THE MECHANICS OF DE MERGER : A STUDY OF RELIANCE INDUSTRIES LTD.

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Abstract

Although the field of mergers and acquisitions tends to focus on corporate expansion, companies often have to contract and downsize their operations. This need may arise because a division of the company is performing poorly or simply because it no longer fits into the firm's plans. One motive that is often ascribed to mergers and acquisitions is synergy. Synergy refers to the additional gains that may be derived when two forms combine. When synergy exists, the combined entity is worth more than the sum of the parts valued separately. Reverse Synergy means that the parts are valued separately than they are within the parent company's corporate structure. This is an effort to gauge through the concept of reverse synergy in the back drop of India's biggest private sector corporate entity Reliance Industries Limited.

Keywords: *synergy, reverse synergy, divestitures.*

Smart Apple farmers routinely saw off dead and weakened branches to keep their trees healthy. Every year they also cut back a number of vigorous limbs – those that are blocking light from the rest of the tree or otherwise hampering its growth. And, as the growing season progresses, they pick and discard some perfectly good apples, ensuring that the remaining fruit gets the energy needed to reach its full size and ripeness. Only through such careful, systematic pruning does an orchard produce its highest yield.(1& 12) Although the field of mergers and acquisitions tends to focus on corporate expansion, companies often have to contract and downsize their operations. This need may arise because a division of the company is performing poorly or simply because it no longer fits into the firm's plans.2

One motive that is often ascribed to mergers and acquisitions is synergy. Synergy refers to the additional gains that may be derived when two forms combine. When synergy exists, the combined entity is worth more than the sum of the parts valued separately. In other words, 2+2 = 5. Reverse Synergy means that the parts are valued separately than they are within the parent company's corporate structure. In other words, 4 -1 = 5.

RELIANCE INDUSTRIES LIMITED

The Reliance Group, founded by Dhirubhai H. Ambani (1932-2002), is India's largest business house with total revenues of over US$ 22.6 billion (Rs. 99,000 crore), cash profit of US$ 2.8 billion (Rs.12,500 crore), net profit of (US$ 1.4 billion) Rs 6,200 crore and exports of US$ 3.6 billion (Rs 15,900 crore).The Group's activities span exploration and production (E&P) of oil and gas, refining and marketing, petrochemicals (polyester, polymers, and intermediates), textiles, financial services and insurance, power, telecom and infocomm initiatives.

The Reliance Group Companies include: Reliance Industries Limited, Reliance Capital Limited, Reliance Industrial Infrastructure Limited, Reliance Telecom Limited, Reliance Infocomm Limited, Reliance General Insurance Company Limited, Indian Petrochemicals Corporation Ltd. and Reliance Energy Limited.

Reliance Industries Limited (RIL) is India's largest private sector company on all major financial parameters with turnover of US$ 16.7 billion (Rs 73,164 crore), cash profit of US$ 2.8 billion (Rs.12,087 crore), net profit of US$ 1.7 billion (Rs 7,572 crore) and net worth of US$ 9.2 billion (Rs 40,403 crore).

RIL is the first and only private sector company from India to feature in the 2004 Fortune Global 500 list of 'World's Largest Corporations' and ranks amongst the world's Top 200 companies in terms of profits. RIL emerged in the world's 10 most respected energy/chemicals companies and amongst the top 50 companies that create the most value for their shareholders in a global survey and research conducted by PricewaterhouseCoopers and Financial Times in 2004. RIL also features in the Forbes Global list of world's 400 best big companies and in FT Global 500 list of world's largest companies.

RIL was adjudged as the 'Best Managed Company' in India in a study by Business Today and A.T. Kearney in 2003. In 2004, the company emerged as 'India's biggest wealth creator' in the private sector over a 5-year period in a study by Business Today - Stern Stewart and as India's 'Most Admired Company' in a Business Barons - TNS Mode Opinion Poll.

SCHEME OF DEMERGER

Voluntary de mergers are more common than involuntary divestitures and are motivated by a variety of reasons. For example, the parent company may want to move out of a particular line of business that it feels no longer fits into its plans or in which it is unviable to operate profitably or exceptionally but surely ownership battle may be one of the reasons to initiate the undercurrent of de merger and so on so forth.(3, 6)

The Board of Directors of Reliance Industries Ltd. (RIL) unanimously approved the scheme of De merger of the businesses of the company on, August 5, 2005 at Mumbai.

The Board at its meeting held on June 18, 2005 had resolved in principle to consider reorganisation of the businesses of the Company and authorised the Corporate Governance and Stakeholders' Interface Committee of Directors (CG Committee) to examine in depth all the relevant issues including statutory and legal requirements for a suitable reorganization of Company's businesses and suggest a proposal to the Board including any Scheme of De merger. On August 2, 2005 the Board approved in-principle the proposal for De merger. CRISIL, JM Morgan Stanley, Deloitte Haskins and Sells and M/s Amarchand Mangaldas and Suresh A. Shroff & Co were appointed to advise the CG Committee and the Board. The CG Committee along with the Advisors presented a Scheme for the approval of the Board of Directors on Aug.02, 2005. In accordance with the principles of fairness, protection of minority shareholders' interest, full disclosure and the objective of unlocking value for all shareholders, the Board of Directors, after extensive deliberations and discussions, have approved the Scheme of De-merger.

The Scheme proposes to de-merge assets and liabilities of the following undertakings of RIL:

1. Telecommunications Undertaking
2. Coal based energy Undertaking
3. Financial Services Undertaking
4. Gas based energy Undertaking

The Appointed Date for the Scheme would be 1st September 2005. The Scheme envisages the De merger of the aforesaid undertakings in 4 (four) separate Companies as going concerns. They are:

1. Reliance Communication Ventures Ltd.

1.1. Reliance Communication Ventures Limited for telecommunications Undertaking including RIL's investments in Reliance Communications Infrastructure Limited (RCIL), Reliance Infocomm Limited (RIC) and Reliance Telecom Limited (RTL).

1.2. Reliance Communications Infrastructure Limited has set up the backbone infrastructure required by Reliance Infocomm Limited for its telecom operations.

1.3. Reliance Infocomm Limited was set up to provide wireless and wireline telecommunication services based on CDMA technology in various parts of India.

1.4. Reliance Telecom Limited was promoted for providing cellular mobile telephony services using the GSM technology in East and North-East India and basic telephone services in Gujarat.

1.5. RIL currently holds

- .9 billion or 900 million (90 crore) equity shares of face value of Rs.1 each in Reliance Communications Infrastructure Limited,
- 3.1926 billion (319.26 crore) equity shares of face value of Rs.1 each in Reliance Infocomm Limited and
- 7.1 million (0.71 crore) equity shares of face value of Rs.10 each in Reliance Telecom Limited.

1.6. The value of the investments of RIL in the Undertaking to be de-merged into Reliance Communication Ventures Limited is approximately US$ 154.00 billion (Rs. 15,400 crore).

2. Reliance Energy Ventures Limited

2.1. Reliance Energy Ventures Limited for coal based energy undertaking including RIL's investments in Reliance Energy Limited

2.2. Reliance Energy Limited is engaged in the generation, transmission and distribution of power.

2.3. RIL currently owns 90.0 million (9.09 crore) equity shares of face value of Rs.10 each in Reliance Energy Limited.

2.4. The value of the investments of RIL in the Undertaking to be de-merged into Reliance Energy Ventures Limited is approximately US$ 30 billion (Rs.3,000 crore).

3. Reliance Capital Ventures Limited

3.1. Reliance Capital Ventures Limited for Financial Services Undertaking including insurance.

3.2. Reliance Capital is in the business of financial services including asset management.

3.3. Reliance General Insurance is in the business of general insurance activities.

3.4. Reliance Life Insurance is yet to commence business.

3.5. RIL currently owns:

- 60.1 million (6.01 crore) equity shares of face value of Rs.10 each in Reliance Capital Limited,
- 25.5 million (2.55 crore) equity shares of the face value of Rs.10 each in Reliance General Insurance Co. Limited and
- .5 million (0.05 crore) equity shares of the face value of Rs.10 each in Reliance Life Insurance Company Limited.

3.6. The value of the investments of RIL to be demerged in Reliance Capital Ventures Limited is approximately US$ 6 billion (Rs.600 crore).

4. Global Fuel Management Services Limited for gas based energy undertaking. Value of RIL investment in this company is not significant.

SHAREHOLDING IN DEMERGED ENTITIES

All shareholders of RIL, except the Specified Shareholders', would be issued shares of de-merged undertakings in 1:1 ratio i.e. for each share held in RIL, shareholders would get:

1. One share of Reliance Communications Ventures Ltd. of face value Rs. 5 each fully paid-up
2. One share of Reliance Energy Ventures Limited of face value Rs. 10 each fully paid-up
3. One share of Reliance Capital Ventures Limited of face value Rs. 10 each fully paid-up
4. One share of Global Fuel Management Services Limited of face value Rs. 5 each fully paid-up

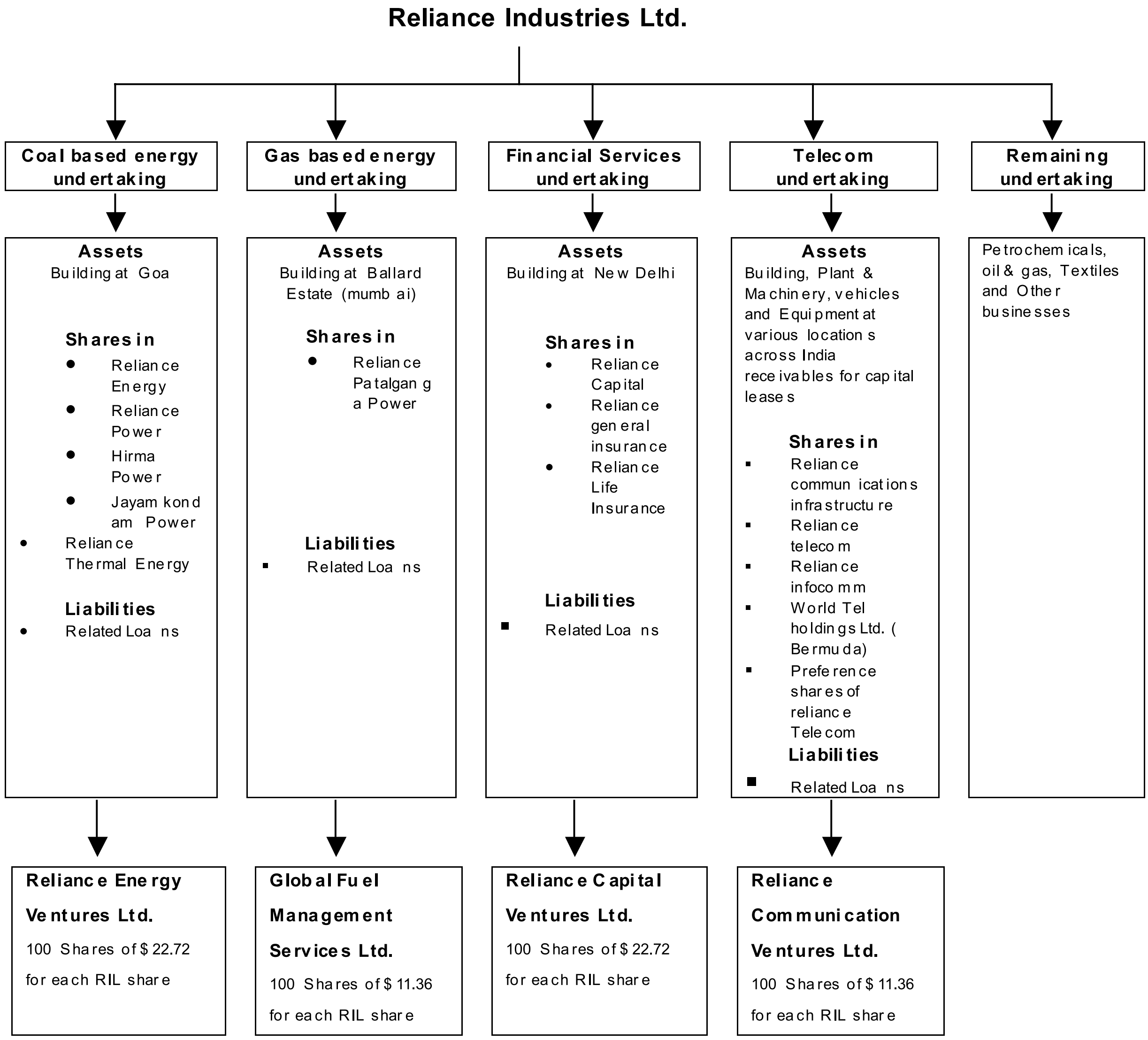
The Specified Shareholders i.e. Trustees of Petroleum Trust (holding 7.5% of RIL) and four companies - Reliance Aromatics and Petrochemicals Pvt. Ltd., Reliance Energy and Project Development Pvt. Ltd., Reliance Chemicals Pvt. Ltd. and Reliance Polyolefins Pvt. Ltd. (collectively holding 4.7% of RIL) hold RIL shares for the economic benefit of RIL shareholders. The Specified Shareholders will not take shares of the resulting companies. The RIL shareholders will get proportionate benefit of this also. As a result thereof, the total number of shares to be issued by each of the resulting companies would be 1.22 billion (122 crore) as against 1.39 billion (139 crore) equity shares of RIL.

BENEFITS TO SHAREHOLDERS

The shareholders of RIL would continue to participate in the growth and progress of RIL, which is a global oil, gas, refining and petrochemicals company. They would continue to hold the same number of shares as they currently hold in RIL.

In addition to that, they would receive separate shares in the four de-merged entities, which will allow them to participate individually as well as collectively in the growth areas of telecom, financial services and coal and gas based energy businesses.

The shares of the resulting companies will be listed on the Stock Exchanges in India, where RIL shares are currently listed, thus providing liquidity to all shareholders. This will unlock value for all shareholders as they can participate directly in all the businesses that RIL has nurtured and brought to stature.



(The Business Line, Oct.16, 2005)

The scheme of de merger got the no objection certificate (NOC) from Bombay Stock Exchange as well as National Stock Exchange on Sept. 07, 2005, therefore intimation and thereon approval in the form of NOC from both the national level stock exchange was procured by the company.

Based on the Company Application, the Hon 'ble High Court of Judicature at Bombay has directed that a meeting of the Equity Shareholders of the Applicant Company be convened and thereon an EGM was held on Friday, the October 21, 2005 at 11.00 a.m. at Birla Matushri Sabhagar,19,Marine Lines, Mumbai -400 020 for the purpose of considering and, if thought fit, approving with or without modification(s),the Scheme of Arrangement between Reliance Industries Limited, Reliance Energy Ventures Limited, Global Fuel Management Services Limited, Reliance Capital Ventures Limited and Reliance Communication Ventures Limited and their respective shareholders and creditors.

The share capital structure of the Applicant Company as on August 31, 2005 is as under:

	Amount in US$
Authorized Capital Comprising 2.50 billion equity shares of Rs.10 each aggregating US$ 25.00 billion and 500 million preference shares of Rs.10 each aggregating US$ 5.00 billion.	30.00 billion
Issued, Subscribed and Paid-up Comprising 139,35,08,041 equity shares of Rs.10 each* Less: Calls in arrears	13.9351 billion 35 million

*Includes 9,23,71,131 equity shares represented by GDRs and 17,03,77,615 equity shares held by Specified Shareholders.

The share capital structure of the Coal Based Energy Resulting Company as on August 31,2005 is as under:

	Amount in US$
Authorized Capital Comprising 50,000 Equity Shares of Rs.10/-each	5,00,000
Issued, Subscribed and Paid-up Comprising 50,000 Equity Shares of Rs.10/-each	5,00,000

The equity shares of the Coal Based Energy Resulting Company are, at present, not listed on any Stock Exchanges.

The share capital structure of the Gas Based Energy Resulting Company as on August 31,2005 is as under:

	Amount in US$
Authorized Capital Comprising 20,00,000 Equity Shares of Rs.5/- each	100,00,000
Issued, Subscribed and Paid-up Comprising 1,00,000 Equity Shares of Rs.5/-each	5,00,000

The equity shares of the Gas Based Energy Resulting Company are, at present, not listed on any Stock Exchanges.

The share capital structure of the Financial Services Resulting Company as on August 31,2005 is as under:

	Amount in US$
Authorized Capital Comprising 50,000 Equity Shares of Rs.10/-each	5,00,000
Issued, Subscribed and Paid-up Comprising 50,000 Equity Shares of Rs.10/-each	5,00,000

The equity shares of the Financial Services Resulting Company are, at present, not listed on any Stock Exchanges.

The share capital structure of the Telecommunication Resulting Company as on August 31,2005 is as under:

	Amount in US$
Authorized Capital Comprising 1,00,000 Equity Shares of Rs.5/-each	5,00,000
Issued, Subscribed and Paid-up Comprising 1,00,000 Equity Shares of Rs.5/-each	5,00,000

The equity shares of the Telecommunication Resulting Company are, at present, not listed on any Stock Exchanges.

SCHEME OF ARRANGEMENT UNDER SECTIONS 391 TO 394 OF THE COMPANIES ACT,1956 :

Rationale: Each of the several businesses carried on by RIL by itself and through its subsidiaries and affiliate companies and through strategic investments in other companies including Coal Based Energy Undertaking, Gas Based Energy Undertaking, Financial Services Undertaking and Telecommunication Undertaking have significant potential for growth. The nature of risk and competition involved in each of these businesses is distinct from others and consequently each business or undertaking is capable of attracting a different set of investors, strategic partners, lenders and other stakeholders. There are also differences in the manner in which each of these businesses are required to be managed. In order to enable distinct focus of investors to invest in some of the key businesses and to lend greater focus to the operation of each of its diverse businesses, RIL proposes to re-organize and segregate, by way of a de-merger, its business and undertakings engaged in:

(i) Coal based power generation, distribution and transmission – Coal Based Energy Undertaking.
(ii) Gas based power generation, distribution and transmission – Gas Based Energy Undertaking

(iii) Financial services including insurance – Financial Services Undertaking.

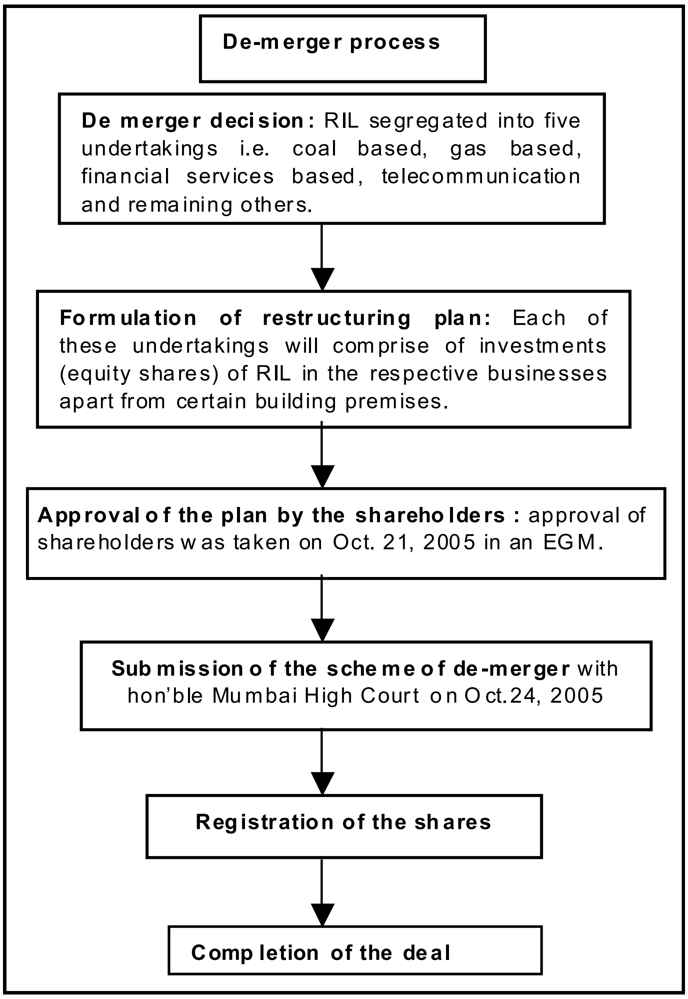
(iv) Wireless & Wireline telecommunication services – Telecommunication Undertaking.

Each of these businesses have tremendous growth and profitability potential and are at a stage where they require focused leadership and management attention. Hence, simultaneously, with the re-organisation and segregation of businesses, RIL also intends to re-organise the management of various businesses and undertakings to provide focused management attention and leadership required by the businesses which are to be segregated and de-merged. In particular, Shri Anil D. Ambani, the erstwhile Vice Chairman & Managing Director of RIL would take responsibility for providing such focused management attention and leadership to the segregated and de-merged businesses whereas Shri. Mukesh D. Ambani, Chairman & Managing Director of RIL would continue to lead the businesses retained by RIL including, particularly petrochemicals, refining, oil and gas exploration and production, textiles etc.

The de-merger will also provide scope for independent collaboration and expansion without committing the existing organization in its entirety. (5,8)It is believed that the proposed segregation will create enhanced value for shareholders and allow a focused strategy in operations, which would be in the best interest of RIL, its shareholders, creditors and all persons connected with RIL. The de-merger proposed by this Scheme of Arrangement will enable investors to separately hold investments in businesses with different investment characteristics thereby enabling them to select investments which best suit their investment strategies and risk profiles. (9&11)

The Share Capital of the De-merged Company has been shown above in page 7 and 8. Each of the resulting Companies is presently a wholly owned subsidiary of RIL. After issue of shares by each Resulting Company the Resulting Companies would cease to be subsidiaries of RIL.

All the assets, properties and liabilities of the De merged Undertakings shall be transferred to the Resulting Companies at the values appearing in the books of the De merged Company (at historical cost less depreciation) on the close of business on August 31,2005.



The entire exercise of settlement between the brothers has been given the character of a de-merger so that the stamp duties and capital gains taxes can be avoided in the hands of the RIL and its shareholders. The exercise satisfy the letter of the law as the assets have been transferred along with the liabilities, and shareholders in RIL will also be the shareholders in the resulting companies.

The effect may be different if the taxman were to interpret it differently for what is being "de-merged" are not physical assets used in production but investments, especially in the case of power and financial services. The companies act clearly distinguishes sale of investments and sale of assets. While shareholders approval is required for the latter, it is not necessary for the former.7

In the present de-merger, except for a few building premises, the majority of assets being transferred are shares in the group companies that are into power and financial services. It is only in the telecom business that there is a transfer of plant and machinery and equipment. So will this qualify for a de-merger and the attendant benefits?

Last but not the least, no quarrels with the logic. Future has yet to unfold the cost and benefits for the shareholders of de-merged entities and the manner in which the valuation of assets is done.

None the less according to "Mr. Rajnikant C. Shah, who owns RIL shares, there was hardly any reason for the shareholders to be unhappy. For him, the net gain would come in form of 2,000 shares each in the four new companies." The Business Line, pg.2, Oct.21,05.

Points to ponder

- *Contribution of de-merger to the economic growth of Indian corporate sector?*
- *Contribution of de-merger to the RIL?*
- *Promoter's wealth maximisation vs. Owner's wealth maximisation.*
- *Scope and relevance of corporate governance ?*

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