

THE EFFECT OF MERGERS AND ACQUISITIONS  
ON THE PERFORMANCE OF MALAYSIAN  
BANKING INSTITUTIONS: CASE STUDY ON BANK  
OF COMMERCE AND RHB BANK

ABSTRACT

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الجامعة الإسلامية العالمية ماليزيا  
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA  
بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

**THE EFFECT OF MERGERS AND ACQUISITIONS  
ON THE PERFORMANCE OF MALAYSIAN  
BANKING INSTITUTIONS: CASE STUDY ON BANK  
OF COMMERCE AND RHB BANK**

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## ABSTRACT

In many instances, mergers and acquisitions have no doubt resulted in the better use of resources and the greater efficiency, which can be achieved in larger units. With the current trend of rapid consolidation of the banking institutions in the global markets, especially in the United States and Europe to take advantage of economies of scale and tap potential synergies, Malaysia has no exception but to follow this trend to survive the challenges of the new millennium. Moreover with the conclusion of General Agreement of Trade in Services (GATS) and the continued pressure by the World Trade Organisation (WTO) to further open the local financial service market. As such, Bank Negara has to accelerate the consolidation process to ensure that the banking system is well positioned to meet the growing and changing demand of the economy.

Therefore the purpose of this study is to analyse the effect of mergers and acquisitions on the profitability and efficiency of the merging institutions through the approach of ratio analysis. This study focuses on the two mergers i.e. Bank of Commerce and RHB Bank. An overview of the financial industrial development, merger theories and the effect are also discussed. The results indicate that merger exercise indeed have favorable effects. The findings support similar study that was conducted by Vennet (1996) that mergers increase performance and exploits synergy.

## APPROVAL PAGE

**TITLE OF PROJECT PAPER: THE EFFECT OF MERGERS AND  
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OF MALAYSIAN BANKING INSTITUTIONS:  
CASE STUDY ON BANK OF COMMERCE  
AND RHB BANK**

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I hereby declare that this project paper is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by reference notes and a bibliography is appended.

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*Dedicated to my children*

*Abdul Rahman  
Abdul Hakim  
Aliya Hasanah  
&  
Anis Syafiqah*

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# CHAPTER 1

## INTRODUCTION

### 1.1 Introduction

The financial services industry is consolidating around the globe through mergers and acquisitions. They are occurring at a torrid pace in the United States, and may occur at a rapid pace in the near future in Europe under monetary union to create larger and better capitalized financial entities. However, in Asia, mergers and acquisitions are more of a solution to stay afloat. They are the continent's answer to its 1997 financial distress.

In Malaysia, banking merger and acquisition activities are not new. Commercial banks have begun to acquire financial companies since mid '60's. They merge with each other to complement their activities. They believe that mergers and acquisitions within the financial circumference to form alliances would create greater financial diversification, resulting in highly lucrative returns. Besides that, the formation of strategic alliances seems to be the most realistic step they have to take in order to face the increasingly fierce competitions.

As of now, the fever over financial mergers and acquisitions in Malaysia is rising due to financial crisis. The devaluation of the local currency, in particular, does have an

adverse effect on the banks because of their liabilities are in foreign currency. So is the foreign debt that is relatively small. Not forgetting a decline in stock market value also has a similar undesirable impact. Hence, banks need to obtain greater resources that include skills, technology, risk management and efficient distribution systems that could abstain from collapsing. Mergers are capable of providing these resources.

## **1.2 Types of mergers**

According to Green (1990), mergers are classified into three distinct types:

### **1.2.1 Horizontal mergers**

Horizontal mergers involve expansion into similar or related product lines. It leads to elimination of a competitor, increase in market share of the acquiring firm, and increase in degree of concentration of industry. The increased concentration generated by this process could lead to an inefficient pricing practice in the market if firms cooperate to set a price for a particular product or service.

### **1.2.2 Vertical mergers**

The vertical merger expands a firm's control into allied product lines. The acquiring company desires to increase its control over more sources of supply and distribution. A firm can expand vertically either forward or backward to integrate components into an existing business.

### **1.2.3 Conglomerate Mergers**

Conglomerate mergers are described as diversification into unrelated areas in order to reduce business risk and to increase the efficiency of distribution network.

### **1.3 Reasons for Bank Mergers**

It has been suggested that mergers and acquisitions are good for the economy as they entrust a company's assets to those who can manage them more efficiently. What more, they result in positive Net Present Value (NPV) projects that will increase shareholders' wealth. Sinkey (1983) stated that economies of scale as one of the most common motives for bank mergers. With optimum bank size being relatively small, opportunities for economies of scale are limited.

Merging has the potential benefits for the acquiring bank's shareholders to increase market share. To the extent that greater market share means greater monopoly power, thus the market could be exploited by the bank. Moreover the potential merger synergy is the opportunity to combine complementary resources or markets. For example, if the acquiring bank were operating in a market with strong loan demand but a shortage of funds while the acquired bank has surplus deposits, their marriage would be complementary one. The other reason is the possibility of eliminating inefficiencies in acquired banks through better operating and /or financial management.



Rose (1995) stated that the reasons for rapid growth of bank mergers are due to the following motives:

### **1.3.1 Profit potential**

Many mergers occur because the shareholders of the bank expected increased profit potential once the merger is consummated. If the acquiring organisation has more aggressive management than the banking firm it acquires, bank revenues may rise as markets are more fully exploited and new services developed. If the acquiring bank's management is better trained than the management of the acquired bank, the efficiency of the merged organisation may increase, resulting in more effective control over operating expenses.

### **1.3.2 Risk reduction**

Many partners to merger anticipate reduced cash flow risk and reduced earning risk. In an effort to broaden the menu of services offered to the public, they are motivated by the search for "complementarily" in services. In doing so, it will help to reduce the merging bank's risk exposure from relying upon too narrow a lineup of services. The merger can also help to diversify the merging banking organisation's sources of cash flow and earnings. This will lead to a more stable banking firm able to withstand wide fluctuations in economic conditions and in the competitive environment of the industry.

### **1.3.3 Rescue of failing banks**

One of the alternative ways to rescue a failing bank is through merger as it conserves the scarce reserves and avoids an interruption of customer services.

#### **1.3.4 Tax and market positioning motives**

Many mergers arise from expected tax benefits; especially where the acquired bank has earning losses that can be used to offset taxable profits of the acquirer. They may also be market- positioning benefits, in which a merger will permit the acquiring bank to acquire a base in a completely new market. Acquiring an existing bank rather than embarking into new banking firm with new personnel, will significantly reduced the cost of positioning in a new market. Alternatively, a merger may allow banks with different packages of services to combine their service menus, expanding the service options presented to their customers.

#### **1.3.5 Cost savings or efficiency motives**

Merger also illustrates the cost-saving or efficiency motives. The bank might achieve greater efficiency by consolidating operations and eliminating unnecessary duplication, thereby reduce operations costs and generate additional earning. Thus, instead of two separate planning and marketing programs, two separate auditing staffs, and so forth; the merged bank may be able to get by with just one. Existing resources may be utilized more efficiently if new production and service delivery methods are adopted, increasing the volume of services produced with the same number of inputs.

#### **1.3.6 Other motives**

Management may believe a merger will result in increased capacity for growth, maintaining the acquiring bank's historic growth rate. Moreover, a merger enables a bank to expand its loan limit to better accommodate corporate customers. This is particularly

important factor in market where the bank's principal business customers may be growing more rapidly than the bank itself.

On the other hand, studies on bank mergers found that the profitability of the merging banks was not significantly greater than that of non-merging banks (Smith, 1971; Hobson, Masten and Severeins, 1978). However, the performance of the merging banks was significantly different according to a number of accounting-based performance measures.

#### **1.4 Method of Consummating Merger Transaction**

Mergers are generally carried out using one of two techniques, i.e. purchase of assets (acquisition method) and purchase of stock method (pooling method). With the purchase of assets, the acquiring institution buys all or a portion of the assets of the acquired organization, using either cash or its own stock. In purchase-of-assets mergers, the acquired institution usually distributes the cash or stock to its shareholders in the form of a liquidating dividend and the acquired organisation is then dissolved. With some asset purchase deals, however, the institution selling its assets may continue to operate as a separate, but smaller, corporation.

As for the purchase-of-stock method, the acquired firm ceases to exist while the acquiring firm assumes all of its assets and liabilities. Cash may be used to settle either type of merger transaction.

## 1.5 Why Do Mergers Fail?

Although mergers provide many benefits, studies show that 70% of the M&A have failed. Kitching (1968) has his own idea and explanation on why do acquisitions fail. He stated that the causes could be summarized in five main points:

- Managers of change

The quality of management talent determines the success or failure of the venture, and it is at this time that careful planning allows the synergy potential to be released, if it is released at all.

An interesting finding by Kitching is that few top managers regard synergy is being inherent in a situation; most feel that synergy is a product or result of superior management.

- Skills for the task

The sum management skills must be greater than the joint management task. A common mistake is to underestimate the demands an acquisition will make on management time; executive erroneously believe that, because the target company is smaller than the acquirer, its problems will require proportionately less management time.

- Management relationships

The most successful acquisitions seem to be distinguished by proficient, competent and contemporary of control between the acquirer management and the target management.

- Effective criteria

A key factor for success is having acquisitions that are consistent and rigorously applied.

- Analysis of future needs

A failure to make careful analysis of their targets' future requirements may lead to negative effects. Statement of financial results of a number of the acquisitions must be compared with the returns projected as at acquisition time.

Dodd (1994) stated that there are usually more failures than successes in the acquisition game. Failures stem primarily from shortcomings in the assumptions that the acquirer makes of the acquired company. The reasons for success usually relate to companies that are well managed and have a good product or services, and where the existing shareholders have good reasons to relinquish their control.

Foong (1997) stated that there are four reasons why acquisitions failed. Factors that hinder the relation of the benefits of mergers and acquisition include:

- Misunderstood integration assumptions, objectives, task and priorities;
- Failure to manage customer and employees attrition risks proactively;

- Failure to communicate early, often, openly and consistently to all stakeholders; and
- Poorly managed integration programs resulting in missed deadlines and loss of momentum; failure to establish leadership and commit best people to the integration process.

Foong (1997) also added that a common reason for most failed acquisition is the obsession with the financial deal itself. Often, too little attention is paid to what happens next especially the complex business of integrating and fusing the technology, systems, business processes and operational cultures within the diverse organizations. Without clearly defined post-merger and post acquisition integration strategy to address the issues of creating harmony in the merging organization's diversity, the chances of successfully unlocking the synergistic value of the merged or acquired entity are slim.

Since bank merger and acquisition activities have attracted much attention especially in the United State and some other parts of the globe, it will be interesting to look into the local scenario. What is the track record of the Malaysian's bank mergers? What impact do they have on the public and upon bank stockholders? Hence, this study is then set to evaluate on the merger and acquisition activities that have taken place within the local banking industry in this decade.

## **1.6 Objectives of the Study**

The objective of this paper is to analyze the effect of mergers and acquisitions on the operational efficiency and profitability of the Malaysian banking institution in conjunction with the period of surrounding mergers and acquisitions that is two years before and after the merger event. In analysing the performance changes associated with mergers, the researcher will use ratio analysis based on accounting data. It is hoped that this study will complement the earlier works of researchers by demonstrating the extent to which empirical evidence of the prior study can be used to influence more future merger and acquisition activity. In addition, this paper will also study the background of the companies and the merger events.

## **1.7 Scope of the Study**

The analysis of this paper will focus on the merger between the Bank of Commerce (BCB) and United Asian Bank (AUB), an ailing bank under the care of BNM, and the merger between Development & Commercial Bank (DCBH) and Kwong Yik Bank Berhad (KYBB). Though the banking industry has experienced a hive of merger and acquisition activities over the decade, only these two mergers are chosen. The reason is simply because they were considered as genuine mergers, that is between two banking institutions.

In assessing the economic impact of the mergers, the performance of the participating banks will be analyzed in the period surrounding the event that is two years before and two years after the merger. Comparisons of pre and post-merger performance of the banks will be made. For the purpose of comparison, both the acquirers will be taken as control. The comparison allows testing the hypotheses of value maximizing motive that mergers and acquisitions may increase efficiency and that typical bank takeover involves a well-run acquirer taking over an under-performing target.

## 1.8 Definition of Terms

The following terms given are based on Dr. Fauzias Mat Nor (1996) in her book on Malaysian Mergers and Acquisitions.

**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 more specific forms of transactions, such as an asset acquisition, a stock acquisition, merger, consolidation and takeover.

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