CHAPTER 2

LITERATURE REVIEW

Michael Firth (1976) stipulated that there were generally much more takeover activities during bull period than during bear period in the stock market. In his book, he said that part of the reasons for increased acquisition and merger activities during market uptrend was the expectation of the acquiring companies that the share prices of the target firms would continue to rise higher. Some acquiring companies even take on the acquisition exercise without clear commercial objectives. He commented that comparing characteristics using valuation ratio and price-earnings ratio that involved share prices could lead to result discrepancies, as the date and method of retrieving price data became paramount. Michael Firth's study in 1976 covered firms involved in takeover exercises in the period from 1973 to 1974 in London Stock Exchange. He found that the acquired firms were those with high gearing, low profitability and relatively lower dividend payout ratios. He also pointed out that there were no differences in liquidity, price-earnings ratios and that valuation ratio was not comparable. He commented that '*the fact that takeover incidence was less when the stock-market indices, and hence valuation ratios fell would seem to suggest that under-valuation is not so important a criterion as some would have us thought. Even cash takeover bids decreased when valuation fell in 1974. Strict comparisons with prior studies is not tenable because of the wide variety of dates used in measuring the valuation ratios. Additionally, stock-market levels differ from period* *to period and make comparisons difficult. It is possible, however, that low valuation ratios in firms are no longer easy to obtain. This is because prior comments by Marris, Buckley and others have had some impact on the investment community, and obvious takeover candidates are being discounted by the market (the large investment gains associated with holding shares in takeover firms have attracted a lot of interest by investors, and fewer cheap situations now exist)'.*

Buckley's study in 1972 on public listed companies acquired during 1971 with consideration exceeding 2.5 million pounds found that acquired companies generally had low valuation ratios, declining or static earnings, low price-earnings ratios relative to appropriate industrial average and slightly under-geared. Through his study, Buckley concluded that the acquisition signals were (a) valuation ratio of 1.25 or lower, or (b) less than 10% earning growth over a two-year period with price-earnings ratio below 80 of the sectorial average when the valuation ratio exceeded 1.25.

Kuehn (1975) suggested that the acquiring companies usually referred to the published annual accounts of their intended targets before proceeding with takeover exercise. Using linear probability models and probit analysis on companies acquired from January 1957 to December 1969, Kuehn found that these companies usually had low valuation ratios, low profitability, low growth and low liquidity ratios. The dividend payout policy was found to have no impact. Through his study, Kuehn concluded that the valuation ratio was the major variable to determine the likelihood of a takeover.

Newbould (1970) conducted a study on companies involved in mergers and acquisitions from 1967 to 1968 in United Kingdom. Using univariate analysis, he concluded that the acquired companies had relatively lower price-earnings ratio in comparison to acquiring firms. There were however contradicting results on the valuation ratio. His study found that the valuation ratios for the acquired firms were not low. He went on to comment that *'the valuation ratio has not been found to be able to offer any explanation of the incidence of mergers, either in indicating those firms which receive bids, those which make bids, or in explaining the incidence of merger activity overtime. Perhaps this is another example of the excess rationality imputed by economists into the actions of management'*.

Ajit Singh (1971) investigated the takeover activities of public listed companies in 1955 to 1960, using both discriminant analysis and univariate analysis. His study found that the characteristics of acquired companies were low profitability, low valuation ratio and low growth when compared to non-acquired companies. Singh concluded that profitability was the major determining factor in deciding takeover targets. He further suggested that valuation ratio was a very poor factor to explain takeover activities. He commented that *'the results of our investigation indicate that although the valuation ratio of the taken-over firms is significantly less than that of the non-taken-over firms, there is a very considerable degree of overlap between the two groups. In the period studied, there was a relatively large number of acquired firms with above average valuation ratios, and a similarly large proportion of non-taken-over firms whose valuation ratios were below the average for their respective industries. This evidence clearly refutes the relationship between the valuation ratio and the probability of take-over is likely to be very weak. Thus, the achievement of a relatively high valuation ratio, far from guaranteeing a firm against take-over, may not even greatly reduce its chance of being acquired'*.

Taussig and Hays (1968) conducted a study that involved 50 cash takeovers in 1960s. The results of their study were that the acquired companies usually were those with high liquidity, poor earnings and a declining dividend policy.

Stevens (1973) published an article from his investigation on 40 firms acquired in 1966. Using factor analysis and discriminant analysis, he found that the major discriminating factors were low gearing level and high liquidity.

Kamal (1987) through his research on companies acquired in KLSE from 1976 to 1982 concluded that there were no significant differences between the valuation, price earnings, acid test and leverage ratios of the acquired companies relative their controls. In his study, he found that acquired companies generally suffered low profitability and reduced sales/total assets. Using multiple discriminant analysis, he found the discriminators classifying these companies were growth in net income and liquidity ratio.

Lim and Mansor (1993) through their research in behaviour of share prices around acquisition announcement in KLSE, stated that acquisitions in Malaysia generally were slow in the bearish period but were active during the bull run. They commented that takeover exercises were used for expansion, diversification, reverse takeover and growth. They concluded that acquisitions generally resulted in price appreciation of target firms more than acquiring firms.