However, this finding goes against the findings of Nafzigir who found that the small-scale entrepreneurs usually did not have access to funds from organised financial institutions. As a result, 44% entrepreneurs received most or all of it from their relatives and friends (Nafzigir 1975: 143). This difference in findings is, perhaps, explained by the fact that the scene might have undergone a considerable change after bank nationalisation in July 1969. The reason is that the purpose-oriented lending is now made to replace security-oriented lending.

The sources used for raising funds determine what is called in financial terminology 'capital structure'. The following section 17.3 deals, in detail, with this aspect.

17.3 CAPITAL STRUCTURE

What is capital structure? You have just learnt that an enterprise/business raises funds from the internal and external sources. These take the forms of ownership capital and borrowed capital respectively. The former is also known as equity and the latter as debt. The composition of equity and debt in overall capital of an enterprise is called '*capital structure*.' In simple words, capital structure is the ratio between debt and equity capital. Hence, it is also expressed as the *debt-equity ratio*.

Here, it must be noted that the term capital structure differs from financial structure. Capital structure means the permanent financing of the enterprise represented primarily by long-term sources of funds, *i.e.*, debt and equity. Thus, it excludes funds raised from short-term sources. But, financial structure refers to how the firm's assets are financed by raising funds from both long-term and short-term sources.

A business enterprise needs to maintain a proper ratio between these two in order to function smoothly and efficiently. Then, the obvious question arises is what should [illegible] *capital structure*? In fact, it depends

Table 17.1: Sources of Initial Finance

Sources of Initial Capital	*No. of Entrepreneurs*	*% to the Total*
Own Capital	21	42
Participation with or borrowings from relatives and friends	1	2
Loans from financial institutions and banks	27	54
No response	1	2
Total	50	100

Note: In majority of the cases, more than one source was stated by the entrepreneurs for arranging their initial capital. For analytical purposes, only one source from which the entrepreneurs received most or all of their initial capital was taken into account.

The heavy dependency upon institutional finance for arranging initial capital is depicted in Figure. 17.2 also.

It is seen from Table 17.1 that the majority of the entrepreneurs (54%) arranged their initial capital from institutional sources, followed by those who arranged the same from their own internal sources. Of course, those who relied on their relatives and friends for arranging their capital requirements were rare. The reason is that one relies on relatives and friends as a last resort. One is usually unwilling to divulge what he/she considers secret information to others, especially the relatives and friends for reasons of personal esteem. At the same time, the popularity of financial institutions and banks as also their lower rates of interest on loans may be important reasons for one's heavier reliance on these institutions for seeking financial assistance.

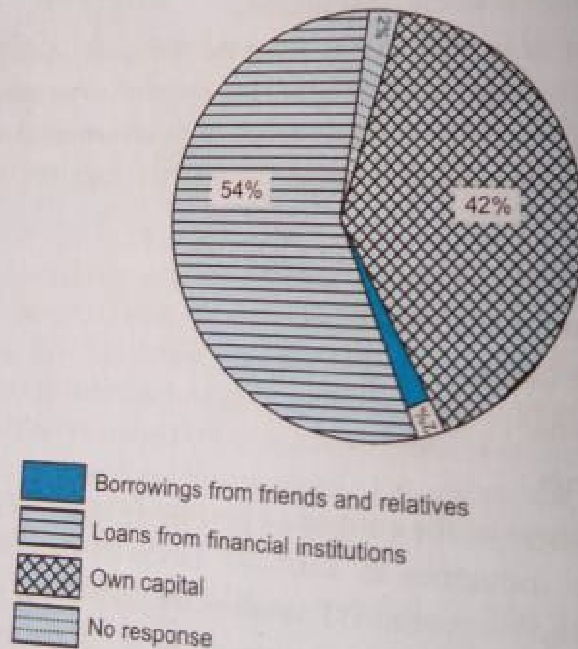

Figure 17.2: Heavy Dependency upon Institutional Finance

In fact, ... financial strain ... The capital structure should ensure ... it should not be a control diluting one.

(iv) The capital structure should ... In any case, it should not be a control diluting one. ... the enterprise.

While one can add certain other features to these for some particular enterprises, the said features appear to be common and major ones.

Factors Determining Capital Structure

Maintaining the capital structure in any enterprise depends on a variety of factors. These include:

1. **Nature of Business:** The nature of the business itself is one of the factors determining capital structure to be maintained. The businesses subject to wide fluctuations in sales need to maintain smaller proportion of borrowed funds, *i.e.,* debt capital. Companies manufacturing televisions, refrigerators, machine tools and like are examples of businesses subject to fluctuations in their sales. On the contrary, the business firms dealing in items/goods having inelastic demand like essential consumer goods may have larger proportion of borrowed capital. The reason is that these firms generally have stable earnings.

The capital structure of companies is also determined by the competitiveness found among them. For example, in case of ready-made garments industry, competition is mainly based on styles and fashions which are subject to frequent and unpredictable changes. As such, these firms have to depend less on borrowed capital and more on equity or owner's capital.

2. **Size of the Enterprise:** Small enterprises have to rely less on borrowed capital and depend more on owner's capital. This is because investors consider lending to small firms more risky. On the other hand, large enterprises are considered less risky. Therefore, investors believe that their money is safe and, hence, prefer to lend money to large enterprises. This enables the large enterprises to raise funds from different sources.

3. **Trading on Equity:** In case the rate of return on capital employed is more than the rate of interest on debentures or rate of dividend on preference shares, it is called *trading on equity or leverage effect*. In such case, there is greater dependence on borrowed capital in the capital structure.

advantage of having an optimum financial structure, if such an optimum does exist, is two-fold. It minimises the company's cost of capital which in turn its ability to increase and find new wealth by creating investment opportunities. Also, by increasing the firm's opportunity to engage in future wealth-creating investment, it increases the economy's rate of investment and growth."

An optimum capital structure bears the following features:

(*i*) The capital structure should involve the minimum cost and the maximum yields (David 1959: 91-116).

(*ii*) The adopted capital structure should be flexible enough to fulfil the future requirements of the capital as and when needed.

(*iii*) The use of the debts should be within the repaying capacity of the enterprise. In fact, failure to recognize this important aspect is the common cause of financial strain among the small-scale enterprises.

(*iv*) The capital structure should ensure the proper control over the affairs of the enterprise. In any case, it should not be a control diluting one.

While one can add certain other features to these for some particular enterprises, the said features appear to be common and major ones.

Factors Determining Capital Structure

However, this finding goes against the findings of Nafzigir who found that the small-scale entrepreneurs usually did not have access to funds from organised financial institutions. As a result, 44% entrepreneurs received most or all of it from their relatives and friends (Nafzigir 1975: 143). This difference in findings is, perhaps, explained by the fact that the scene might have undergone a considerable change after bank nationalisation in July 1969. The reason is that the purpose-oriented lending is now made to replace security-oriented lending.

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A business enterprise needs to maintain a proper ratio between these two in order to function smoothly and efficiently. Then, the obvious question arises is what should be the proper, or say, *optimum capital structure*? In fact, it depends *inter alia* upon the business conditions of the enterprise concern. As a general principle, for a successful business in favourable conditions, debt capital may be twice or even more than equity capital. But, for a business reeling under unfavourable conditions, say incurring losses, the proportion of debt capital should be as low as possible. This is because on account of fluctuation in earnings and inadequacy of cash, the enterprise may not pay interest and the amount of loan. In consequence, the creditors and suppliers will look upon the financial position of the enterprise as unreliable and, hence, may stop extending credit. Such position will culminate to make the enterprise insolvent.

In simple words, an optimum capital structure can be defined as a financing mix incurring the least cost but yielding the maximum returns. It is obtained when the market value per equity share is the maximum. Ezra Solomon (1969: 42) has defined capital structure in the following words:

"Optimum leverage can be defined as that mix of debt and equity which will maximise the market value of a company, i.e., the aggregate value of the claims and ownership interests represented on the credit side of the Balance Sheet. Further, the

33.3.4 Mergers and Acquisitions (M&A)

Merger and acquisition are yet other forms of external growth strategy. Merger means a combination of two or more existing enterprises into one. For the enterprise which acquires another, it is called 'acquisition.' For the enterprise which is acquired, it is called 'merger.' Thus, merger and acquisition are the two sides of the same coin. If both organizations dissolve their identity to create a new organization, it is called consolidation. The other terms used for M&A are absorption, amalgamation, and integration. M&A are more popularly known as takeovers. For more than three decades after Independence, the normal route of growth was through licensing and setting up new projects. But the post-liberalization, since 1991, has witnessed an increasing use of takeover strategies as the means or rapid growth. Mahindra & Mahindra's takeover of a German company Schoneweiss, Tata's takeover of Corus, and PricewaterhouseCoopers's takeover of Mumbai-based taxation company RSM Ambit are illustrative examples of mergers & acquisitions.

Reasons for Mergers and Acquisitions

For a merger to take place, two enterprises or organizations have to act. One is the buyer enterprise and the other is the seller. Both these types of enterprises have a set of reasons on the basis of which they merge. Following are the illustrative ones:

Reasons for Buyer to Merge:

(*i*) To increase the value of the enterprise's stock.
(*ii*) To increase the growth rate and make a good investment.
(*iii*) To improve the stability of its earnings and sales.
(*iv*) To balance, compete or diversify its product line.
(*v*) To reduce competition.
(*vi*) To acquire a needed resource quickly.
(*vii*) To avail tax concessions and benefits.
(*viii*) To take advantage of synergy.

Reasons for Seller to Merge:

(*i*) To increase the value of the owner's stock and investment.
(*ii*) To increase the growth rate.
(*iii*) To acquire resources to stabilize resources.
(*iv*) To benefit from the tax legislation.
(*v*) To deal with top management succession problem.

Types of Mergers and Acquisitions

Mergers and acquisitions can be classified into the following types:

1. *Horizontal M&A:* Horizontal M&A take place when there is a combination of two or more organizations in the same business, or organizations engaged in certain aspects of the production or marketing processes. A footwear

without joining hands with [illegible] internal growth [illegible] been the popular forms of internal growth [illegible]

2. **External Growth Strategy**: What is not internal growth strategy is external growth strategy. In case of external growth strategy, enterprises grow by joining hands with other enterprises. The popular forms of external growth strategies include joint ventures, mergers and acquisitions, and sub-contracting.

In this way, the main strategies of growth can be listed as follows:

33.3. 1. Expansion

33.3. 2. Diversification

33.3. 3. Joint Venture

33.3. 4. Mergers and Acquisitions

33.3. 5. Sub-Contracting

33.3. 6. Franchising

These are now discussed one by one.

33.3.1 Expansion

Expansion is one of the forms of internal growth of business. It means enlargement or increase in the same line of activity. Expansion is a natural growth of business enterprise taking place in course of time. In case of expansion, the enterprise grows its own without joining hands with any other enterprise. There are three common forms of business expansion. These are:

1. **Expansion Through Market Penetration:** It means the enterprise increases the sales of its existing product by enlarging the existing market. In other words, market penetration means making deeper in roads in the existing market. Various schemes are launched to penetrate into an existing market. The scheme for exchanging an old scooter for new one introduced by LML, for example, is a form of market penetration.

2. **Expansion Through Market Development**: It implies exploring new markets for the existing product. In order to increase the sale of existing product, the enterprise makes searches for new customers.

3. **Expansion Through Product Development and/or Modification**: It implies developing or modifying the existing product to meet the requirements of

(iii) Diversification adds to the competitive strength of the business.

(iv) Diversification also enables an enterprise to tide over business fluctuations and, thus, ensures smooth running of the business.

Disadvantages: All is not good with diversification. It also suffers from certain disadvantages.

(i) Diversification involves business reorganization which requires additional resources. Thus, diversification becomes a costly proposition.

(ii) It becomes difficult, is not impossible, to effectively manage and coordinate the diverse business.

Types of Diversification: There is no uniform type of diversification adopted by all enterprises. It varies from enterprise to enterprise. Usually, diversification is of four types:

1. Horizontal Diversification
2. Vertical Diversification
3. Concentric Diversification, and
4. Conglomerate Diversification

A brief description of these follows:

1. Horizontal Diversification: In this type of diversification, the same type of product or market added to the existing ones. Adding refrigerators to its original products of steel safes and locks by Godrej is an example of Horizontal Diversification.

2. Vertical Diversification: In this type of diversification, complementary products or services are added to the existing product or service line of the enterprise. The new products or services serve either as inputs or a customer for the firm's own product. A T.V. manufacturer may start producing picture tubes needed by it. Similarly, a sugar mill may develop a sugarcane farm to supply raw material or inputs for it. Setting up of retail shops by companies like Delhi Cloth Mills to sell its fabrics is also vertical type of diversification.

3. Concentric Diversification: In case of concentric type of diversification, an enterprise enters into the business related to its present one in terms of technology, marketing or both. Nestle, originally, a baby food producers entered into related products like 'Tomato Ketchup' and 'Maggi Noodles'. Similarly, a tea company like Lipton may diversify into coffee.

4. Conglomerate Diversification: This type of diversification is just contrary to concentric diversification. In this type of growth strategy, an enterprise diversifies into the business that is not related to its existing business neither in terms of technology nor marketing. JVG carrying on business in newspaper and detergent cake and powder, Godrej manufacturing steel safes and shaving cream are examples of conglomerate diversification.

33.3.3 Joint Venture

Joint venture is a type of external growth strategy adopted by business firms. A joint venture could be considered as an entity resulting from a long-term

strengths that would help the enterprise during the post-merger duration to achieve its objectives in an effective and better manner.

2. *Financial Issues:* There are three major financial issues involved in M&A. These are: (*i*) valuation of the business and shares of the target firm; (*ii*) sources of financing for mergers; and (*iii*) taxation matters after M&A. The valuation of the business of the target firm is a detailed and comprehensive process that should take into account a range of factors including the tangible and intangible assets, the industry profile of the firm and its prospects and the future earnings and prospects of the target firm. Similarly, the valuation of the shares in an M&A is equally complicated process involving issues such as the stock exchange price of the shares of the target firm, dividends paid, growth prospects of the firm, value of its assets, quality and integrity of the top management, competitive conditions, opportunity costs in terms of investments and market sentiments. The second financial issue is of the sources of financing required for enterprises involved in M&A. Several sources of funds available range from the acquiring companies' own funds or borrowed funds, raised through the issue of debentures, bonds, deposits, external commercial borrowings, global depositary receipts, loans from Central or State financial institutions or rehabilitation finance provide to sick industrial companies. The third issue is of the taxation matters that are dealt with under the relevant provisions of the Income Tax Act, 1961, and which are related to various technical aspects such as the carrying forward or set-off of losses and unabsorbed depreciation, capital gains, tax and amortization of expenses.

3. *Managerial Issues:* These issues relate to the umpteen problems of managing enterprises after the M&A has taken place. It is important to note that the perception of how the management will take place after M&A also matters and affects the process involved in it. The usual experience is that the post M&A is characterized by changes in staff, specially chief executives and top mangers. If there is an assurance that the merger will lead to a *status quo*, or that 'professional management' would be adopted,

example is insurance players such as Prudential and Standard Life having global presence. Thus, it becomes a good opportunity for the Indian partner to join such global partner in the joint venture.

- *Regulation:* Regulation becomes a trigger especially when a sector which was highly restricted and closed sector for foreign partner for long period is now opened up. Here again, insurance sector in India is one such example which was recently opened for foreign players. It is due to this regulatory change the Indian partners like Bajaj and Indian Credit and Investment Corporation of India (ICICI) joined foreign players in joint ventures in the insurance sector.
- *Sharing of Risk and Capital:* This includes capital-intensive sectors like heavy-engineering requiring highly sophisticated technological expertise. In such cases, both the partners involved in joint venture share risks and capital equally to effectively run the venture.
- *Intellectual Exchange:* Legal business could be such sector where both the partners gain intellectual advantage irrespective of law on the entry of foreign law firms in one country.

...pes of Joint Ventures

Experience suggests that joint venture is especially useful for entering ...ernational markets. As such, an Indian organization can enter a foreign marke... joint venture with a foreign organization. Similarly, a foreign firm can als... ...r into a joint venture with an Indian organization. From the point of vi... ...dian organizations, the following five types of joint ventures are poss...

of the strategies of M&A requires a thorough understanding of relevant provisions. It is interesting to mention that the term 'merger' is not used in the Companies Act; only the term 'amalgamation' is used in Section 394 of the Act. The only section that deals with the transfer of shares (or takeover bids) is Section 385. Apart from the Companies Act and the MRTP Act, Section 72 A (I) of the Income Tax Act, 1961 is also relevant for taxation purposes of amalgamated companies and provides for carrying forward accumulated losses and unabsorbed depreciation of the amalgamating company, *i.e.* M&A organizations.

How Mergers and Acquisitions Take Place?

M&A can take place in various ways. There is no specific and standard procedure available for M&A to take place. However, based on experiences relating to M&A, it is realized that following certain guidelines can be useful for M&As to take place systematically. The major steps include but are not limited to the following only:

- Spell out the objective
- Indicate how the objective would be achieved
- Assess managerial quality
- Check the compatibility of business styles
- Anticipate and solve problems early
- Treat people with dignity and concern

33.3.5 Sub-Contracting

What is Sub-Contracting System?

Sub-contracting system is a mutually beneficial commercial relationshi[p] between the two companies. This is known as Ancilliarization in India a[nd] more generally as '*sub-contracting*.' Sub-contracting can be defined as follow[s]

A sub-contracting relationship exists when a company (called a contrac[tor]) places an order with another company (called the sub-contractee) for [...] of parts, components, sub-assemblies or assemblies to be incorpo[rated ...] Such orders may include the proc[...]

company combining with another footwear company is one such example of horizontal M&A.

2. *Vertical M&A:* In vertical M&A, two or more organizations, not necessarily in the same business, come together to create complementarities either in terms of supply of materials (say material) or marketing of goods and services (say outputs). For example, pharmaceutical company combines with retail medical store.

3. *Concentric M&A:* This refers to two or more organizations related to each other either in terms of customer function or alternative technologies combine together. For example, a footwear company combines with a hosiery firm making socks.

4. *Conglomerate M&A:* This is just opposite of concentric M&A. In this case, two or more organizations not related to each other either in terms of customer functions or alternative technologies. Combination between a pharmaceutical company and footwear company is one such example.

All these four types are already discussed under "Types of Diversification". Hence, these are not discussed here again to avoid repetition.

Advantage: Mergers and acquisitions provide the following advantages:

(i) Provide benefits of economies of scale in terms of production and sales.
(ii) Facilitate better use of resources.
(iii) Enable sick enterprises to merger into the healthy ones.
(iv) Promote diversification in product line to take advantages of opportunities available in the particular business.

Disadvantages: Mergers and acquisitions are not unmixed blessings. These also suffer from the following drawbacks:

(i) Larger scale operations often make co-ordination and control ineffective. This adversely affects business performance as a whole.
(ii) Sometimes mergers and acquisitions lead to monopoly in the particular business. Monopoly is not welcome in the interest of the society.

Important Issues Involved in Mergers and Acquisitions

Mergers and acquisitions are as much important are not so simple. Meaningful mergers and acquisitions involve expertise in special areas such as accounting, finance and legal matters and negotiations. Following are some of the important strategic, financial, managerial, and legal issues involved in mergers and acquisitions:

1. *Strategic Issues:* These issues relate to the commonality of strategic interests between the buyer and seller firms. The main objective of M&A is to create synergetic effects for the enterprises. Therefore, the strategic advantages and distinctive competencies due to M&A for the merging enterprises have to be duly examined and analysed. It is also important to note that there has to be a fine match between the objectives of the firms involved in M&A. For example, a merger should ideally lead to the generation of sufficient

contracting system in the industrial world. Japan is considered the birth place of modern sub-contracting system. In Japan, when military demand for machinery industry expended enormously during 1930s, the large firm could not meet the ever huge orders. In 1938, Mitsubishi Heavy Industry could not meet orders equivalent to over its two years' production capacity, for example. Increasing production capacity of heavy machinery industries had crucial importance in the Japanese economies. As per the need of the hour, small enterprises and cottage industries shifted their production to support the large machinery firms to meet their orders. In view of poor technological knowledge of small enterprises, a new relationship known as Sub-contracting System was introduced to make long-term and direct trade relations between small and large industries, instead of floating and short –term relations mediated by the brokers. Today, the key to so many small firms in Japan lies in this sub-contracting system only. As a matter of fact, sub-contracting has become basic to the character of the Japanese industries. 56 per cent of the small manufacturing companies (having less than 300 employees) are producing under sub-contracting system. In India, Sub-contracting has emerged in the name of ancillarsation or 'ancillary units'.

We have only mentioned the historical background of sub-contracting system in the industrial economy of Japan. The real role of sub-contracting can perhaps be clearly seen by juxtaposing of its advantages and disadvantages to small-scale enterprises. To this we turn in the following paragraphs:

Advantages: Sub-contracting system bears the following advantages.

(*i*) It increases production in the fastest way without making many efforts.

(*ii*) The contractor can produce products without investing in plant and machinery.

(*iii*) Sub-contracting is particularly suitable to manufacture goods temporarily.

(*iv*) It enables the contractor to make use of technical and managerial abilities of sub-contractors.

(*v*) Despite leading to dependence, sub-contracting ensures existence of Sub-contractors by providing them business.

(*vi*) Last but no means the least; sub-contracting makes the core firms more flexible in their production.

Disadvantages: However, sub-contracting has some disadvantages also. These are:

(*i*) It does not ensure the regular and uninterrupted supply of goods to the core firms, *i.e.* contractors which adversely affect the functioning of the core firms.

(*ii*) Goods produced under Sub-contracting system are often qualitatively inferior.

(*iii*) Sub-contracting also delimits the expansion and diversification of the core firms.

(*iv*) A delay in payments, a common feature, by the contractor to the sub-contractors endangers the very survival of the latter.

paid, growth pro[illegible] of the
of the top management, competi[illegible]. The sec[illegible]
of investments and market sentiments. The [illegible] involved in M&A. Several
sources of financing required for enterprises acquiring companies' own funds
sources of funds available range from the acquiring debentures, bonds, deposits,
or borrowed funds, raised through the issue of depositary receipts, loans from
external commercial borrowings, global rehabilitation finance provide to
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4. *Legal Issues:* These issues relate to the provisions made in law for the purpose of M&A. In India, the provisions relating to M&A and other schemes are contained in Chapter V of the Companies Act, 1956 and specifically, in Sections 391 to 395 of the Companies Act, 1956 and in the rules 67 to 87 of the Companies (Court) Rules, 1959. The implementation