Suzlon Acquisition of Repower Systems- An Empirical Case Study

Manish Sharma
Assistant Professor (SAMA) & Research Scholar,
University of Lucknow,
Uttar Pradesh, India.

In 1995 Suzlon Energy Ltd., an Indian owned wind energy company, was founded by Tulsi Tanti, a textile manufacturer, to power his family's textile operations. Its IPO was launched in 2005 and was oversubscribed by five times. The company raised around Rs.1500 crore from IPO that valued the company around Rs.18,000 crore. In less than four years of its operations Suzlon captured 50% of market in India and by 2007 it was Asia's market leader in wind energy. Two American investment groups-City Group & Chryscapital were Suzlon's major investors. Suzlon's group headquarter is in Pune, India and its international headquarter was established in 2004 in Aarhus, Denmark. The annual growth of Suzlon was to the tune of 50-80 percent but supply chain key component in the wind industry-gearboxes bottleneck creates hindrance in growth now and then. To resolve this issue, Suzlon purchase Hansen Transmissions in 2006, a Belgian wind turbine gearbox manufacturer in $565million (EUR 371 million) deal to became world's most vertically intergrated wind turbine manufacturer. Hansen Transmission's acquisition was proved to be a right fit in terms of management style and vision for Suzlon Energy Ltd. Suzlon kept Hansen as a separate entity giving due importance to its existing customers including its own competitors in wind energy business. Suzlon gets Hansen listed on London Stock Exchange.

Creation of synergies owing to strong growth plans followed by Suzlon's management resulted in increase of market capitalization of Hansen to EUR 2.5 billion in 18 months of its acquisition.

REpower Systems was the result of combination of two German wind companies Jacobs Energie and BWU (Brandanburgische Wind-und Umwelttechnologien GmbH) & the German engineering consultancy pro+pro Energiesysteme in 2001.

In June 2007, Suzlon Energy acquired 87.1% of voting power in German wind turbine manufacturer REpower to have a strong foothold in European market. Suzlon fought five-month long takeover battle with French state owned company Areva for REpower. The deal was valued $1.8Bn. Tulsi Tanti, Managing Director of Suzlon Energy was elected as Chairman of the board at annual general meeting of REpower Systems. Suzlon had production development centres in India, Germany and Netherland with production facilities in US, China and India. The real gain to Suzlon from REpower's acquisition was immediate access to 5MW class off shore wind technology of Repower apart from complementary- geographical presence, product portfolio and supply chain strategies. R&D at Suzlon along with its strong supply chain doubled the value of REpower. Suzlon utilized the expertise of REpower in latest technology to concentrate on development of more efficient wind turbine models.

In April 2011, Suzlon Energy who already owns 95% stake in REpower, planned to initiate squeezed-out[*] procedure to make it its wholly owned subsidiary and to get full control over REpower cash and technology.

Suzlon Energy's aggressive pursuit to expand its business in India and abroad lands the company under debt of Rs.10,000 crore that forced the company to sell some of its assets and its Chinese subsidiary Suzlon Energy Tianjin Ltd for $60 million (approx Rs 340 crore) in 2012.

State Bank of India, which has Rs.3,500 crore exposure to Suzlon advised for the merger of REpower with Suzlon to pare the dented balance sheet of Suzlon Energy Ltd.

Much of Suzlon's debt had to do with back to back purchase of Hansen Transmission International Ltd and REpower Systems. The first acquisition proved profitable for Suzlon while the latter has being weighing it down.

Another significant factor about Suzlon's acquisition of REpower was that REpower's finances were ring fenced that restrict Suzlon to utilize REpower's cash reserve to pay of its debts. Reeling under financial crunch and due to economic slowdown in Europe and US since 2008, Suzlon, with heavy book debts, defaulted on redeeming its foreign bondholders in 2012.

Experts believed that the price paid by Suzlon for a small player like REpower was on higher side and that too with accompanied uncertainities in future prospects.

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 *Squeezed-Out-Under German law the holding company having 95% stake can acquire minority

shareholder's stake on compulsory basis.

Other optimist view was that Suzlon being also a small player can exploit combined manufacturing capabilities, can tap unaccessable market outside India and with financial economies can be able to generate value from this acquisition. For this the company has reworked its strategy. Suzlon would start focuing on developing countries India, China, West africa, Brazil etc. and REpower will concentrate on expanding business in developed economis of Europe and US.

Suzlon has evolved as a global market leader and supportive national policy environment for wind energy development has played a major role in its endeavour. Suzlon growth model can be summarized as a model that involved innovation, dispersed operation across the globe with fuller utilization of economies of scale. In January, 2015 reports came that Suzlon Energy is contemplating sale of Repower (now named Senvion) to repay debts and to open a new leaf in its renewable energy business. Suzlon finally sold Senvion to Centrebridge Partners, LP for 1 billion Euros (approx Rs. 7,500 crore).

In narrow sense, the market value of firm is the summation of its value of debt and its value of equity. Evaluating the success of M&A, as already stated earlier, involves segregating the market value of firm into its realized i.e. known component and component incorporating future expectations.

It is a well established fact and need to be noted here that only after recovering the cost of capital invested in shaping the acquisition, the acquirer can begin to reap benefits for their shareholders from M&A activity. Another question will be whether the benefits they are reaping is the same or better than the benefits they are reaping before investing new capital. Answer to these questions, though in approximation, must be found before management actually proceeds with acquiring a target.

Modigliani & Miller (MM) had proposed in their work that if free cash flow (FCF) accruing to the firm is discounted by taking weighted mean capital cost as base, the discounted or present value so arrived at will represent market value of firm.

Using the Modigliani & Miller's formula for deriving the present value of firm from free cash flow, we get market value of firm as

Present Market Value of Firm = $\displaystyle\sum_{t=0}^{\infty} \frac{(NOPAT - Investment_t)}{(1+c)^{t+1}}$ **(1)**

Where:

NOPAT: *Net Operating Profit after Taxes at the end of the year*

c: *Cost of Capital to the firm for funds required for M&A*

Investment here represents any new capital investment required to be made by the firm (in this case acquirer) at the end of the year, rendering benefits over longer period of time.

Value calculated from above though can render a reliable measure of the value of firm, use of free cash flow has its limitation as it fails to evaluate true operating performance of firm on annual basis. The reason to this, belong to the fact that the entire investment cost is charged in the year of investment itself instead of spreading it to over a period of its benefits.

It is a well established fact and need to be noted here that only after recovering the cost of capital invested in shaping the acquisition, the acquirer can begin to reap benefits for their shareholders from M&A activity.

By making an adjustment in the above formula and introducing the concept of economic value added instead of free cash flow, this limitation can be eliminated & the value of the firm can be calculated in an effective manner.

Economic Value Added is arrived at after deducting Effective Capital Cost (ECC) from NOPAT.

$$\text{Economic Value Added} = \text{NOPAT} - \text{ECC} \tag{2}$$

Effective Capital Cost (ECC) is arrived at as a product of Capital investment and Weighted Mean Capital Cost

$$\text{Effective Capital Cost} = \text{Capital Investment} * \text{WACC} \tag{3}$$

Mark L. Sirower, of the New York University, presented his article on 'New Frontiers in Mergers and Acquisitions Research' in a Symposium in 1997 at Academy of Management Meetings, Boston, MA and pointed out that if for a firm the initial capital invested is added to the discounted future economic value added ,we can equate it to the discounted future free cash flow and in turn to market value of firm.[4]

According to him as the discounted value of capital consumption & capital cost for EVA can be equated to cost of initial investment for FCF, the discounted value of any newer investment is same in case of both Economic Value Added (EVA) & Free Cash Flow (FCF).

In other words,

Market Value of Firm = Discounted Future EVA+ Initial Investment of Capital

Now, by utilizing the concept of Economic Value Added and segregating the firm's value (acquirer) into its present known component and component for future expectation involving growth element by using MM equation (1961,416, Eq12) work on Dividend Policy Growth and Valuation of Shares, Journal of Business, University of Chicago (Vol XXXIV, No. 4) in October 1961[5]

$$X_0 \Big/ p + \sum_{t=0}^{\infty} I_t [p*(t) - p)] / [p(1+p)^{t+1}] \dots\dots\dots\dots\dots\text{Equation}\dots A$$

Where:

X_0: is uniform perpetual earning on the current asset base

I_t: is the investment at the end of the year t

$p*(t)$: is the constant rate of return on I_t and p is the cost of capital

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O'Byrne (1996) has transformed above **equation A** given by MM, and derived a generalized form for obtaining Economic Value Added's known & future expectional component as

Present Market Value = Book Capital $_{t\,=\,0}$ + (NOPAT- c* Capital $_{t\,=\,-1}$)+ Δ EVA of Firm.....Equation B

i.e.

$$MV_0 = Cap_0 + EVA_0 / c + [(1+c)/c] * \sum_{t=1}^{\infty} \Delta EVA_t /(1+c)^t \qquad \qquad \textbf{(4)}$$

c is the weighted average cost of capital (WACC) using long rerm treasury return, target's beta, and risk premium (if any).

The first term Cap_0 calculates the Invested Capital of the Target (using Total Assets- Short and Long Term Non Interest bearing Liabilities-Deferred taxes+ Cumulative Amortization (for goodwill written off, if any). The second term Capitalizes the targets's cureent Economic Value Added at weighted average cost of capital (c). The first two term combined in above equation captures the known component of EVA or current operation value.

The third term will capture the growth in EVA or change in EVA i.e Δ EVA. This discounted value of expectational annual growth in EVA is also termed as Future Growth Value or FGV.

For any capital investment like M&A, investors desires a return high enough to recapture cost of capital on current operation value as well as on future growth value & hence an adequate return of cost of capital on total market value is all what is actually desirable.This lays the very basis of standard performance against which any merger & acquisition performance can be evaluated.

While focussing on achieving cost of capital return on FGV or expectational component of EVA or Δ EVA in today's competitive scenario, each and every company almost have positive change in their future growth value i.e. Δ FGV > 0. But by taking an assumption of constant change in FGV i.e. Δ FGV =0, will simplify our model and is recommended to dimmune the complexity of calculations.

The consequence of this assumption, on acheiving a cost of capital return on an expected EVA improvement or FGV ,requires fulfillment of equation

FGV$_0$ * c = Change in EVA$_{1\,+}$ Perpetual Value of EVA$_1$ + Change in FGV$_1$ $\qquad \qquad$ **(5)**

Or,

FGV$_0$ * c = Δ EVA$_1$ + ΔEVA$_1$ /c + Δ FGV$_1$ $\qquad \qquad$ **(6)**

On assuming constant FGV , Δ **FGV$_1$=0** We get, $\qquad \qquad$ **(7)**

FGV$_0$ * c = Δ EVA$_1$ + ΔEVA$_1$ /c ....Equation C

For any capital investment particularly, M&A ,having long term consequences, irrevocable, complex in nature and future centric, it is highly essential to assess the impact before proceeding to make the actual investment.

Right side of **equation (C)** depicts future expectational Economic Value Added in its current and perpetual form that contributes value not only to current FCF (free cash flow) but also to current operational value in perpetuity. For a unit of money worth of EVA improvement there is a contribution of (1+c)/c times to value.This can be explained as below using **equation C**

FGV$_0$ * c = Δ EVA$_1$ + ΔEVA$_1$ /c ....Equation C

Or

$FGV_0 * c = \Delta EVA_1 (1+1/c)$ or $\Delta EVA_1 (1+c)/c$ ....Equation C1

Or

$\Delta EVA_1 = FGV_0 * [c*c]/(1+c)$..Equation C2

In all, above equations provide that 1 unit money of EVA improvement add 1 unit money to current free cash flow & perpetual value 1/c to current operation value which makes total contribution of each unit of money of ΔEVA to (1+c)/c of value.

(1) Calculation- REPower

Deal Value = $1.8Bn

Deal premium = 20 percent (Suzlon Energy's offer of EUR 126.00 per share has taken into consideration of EUR 105.00 offered in the Areva Offer (Areva had 30.15 percent holding in REPower) as base. EUR 21 increase from base price EUR105 amounts to premium of 20 percent). Suzlon Energy finally paid EUR150.00 per share for REPower against final bid offer of French Areva of EUR 140.00

    (a)   **For REPower Group (2007)**

        (i)   Market Value (Debt +Equity)   = $2.74Bn

        (ii)   Treasury Yield (R_f)   = 2.75%

        (iii)   Risk Premium (R_m-R_f)   = 7.48%

        (iv)   Beta   = 0.4400

        (v)   Cost of Debt (after tax)   = 1.95%

        (vi)   Cost of Equity   = 10.2%

        (vii)   Tax Rate   = 29.0%

        (viii)   Debt-Equity Ratio   = 0.60

        (ix)   WACC   = 5.25%

        (x)   Capital Employed one year prior (2006) = $1.17Bn

    (b)   EVA of REPower (2007) = NOPAT - (WACC* $Capital_{-1}$)

              = $0.0532Bn- (0.0.0525*$1.17Bn)

              = $0.0532Bn- $0.0614Bn or -$0.008Bn

    (c)   Current Operation Value of REPower (2007) = (EVA/c) + $Capital_0$

              = -$0.008Bn/0.0525 + $1.56Bn

              = -$0.1524Bn + $1.56Bn or $1.4076Bn

Applying, .. Equation B (Refer Chapter 6)

Market Value = Current Operation Value + PV of Expected EVA Improvement,or,

Market Value = $Capital_0$ + Capitalized EVA (EVA/c) + PV of Expected EVA Improv.

$2.74Bn = $1.56Bn+ (-$0.1524Bn) + PV of Expected EVA Improvement

Therefore, PV of Expected EVA Improvement= $1.3324Bn

Investors expects return on Market Value of $2.74Bn at WACC 0.0525 i.e. ($2.74Bn*0.0525) = $0.1438Bn of which ($1.3324Bn*0.0525) = $0.06995Bn represents expected return on REPower future growth value.

Assuming $\Delta FGV = 0$, to provide return of $0.06995Bn or $69.95 million on REPower future growth value, the company need to acheive,

($0.06995Bn/$20.04) = $0.00349Bn or $3.49 million of ΔEVA improvement in perpetuity as each $1 of EVA improvement contribute $20.04 of value.

(using $1+$1/0.0525 = $20.04- *Equation C*)

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- Financial Result of REPower Group use F.Y. from Jan-Dec and therefore values are adjusted accordingly for period of 3 months to find NOPAT and Capital employed for 2006-07 (using exchange rates as on 31-03-2007)
- Suzlon Energy Ltd. holds around 88 percent in REpower by June 2007, so calculations are done considering it a subsidiary of Suzlon Energy Ltd and taking balance shareholding as minority interest.

(2) Effect of Premium paid

Effect of paying premium of CHF 0.117Bn or $0.096Bn by Suzlon Energy would result in enhancement of future growth value of REPower ($1.3324Bn) by amount of premium i.e. $1.3324Bn+ $0.096Bn = $1.4284Bn. So, Future Growth Value of REPower would be ($1.4284Bn *0.0525) = $0.07499Bn as against $0.06995Bn computed above & correspondingly Expected EVA improvement required would also be enhanced. Therefore, using ($0.07499Bn/$20.04) = $0.003742Bn or $3.74million annual expected EVA improvement is required to provide cost of capital return on $20.04 of FGV.

(3) Calculation Suzlon Energy (standalone)

(a) **For Suzlon Energy (2007)-**

(i)	Market Value (Debt +Equity)	= $7.22Bn
(ii)	Treasury Yield (Rf) -5YR	= 8.0%
(iii)	Cost of Debt after tax	= 5.36%
(iv)	Cost of Equity	= 10.74%
(v)	Debt–Equity Ratio	= 0.30
(vi)	Risk Premium (Rm- Rf)	= 2.20
(vii)	Beta	= 1.24
(viii)	Tax Rate	= 33%
(ix)	WACC	= 0.0912
(x)	Capital Employed one year prior (2006)	= $0.7Bn

(b) EVA of Suzlon Energy (2007) = NOPAT- (WACC* $Capital_{-1}$)

$$= \$0.242Bn- (0.0912*\$0.7Bn)$$

$$= \$0.1782Bn$$

(c) Current Operation Value of Suzlon Energy (2007)

$$= (EVA/c) + Capital_0$$

$$= \$0.1782Bn/0.0912 + \$1.17Bn$$

$$= \$1.954Bn + 1.17Bn$$

$$= \$3.124Bn$$

Applying, .. Equation B

Market Value = Current Operation Value + PV of Expected EVA Improvement, or,

Market Value = $Capital_0$ + Capitalized EVA (EVA/c) + PV of Expected EVA Improv.

$$\$7.22Bn = \$1.17Bn + \$1.954Bn) + \text{PV of Expected EVA Improvement}$$

Therefore, PV of Expected EVA Improvement = $4.096Bn

(4) Suzlon Energy(combined)–Suzlon Energy(standalone)+REPower Group

(a) *Market Value of Suzlon Energy (combined)* = Market Value Suzlon Energy

(standalone)+ Market Value of REPower +Acquisition premium (if any)

Market Value of Suzlon Energy (combined) -

$$\mathbf{MV_{combined}} = \$7.22Bn + \$2.74Bn + \$0.096Bn$$

$$\mathbf{MV_{combined}} = \$ 10.056Bn \sim \$10.1Bn$$

(b) *Combined Invested Capital (Capital$_{combined}$)*

(purchase method is used in case of acquisition)

$$= \text{Book Capital of Suzlon Energy (2007)} + \text{Purchase Price of REPower}$$

$$= \$1.17Bn + \$1.80 Bn \quad \text{or} \quad \mathbf{Capital_{combined}} = \$2.97 Bn$$

(c) *NOPAT of Suzlon Energy combined-* (**NOPAT$_{combined}$**)

$$= \text{NOPAT of Suzlon Energy (standalone)} + \text{NOPAT of REPower Group}$$

(adjusted)

$$= \$0.242Bn + \$ 0.0532Bn = \$0.2952 \sim \$0.30Bn$$

(d) *WACC of Suzlon Energy (combined)* (by market value of two companies)

$$\mathbf{WACC_{combined}} = 0.0830 \text{ (for 2007)}$$

Calculation of Benchmark Performance (Post Deal):

(5) Expected EVA & EVA improvement of combined entity

(a) Expected EVA of Suzlon Energy (combined)

$$\mathbf{EVA_{combined}} = NOPAT_{combined} - (WACC_{combined} * Capital_{-1})$$

$$\mathbf{EVA_{combined}} = \$0.30Bn - (0.0830 * \$1.87Bn)$$

$$= \$0.30Bn - \$0.1552Bn$$

$$\mathbf{EVA_{combined}} = \$0.145Bn$$

(b) Current Operation Value of Suzlon Energy (combined)

$$= (EVA_{combined} / c) + Capital_{combined}$$

$$= (\$0.145Bn / 0.0830) + \$2.97Bn$$

= $1.747Bn + $2.97Bn

= $4.717Bn~ $4.72Bn

Applying, .. Equation B

Market Value = Current Operation Value + PV of Expected EVA Improvement, or,

Market Value = $Capital_0$ + Capitalized EVA (EVA/c) + PV of Expected EVA Improv.

$10.1Bn = $2.97Bn + $1.747Bn + PV of Expected EVA Improvement

Therefore, PV of Expected EVA Improvement = $5.383Bn~ $5.4Bn

So, Investors' expectations for return on total combined market value of $10.1Bn is ($10.1Bn* $WACC_{combined}$) or $0.8383Bn out of which return on future growth value of Suzlon Energy (combined) would be (PV of Expected EVA Improvement* $WACC_{combined}$) i.e.

Return on Suzlon Energy Combined FGV= ($5.4Bn* 0.0830) or $0.448Bn

With our assumtion of Δ FGV = 0, to provide return of $0.448Bn or $448 million on Suzlon Energy (combined) future growth value, the company need to acheive,

$0.448Bn/$13.0 = $0.0345Bn or $34.5million of ΔEVA improvement in perpetuity as each $1 of EVA improvement contribute $13.0 of value.

(using $1+$1/0.0830 = $13.0- *Equation C*)

Actual performance in relation to performance benchmark

Analysis on Suzlon Energy (combined)[&] on Proforma Base Figure

The relevant extract from acquirer company's financial report has been reproduced below.

Base Year   (fig.in billion dollars)

S.No.	Year Ending March 31st	2007	2008	2009	2010	2011	2012	2013
1.	Capital employed (Suzlon Energy standalone)	1.17	2.97[#]	2.88	2.89	2.90	1.96	1.48
2.	Average debt/total capital (%)	0.23	0.31	0.53	0.58	0.50	0.46	0.74
3.	Beta variant (β)	1.24	1.09	1.55	1.52	1.48	1.60	1.67
4.	Risk free debt cost (%) (R_f)	7.8	7.6	7.6	7.2	7.9	8.4	7.4
5.	Market premium (R_M- R_f)	9.3	13.2	-44.5	74.8	4.2	-17.3	2.1
6.	Cost of Equity (%)	19.33	21.98	-61.37	120.89	14.11	-19.28	10.91
7.	Cost of Debt (post-tax) (%)	5.26	2.72	3.47	5.76	7.74	4.15	9.95
8.	Weighted Average Cost of Capital (WACC) (%)	16.10	16.00	20.82	54.11	10.93	-8.53	10.19
	Enterprise Value (EV)							
	Market Value of Equity	6.94	8.76	1.31~	2.45	1.74	0.84	0.41
	Value of Debt	0.27	0.70	1.52	1.66	1.44	0.91	1.10
9.	Enterprise Value	7.21	9.46	2.83	4.11	3.18	1.75	1.51
	Computation of Economic Value Added (EVA)							
	Average Capital Employed	1.51	2.11	3.50	4.13	4.31	4.31	3.65
	NOPAT	0.30	0.45	0.49	1.11~	0.10	0.10	(0.37)
	WACC	0.083						
10.	**EVA**	0.175	0.274	0.199	0.767	-0.258	-0.258	-0.673
11.	Improvement in EVA	-	0.10	-0.08	0.57	-1.03	--	-0.42

| 12. | EVA as per Performance Benchmark | - | 0.0345 | 0.0345 | 0.0345 | 0.0345 | 0.0345 | 0.0345 |
| 13. | Excess/negative EVA improvement against Benchmark | | 0.066 | -0.114 | 0.535 | -1.065 | -0.0345 | -0.455 |

& Figures in table above are of Suzlon Energy (standalone) and EVA computation ultilizes data of Suzlon Energy (standalone) and REPower Group only.

*The financial statements of REPower Group are adjusted on average approximation basis to bring uniformity in F.Y of both the entity. @NOPAT of Suzlon Energy (combined) for 2007-08 is adjusted to reflect the NOPAT of REPower Group considering it as a wholly owned subsidiary of Suzlon Energy. (Suzlon Energy hold approx 95 percent only in REPower Group till April 2011)

Book value of Capital of two entities was $2.97Bn (for Combined capital of two entities, purchase price of REPower is used).

~ In 2008 Suzlon Energy Ltd shares were subdivided in tofive shares of Rs 2 each from one share of face value of Rs 10, hence there is decrease in market value with this stock split.

- In 2010 NOPAT of two entities $1.11Bn includes loss of operation of Suzlon Energy of $0.11Bn.

Finding:

Suzlon's acquistion of REPower initially bring both; increase in Suzlon's brand value across globe and fortune to shareholders of the company. Other quick acquisitions before and after this deal by Suzlon and huge capital requirement to build requisite infrastructure for expansion programmes resulted in debt–laden Suzlon to sell some of its assets to pare huge debt present in company's balance sheet. Moreover, slump in demand of clean energy in European countries and lack of demand in Asian sub continent owing to its high cost with respect to alternative sources further deteriorate Suzlon's balance sheet with high investment cost, decreasing revenues and hence negative combined EVA in following years of the deal. Analysis shows Suzlon's acquisition of REPower failed to achieve performance benchmark even after five years post deal.

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