MASTER IN BUSINESS ADMINISTRATION

MANAGEMENT CENTER
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

PERFORMANCE CHANGES AND SHAREHOLDER WEALTH CREATION ASSOCIATED WITH MERGERS - EVIDENCE FROM SELECTED PUBLICLY TRADED ORGANISATIONS IN MALAYSIA

BY :

WONG CHEE KONG

الجامعة الاسلامية العالمية ماليزيا

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

اونيۏرسيتي اسلام انتارابڠسا مليسيا

Performance Changes and Shareholder Wealth Creation Associated with Mergers - Evidence From Selected Publicly Traded Organisations In Malaysia

Wong Chee Kong
(G 9510162)

MBA Project Paper

Submitted to the Management Centre
International Islamic University Malaysia

In Partial Fulfilment of the Requirements
for the degree of Masters Of Business Administration

1997

APPROVAL

CANDIDATE NAME :

WONG CHEE KONG (G 9510162)

TITLE OF PROJECT PAPER :

PERFORMANCE CHANGES AND SHAREHOLDER WEALTH CREATION ASSOCIATED WITH MERGERS - EVIDENCE FROM SELECTED PUBLICLY TRADED ORGANISATIONS IN MALAYSIA

The undersigned certifies that the above candidate has fulfilled the conditions of the project paper prepared in partial fulfilment of the requirement for the Masters of Business Administration (MBA)

Supervisor

DR. OBIYATHULLA ISMATH BACHA

Date : 31 December 1997

TABLE OF CONTENTS

ACKNOWLEDGEMENT .... **i**

ABSTRACT .... **ii**

1. INTRODUCTION **1**

1.1 Merger and Acquisition Defined 1

1.2 Reasons For Merger And Acquisition 3

1.3 The Legal Framework 5

1.4 Theories Behind Merger and Acquisition 7

2. OBJECTIVE AND MOTIVATION FOR STUDY **10**

3. LITERATURE REVIEW **12**

3.1 Studies on Stock Returns 12

3.2 Studies On Performance Changes Based On Accounting Data 15

4. SAMPLE AND DATA **17**

4.1 Merger Samples 19

4.1.1 Advance Synergy Berhad & United Merchant Group Berhad 20

4.1.2 Lingui Developments Berhad & Glenealy Plantations (Malaya) Berhad 21

4.1.3 Malaysian Helicopter Services Berhad & Malaysian Airline System Berhad 22

4.1.4 Malaysian Mosaics Berhad & The East Asiatic Company (Malaysia) Berhad 23

4.1.5 Malaysian Resouces Corporation Berhad & The New Straits Times Press (Malaysia) Berhad and Sistem Televisyen Malaysia Berhad 24

4.1.6 Nanyang Press (Malaysia) Berhad & Life Publishers Berhad and The China Press Berhad 25

4.1.7 Renong Berhad & Park May Berhad 27

4.1.8 Diversified Resources Berhad & Gadek (Malaysia) Berhad 28

TABLE OF CONTENTS

5. **METHODOLOGY 30**
   - 5.1 Profitability, Efficiency And Balance Sheet Measures 30
     - 5.1.1 Defining Performance Measures 30
     - 5.1.2 Measuring Performance Changes 33
   - 5.2 Valuation Of Firm 35
   - 5.3 Event Study of Stock Market Return 38

6. **EMPIRICAL RESULTS 41**
   - 6.1 Mean Performance Changes Analysis Of Mergers 41
     - 6.1.1 Changes In Performance Measures 42
     - 6.1.2 Changes In Value Of Firm 45
     - 6.1.3 Market Reactions To Merger Announcements 46
   - 6.2 Cross-Sectional Behaviour Analysis Of Mergers 51
     - 6.2.1 Relative Size Of Target To Acquirer 52
     - 6.2.2 Premium Paid In Acquiring Target 55
     - 6.2.3 Purchase Consideration 56

7. **CONCLUSION 58**

8. **IMPLICATIONS AND SUGGESTIONS FOR FUTURE RESEARCH 61**

Appendix 1. References

Appendix 2. Merger

Appendix 3. Organisation's Financial Data

Appendix 4. Stock Price Reaction To Merger Announcement

Appendix 5. Cross-Sectional Analysis

ACKNOWLEDGEMENT

I would like to take this opportunity to extend my appreciation to the various parties that have helped in one way or another in the information gathering process during the initial stages of the preparation of my project paper, without which will be an impossible task. Special thanks go to En. Mohd Noor Abdul Rahim, Takeovers and Mergers Department of Securities Commission and Mr. Russ Arensman of Asia Inc. Hong Kong.

I would like to express my sincere thanks to my supervisor, Dr. Obiyathulla Ismath Bacha for providing me the guidance, constructive ideas and encouragement through out the preparation of this project paper. It has been an extremely worthwhile experience although it meant working on the project paper through crazy hours during the nights, wee hours in the morning and over all weekends, amidst my packed working schedule.

Special thanks also goes to the IIUM Management Centre for their professional ways in scheduling and co-ordinating the stages of work relating to the submission of the project paper.

Lastly, I would like to extend my greatest thanks to my wife, my parents and my parents-in-law for tirelessly taking over the many family responsibilities, especially caring for my first child which my pursuit on the MBA programme has forced me to neglect.

ABSTRACT

The objective of the study was to analyse the performance changes and shareholder wealth creation associated with selected mergers of public limited organisations in Malaysia over the period of 1990 - 1995. The key feature of the study was the use of three different methods in analysing the performance changes and shareholder wealth creation and to determine if these methods yield consistent implications regarding any gains achieved.

The study found that mergers do not create performance improvements and shareholder wealth in the short-term. Any merger related gains can only be realised in the longer term as mergers are long-term business investments.

In the cross-sectional analysis, the study found that selected variables (e.g., target size and premium paid for target) are correlated with performance changes but found no correlation between such variables with abnormal returns. This findings tend to point to the fact that specific factors can influence the merger outcome and that market expectations are unrelated to subsequent merger-related gains.

1. INTRODUCTION

Over the last decade, the Malaysian corporate world has experienced an unprecedented level of consolidation as mergers and acquisitions (M&A) have taken place at record levels, despite the subdued stock market. For instance, in 1994 domestic Malaysian deals accounted for nine of the 50 largest transactions in the Asian region, worth a total of US$2.27 billion. In the more recent time-frame, M&A activities became more significant with the Malaysian government encouraging mega-mergers with the aim to create stronger and more efficient organisations that are capable to compete globally, envisaged under the General Agreement on Trade.

1.1 Merger and Acquisition Defined

The term acquisition is used to describe any transaction in which a buyer acquires all or part of the assets and business of a seller, or all or part of the stocks or other securities of a seller. Within the general terms of acquisition, there are five basic legal procedures that one firm can use to acquire another firm, i.e., merger, consolidation, acquisition of stock, acquisition of assets and takeover. Although these forms are different from a legal standpoint, the financial press frequently does not distinguish between them. The term merger and acquisition (M&A) is often used regardless of the actual form of the acquisition.

A merger refers to the complete absorption of one firm by another. The acquiring firm retains its name and its identity, and it acquires all of the assets

and liabilities of the acquired firm. After a merger, the acquired firm ceases to exist as a separate business entity.

A consolidation is the same as a merger except that an entirely new firm is created. In a consolidation, both the acquiring firm and the acquired firm terminate their previous legal existence and become part of a new firm. For this reason, the distinction between the acquiring and the acquired firm is not as important in a consolidation as it is in a merger.

An acquisition of stock is a transaction in which all or part of the outstanding stocks of the seller are acquired from the stockholders of the seller while an acquisition of asset is an acquisition in which the buyer acquires all or part of the assets and business of the seller.

A transaction is referred as a takeover whenever one group takes control from another. This can occur when the acquiring company acquires control over the assets of the target company, either directly or indirectly through control of either the voting rights or the management of the latter.

The terms merger and acquisition are used interchangeably in this paper regardless of the actual form of the acquisition.

In addition, this paper refers to the acquiring organisation as the acquirer. This is the organisation that will make an offer to distribute cash or securities to obtain the stocks or assets of another company. The organisation that is acquired is called the target organisation. The cash or stocks offered to the target organisation are the consideration in the acquisition.

1.2 Reasons For Merger And Acquisition

Although there are many reasons that have been quoted by organisations involved in M&As, these reasons can generally be categorised into six major categories that primarily aim to achieve an increase in revenue and reduction in costs.

a. Synergies

One important reason for M&A is that the combined organisation may generate greater revenue than two separate organisations. Increases in revenue may come from marketing gains, strategic benefits and increases in market power in addition to cost reduction from reduced duplication.

b. Economies of Scale

Economies of scale relate to the average cost per unit of producing goods and services. If the per unit cost of production falls as the level of production increases, then an economy of scale exists. Frequently, the phrase "spreading overhead" is used in connection with economies of scale. This expression refers to the sharing of central facilities such as corporate headquarters, top management and computer services.

c. Economies of Vertical Integration

Operating economies can be gained from vertical combinations as well as from horizontal combinations. The main purpose of vertical acquisitions is to make co-ordination of closely related operating activities easier. For example, benefits from vertical integration are probably the

reason that most forest product organisations that cut timber also own sawmills and hauling equipment.

d. Complementary Resources

Some organisations acquire others to make better use of existing resources or to provide the missing ingredient for success.

e. Elimination of Inefficiencies

There are organisations whose value could be increased with a change in management. These are organisations that are poorly run or otherwise do not efficiently use their assets to create shareholder value. In such case, M&As are means of replacing inefficient management.

f. Lower Taxes

Tax gains often are powerful incentives for some acquisitions. The possible tax gains from an acquisition include :

i. Use of tax losses

ii. Use of unused debt capacity

iii. Use of surplus funds

iv. Ability to write-up the value of depreciable assets.

The fervour of M&A is based on the belief that gains can be accrued through the above mentioned reasons. However, whether or not M&A actually achieve the expected performance gains is the critical question. If M&A does in fact lead to performance gains, then shareholder wealth can be increased. On the

other hand, if difficulties in M&A entities are sufficiently great, then M&A may lead to a less profitable and valuable industry.

1.3 The Legal Framework

A takeover occurs when an organisation or person (the acquirer) acquires voting control in relation to another organisation (the target organisation). In Malaysia, takeovers are regulated by Section 33 of Securities Commission Act, 1993 and by a non-statutory Code known as the Malaysian Code on Takeovers and Mergers, 1987 made under the Companies Act.

After the establishment of the Securities Commission (SC) in 1993, the regulatory structure of corporate acquisitions has been much simplified. A takeover proposal invariably requires the approval of the Securities Commission and the Foreign Issue Committee (FIC), aside from the approval of the shareholders. Section 179 of the Company Act, 1965, provides for the appointment of a Panel on Takeovers and Mergers to administer, supervise and control takeovers and mergers. It is further provided that the Panel may prepare a code, i.e., Code on Takeovers and Mergers containing general principles and rules to be complied with by firms involved in a takeover and merger. In addition, where the target organisation's shares are quoted on the Kuala Lumpur Stock Exchange (KLSE), the provisions of the Stock Exchange Listing Manual regarding takeovers must also be complied.

Under the Securities Commission Act, a takeover means an acquisition of shares in an organisation which, when aggregated with shares already held by the acquirer, would give the acquirer the right to exercise or control the exercise of

more than 33% of the voting right of that company. Rule 34 of the Code provides that if a purchaser acquires 33% or more of the voting rights of a company, then the acquirer is obliged to make an unconditional offer for the company's remaining equity. This kind of offer is termed a "general offer".

The Code sets down the procedure to be followed in the event of such general offer. In this regard, Rule 34 is the most difficult and controversial of all the Rules of the Code and it has important impact on takeovers. It increases the costs of the acquisition, as well as the uncertainty of success. The Code requires confirmation by the acquirer's merchant bank or other independent financial adviser to ensure that sufficient financial resources are available to the acquirer to satisfy possible full acceptance of the general offer. Since a mandatory offer is a costly exercise, it is not uncommon for an acquirer to announce that an acquisition of shares in the target is conditional on a waiver being granted by the takeover panel from making a mandatory general offer.

In addition to the Securities Commission approval, the proposal also has to obtain approval of the FIC. The FIC was formed on 29 February 1974 to formulate policy guidelines, supervise and advise Ministries and Government agencies on all matters concerning investments in Malaysia and to examine, among other things, proposals for acquisition of assets or any interests, mergers and takeovers of companies and business in Malaysia in the light of the objectives of the New Economic Policy. The operating guideline is contained in the "Guidelines for Regulation of Acquisition of Assets, Mergers and Takeovers" (1989) published by the Economic Planning Unit of the Prime Minister's Department. The FIC Guidelines require that the proposed merger or takeover

should result in a more balanced Malaysian participation in ownership and control and they should lead to net economic benefits in relation to matters such as the extend of Malaysian participation. In relation to takeovers, the FIC Guidelines will apply for any proposed takeovers of assets or interests exceeding in value of the sum of RM 5 million, whether by Malaysian or foreign interest.

Apart from the statutory and non statutory controls above, takeover activity or mergers and acquisitions are also subject to the approvals of the relevant regulatory bodies in which the participating organisations are in, e.g., the Ministry of International Trade and Industry, the Ministry of Finance, the Bank Negara Malaysia, the Director General of Insurance and the Registrar of Companies.

1.4 Theories Behind Merger and Acquisition[1]

There are several theories which can explain takeover motivation and why takeover should bring benefits to parties involved [Copeland and Weston (1988), Weston and Chung (1983)]. Two of the theories that have gained considerable support are the synergistic gains hypothesis and the information effect hypothesis [Isa and Lim (1993)].

The synergistic gains hypothesis of corporate acquisitions imply that the combination of two organisations may result in a combined net gain that is more than the sum of the pre-acquisition value of the individual organisations, i.e.,

V^{post}_{merged} is greater than $V^{pre}_{acquirer} + V^{pre}_{target}$.

[1] See:, Isa & Lim, "Share Price Behaviour Around Acquisition Announcement", Capital Markets Review, Volume 1, No. 2, 1993

The achievement of synergies through corporate acquisitions may be due to several reasons as mentionded in Section 1.2. Synergies may arise from the combining of differential efficiency in the acquirer and the target organisations. Thus, if the management of the acquiring organisations is more efficient than the management of the target organisation, then overall efficiency could be increased. This would be reflected in a combined net gain. Synergy may also arise if the target organisation, is simply inefficiently managed and therefore not performing up to its potential. If it is acquired, the acquiring organisation may be able to manage the inefficient organisation's asset better.

Synergies may also arise from economies of scale enjoyed by combining organisations. Basically, economies of scale involve "indivisibilities" such as people, equipment and overhead, which provide increasing returns if spread over a large number of units of output. Known as operating synergies, it assumes that prior to the combination, the organisations are operating at levels of activity that fall short of achieving economies of scale. The combination of these organisations can also lead to financial synergies which can be brought about by lower costs of capital as a result of reduced risk of bankruptcy.

The second of the two theories, i.e., information effect hypothesis refers to an upward revaluation of target's share prices due to the dissemination of new information during takeover announcements. There are two arguments for this hypothesis. The passive view says that the upward revaluation of target share prices is only a consequence of under-valuation by the market prior to takeover announcements where the true value was never discovered until the target begins to attract market attention in takeover bids. This situation has been labelled by

The achievement of synergies through corporate acquisitions may be due to several reasons as mentionded in Section 1.2. Synergies may arise from the combining of differential efficiency in the acquirer and the target organisations. Thus, if the management of the acquiring organisations is more efficient than the management of the target organisation, then overall efficiency could be increased. This would be reflected in a combined net gain. Synergy may also arise if the target organisation, is simply inefficiently managed and therefore not performing up to its potential. If it is acquired, the acquiring organisation may be able to manage the inefficient organisation's asset better.

Synergies may also arise from economies of scale enjoyed by combining organisations. Basically, economies of scale involve "indivisibilities" such as people, equipment and overhead, which provide increasing returns if spread over a large number of units of output. Known as operating synergies, it assumes that prior to the combination, the organisations are operating at levels of activity that fall short of achieving economies of scale. The combination of these organisations can also lead to financial synergies which can be brought about by lower costs of capital as a result of reduced risk of bankruptcy.

The second of the two theories, i.e., information effect hypothesis refers to an upward revaluation of target's share prices due to the dissemination of new information during takeover announcements. There are two arguments for this hypothesis. The passive view says that the upward revaluation of target share prices is only a consequence of under-valuation by the market prior to takeover announcements where the true value was never discovered until the target begins to attract market attention in takeover bids. This situation has been labelled by

Bradley, Desai and Kim (1983) as the "sitting on a gold mine" hypothesis. The active view, on the other hand, holds that the target organisation's management is inspired to manage the organisation more effectively than before, in view of the real takeover threat. It implicitly assumes that target's management resists takeover, and strives to improve its organisation's performance.

The information effect hypothesis is also related to synergistic motives for mergers and takeovers. If the market believes that the acquiring organisations possess inside information on target organisations, the potential value of the offer would be reflected on both the acquiring as wells as the target organisations.

2. OBJECTIVE AND MOTIVATION FOR STUDY

Most academic studies follow one of two distinct approaches to evaluating merger-related gains. The first approach compares the performance of organisations, based on accounting data, before and after the merger to determine whether consolidation results in gains [DeYoung (1993), Berger and Humphey (1992), Linder and Crane (1992) and Chamberlain (1992)]. By comparing pre-merger and post-merger data, performance changes can be directly estimated, as the difference in appropriately adjusted performance measures the effect of the merger. The drawback of these studies, however, is that the results are driven by accounting data which are based on historical figures and often neglect current market value.

The second approach to analysing merger benefits is to evaluate the stock market reaction to merger announcements [Isa (1994), Fauzias (1993), Isa and Lim (1993), Yap (1990), Bradley, Desai and Kim (1983, 1988), Asquith (1983) and Asquith, Bruner and Mullins (1983)]. This measure quantifies the value creation which the market believes the merger will provide. These studies have the benefit of not relying on potentially misleading accounting data. However, they are based solely on market expectations and do not address the issue of actual gains resulting from mergers. It is also noted that all studies that have been conducted on the Malaysian M&A market have been based on this approach.

The objective of this paper is to analyse the performance changes and shareholder wealth creation associated with mergers by combining both approaches found in the literature and the addition of another approach, i.e., the

valuation of firm approach by examining whether all three results, i.e., accounting data, market data and firm's intrinsic value yield consistent implications regarding the gains achieved. In addition to analysing average performance changes and abnormal returns, this paper extends the analysis by examining the cross-sectional behaviour of these measures, as well, to determine the ability of certain pre-merger variables related to the size, industry, and operating performance of merging institutions to explain variation in both accounting outcomes and abnormal returns. Variables which are correlated with performance changes can be interpreted as those factors which influence merger outcomes, while variables which are correlated with abnormal returns can be interpreted as those factors which market expects to influence merger outcomes. Finally, the paper examines the market's ability to accurately forecast performance improvements by directly measuring the relationship between results based on accounting data and abnormal returns. The detail and rigorous analysis of selected merger samples makes an interesting study of the Malaysian M&A market which is undergoing continuous merger activities, e.g., in the financial services industries.

3. LITERATURE REVIEW

Many empirical studies have been undertaken to examine whether acquisitions, takeovers and mergers are gainful exercises to the participating organisations. Most of these studies have adopted the event study of stock returns associated with mergers while very few studies have adopted the comparisons of performance based on historical accounting data before and after merger. There has not been any extensive studies on mergers that have been done based on the firm value approach, i.e., the method that evaluates the intrinsic value of the organisation before and after a merger.

3.1 Studies on Stock Returns[2]

Many empirical studies have been published concerning shareholder wealth associated with mergers. The findings of these studies consistently reveal significant positive stock price reactions for target organisations around the announcement date of a merger. The conclusions concerning price reactions for acquirers have not been consistent.

In a comprehensive summary article, Jensen and Ruback (1983) reviewed 13 studies on mergers and acquisitions that include, among others, Asquith (1983), Asquith, Bruner and Mullins (1983), Bradley, Desai and Kim (1983), Malatesta (1983), and Ruback (1983). They concluded that takeovers and mergers do generate positive gains for the participating firms. While the division of gains between the target and bidders is not equal, on the whole, the authors are

[2] See:, Isa, "Reverse Takeover in Malaysia", July 1997

satisfied that "targets gain and bidders do not appear to lose". Although researchers are generally in agreement that target shareholders enjoy significant premiums, evidence on the returns to acquiring firm shareholders are less certain and sometimes conflicting.

Bertin, Ghazanfari, and Torabzadeh (1989) and James and Wier (1987) conducted a study on samples of 33 acquirers for the period 1982 - 1987 and 19 acquirers for the period 1973 - 1983 and concluded that acquiring organisations underbid for targets, thus, receiving positive abnormal returns for the periods of their studies. They examined a 20-day period following the announcement but did not find evidence of negative returns. However, Pettway and Trifts (1985) conducted a similar study but concluded that organisations that overbid, results in losses to their shareholders. They found significant positive returns for the period 10 days prior to the announcement, but these results were cancelled out by significant negative returns for the 50-day period following the announcement.

In the Bradley, Desai and Kim (1988, 1983) studies, they found that successful tender offer increases the combined value of the targets and acquirers. They also provided empirical evidence that competition among bidders decreases returns to acquirers while increases returns to targets. They also presented evidence that government regulations have no impact on the total synergistic gains created, but have significantly affected the division between the stockholders of targets and acquirers.

Maletesta (1983) examined price behaviour on two merger event dates, i.e., the announcement date and the outcome date. His results showed that targets' price reaction to the announcement of merger was significantly positive, in both

pre- and post-announcement periods. For acquiring firms, returns for pre-announcement period are not significantly different from zero while post-announcement period are significantly negative. However, at the announcement of the board approval, the cumulative returns for acquiring organisations dropped, whilst the acquired organisation experienced a price appreciation.

In the Malaysian environment, very few empirical studies have been conducted on acquisitions, takeovers and mergers of public listed companies in Malaysia. Isa and Lim (1993) studied the stock price behaviour around acquisition announcement, and spilt the sample into successful and unsuccessful acquisitions. They conducted a study on 53 organisations, with 19 unsuccessful transactions and 34 successful transactions during the period of 1984 - 1989. They found that, around the announcement date, the successful target organisations gain positive abnormal returns in the 20-day pre-announcement period, but lose them all in the 20-day post-announcement period. However, the unsuccessful targets, who gained even more than the successful targets in the pre-announcement period, do not lose in the post-announcement period. They also found that at the outcome date (upon the announcement of the approval of the last of the approving bodies, which is normally the Extraordinary General Meeting), the successful targets do not gain or lose, but the unsuccessful targets tend to lose. Generally, they found that acquisition activities create positive gains, most of which go to the target companies.

Another significant research was done by Fauzias (1993) who has adopted a few models in computing abnormal returns in her study, i.e., the market model, unconstrained Capital Asset Pricing Model (CAPM) and constrained CAPM. In

all her models, she found that both targets and acquirers received significant gains around the announcement day, and that the gains to targets are greater than the acquirers. In addition, Isa (1994) conducted a study that found the market prefers cash offers to share exchange offers.

3.2 Studies On Performance Changes Based On Accounting Data

No major study has been conducted based on this method in Malaysia. In addition, most studies conducted overseas with this method have been focused on specific industries (e.g., banking industry) as these studies aim to provide an in-depth analysis of the performance changes.

Berger and Humphrey (1992) examined mergers occurring in the 1980's that involved banking organisations and concluded that the amount of market overlap and the difference between acquirer and target efficiency do not affect post-merger efficiency gains. In addition, they analysed the return on assets and total costs to assets and reached a similar conclusion : no average gains and no relation between gains and the relative performance of acquirers and targets. DeYoung (1993) in another research found that benefits from mergers do not exist for 348 bank-level mergers taking place in 1986 and 1987. He found that in addition to the lack of gains, improvements are unrelated to the difference between acquirer and target efficiency. However, DeYoung found that when both the acquirer and target are poor performers, mergers result in efficiency gain.

Srinivasan and Wall (1992) employed standard corporate finance measures to analyse mergers. They examined all commercial bank and bank holding company mergers occurring between 1982 and 1986 and found that mergers do

not reduce non-interest expenses. Because this study focuses only on non-interest costs, they provide an incomplete picture of the cost savings associated with mergers.

In another study, Linder and Crane (1992) analysed the operating performance of 47 merger samples. They aggregated the acquirers and targets data one year before the merger and compared them to performance one and two years after the merger. They found that mergers do not result in improved operating income, as measured by net interest income plus net non-interest income to assets.