

**MALAYSIAN MANAGEMENT SEMINAR SERIES  
“MERGERS AND DE-MERGERS”**

**“MERGERS – ISSUES OF FINANCIAL  
PERFORMANCE”**

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## MERGERS – ISSUES OF FINANCIAL PERFORMANCE

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Let me begin by thanking Universiti Utara Malaysia for appointing me as one of its Adjunct Professors and in that capacity, I am invited to speak tonight on a topic entitled ***Mergers – Issues on Financial Performance***.

This is an interesting subject; what with the corporate restructuring exercises, commonly called the M&A initiatives, being undertaken in many parts of the world. This has impacted the way we do business today. Many a business organisation has gone back to the drawing board in attempting to redefine their corporate and commercial objectives, handle competition and satisfy their customers' needs. They see mergers as the chosen path to stay ahead of the competition. Merger is their winning formula. We see mergers taking place in the banking industry, the professional firms in particular the international accounting firms, trading houses, international oil companies and other manufacturing concerns. Malaysia has also undergone several M&A exercises, involving the banking and finance industry, and recently in the plantation industry which saw the mergers of three large corporations, Kumpulan Guthrie, Golden Hope Plantations and Sime Darby into the giant plantation conglomerate using, simply Sime Darby as its name.

This has prompted many individuals from the accounting profession and the academia to conduct studies and researches on the subject of merger. Much of their findings are well documented, many of which are easily accessible via the internet. I had the advantage of having a partner, Mr Neezal Noordin who is rather savvy in surfing the various websites to avail me some of these literature which I had relied upon rather extensively in writing this paper for the presentation tonight.

The points for discussion under this topic are so numerous that I could not possibly cover them all in the 45 minutes allotted to me tonight. Therefore, I will only speak to you on a selected narrow angle, bearing in mind that the matter being tabled is not exhaustive. I propose to approach this topic by firstly reminding ourselves as to the definition of merger. I realize that earlier speakers would probably have dwelt extensively on this matter. Therefore, we will only give it a brief stop-over, just so we can recollect and focus our attention accordingly. Secondly, we will answer the time-honoured question of why corporations merge, with particular emphasis on the financial implications of the exercise. Following this, we will visit some of the financial tools that are being employed when analyzing and assessing the resultant monetary values which can help the stewards of the merged organisations identify the variables to be changed or otherwise in order to stay on course and avoid disaster. Finally, we will formulate some conclusions so as to bring this matter to a close.

### **Definition of Merger**

In lay terms, a merger is an act of two or more companies coming together to form larger ones.

The Oxford Dictionary of Business describes merger to mean a combination of two or more businesses on an equal footing that results in the creation of a new reporting entity formed from the combining business. The shareholders of the combining entities mutually share the risks and rewards of the new entity and no one party to the merger obtains control over another.

In like manner, Ghobadian, A.J.P, Liu J & Viney H (1999) say a merger is when two companies integrate to form a new company with shared resources and corporate objectives.

It is interesting to note that the terms merger and acquisition have been labelled as synonymous by many of us. There is of course a distinct difference between the two. Schroeder & Self (2003) aptly pointed out the difference when they said that mergers were regularly characterized as the consolidation of two companies into one organization. In contrast, acquisition is often characterized as the purchase of a single company from another where the acquirer or buyer maintains control.

### **Why Merge?**

Every merger is accompanied by the expectation of a significant impact on the financial performance of the new company. This is normally translated as wanting to realize a value for the newly merged company to be higher than the value of the two merger companies combined together. In essence the derivative of one plus one must equal to three or more, not just two; to make the merger a desired prospect.

This expectation is a key factor for the success of mergers. Since not all mergers are successful it is vital to evaluate the financial performance of the merged entity from its inception and remain focus on the main motives of the merger.

According to Gaughan (2002), there are four main motives of mergers:

- 1) As a means for firms to grow quickly;
- 2) To experience economic gains as a result of economies of scale or scope;
- 3) The enlarged firm may have better access to capital market with lower cost of capital enabling it to enjoy better financial benefits; and
- 4) In anticipation of gains which the merged firm may experience when applying its superior management skills to the target business.

In the local context, PriceWaterhouseCoopers states that in Malaysia, there is no statutory concept of merger. The mode of a merger typically involves an acquisition of shares or business assets and the transfer of liabilities of another company. It also suggested that when structuring M&A transactions, in addition to commercial considerations, income tax (including impact on tax incentives), stamp duty and real property gains tax implications should be considered. Non-tax considerations, such as exchange control and foreign equity participation requirements may also impact the transactions.

I might add as an update to this statement that the real property gains tax system had been abolished since the year 2007. Future merger players may wish to take note of this favourable fiscal change accordingly.

### **Evaluation of Financial Performance**

In practice, some of the mergers failed to achieve their intended targets and increase shareholders' values. There are many reasons for this. According to Frank C Evans & David M Bishop (2001), the reasons vary by the transaction and circumstance involved. The most common causes, however, seem to be;

- 1) The price being paid is too high  
This frequently results from the failure to distinguish the target from the investment. Even the best company can be a poor investment if the price paid exceeds the present value of its anticipated future returns.
- 2) Inadequate risk analysis  
This involves the failure to rigorously assess the likelihood of success of a transaction or to consider management discretion in future periods.
- 3) Exaggerated synergies  
Anticipated revenue enhancements, cost reductions, operating efficiencies or financing benefits are overestimated.
- 4) Failure to integrate operations quickly  
With the price for synergies paid up front, they must be achieved on time to yield benefits and create values.
- 5) Failure to estimate and recognize stand-alone fair market value  
For private companies that lack an established value, buyers may look only at investment value, including synergies and ignore the target's lower value on a stand-alone basis.
- 6) Make-it-happen pressure from the executive level  
This often results from the executives' desire to move quickly or to make their mark on the company without adequate analysis of the effects of the transaction on value.

7) Inadequate due diligence

In the pre-combination phase, ineffective strategic planning or assessment of value drivers and risk drivers or pressure to win negotiations prevails over sound decision making.

8) Failure to consider first-year negative synergies

Mergers or acquisitions often cause disruptions, including name changes, additional regulatory requirements, strained shareholder relations, negative public perception of the effect on consumers or of closing facilities, and the cost of severance packages and closing facilities, all of which should be quantified as part of the analysis.

9) Failure to accurately assess customer reaction

The newly combined company may force certain customers to seek a different source of supply to avoid buying from what has become a competitor or to avoid excessive reliance on one source of supply.

10) Inconsistent strategy

Inaccurate assessment of strategic benefits may occur.

11) Distraction from existing business

Failure to anticipate or effectively react to competitors' response to the acquisition, including inattention to ongoing operations and loss of key personnel of acquirer or target, affect profitability.

In 2007, Dr S Vanitha & M Selvam of Tamil Nadu, India conducted a study on several merged manufacturing concerns in India. The purpose of the study was to advance what they termed as a null hypothesis of mergers; which are:

- 1) That the merged companies did not achieve better liquidity, better solvency and improved profitability after merger, and
- 2) That the merged companies did not expand their business activities after merger.

In this regard they evaluated the financial performances of the sample companies before and after the mergers, using an average of three years of financial information. The financial data were subjected to a series of tests using several financial parameters and ratios to prove or disprove their null hypothesis.

In the case of the first null hypothesis, the following parameters have been selected to test the results of pre and post merger periods:

- A. Liquidity Parameters
  - a. Current ratio
  - b. Quick ratio
  - c. Net working capital, and
  - d. Diversion of short-term funds
  
- B. Leverage Parameters
  - a. Total debt and equity to total assets
  - b. Total borrowings and equity to EBITD, and
  - c. Interest coverage ratio
  
- C. Profitability and Other Parameters
  - a. Operating profit
  - b. Net profit
  - c. Return on Investment
  - d. Net worth

To test the validity of the second null hypothesis Vanitha & Selvam employed the following financial ratios:

- i) Capital formation, and
  
- ii) Increase in the Investment

The results of their study bore some very interesting conclusions, albeit not a final one in that there was no basis established to support the null hypothesis on mergers. They concluded that the financial evaluation they conducted showed that the merging companies were taken over by companies with reputed good management. Therefore, it was possible for the merged firms to turn around successfully in due course.

In a working paper for the European Central Bank entitled Mergers and Acquisitions and Bank Performance in Europe, Yener Altunbas & David Marques Ibanez measure the strategic similarities of banks involved in M&A activity by using financial indicators across several dimensions calculated from individual bank's accounting data. I dare say that these dimensions are equally applicable to merged entities of other businesses, taking care of course to suit the attributes of these dimensions accordingly.

The first of such a dimension is the **earnings diversification** strategy. The effectiveness of the merger activity is measured by the potential new revenues that can be derived, either from an enlarged customer base and/or in combination with new business lines, products and services.

The second dimension is to evaluate the **asset quality** profile. In the banking industry, the asset quality is represented by the bank's credit stance, measured as the level of loan loss provisions divided by interest revenues. In the non-banking business concerns, this could be represented by the quality of their receivables as measured by the level of bad debt provisions or the ageing situation of the receivables and the level of days' sales outstanding.

Thirdly, it is to look at the **cost controlling strategy**. This shows the emphasis to minimize costs by relating expenses to returns. Yener & David suggest that this can be measured by the total cost-to-total income ratio (CIR). They suggested that as a result of economies of scale and scope deriving from the combination of similar skills, a firm competing on the basis of low-cost and operating efficiency is expected to benefit from merging with another organization characterized by a set of similar competencies. Firms characterized by different cost controlling strategies, however, may show a drop in performance if they decide to merge.

Fourthly, the **capital adequacy levels**, which show the firms' strategy regarding their capital structure, measured as the ratio of equity to total assets (CA/TA).

Fifthly, paying attention to the **liquidity risk** which is measured by the ratio of liquid assets to short-term funding. An optimum level of liquidity is the desired goal as maintaining a generous liquidity ratio is expensive to the firms.

And lastly, a review of the firms' strategy in terms of **technology and innovation** which is measured as other costs (i.e total costs excluding interest, staff and other related overhead payments) as a proportion of total assets.

### **Conclusion**

In conclusion, I wish to share with you the statement made by Vanitha & Selvam on the good points of mergers and acquisitions.

A company may grow internally or externally. The objective of the firm in either case is to maximize the wealth of the existing shareholders. Most corporate growth occurs by internal expansion. M&As may be critical to the healthy expansion of business firms as they evolve through successive stages of growth and development. The successful entry into new product markets and into new geographical markets by a firm may require M&As at some stage in the firm's development. The successful competition in international markets may depend on capabilities obtained in a timely and efficient fashion through M&As.

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