CHAPTER 2

LITERATURE REVIEW

Introduction

Numerous researches on mergers and acquisitions have been carried out in many developed countries, particularly in United States and United Kingdom. The areas of interest include the profile and financial characteristics of the acquirers and acquirees, the pre- and post acquisition performance of the participating firms, the impacts of mergers and acquisitions on the capital market, the various theories of the firm in relation to acquisitions, the trend of mergers and acquisitions. The major financial variables analysed by most of the researchers were valuation ratios, profitability, sales growth, leverage, liquidity, dividend performance and price earnings ratios. These financial variables were normally based on the accounting data of the firms and the stock prices in their respective stock exchanges.

Mergers and Acquisitions Activities in United States

Lynch (1977) observed that the mergers and acquisitions in United States have gone through five different movements, each of which has its own distinctive characteristics. He classified the movements into the followings :-

1. 1879 to 1904 - the era of "monopoly building and buyers collusion"

2. 1919 to 1930 - the era of "congeneric mergers and acquisitions"

3. 1940 to 1949 - the era of selling out by smaller companies to escape the estate tax

4. 1955 to 1968 - the era of "conglomerate building"

5. 1976 to present - the era dominated by "strategic acquisition"

He described the first movement during which many companies merged horizontally and as a result of the horizontal mergers, many firms were able to increase their monopolistic powers in their respective industries. During this period, a total of 3,012 mergers and acquisition had taken place.

The second movement was characterised by vertical integrations where the acquiring firms took over companies of related business for the purpose of constructive growth and better control over its upstream and downstream activities. During this period, the mergers and acquisitions reached its peak in 1929 with a record high of 1,245 cases occuring that year. However, these activities suffered a drastic drop in the following decade of 1930 - 1940 during which the U.S. was at its worst economic depression.

During the period 1940 to 1949, many smaller businesses were selling out to escape the payment of estate taxes and this had resulted in another spate of acquisitions by many bigger firms. This phenomenon was rather peculiar and was not influenced by any particular economic motivation of the acquiring firm.

During the fourth movement of 1955 to 1968, many firms diversified itself into different markets or industries through conglomerate acquisition. The move was to spread the firms' risk over a number of markets. Lynch reported that, during this period, the number of acquisition increased steadily from 1,893 in 1965 to 2377 in 1967, 2,975 in 1967 and 7,000 in 1968. In their zeal of conglomerate expansion, the acquiring firms were less discriminate about the target companies' growth and profitability record.

The fifth and last movement saw more emphasis being placed on strategic planning of mergers and acquisitions by the acquirers. In their pursuits, the firms acquired other firms selectively to meet their strategies so as to extract the greatest benefits from the acquisitions.

Mergers and Acquisitions Activities in United Kingdom

United Kingdom also took on an unprecedented level of mergers and acquisitions activities after the mid-fifties. Singh (1971) reported that in the period of 1948-53, there were only 56 acquisitions, the number increased drastically to 405 in the following period of 1954-60. Thus, a total of 461 acquisitions took place during this period of 1948-60 representing 25% of the total number of public listed companies at that time. Kuehn (1975) observed that the United Kingdom's mergers and acquisitions boom appeared to take-off in 1959-60. During the period of 1957-69, there were 1,554 acquisitions and this represented 43.4% of the 3,566 public listed companies of the same time. The yearly number of acquisitions fluctuated slightly between 1957 and 1966 but increased rapidly in 1967 and reached its peak in 1968 with 240 acquisitions.

Studies on Mergers and Acquisitions

Studies of mergers occuring in the period from 1955 to 1965 tended to produce a uniform picture of merger targets as relatively unprofitable, sluggish, over-liquid firms, often with a history of static or declining earnings and dividends. In general, these are the findings of Hayes and Taussig (1967) with respect to takeover bids in the United States in the period 1957 - 1966 and of Ajit Singh (1971) in the period 1954 - 1960 in the United Kingdom. These findings opened the possibility that many, perhaps most, merger targets were "potentially failing firms," and to the view of mergers as an efficient alternative to bankruptcy.

Boyle (1970) explored largely this possibility. He studied 698 of the 1,275 acquired firms involved in large acquisitions over the period 1948-68 for which complete financial data were available for the five years preceding the acquisitions. He showed that few were suffering losses, and that on the average acquired firms were only slightly less profitable than all other firms. Moreover the firms acquired by conglomerate acquirers were among the more profitable and were the ones for which their rates of return were growing. His study effectively refuted the hypothesis of mergers as a response to impending bankruptcy. This finding has received repeated support from other samples. The United States Federal Trade Commission Report (1972), studying the 1960-68 acquisitions of nine leading conglomerate acquirers, found that the majority of target companies earned profits in the period before acquisition, even though they were somewhat below average for their industries.

In Denis Binder's (1973) study which covered the1960s, he found that while target firms records profitability lower than their control during the first half of the decade, the target companies in the period 1965-69 were relatively more profitable. In particular, they had relatively high price-earnings ratios which averaged at 18. This is within the range that Wall Street analysts of the period regarded as showing respectable prospects of future growth and profitability and thus suggests that during the late 1960s targets were not generally sluggish, unprofitable and unpromising companies.

The relevance of these findings for a "real efficiencies" hypothesis is subsequently explored by Brian Hindley (1970) who shed a different, but not contradictory light on the question that mergers are motivated by profit opportunities arising from takeovers of inefficiently run firms. His hypothesis led him to focus on mergers where incumbent managements of the targets have opposed the merger. His sample concerned 49 contested takeovers in the period 1958 and 1963 which were compared with composite controls, formed by taking the average of firms with similar product mixes. His principal finding was that an index of the "ineffectiveness of the incumbent managements" was very much higher for the targets than for the controls, and thus provided support for the hypothesis that mergers were transactions in the market for corporate control.

The studies of Hayes and Taussig, Singh, Binder, and others cited above tend to show acquiring firms to be somewhat above average in profitability, with a tradition of retaining and reinvesting profits rather than paying large dividends, and with having less than average liquidity. Binder (1973) in particular found that they had lower than average profit margins on sales and higher than average profit margins on assets. One might also have expected active acquirers to have well above average price-earnings ratios, but a study by Steiner (1975) on price-earnings ratios of all acquirers in the Federal Trade Commission's sample of 1,099 large acquisition during the decade of 1960s, while not inconsistent with this hypothesis, failed to show a significant consistent pattern.

Ansoff et al. (1971) found an interesting difference between acquirers who had slow growth rates before they embarked on acquisition behaviour and those who had rapid growth, in the earlier part of their twenty-year study period. The former appeared to be weaker than average and thus embarked on acquisition in response to poor performance; the latter were at or above the average and were judged to be motivated by aggressive managements rather than poor performance.

Thomas Hogarty (1970) studied 43 heavily merging firms over the period 1953-64. Heavily merging firms were defined as those that acquired (in aggregate) assets of at least 20 percent of their pre-acquisition levels. As a control for each such firm, he used the average of the industry of the acquirers. His performance measures relied both on the prices of stock and also on dividend policies. Hogarty found most of these firms did not generate stock market performance for their stockholders that was better than the average firm of their industries, and many performed worse. There were however great variance, and a few were enormously successful. Hogarty concluded by suggesting that despite the typical poor performance of merging firms, the few enormously successful ones may have made the whole pattern justified on an expected value criterion.

The study by Meek (1977), on the profitability of mergers in United Kingdom, comprises 233 public companies involved in merger activities. He found that except for the first year after the merger, the average profitability of the merging firms declined in all the years thereafter, up to the seventh year. The difference in the first year profitability was due to the fact that the full effects of merger do not make an immediate impact on the firms profitability and any effect of corporate reorganisation will only be reflected in the firms accounting record of subsequent years.

Weston and Mansinghka (1971) compared 63 conglomerate companies with two control groups randomly selected from among the Fortune 500 industrial and 250 non-industrial companies. Their data covered the periods 1958-68 and 1960-68 and thus they avoided the disadvantage of the preceding studies, which were limited to data for a period before the great merger wave of the late 1960s. They concluded that the greater than average relative growth of acquirers reflected merger activity rather than greater internal growth. This greater growth, contrary to earlier studies, extended to stock prices. They believed that earlier studies suffered from a too-early termination date. They also found that the earnings performance on net worth of conglomerates were somewhat higher than the control groups, even though the actual differences in earnings were small. They attributed this to the increased use of debt financing. They also reported that the earnings of the conglomerates at the start of the period were lower than those of controls but by 1968 they had become not significantly different. Weston and Masinghka concluded that the conglomerates' economic success was in raising the profitability of firms with depressed earnings to the average of the industry in general.

Lev and Mandelker (1972) studied 69 matched pairs of firms covering the period 1952-63. Their focus, however, was on major mergers rather than on heavily merging firms. Each acquiring firm was matched with a firm from the same industry with similar asset size. Profits and other measures were computed for a period of five years prior to the mergers and five years after. In contrast to the earlier studies but consistent with Weston and Mansinghka (1971), Lev and Mandelker (1972) found that acquiring firms were somewhat more profitable than the nonmerging partners, in terms of stock market performance. Additionally, they found that merging firms did not appear to reduce the variance of the combined companies' stock relative to the stock of the control firms. Thus, they argued against stockholder risk reduction as an important motive of mergers.

On the Malaysian scene, Cheng (1987) sampled 40 firms involved in the mergers and acquisitions activities. He studied the post acquisition earnings per share, price earnings ratios and market price of the combining firms to evaluate the benefits, if any, accrued to the shareholders directly from the merger. He reported that the earnings per share and stock price of the combined company increased after the acquisition.

Kamal Adzam (1987) reported that takeover activities did not result in any net gain to either acquirers or acquirees relative to non-participating firms. He inferred that takeovers in Malaysia between 1976-1982 was a logical and attractive opportunity for corporate growth in the interest of efficient allocation of resources. The acquirers had sufficient internal cashflow and access to capital market to support the acquisitions and growth of the acquired firms. The acquirers sought target firms that showed poor growth but were relatively liquid and undervalued. The characteristics of these target firms suggest that they were inefficiently managed, and were moribund with low cashflow and under utilised assets.

Conclusion

Despite numerous empirical studies on the the benefits of mergers and acquisitions to the participating firms, the findings has thus far been inconclusive. However, if one accepts the assumption that stockholders wealth maximisation is the ultimate objective, one would intuitively expect a well considered mergers and acquisitions to produce net benefits gains for the participating firms. If there is no gain in benefit from undertaking an acquisition, there is no motivation for the acquiring firms to undertake such an investment, let alone paying a premium price for the target firms in general. We can thus safely say that if the participating firms decline in performance and profit in the post-acquisition years, then the mergers and acquisitions have "failed".

Much of the studies measured the post-acquisition performance of both the acquiring and acquired firm combined together. In many instances, the assets of the acquired firm may only represent a small portion of the combined assets of the participating firms. Any real improvement in performance of the acquired firm after the acquisition may be over-shadowed by the general performance of the acquiring firm itself. In order to investigate the performance of acquired firm under the new owner and / or management after the acquisition, we should then concern ourselves with the financial performance of the acquired firm alone. It is the purpose of this study to test the hypothesis that the financial performance of the acquirees (generally viewed as less profitable and less efficient) can be improved under the new ownership and management.