CHAPTER TWO

LITERATURE REVIEW

2.1 Performance and Shareholder Value Appreciation

Ansoff (1971) in his comparative study of mergers and acquisitions of US manufacturing firms, conducted a research involving 271 manufacturing firms between 1946 and 1965. The sampling was grouped into two main categories, **low sales growth companies** which had average sales growth rates of 4% and the second group was **high sales growth companies** which showed average sales growth rates of 10%. He also added that the growth of sales is directly related to a number of variables such as total assets, earnings/equity, dividends/share, debt/equity and price/equity ratio.

He found out after an acquisition, low sales growth companies showed significantly higher rates of growth, whereas, high sales growth companies showed lower rates of growth. However, even though low sales growth companies showed higher rates of growth after acquisitions, they actually suffered decreases in their mean P/E ratios, mean EPS and mean dividend payouts. The similar pattern of inconsistency found in the high sales growth companies whereby their performance levels for MPS, EPS, P/E ratio, earnings and dividend payouts were greater.

In relation to the element " tradeoff ", the study revealed low sales growth companies financed their acquisitions through decreased dividend payouts and the use of new debts. In contrast, high sales growth companies with other strategies tended to decrease debts but increase dividend payouts.

Ansoff's study also analysed the performance of 271 acquiring firms in comparison with 82 non-acquiring firms during the similar period of time. He discovered that acquisitions were in general unprofitable, as they did not contribute to increases in all of the variables of the companies' growth. Acquiring firms registered lower rates of growth as compared to the non-acquiring firms and this was more pronounced for low sales growth acquiring firms.

Ajit Singh (1971) in his study on 'takeovers' had selected a group of non-financial acquiring firms involving various industries and compared their performance in terms of profitability. The industries comprised of non-electrical engineering, electrical engineering, food, drink and clothing & footwear. The study was carried out on a two-period basis, i.e., 1 year after acquisition and 2 years after acquisition. After a two-year period of takeover, it was noted that there was a deterioration in their relative profitability records. Ajit Singh had also implicitly highlighted as in relation to the EPS, the biggest potential losers are shareholders in bidding companies, who have been ignored in order to provide the expansion which the managers seek. He also argued the main reason for profitability falls after takeover was sacrificing profits for future growth. He added that those acquiring firms could have maintained their profitability records if they were not involved in takeovers.

Ajit Singh's study has also supplemented some insightful information. He selected 2 groups of firms, acquiring companies and non-acquiring companies in the same year. The sample size was 93 companies in each group. In addition, firms which made two or more acquisitions in the same year was included only once. A number of variables were used as the basis for comparison. They were pre-tax profitability, liquidity, gearing and retention ratio. The results showed that on a univariate basis, growth and retention ratio were the only statistically significant discriminators between the two samples.

A comparison was also made in relation to a certain set of criteria between the acquiring and non-acquiring companies prior to takeovers. Ajit discovered that the acquiring firms are larger and more dynamic than the non-acquiring firms. A part from a high rate of growth, they have all other attributes, which can be associated with ' growth-minded' firms, i.e., higher retention ratios, higher gearing ratios and less liquidity.

On the other hand, Schmidt, Dennis R, Fowler and Karen L (1990) in their study entitled 'Post-Acquisition Financial Performance and Executive Compensation', they used a few determinants including the firm size and financial performance of acquiring firms. For the study, a 4-year period was adopted both preceding and following acquisition activity. Based on the results, firms that engaged in major acquisitions registered poor performance in the post-acquisition period.

2.2 Economic Gains and Merger Strategies.

In another study on 'merger strategies and stockholder value' , conducted by Michael Lubatkin (1987), he selected a sample size of 257 acquiring firms was adopted, they were the listed companies on the NYSE and ownership by the acquiring companies in the acquired companies in all cases exceeded 50 percent. Those companies chosen for the study were operational for a full 67 months prior to the merger month and for a full 64 months after the merger month to allow evaluation of pre-merger and post-merger performance.

Through his empirical findings, in general, related mergers (product concentric[4], and horizontal/market concentric[5]) *do not* create more value for stockholders of acquiring firms than do unrelated and vertical mergers. He also reiterated, *'some product and market relatedness is better than none'.*

[4] Product concentric refers to related product but clearly differentiated from the organisation's current business.

[5] Horizontal/market concentric refers to mergers that involve both the buyer and seller who are in the same product-marketing chain and serving the same market.

However, his evidence suggests that this popular prescription from the literature of acquisition strategies may be misleading. As such, in light with his findings, investors do not hold more favourable expectations for related mergers than for unrelated ones and stockholder value appreciates most for vertical mergers.

Conversely, Harbir Singh (1987) in his study on ' Corporate Acquisition Strategies and Economic Performance' concluded that firms participated in related acquisitions experienced superior economic returns in comparison with unrelated acquisitions. The rationale for the superior economic performance was due to the synergetic effect especially via complementary resources.

In other studies, Ingham (1992) conducted a survey to examine merger activities in large firms over the period 1984-1988. More precisely, the survey involved UK' top 500 companies between 1986 and 1987. The study revealed that *'it is the expected reward of increased profitability that has driven the takeover market'* and as such, a takeover activity has been performance enhancing for those companies. The study also indicated that integration of small acquisitions into an existing organisational structure might be achieved without the severe problems of loss of control and subsequent decline in performance that beset large acquisitions.

2.3 Related Issues of mergers and Acquisitions.

Other general aspects of a merger and acquisition activity that widely discussed in most textbooks are as follows:

2.3.1 Rationale for mergers.

- Synergetic effect

  The primary motivation for most mergers is to increase the value of the combined enterprise. The synergetic effect could mainly result from operating economies (management, marketing and productions), financial economies (lower transaction costs), differential efficiency of the two companies and increased market power (reduced competition).

- Diversification

  Diversification via a merger helps a company to stabilise its earnings stream and thus benefits its shareholders.

- Purchase of assets below their replacement cost

  In some cases, companies find that acquiring a new company is cheaper than purchasing stocks or reserves for their daily operations.

- Tax consideration

  Tax considerations can also stimulate mergers. Highly profitable companies could acquire problem companies as their accumulated losses could be turned into tax savings for the acquiring companies.

- Managers' personal incentives

  Some managers are more inclined to maximising shareholders' wealth. But some tend show their 'ego' as their primary reason behind the merger.

- Breakup value

  Firms are usually valued by book value and economic value. However if the 'breakup value' is greater than the market value, the deal seems to be favourable from an acquiring company's point of view.

- Increase EPS

  This type of rationale is very much adopted by conglomerates whereby their aggressive strategy is very much focused on rising their EPS rather than benefiting from economic gains.

- Lower financing cost

  It is also learned that merged firms seem to bear lower financing cost where bank loans are concerned.

2.3.2 Motives for mergers

- Economies of scale

  Achieving economies of scale is a natural goal of related merger (either vertical or horizontal merger). The architects of these merger have pointed to the economies that come from sharing central services, such as office management and accounting and financial control.

- Economies of vertical integration

  Large companies would like to gain as much control as possible over the production process by expanding backward toward the suppliers or forward toward the ultimate customers.

- Complementary resources

  Complementary resources give a boost to large companies to acquire small companies. For instance, the small firm may have a unique product but due to lack of engineering skill, it tends to invite a large and experienced firm to generate greater profits.

- Utilisation of unused tax shield

  A firm may be motivated for a merger and to generate profits from the merger in order to take advantage of the unused tax shield.

- Surplus funds

  Merger is also motivated by surplus funds. When a company has excessive cash generated from its current operations, it tends to expand by getting involved in new projects instead of paying higher dividends.

- Elimination of inefficiencies

  In some cases, mergers are also intended to eliminating inefficiencies in the management team of target companies.

However, Hamill and Crosbie (1990) studied the trend in US acquisitions by UK retailers over the period 1984-1989. Some specific issues were discovered and one of them was 'motivations for acquisition' which included 1. Declining growth prospects, 2. Foreign market size and growth prospects, 3. The desire to export a unique niche offering, 4. Organisational learning from overseas experience and 5. Management's desire to become transnational.

2.3.3 Types of mergers

- Horizontal Merger

  A horizontal merger is one that takes place between two firms in the same line of business; most of the mergers around the turn of the century were of this type. Recent example, Bank Bumiputera's merger with Bank of Commerce.

- Vertical Merger

  A vertical merger involves companies in related lines of business. The acquirer expands backward toward the source of raw materials or forward in the direction of the ultimate customer. For instance, Sime Darby (rubber plantation) has acquired Sime Tyre (tyre manufacturer).

- Congeneric Merger

  A congeneric merger involves related enterprises but not producers of the same product (horizontal) or firms in a producer-supplier relationship (vertical). An example of this is the acquisition of MAS by Malaysian Helicopter Services.

- Conglomerate Merger

  A conglomerate merger involves companies in unrelated lines of business. For instance, the Hong Leong Group from acquired MUI bank, Yamaha Motor, Packaging companies and etc.

However, in practice horizontal merger, vertical merger and congeneric merger are called 'related mergers'. Whereas, conglomerate merger is called 'unrelated merger'.

2.3.4 Estimating the economic gains and costs from mergers

Assuming Company A is acquiring Company B and the normal method to justify the acquisition as outlined by Brealey and Myers (1996) is as follows;

Gains = PVab - (PVa + PVb)

Costs = Cash - PVb

NPV = gains - costs

PVab - (PVa + PVb) - (cash - PVb)

Note:

PV- Present Value

NPV- Net Present Value

a- Company A

b- Company B

In light with the M&A activity, Ernst & Young (1994) have notified some relevant information and it could be outlined as shown below;

a. Acquisition Process:

- Establish responsibility at the policy level
- Develop an acquisition plan
- Define acquisition criteria
- Identify potential acquisition candidates
- Make effective contact with candidates
- Perform thorough due diligence
- Negotiate terms that preserve the benefits identified
- Reap the benefits through effective post-acquisition integration

b. Techniques for valuing a potential acquisition or takeover.

- Discounted cash flow analysis

  This is a very common approach. This technique takes into account that a dollar received today is worth more than a dollar received one or two years from now. Therefore, discounted cash analysis is to obtain a value in today's dollar by discounting (at a predetermined discount rate) all the company's future cash flows over a specified period of time.

- Comparable transaction analysis
  The valuation on a target company is carried out based on the performance of the industry in which it operates. As such, use of PE ratio and other market indeces will be used to determine the value of the company.

- Comparable companies analysis.
  This analysis involves a comparison study between the target company and other in the same market. Emphasis is given on the economic trends and risks that the target company experiencing as compared to others.

In relation to the above, Allen and Pat (1990) reiterated that an acceptable premium should be no more than the discounted cash flows of a firm, as adjusted for any efficiencies or synergies the acquisition would exploit. The study found that the premiums equalled 2 times of discounted cash flow values. Thus, they suggested special emphasis should be placed on some of the hidden costs mainly investment and mortgage-backed securities, loans, credit card operations and office properties and equipment.

Fabrice Desmarescaux (1998) in his study 'Exploring the Merger Myth', has come up with many interesting findings in light with the Asian context. He found that during the M&A activity is concerned, most cost reduction materialise from either worker layoffs or renegotiating supplier contracts during the merger process.

In Asia, managers have been reluctant to implement layoffs or to restructure sourcing contracts because of tradition of lifetime employment. Not only that, access to funding might be problematic when banks with diverse risk structures are combined. He further concluded, where acquisitions or takeovers are concerned, some of the difficult questions to answer in Asian cultures are as follows; 1. How many highly paid directors are needed, 2. How many employees should be terminated, 3. What buildings can be closed, 4. Which information should be kept.