., in the post Corus years. This means that after acquisition, TATA has shown an increase in the EPS. The main reason would

have been increasing PAT as has already been reflected from Chart-1. And further this could have been mainly due to substantial increase in revenue and sales. It shows a sign of encouragement for the shareholders of both the companies. However, in 2008-09 EPS showed a as PAT slide down.

Chart-3 Ebitdata Margin During Year 2006-2009

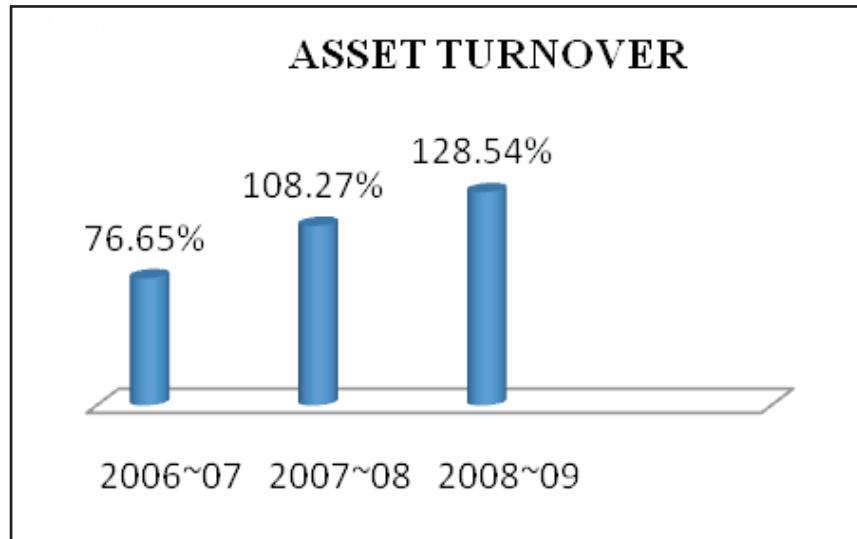


Source: Same as Chart-1

EBITDTA is a financial metric used to assess a company's profitability by comparing its revenue with earnings. More specifically, since EBITDA is derived from revenue, this metric would indicate the percentage of a company's

earning remaining after operating expenses. Chart-3 depicts EBITDA margin. In 2006-07 the EBITDTA margin was 30.80%, which slipped to 14.08% in 2007-08 and further to 13.00% in 2008-09.

Chart-4 Tata's Asset Turnover During Year 2006-2009

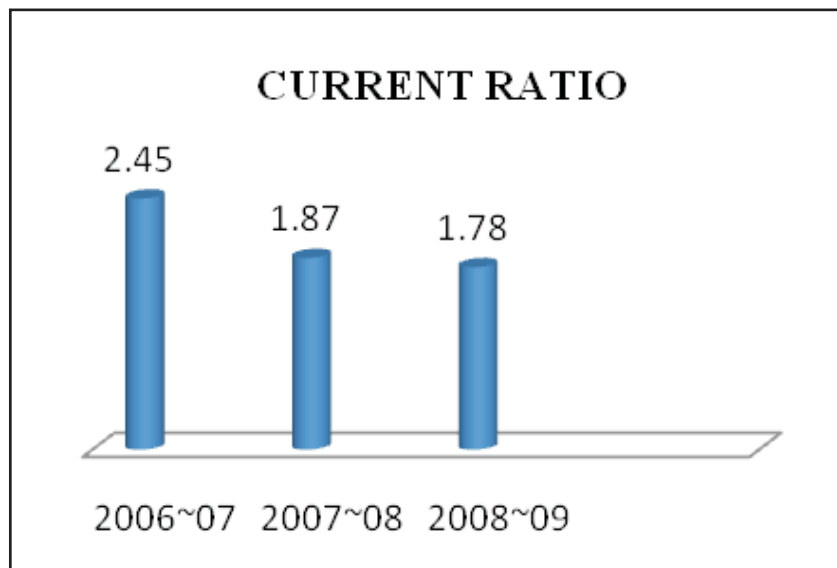


Source: Same as Chart-1

Chart-4 shows the data for Asset Turnover for all the study years i.e., 2006-07, 2007-08 & 2008-09. It was found to be 76.65%, 108.27% & 128.54% respectively in 2006-

07, 2007-08 & 2008-09. This increase in asset-turnover suggests that, after acquisition, capacity utilization of fixed assets has increased in TATA bringing benefit of large scale of production to it.

Chart-5 Tata's Current Ratio During Year 2006-2009

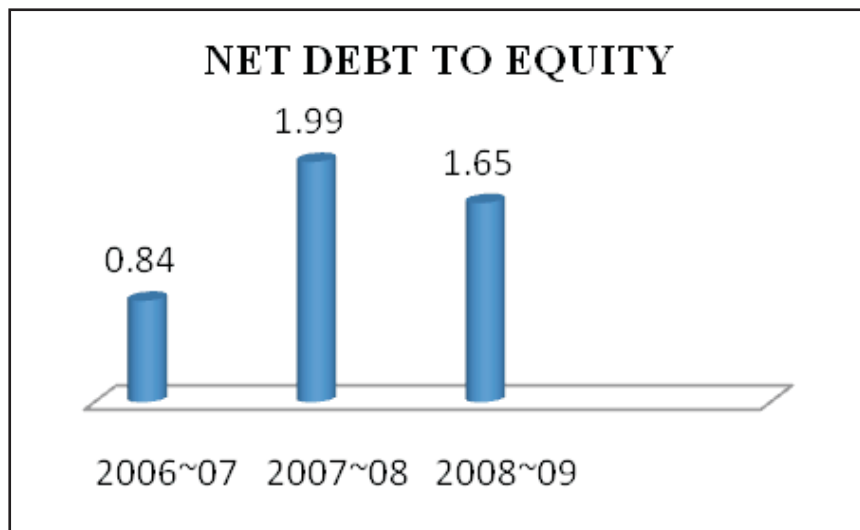


Source: Same as Chart-1

The current ratio of the company, as shown in Chart-5, was 2.45 in 2006-7 which has decreased to 1.87 in the year 2007-08 and to 1.78 in the year 2008-09. The decrease in current ratio was due to large cash outflow of the company for acquiring Corus in 2006-07. Cash and

bank balances was 10887.96 crores which has decreased to 4231.86 crores and 6148.36 crores in 2007-08 and 2008-09 respectively. Current liability in the year 2006-07 was 5444.19 crores which has increased to 26360.74 crores 2007-08 and again to 23093.30 crores in 2008-09.

Chart-6 Tata's Debt Equity Ratio During Year 2006-2009

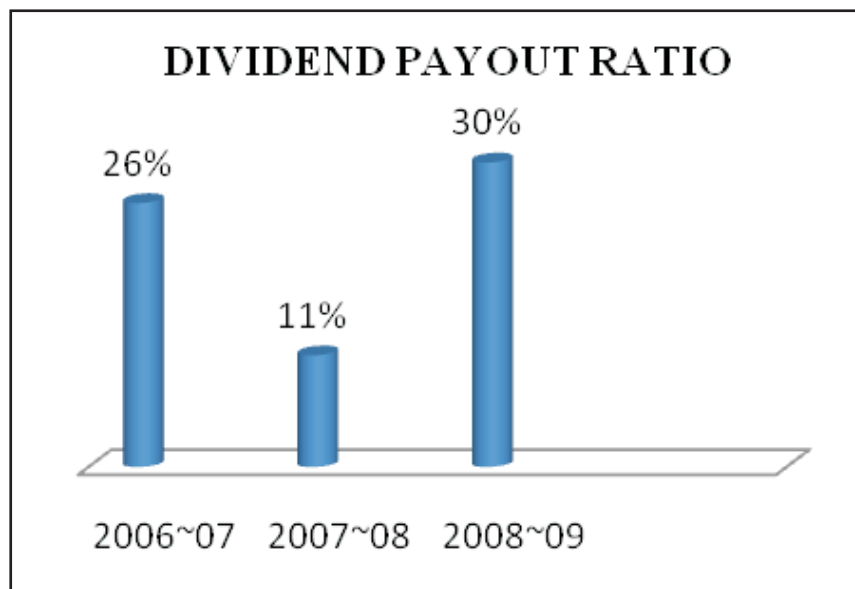


Source: Same as Chart-1

Chart-6 carries information regarding debt-equity ratio of the company. It is evident that the debt-equity ratio has increased from 0.84 in 2006-07 to 1.99 in 2007-08 with a marginal

slip in 2008-09 i.e. to 1.65. The principal reason behind such increase in Debt Equity Ratio is increase in investment in debts by the company for acquisition of Corus.

Chart-7 Tata's Dividend Payout Ratio During Year 2006-2009

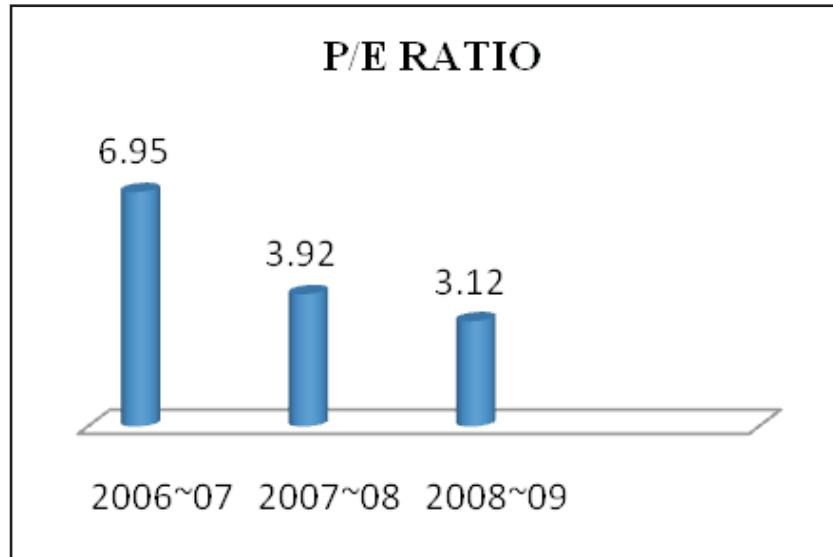


Source: Same as Chart-1

Chart-7 depicts the dividend pay out ratio of TATA. It is seen from the chart that in 2006-07 the dividend payout ratio was 26%. But it declined to as low as 11% in 2007-08

owing mainly to decline in equity dividend per share and increase in NP after tax preferential dividend. In 2008-09 it has again increased to 30%.

Chart-8 Tata's P/E ratio During Year 2006-2009

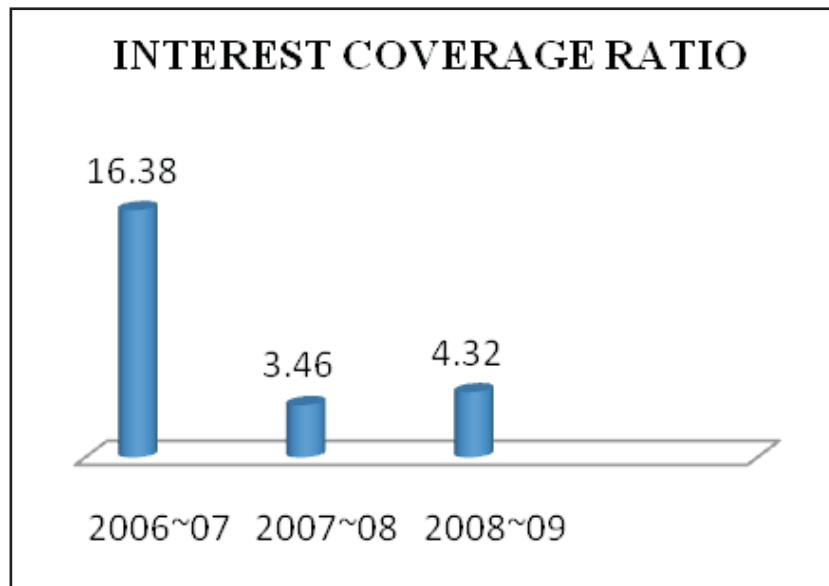


Source: Same as Chart-1

Chart-8 shows that in 2006-07 P/E Ratio of the company under study was 6.95 which decreased in 2007-08 and 2008-09 to 3.92 and 3.12 respectively. This ratio highlights

the EPS reflected by market share. This decline in P/E ratio has been because of decline in market price of the share.

Chart-9 Interest Coverage Ratio During Year 2006-2009

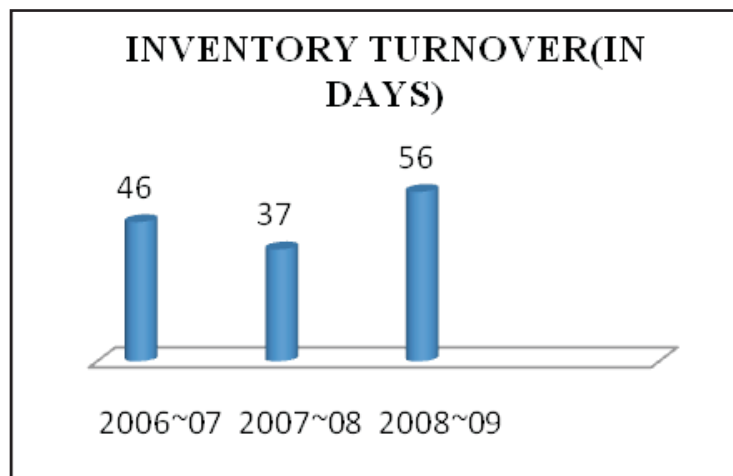


Source: Same as Chart-1

The interest coverage ratio establishes a relationship between the amount of net profit before deduction of interest and tax, and the fixed interest charges. Higher the ratio the more secure the debenture holders and other lenders are with respect to their periodical interest income. Chart-9 depicts that interest coverage ratio of the

company before acquisition i.e., in 2006-07 was 16.38 which became substantially low in 2007-08 and 2008-09. It was 3.46 and 4.32 in 2007-08 and 2008-09 respectively. For acquiring Corus TATA borrowed funds from outside due to which interest amount increased quite highly.

Chart-10 Tata's Inventory turnover Ratio During Year 2006-2009

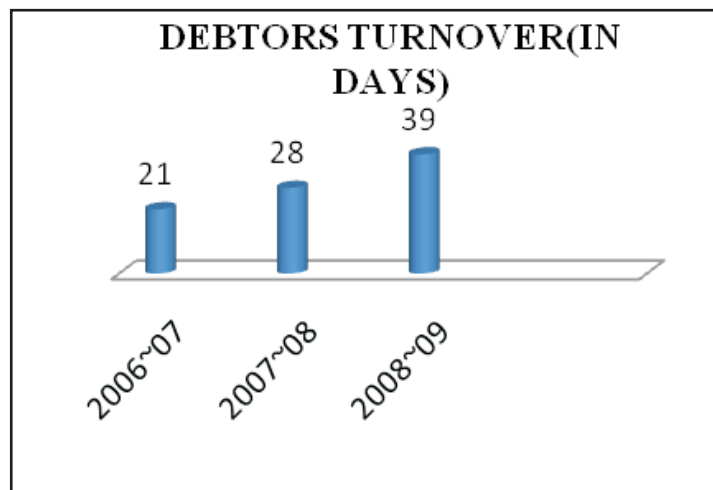


Source: Same as Chart-1

The inventory turnover ratio shows whether the investment in stock in trade is effectively utilized or not. In other words it indicates the number of times the stock has been turned over in business during a particular period. Chart-10 shows that in 2006-07 (Pre Corus) the inventory turnover ratio was 46 days which came down to 37 days

in 2007-08 (Post-Corus) which means after acquisition the inventory was utilized more efficiently. However, in 2008-09 inventory turnover ratio again went up to 56 days mainly due to the recession that pulled down the sales and also there was an increase in the stock lying with the company.

Chart- 11 Debtors Turnover Ratio During Year 2006-2009



Source: Same as Chart-1

This ratio shows how quickly the debtors are converted into cash. Chart-11 shows that in 2006-07 (Pre-Corus) debtors turnover was 21 days which has increased to 28 days and 39 days in 2007-08 and 2008-09 (Post Corus) respectively. Thus, there was an increase in the amount of debtors in 2007-08 and 2008-09 as compared to 2006-07.

7. Findings

The study has, in the light of data analysis, come up with the following major findings.

There was a moderate increase in PAT of TATA in the post acquisition years. However, in the immediate year after acquisition the company saw a relatively very high increase in PAT which as much as 12,350 crore as compared to just 4177 crore in 2006-07 (Pre-Corus).

Net revenue of TATA was 25,651 in 2006-07, 1,32,110 in 2007-08 and 1,47,595 in 2008-09. This means that the company has gained from acquisition in terms of net revenue.

In terms of EPS also a moderate result has been seen. EPS was 73.06 in 2006-07, 162.62 in 2007-08 and 58.99 in 2008-09. The increase in EPS in 2007-08 was mainly due to increase in PAT. However due to global recession EPS reduced to 58.99 in 2008-09.

Interest coverage ratio in 2006-07 was 16.38 which declined in 2007-08 and 2008-09 after acquisition to 3.46 and 4.32 respectively. This was mainly due to TATA's heavy borrowing of funds from outside which resulted in large outflow of interest amount on the same.

The Indian government plans to invest over US\$ 350 billion in industries related to infrastructure and construction which will give a fillip to the steel sector.

According to an estimate, with the growing need for oil and gas transportation infrastructure, a US\$ 118 billion opportunity is waiting to be tapped by steel manufacturers in the next five years.

8. Conclusion

India's lower wages and favorable energy prices will continue to promise substantial cost advantages compared to production facilities in (Western) Europe or the US.

The growth prospects of the client industries are also very good. Corus' expertise in making the grades of steel used in automobiles and in aerospace are useful for Tata Steel's supplies to the Indian automobile market. Corus in turn get benefit from Tata Steel's expertise in low cost manufacturing of steel. If we will compare the financial ratios of 2006-07(Pre Corus) and 2007-08(Post Corus) it shows very good financial result after acquisition but due to global recession in 2008-09 there was decline in PAT and in other financial parameters of the company.

The acquisition of Corus is in line with company's plans of global acquisitions and its rationale of expansion strategy. This was the biggest overseas acquisition by an Indian company. The Tata Steel-Corus combine has now become the fifth largest steel maker in the world with a capacity of 23 million tons a year. Whatever the cost, Corus is in the Tata bag. The rapid progress of the Indian automobile, engineering and construction industries means that the country will need more and more high-quality steel. Access to Corus technology will, in course of time, allow Tata Steel to move up in the value chain and in that case it will be win win situation for TATA.

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