



DEMERGER AND IT'S IMPACT ON PERFORMANCE: A CASE STUDY OF HERO HONDA LTD

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Abstract

Demerger allows a conglomerate or large company to split off its various brand or department into a separate legal entity. The demerger is a unique and complicated strategy, it can directly affect the financial position of the demerged company and the earning available to the stakeholders. A demerger involves other compliance, usually, accounting, taxation, and legal aspect involved. This paper aims to understand the concept of the demerger. Nowadays demerger has become an important tool of corporate action. The Companies re-evaluate the value of the corporate entity and take the best decision as required. In process of corporate restructuring, demerger is applied as a tool. In this paper, the legal, accounting, and taxation concepts are being elaborated and the impact of the demerger of Hero Honda is analysed with help of the ten-year financial data and various ratios.

JEL Classification: M4, M41

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Introduction

Management of business in this challenging era is quite often dependent upon the efficiency of implementation of corporate action. Management has always been concerned about sufficient earnings of business operations for its shareholder. Since the business is very dynamic, no one can say with confidence that the policy adopted by the firm will be effective in every scenario, so many changes are happening so fast, they can affect to the firm badly or avail opportunity to the firm. The management of a business firm has to create and implement the best suitable policy as per the scenarios of the business. The demerger as a business strategy is not a new concept in a corporate action, it was traced in America in the 1920s, later, it become popular in the 1950s. A demerger can be regarded as corporate separation, demerger is just the opposite of Merger and acquisition. "A merger said to occur when two or more companies combine into one company" (Pandey, I M 2015 p.763). The merger is the result of conserved thinking that it will create synergy. "A full joining together of two previously separated corporations. A true merger in the legal sense occurs when both businesses dissolve and fold their assets and liabilities into a newly created third entity, thus it entails the creation of a new corporation" (Vadapalli, Ravinder 2007p.3). The Demerger can be described as breakup of division of an enterprise into the greater number of the units. The new companies, the transferees, want no longer to be the subsidiaries of the guardian groups gone through such breakup or division. The New Oxford Dictionary defines the period "demerger" as "the separation of a large organisation into two or greater smaller organizations." (Oxford University Press). A spin-off is also a form of demerger in which a company is divided into two or more separate wholly owned entities of parent corporation by distribution of all its share of the subsidiary company on a pro-rata basis among the existing shareholder, by this way, both the parent and resulting company exist.



Conceptual Framework of Demerger in Regard Accounting and Taxations

1. **Accounting concepts for demerger:** The conceptual framework of Demerger covers the provision of company law, taxation, and accounting methodology of demerger while practicing accounting, neither the Indian accounting standard 14 for amalgamation nor international financial reporting standard 3 specifically deal for the accounting of demerger, however the accounting of demerger is not complex. Demerger is not a result of buy or sale transaction, this is a division of a part of the exiting firm's department, hence, demerger is treated at recorded value, assets and liabilities will be transferred to new entity, accounting standard 14 of amalgamation applied has to be applied.

2. **Taxation of Demerger:** Under section 2(19AA) of the Income Tax Act 1961, except the context is not otherwise, "demerger" is concerned the transfer of means, under provision of sections 230(1) and section 232 of the Companies Act, 2013, by a demerged company of its one or greater undertakings to any resulting company.

3. Provisions applicable to company

I. **Capital Gain (Sections 47(vi) and 47(vii))-** Capital Gains, if any, arise on transfer of a capital asset, in a scheme of demerger to the resulting entity for an Indian Company to be exempt. all Accumulated loss or unsettled depreciation on assets of the demerged organizations can be carried forward by the new company for set off against its earning (Section 72A (4)):

- Where it immediately relatable to undertaking transferred, it needs to be such relatable amount.
- Where it is no longer relatable to the venture transferred, it ought to be apportioned in the ratio of property retained by the demerged organizations and transferred to the resulting company.

I. **Allowability of expenditure concerning to demerger (Section 35DD):** An Indian organization will be allowed a deduction of 1/5th of the expenditure incurred for demerger for 5 years from the 12 months in which demerger takes place.

II. **Depreciation in the year of demerger (32(1)):** Depreciation to demerged corporation and the ensuing organisation in the year of demerger shall be apportioned in the ratio of the quantity of days for which the belongings had been used.

Written Down Value ('WDV') (Sections 32 and 43(6)(c)): WDV in the arms of the ensuing business enterprise shall be the WDV of transferred property of the demerged organisation straight away earlier than the demerger. WDV in the palms of the demerged enterprise shall be the WDV of the block of property earlier than demerger much less WDV of belongings transferred to the ensuing company.

4. Provisions Applicable to Shareholders:

•Acquisition of shares of the ensuing firm through the shareholders of the demerged company pursuant to scheme of demerger will neither taxed as capital gains nor the dividends. (Sections 47 (vii) and 2(22)(v)).

•Period of conserving the shares of the resulting enterprise will consist of the period for which the shares in the demerged company had been held through the shareholder. (Sections 2(42A) (c) and 2(42A) (g)).



Case study of Hero Honda joint venture

The Hero was established in 1944 when four brothers of the Munjal family started a bicycle spare parts business. In 1956 the Hero cycle was commenced manufacture in Ludhiana, 1975 the hero had become the largest manufacturer of the bicycle in India. In 1978 the Hero enter in motorcycle market as Majestic Auto ltd. was incorporated and the first from this venture was Hero Majestic Moped a motorized two-wheeler. In the early 1990s, Japan-based Honda was looking for entering in Indian two-wheeler market through the joint venture. Honda had efficiency in producing motorcycles and scooters and was one of the largest manufactures of the motorcycle since 1959. Honda was in search of the best partner of this business to form a venture, initially, he formed a joint venture with Bajaj Auto ltd. and thereafter with kinetic engineering ltd and lunch kinetic scooter famous Luna brand of moped, in 1983 Honda approached Hero and it was the time when they both agreed to come into the joint venture 1984. The joint venture agreement was signed between Honda and Hero contained the terms and conditions of the partnership, this venture was signed for ten years and according to the agreement Honda was ready to share technical know-how and with Hero Honda, manufacturing setup, and research, and development work. Hero Honda had to pay 4 percent royalty to the Honda on Ex-Factory price. In this venture Hero and Honda, both partners have 26 percent of share and 26 percent was sold to the public, and the rest was issued to the financial institution.

Initially, the venture was only for ten years but the huge business success and market demand led the agreement continued till 2010. On 16th of December 2010, Indian two-wheeler giant Hero (Hero Group) and Japanese counterpart Honda (Honda motor company) signed an agreement with Demerger to end their partnership and it was the end of the most successful joint venture of India. Honda decided to exit from the venture by selling his 26 percent stake to the Munjal family, owner of the Hero group. Both partners further agreed that Honda will provide technical support the Hero till 2014 and Hero will continue to pay a royalty to Honda.

Post-demerger the name of the company was changed from Hero Honda to Hero moto Corp ltd in July 2011. Management of hero moto Corp had changed their logo. Hero Moto Corp has five manufacturing facilities Dharuhera, Gurugram, Neemrana, Haridwar. These manufacturing facilities can produce 7.6 million two-wheelers in a year successfully. along with a strong manufacturing capacity, the hero also has wide sales and services network of over 6000 thousand dealerships and services points in different parts of the country. The hero now has been become one the most successful multinational two-wheeler company, hero has a production facility in Bangladesh as in 2014 hero entered in a joint venture with Bangladeshi Nitol Niloy. group to setup a manufacturing facility in Bangladesh. Hero's presence can be traced on globe as today its vehicle is available across the world except few countries.

Review of Literature

The literature review is an important phase of any research study that provides familiarity with what new has been added in the context or provides insight into the areas that remained unexplored. it is very important to understand that what has been done in the Demerger till today. Though the different scholar has done their work in the field of Demerger at the national and international level, there is always a possibility of carrying research as of today's business is very dynamic and progressive.

Kang and Ozebilgin (1996) analysed the restructuring of 92 Japanese corporations that experienced a significant decrease in operating performance from 1986 to 1990. they identified that those Japanese firm adopted downsizing measures such as plant closures, asset sales, and employee layoffs. Compared to a sample of US firms that experience a similar decline in operating performance, Japanese firms were



less likely to downsize, and layoffs affect a smaller fraction of their workforce.

Kirchmaier (2003) studied the reaction of the market in case of European demergers. The effect of demerger announcements on shareholders' wealth was done using an event window of 21 days starting with 10 days prior to the announcement and ranging up to 10 days after the announcement. The announcement date was considered as Day '0'. On a sample of 48 demergers, it was established in the study that there is a significant positive wealth creation of 4.1 per cent during the 2-day period consisting of Day 0 to Day +1 and 5.5 per cent during the 4-day period consisting of Day -2 to Day +1 for standard demergers. The study concluded that there is a positive reaction to demerger announcements.

Bergh and Lim (2008) analysed the announcement returns of 205 companies which had announced their restructuring (selloffs /spin-offs) during the period from 1990 to 1997. The cumulative abnormal returns were calculated for a 2-day period surrounding the announcement, that is, Day 0 (day of the announcement) and Day +1 (day after the announcement). The authors observed a positive reaction to the restructuring announcement resulting in a 2.20 per cent increase in the cumulative abnormal returns during the event window.

Harvard Business School (2011) corporate restructuring has enabled thousands of organizations around the world to respond more quickly and effectively to new opportunities and unexpected pressures, thereby, re-establishing their competitive advantage. the study signifies the role of corporate restructuring to cope with the changing business environment in this dynamic world.

Vyas, Pathak and Saraf (2015) they had studied the effect of demerger announcement and its returns in India and concluded that the shareholders parent enterprise has benefited in demerger. They had studied about 51 demerger announcements during the period from 2012 to 2014 through the 21-day event window methods. study reveals that CAAR is about 2.59 per cent to the shareholders, in additions the had divided the sample into two categories, sub-samples of small demergers and giant demergers. around forty-one small demergers grant return of 3.5 per cent, ten giant demergers, however, grant poor return of (-)1.35 % to the shareholders. The observations were additionally categorised as listed public companies' demerger and private demergers. authors observed greater returns available to shareholders in case of listed demergers wherein the shares of the demerged company are listed on the stock market.

Veld and Veld- Merkoulova (2004) divided the sample into sub-samples of focus increasing spin-offs and non-focus increasing spin-offs and concluded that focus increasing spin-offs yielded greater returns. While there is a CAAR of 3.57 per cent for focus increasing spin-offs during the 3-day event period, the announcement returns of non-focus increasing spin-offs during the same event period is only 0.76 per cent.

Zakaria and Arnold (2012) Zakaria and Arnold (2012) studied the demerger announcement effect on returns. they had selected 36 Malaysian firms as the sample. sample was categorized in 19 growing spin-offs and 17 normal demergers. They had considered an event window of 41 days consisting of 20 days before to the declaration and 20 days posterior the announcement. The authors determined that there are 8 firms which have abnormal returns of 4.99% as per CARs model and 5.06 t as per market model for the duration of 3 days. effect of demerger announcement on returns under market model used to be only 7.61%, growing spin-offs in contrast to 13.23 of non-focus increasing demerger, difference in unusual returns between the two sub-samples have been found to be statistically significant.



Objectives of the study:

The objective of this paper is to understand the performance of the de-merged company based on financial as well as operating, post demerger of Hero moto Corp ltd. It has become an individual company and has made successive decision to gain market shares in the two-wheeler industries. focuses will be on the followings:

- to identify cause and effect behind the demerger of the Hero Honda ltd.
- to know the capital structure and the market value of the shares of Hero Moto corp.
- to evaluate its operating performance.

Reasons behind the Hero Honda demerger: Up to 2008, the venture between Honda ltd and Hero Moto Corp Ltd was functioning smoothly, thereafter trade-related clashes have been started. Hero Moto Corp Ltd led by the Munjal family had initiated the conversation to breach the venture, the main reason was figure out.

1. New motorcycle launched by Honda: The Honda scooter had launched the new motorcycle in the Indian market which was a breach of the agreement between both. Agreement between both the company, prevent Honda from production & selling the motorcycle in the Indian market, it was a direct competitive challenge for Hero, Rift was started between.

2. Research & Development: Hero wanted to invest billion dollars in Research & development, also want to create its engine technology that was a threat for Honda ltd as the hero was paying the royalty for the engine.

3. Board member: Honda had 4 members in Hero Honda ltd while the hero has no one in Honda ltd. All the plans and information were easily accessible for Honda.

4. Export problem: according to the agreement signed between Hero and Honda, the JV was for domestic production of Motorcycles. But when Hero wanted to export Hero Honda products, Honda did not help them in setting and influencing dealers to sell Hero Honda products.

Research methodology

The research methodology for this study will be based on the analysis of the secondary data. A financial report consisting of the balance sheet, profit, and loss, cash flow statement will be used as research data. To understand the operating and financial performance the key financial ratios will be used. The financial performance can be ascertained by the interpretation of the net profitability ratio, net operating profit ratio, return on equity, earning per share ratio, price-earnings ratio, dividend per share ratio. Operating performance can be measured by interpreting inventory turnover ratio, asset turnover ratios, current asset turnover ratio, working capital turnover ratio and the total capital employed ratios.

Research tool and method

This paper aims to measure the financial performance of Hero Moto Corp Ltd. Rate of return, earning per share, the performance of operations will be measured through traditional methods to assess the level and direction of the performance. In this study, the following formulas have been used to calculate the traditional performance indicators such as, return on investment (ROI) = $\frac{\text{Net Profit before Interest but after Tax}}{\text{Average Capital Employed}} \times 100$. Net profit = $\frac{\text{Net profit}}{\text{sales}} \times 100$ Whereas, the net profit is derived after all expenses and charges. Return on net worth = $\frac{\text{Net income}}{\text{shareholder equity}} \times 100$ (shareholder equity = equity + reserve). Return on capital employed = $\frac{\text{operating profit}}{\text{capital employed}} \times 100$.



Table 1: Table showing the calculated value of the various ratios & other figure

Particular	Pre-Demerger		Demerger	Post Demerger						
	2008	2009		2010	2011	2012	2013	2017	2018	2019
Year	2008	2009	2010	2011	2012	2013	2017	2018	2019	2020
Net Sales*	10345	12325	15839	19397	23579	23768	28500	23230	33650	28836
Net Profit *	8.04	9.46	13.30	9.26	9.42	7.37	11.84	11.47	10.5	12.29
RONW*	35.48	37.77	43.61	60.05	65.64	40	35.6	33.8	27	25
ROCE*	50.99	49.05	48.76	55.76	51.47	37.53	46	44	39	27
EPS	48.76	64	111	96	119	106	169	185	169	181
Debt-Equity ratios	0.05	0.03	0.02	0.12	0.12	0.15	0.0	0.0	0.0	0.01
Market Capitalisation (\$)	2.14	4.5	5.25	5.01	5.06	5.23	8.28	7.18	8.11	10.09
DPS	379	399	2196	2096	898	1198	1737	1697	1897	1937
Total value Addition	1497	1752	2261	2586	2576	2980	4737	5007	5292	5089

(Source: money control and business standard). * Value in percent

Analysis and interpretations

Demerger of Hero Honda Ltd. was not the first one, many successful demergers have had been completed before this, however, the demerger of this venture was unique because all previous demerger was a separation of own department of concerned company, but demerger of Hero Honda Ltd. company has created two strong rivals in the same business segment.

The above table is showing the financial performance and the wealth creation pattern of the Hero Honda Ltd. Key financial ratios are being used as the parameter of growth. Demerger of the hero Honda Ltd. has opened the gateway of the profitability and wealth generation for the Hero moto Corp Ltd. The mean of the Net sales during the pre-demerger period is 11335 and the variance from mean is 990, while post-demerger net sales mean is the 25851 that is 38 % greater than event year sales figure this is quite clear that sales figure has grown up after the demerger, operating profitability and shown by the net profit ratios, return on net worth and the return on capital employed. Mean of net profit ratios during 2008 and 2009 (pre- demerger) 8.75 %, in event year it is 13.2 % after demerger it 10.5 % which two time more or less pre and post demerger figure, return on net worth is showing fluctuation in the deferent year of post demerger in comparison of pre demerger.

In pre demerger mean of the RNOW is 36.6 % and in the event year it is 43 % which is a 19% increase in comparison to pre -demerger but in long term, the growth of RNOW is compromised and on average, it is only 40% which is 6% less than the event year and is 11 % more than pre demerger value. Return on capital employed is showing the declining trend after the demerger before demerger means is 56% in event year is 111%, right after it is only 40 % which is quite fluctuating in nature and indicating a negative impact of covid in 2019 and 2020 that is only 27 %. EPS is showing in positive indication for the hero moto corp, pre demerger mean of EPS is Rs 56 per share while the mean of the post demerger EPS is 146 per share. DPS is a significant indicator of sufficient earning, the per-share dividend rate of dividend has grown up in this post-demerger year. Increment in DPS was 450% in the event year that's



continuing. Total value addition or value-added" describes the economic increment a company gives its products or services.

Conclusion and Suggestions

Hero MotoCorp is the largest motorcycle manufacturer in India having almost 40% market share, at least 14 % of competitive edge on rival company Honda scooter India Ltd. who was used to be a friend before the demerger. after the demerger, the hero becomes one of the most valuable companies of India representing the legacy in best bike manufacturing. Increasing net sales is showing the company's market goodwill and brand positioning. Net profit is also improved but fluctuating in nature. RNOW is quite sound we can say that investors are enjoying it most, they can be assured that they are in a position that can be sure about a good return. Demerger of hero Honda has opened a new dimension. Hero has started exporting their bike to neighbours' countries as well as the African country and others. Hero has set up a new engine development facility which was not possible in JV with Honda. Shareholders are continually enjoying good dividends on per and earning per share is increasing. Demerger of the Hero MotoCorp has been an extreme case as it has a different class. Today's it more valuable company and growing up at a stable growth rate. we can say it is a "Desh ki Dhadkan" brand, as 6 families out of ten have hero motorcycles, which tells us the brand's success.

This research focused only on financial results which told us only financial performance. This study did not address organizational efficiency, which is an important aspect of measurement of demerger success. Future research is to find some organizational aspects in research, such as human policy and managerial as well as non-managerial performance may be a method of new research.

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