

Chapter II

THEORETICAL BACKGROUND

Acquisitions are capital investment decisions by the acquiring firm. It involves the purchase of assets (in this case, a company) to enhance profits of the acquiring companies. The expected benefits of the acquisition are the incremental cash flows generated by the combination of the previously independent firms as a result of synergistic gains in operating, financial and management.

The costs of acquisition should include the cost of search, negotiating and the actual amount paid to shareholders of target firm. The net present value (NPV) of the decision represents the expected returns to the shareholders of acquiring firm. Although this procedure is a fundamental principle in valuing M&A, sometimes it can be misleading because of errors in estimating cashflows. The more practical and realistic way is to start with the target's stand-alone market value and concentrates on the changes in cashflow that would result from the merger. Emphasis should be on why the two firms should be worth more together than apart. The acquiring firm should also consider why the target is worth more to him than the other bidder.

Empirical research have found that acquisitions,

takeovers and mergers do generate positive gains for the participating firms. In Malaysia, empirical results researched by Mansor and Lim (1993), Mansor and Yap (1990) and Fauzias (1993) are consistent with previous studies done in U.S.A.

Hypothesis of Acquisition Motives

There are a number of hypothesis on the motives of acquisition. Two of the more supported hypothesis are as follows.

1. **Information effect hypothesis:-** It refers to an upward revelation of target share prices due to the dissemination of new information during takeover announcements. There are two schools of thought for this hypothesis. First, it argues that the assets of the target firm were not being utilize effectively prior to the announcement. The announcement signals positive information to the market about the true value of target firm's share prices. The information is that target firm is undervalued at that state of operation and shareholder's wealth can be improve if inefficiency is eliminated. This situation has been labelled by Bradley, Desai, and Kim (1983) as the "sitting in a gold mine" hypothesis. The second school of thought assumed the target firm's

management resists takeover and strives to improve its firm's performance. The target firm's management is inspired to manage more efficiently than before the takeover threat. The information effect hypothesis is also related to synergistic motives for mergers and takeovers. If market believes that the acquiring firms possesses inside information on the target firms, the potential value of the offer would be reflected to both the acquiring as well as the target firms.

2. **Synergistic gains hypothesis:-** This hypothesis implies that the combination of two firms may result in a combined net gain that is more than the sum of the value of previously independent firms. If synergism occurs, the value of the combined firm V_{ab} , exceeds the value of the individual firms brought together by the takeover such that

$$V_{ab} > V_a + V_b$$

Synergies may arise from the combining of differential efficiencies in the acquirer and the target firms. Thus if the management of the acquiring firm is more efficient than the management of the target firm, and if after acquisition, the inefficient target is made as efficient as the efficient firm, than overall efficiency has been

increased. This would be reflected in a combined net gain. Synergies may also arise from economies of scale enjoyed by merged firms. Economies of scale may be achieved through saving in "indivisibilities" such as fixed overhead when production increases. This situation will generate cost advantages that can make the firm more competitive.

The acquisition exercise provides redeployment of excess cash held either by acquirer or the target. This better utilisation of financial resources may derive from risk reduction that resulted from diversification. The risk reduction in turn leads to lower cost of capital which translates into lower capitalisation rate and higher profitability.

CHAPTER III

METHODOLOGY

1. Data Collection

All information that described the events of the tussle were summarised from news reports, business magazines and corporate letters to KLSE. The daily returns of the firms, Composite Index (CI) and event information were obtained from the Kuala Stock Exchange Library. The events covered were from June 1991 until May 1994.

The Kuala Lumpur Composite Index was used as a proxy for the market return. Pre-event daily returns (from trading days -250 to trading day -50 before the announcement date) are used to derive the parameters of market model. The market model parameters are computed using Ordinary Least Square (OLS) regression of security returns on market returns. The "press date" is chosen to be the date of first public announcement of acquisition.

2. ESTIMATION OF DAILY RETURN

The holding period formula is used to derive the daily raw return for security i :-

The market model used to analyse the expected rate of return of a security is given by:-

$$R_{1t} = a_1 + b_1 R_{mt} + e_{1t}$$

Where:

R_{1t} = rate of return on firm 1, period t.

R_{mt} = realised return on market index, period t.

a_1, b_1 = Ordinary Least Square parameter estimates.

e_{1t} = Stochastic error term which meets the assumption of the linear regression model.

The abnormal return to the security 1 for period t is

$$A R_{1t} = R_{1t} - (a_1 + b_1 R_{mt})$$

where R_{1t} is realized daily raw return for security 1.

The abnormal return reflects the unanticipated percentage changes in future uncertain opportunities. Thus it means that abnormal return can be unambiguously interpreted when uncertain events becomes certain.