

## Post Performance of Malaysian Acquired Firms: A Preliminary Study

**Fauzias Mat Nor  
Shamsubaridah Ramlee**

### ABSTRACT

*This study uses accounting based measures to draw implication regarding the performance of the acquired firms. The results are reported based on the average of the five years before and after the takeover. This study has shown that the acquisition of public listed companies did not result in improvement in the earning performance after the takeover. In contrast to the actual performance of the companies, the investor's perception on the value of the target increased. The decline in earning performance ratio could be explained by the fact that all the takeovers sample except one are of a conglomerate type. Secondly, most of these acquisitions have been financed by the issue of shares by the bidder to the target's shareholders, resulting in dilution on earning performance.*

### ABSTRAK

*Objektif kajian adalah untuk melihat ukuran yang berasaskan perakaunan supaya rumusan boleh dibuat mengenai prestasi firma yang telah diambilalih. Keputusan dilaporkan berasaskan purata 5 tahun sebelum dan selepas diambilalih. Kajian ini menunjukkan pengambilalihan syarikat tersenarai tidak meningkatkan prestasi perolehannya setelah diambilalih. Berlainan dengan prestasi sebenar syarikat, pelabur-pelabur bertanggung peningkatkan nilai pada syarikat sasaran. Penurunan nisbah prestasi perolehan boleh diterangkan oleh sampel syarikat sasaran yang kesemuanya kecuali satu merupakan jenis syarikat konglomerat. Kedua, kesemua pengambilan dibiayai melalui pemberian saham oleh syarikat penawar kepada pemegang saham syarikat sasaran menyebabkan kecairan prestasi perolehannya.*

### INTRODUCTION

Any theoretical analysis of acquisition involves an examination of the reasons and effects of acquisition. Firms can obtain operational as well as financial benefits attributed to acquisition. Dale (1973) uses five main rationales of growth by acquisition, which include lengthening the product line, gaining shares in a market not previously supplied, enlarging a firm's capacity to supply

old markets, diversifying interests and acquiring access to further process or distribution facilities. According to Dale, generally purely financial gains are merely accompanied by an acquisition and are not a reason for affecting it. The shareholder's wealth maximization theory requires that a takeover or merger leads to increased profitability for the bidders as well as the target firms in order for the merger and takeover to be justified, notably from synergy; either from financial, operational or managerial synergy.

#### FINANCIAL SYNERGY

Financial synergy results in the ability to take advantage from each other's financial positions. It either results in lower cost of capital, cost of debt, a greater debt capacity, or a higher price-earnings ratio. Gains in terms of financial synergy are more in line with Mueller's neoclassical theories (1977). Investing in unrelated businesses will also lower the systematic risk of a company's investment portfolio. The increased size of the firm will give it access to cheaper capital and reduce the probability of bankruptcy. As a result, lenders are willing to lend more to the combined entity than to the companies separately.

Financial synergy also results in the tax benefit of an acquisition to the bidding firm which depends on the tax status of the target firm, or vice-versa. A firm with a large cumulative tax-loss may have little prospect of earning in the future to utilise fully its tax loss carry forward. By merging with any firm with sufficient earnings, it may be possible for the surviving firm to fully utilise the valuable tax deduction from the loss carry forward. Another situation is where the acquisition may derive tax benefit from unused tax depreciation and investment tax credit. Finally there may exist the situation where the combined firm is more highly leveraged, thus reducing its tax bill. However, these economic gains cannot be realised by either company if each remains as separate entity as in the case of most acquisition in Malaysia.

#### OPERATIONAL SYNERGY

Operational synergy results from economies of scale in production and distribution. Haley and Schall (1979) note that this operational synergy has a direct effect on income and cash investment since the combined firms can produce more cheaply (lower expense) or sell the product more efficiently (higher revenue), or that the investment is greater since the merged firms can acquire capital equipment more cheaply or embark on a highly profitable investment programme which raises income more than investment. The attempt by the bidding firm to secure control of the target firm and implement an operating strategy will increase the value of both firms. By their nature, these economies are available to related acquisitions as sources of value creation, and not to unrelated acquisition. Thus, in the case of conglomerate mergers,

mergers involving firms with unrelated business activities, operational is less evident.

#### MANAGERIAL SYNERGY

Managerial synergy results when the bidder's manager possesses superior planning and monitoring abilities that benefit the target's performance. The cost of managing a large diversified firm, resulting from the formation of conglomerate especially, will substantially reduce relative to operating economies.

Mueller (1969), however, notes that the synergistic effects of merger will take place only when they produce some increase in market power, or when they produce a technological or managerial economy of scale. But, in conglomerate merger, most of the theoretical literature of finance has assumed no synergy, except for financial effects [Copeland and Weston (1988)]. The financial possibilities include taking advantage of transient errors in the market valuation of acquisition candidates, utilising the unused debt capacity of an acquired firm subsequent to merger, or simply obtaining a diminished variability of total corporate earnings through the portfolio diversification implied by conglomeration [Lewellen (1971)].

#### AGENCY THEORY

Jensen and Meckling (1976) have developed a comprehensive theory of agency costs. They show that the principals, i.e the stockholders, can assume that the agent (manager) will make optimal decisions only if appropriate incentives are given, and only if the agent is monitored. Thus, the separation of ownership and control in a corporation will give rise to so-called agency cost. It reflects the economic losses to shareholders when management does not act in the shareholders' best interests - i.e the maximisation of the market value of the owners' equity.

Jensen and Meckling (1976) suggest that the value of the firm reflects a valuation by shareholders to include the value perquisites consumed by the managers as the agents of the shareholders. In other words, they suggest that top management remuneration should reflect organisation performance and shareholders' return. Fama (1980) suggests that the primary monitoring of managers comes not from the owners but from the managerial labour market. If the managerial labour market is competitive both within and outside the firm, it will tend to discipline the manager. The market for corporate control, a major component of the managerial labor market, and often referred to as the takeover, is the arena in which alternative management teams compete for the right to manage corporate resources [Jensen and Ruback (1983)]. Jensen (1988) pictures takeovers as a disciplinary force in the capital market which

functions as a market for corporate control. He argues that, the market for corporate control is creating large benefits for shareholders and for the economy as a whole by loosening control vast amount of resources and enabling them to move to their 'highest-value use'. He also describes 'free cash flow' in explaining various aspects of takeover. Free cash flow is defined as cash flow in excess of that required to fund all of a firm's project that have positive net present values when discounted at the relevant cost of capital. Managers who invest in projects with negative net present value or waste it through organisation inefficiency instead of paying the excess cash flow to their shareholders are threatened by competing management teams. The conglomerate firm of an organisation therefore offers the potential for an organisation solution to a reduction in the magnitude of the owner-agent problem; that is, the corporate level or holding company management can effectively monitor the management of the individual firm within the conglomerate.

Empirical test of the various themes of corporate takeovers found in the Finance literature utilises the event study methodology almost exclusively. The event study involves calculating the 'abnormal' return on the shares of common stock for the affected firm as the difference in the actual returns and the expected returns. These abnormal returns are then averaged across all the firms in relation to 'event time'. The evidence from the above theories can then be indirectly inferred from merger customers.

Fauzias (1993) used event study analysis to measure the effects of acquisition, specifically the effects of acquisition announcement on the price behaviour of Malaysian bidders and target firms. The results of her study show that target firms experience a decline prior to the leakage of information and that the bidding firms is assumed to be motivated by information on the efficiency of the target firm. Her study also implies that an investor in the target and bidder firm is capable of outperforming the market before the acquisition announcement date. During the announcement period for both target and bidder and the post announcement period for the target, it can only earn a normal return. The immediate post acquisition announcement for the bidder on the other hand, indicates that it earns a negative return instead. The results of this study appear to indicate that bidders' managers might not act to maximise shareholders' wealth, although further research is needed to confirm this behaviour. They might also over estimate the value of the gains which might result from paying too much for the target's results.

Although the accounting based measures do not take into account risk, it continues to be an important contribution to our understanding of performance implication. Therefore, it is the objective of this study to look at the accounting based measure to draw implication regarding the performance of the acquired firms and try to answer whether acquisition results in the creation of economic value.

RESEARCH METHODOLOGY

The data were collected from the companies' announcement and notice of takeover filed with the Kuala Lumpur Stock Exchange (KLSE), annual reports of each company and KLSE handbooks. Data collected include prices of shares both high and low, net profit, paid up capital, gross profit, interest on long term liabilities, retained earnings, total current liabilities, long term liabilities and total reserves.

The above data were collected for each acquired listed firm for the five years before and five years after the takeover. It was decided that, where the takeover was completed near the end of the financial year, the financial data representing the last year before the takeover, include those of that year. For example, if the takeover was in October for a company with a financial year-end in December, then the financial results for the last year under the old management, included the year it was taken over. Similarly, if the takeover was completed near the beginning of the financial year, then the financial results for the first year under the new management would be the year it was taken over. Only publicly listed Malaysian acquired companies whose chief executive officer and/or a majority of its Board members have substantially changed were selected, to better reflect the performance of the respective management pre and post takeover. A total of 7 acquired firms meet the above requirement from the initial sample of 19 acquired firms.

The comparison of the difference in earning performance of the acquired firms before and after the takeover as a measure of efficiency gains are determined by earning per share (EPS), return on equity (ROE), return on capital employed (ROCE), and return on total assets (ROTA). These are determined by the following formula;

$$EPS = \frac{\text{Net Profit}}{\text{Number of Shares Issued}} \tag{1}$$

$$EBITOTA = \frac{\text{Earning before interest and tax}}{\text{Total assets}} \tag{2}$$

$$ROE = \frac{\text{Net Profit}}{\text{Shareholders' Fund}} \tag{3}$$

$$ROCE = \frac{\text{Gross Profit} + \text{Interest On Long Term Liabilities}}{\text{Total Shareholders' Fund} + \text{Long Term Liabilities}} \tag{4}$$

where, shareholders' Fund is defined as Paid-up capital + Capital and Other Reserves + Share Premium Account + Retained Earnings (4a)

$$\text{ROTA} = \frac{\text{Net Profit}}{\text{Total Assets}} \quad (5)$$

The comparison of the difference in the capital structure as a measure of financial leverage before and after takeover are determined by the ratio of debt and equity (DER), total liabilities to total assets (TLOTA), total liabilities to equity (TLOE) and the ratio of long term debt to total assets (LTDOTA). These are determined by the following formula;

$$\text{DER} = \frac{\text{Loan term debt} + \text{Overdraft} + \text{Preferred capital}}{\text{Shareholders' Fund} + \text{Minority interest}} \quad (6)$$

$$\text{TLOTA} = \frac{\text{Total Liabilities}}{\text{Total Assets}} \quad (7)$$

$$\text{TLOE} = \frac{\text{Total Liabilities}}{\text{Shareholder's fund}} \quad (8)$$

$$\text{LTDOTA} = \frac{\text{Total long term debt}}{\text{Total Assets}} \quad (9)$$

The comparisons of how the market perceives a firm's growth and profit opportunities before and after takeover are determined by multiple of earning or price earnings ratio (P/E), multiple of asset or the ratio of market value of the firm (equity + debt) to the replacement cost of the firm's assets (Tobin's Q), and multiple of book value or market to book value ratio (MTBV). These are determined by the following formula;

$$P/E = \frac{\text{Market price per share}}{\text{Earnings per share}} \quad (10)$$

$$\text{Tobin's Q} = \frac{\text{Market value of equity} + \text{Book value of debt}}{\text{Book value of assets}} \quad (11)$$

$$\text{MTBV} = \frac{\text{Market price per share}}{\text{Book value per share}} \quad (12)$$

The results are reported based on the average of the five years before and after the takeover.

### FINDINGS

Table 1 shows the mean of earning performance before and after takeover. For the years after the takeover, all the earnings ratios were significantly lower than before the takeover. Return on equity, return on total assets, return on capital employed, earning before interest and tax on total assets, and earning per share dropped by 50%, 53%, 46%, 40% and 44% respectively. The results of these means are plotted on the graphs shown in Figure I and II. This finding suggests that takeover did not result in an improvement in the performance of the target firms and this is not consistent with the shareholder's wealth maximization theory; notably not from the operational synergy and managerial economies of scale.

TABLE 1. Earning Performance Before and After Takeover

Five year earning performance	Mean before	Mean after	t value
ROE	13.8%	6.9%	2.9685*
ROTA	8.7%	4.1%	3.6584*
ROCE	24.5%	13.3%	3.1421*
EBITOTA	15.4%	8.3%	3.9685*
EPS	.25	.14	2.8009*

Notes: \* Significant at the 5 percent level.

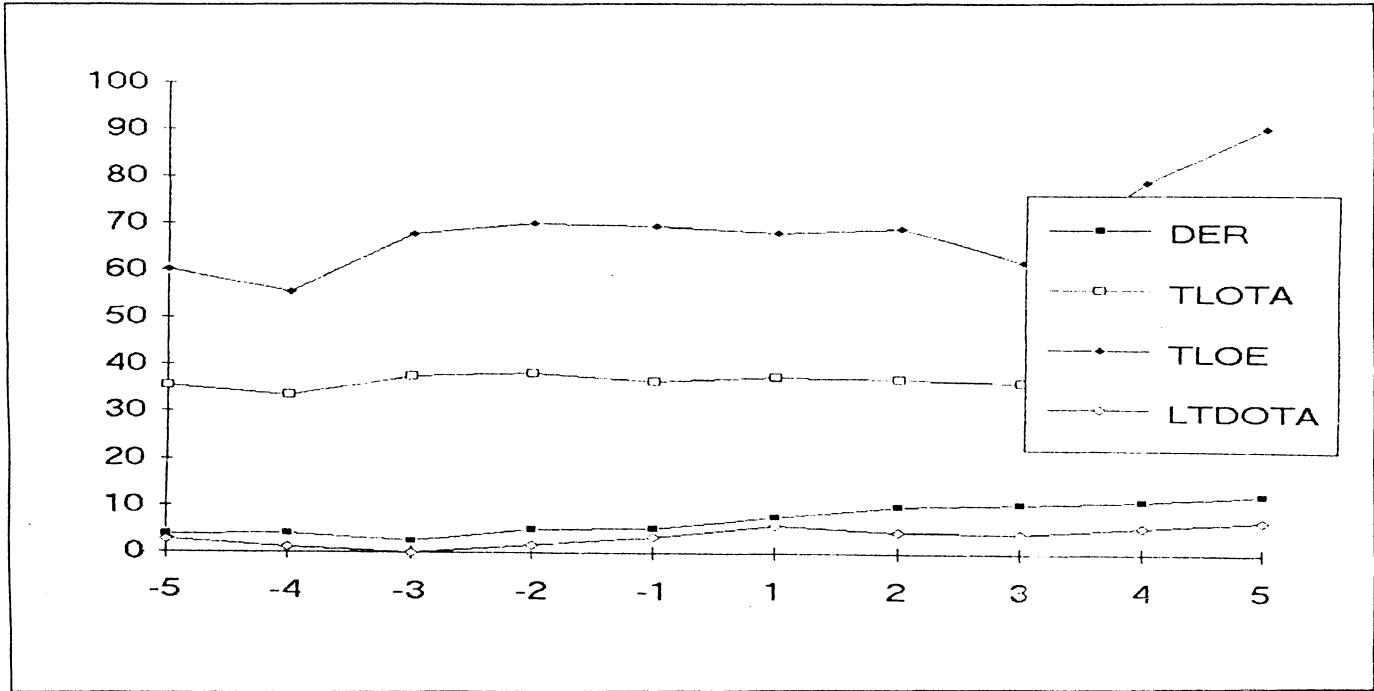


FIGURE III. Capital Structure Before and After Takeover



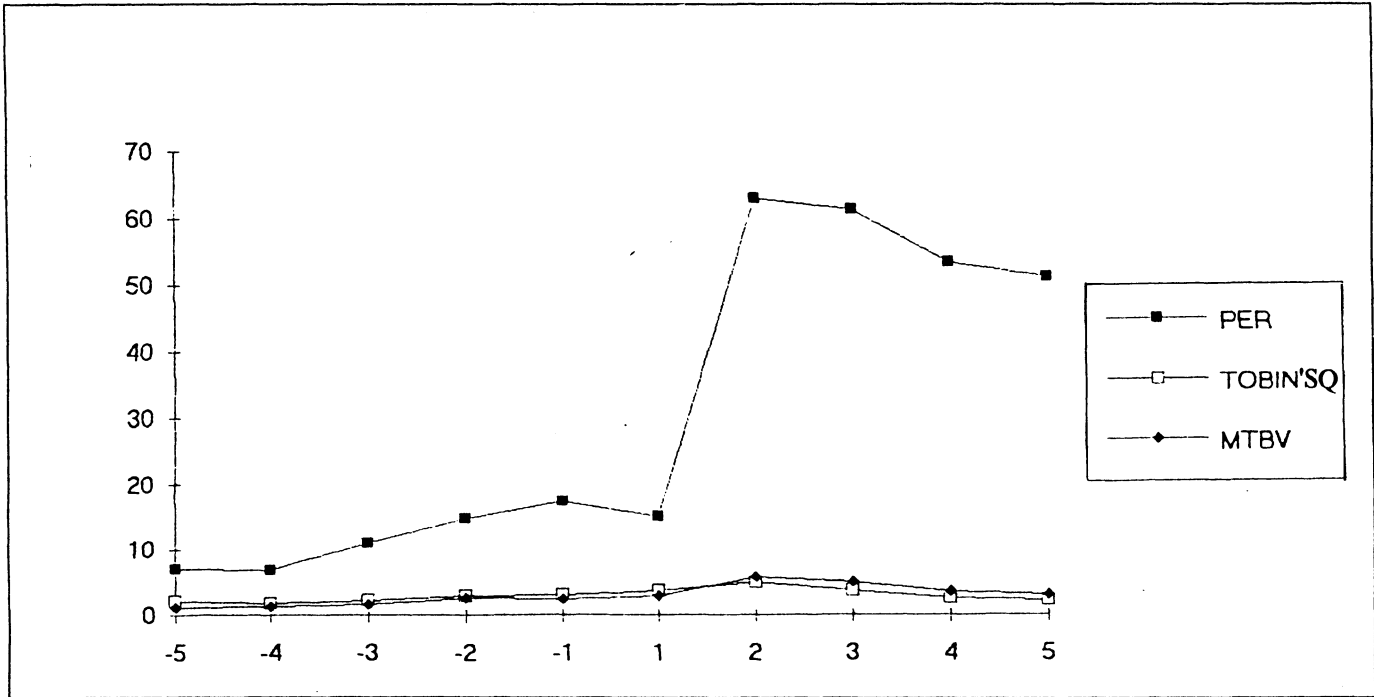


FIGURE IV. Earning, Assets and Book Value Per Share Multiples Performance Before and After Takeover

Table 2 shows the mean of capital structure before and after takeover. For the year after the takeover, long term debt to equity ratio was significantly higher than before the takeover. The ratio of total long term debt on total assets also increased slightly but, significant from 1.7% to 5.4%. Even though total liabilities to total assets and total liabilities to total equity increase from 36.3% and 64.9% to 37.8% and 74.8% respectively, statistically, they are not significant. The results of these means are plotted on the graph shown in Figure III.

An increase in debt to equity ratio and slight increase in debt on total assets, imply an increase reliance on debt by the new management.

TABLE 2. Capital Structure Before and After Takeover

Five year capital structure before and after takeover	Mean before	Mean after	t value
DER	3.9%	10.4%	-6.55*
TLOTA	36.3%	37.8%	-1.55
TLOE	64.9%	74.8%	-1.69
LTDOTA	1.7%	5.4%	-4.885*

Notes: \* Significant at the 5 percent level.

Table 3 shows mean of earnings, assets and book value per share multiples before and after the takeover. For the years after the takeover, all the ratios were significantly higher than before the takeover. The price earning ratio, Tobin's Q and market to book value increased by 131%, 40% and 128% respectively. The results of these means are plotted on the graph shown in Figure IV. This suggest that the market perceived the value of the targets increased after the takeover. This may also indicate positive reactions on the new management by the shareholders of the target.

TABLE 3: Earning, Assets and Book Value Per Share Multiples Before and After Takeover

Five year earning, Assets and book value per share multiples	Mean before	Mean after	t value
PER	21.1	48.7	-4.17*
TOBIN 'Q	2.5	3.5	-1.93**
MTBV	1.8	4.1	-3.42*

Notes: \* Significant at the 5 percent level

\*\* Significant at the 10 percent level

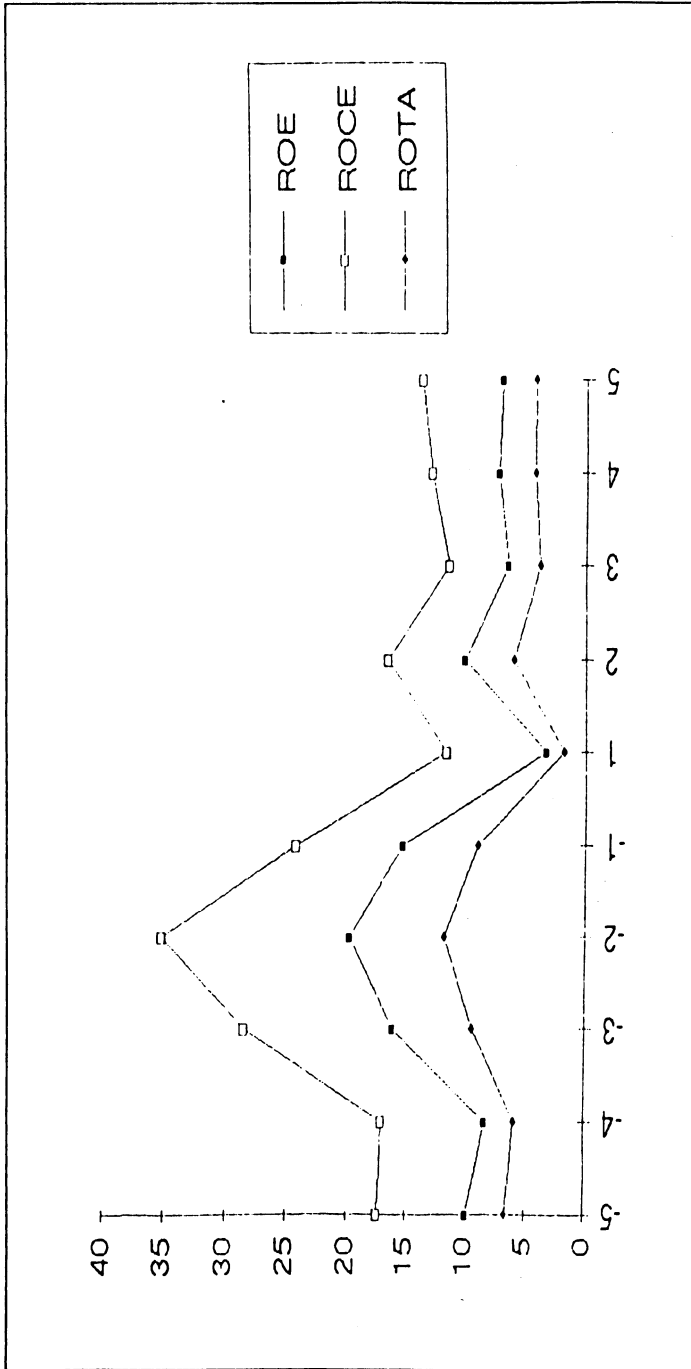


FIGURE 1. Earning Performance Before and After Takeover

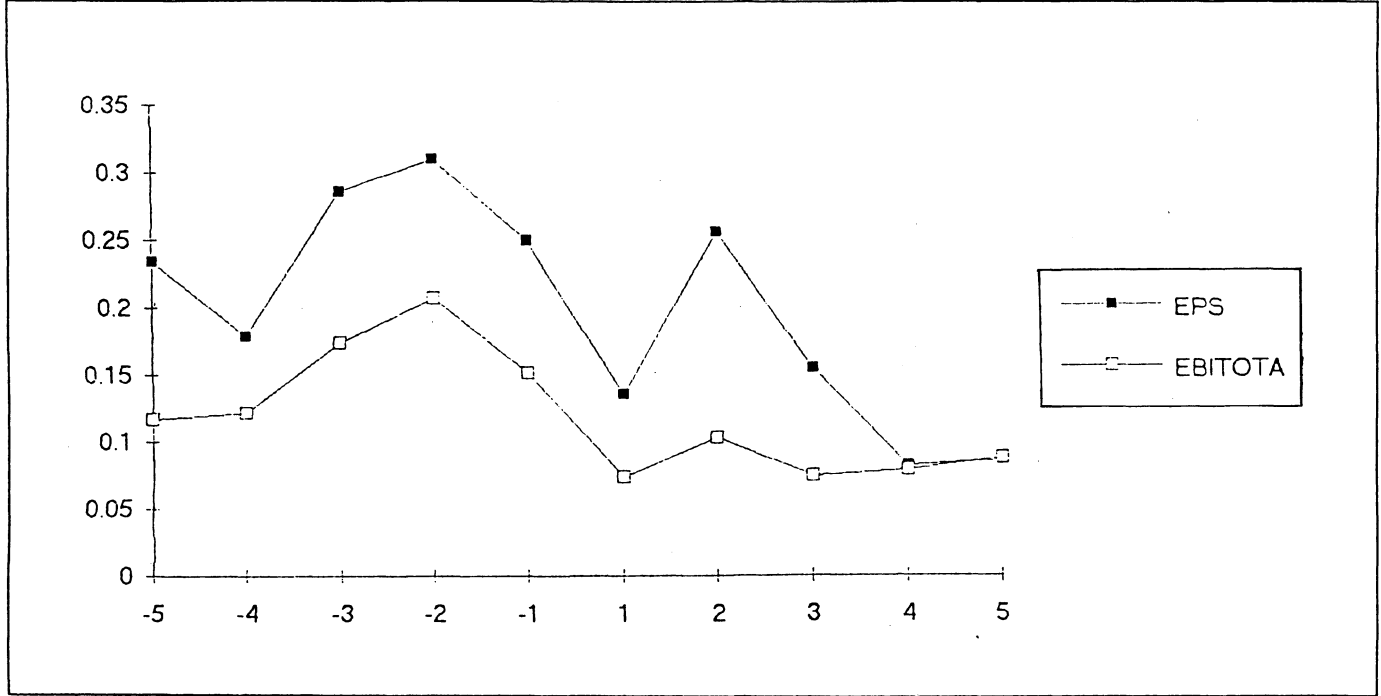


FIGURE II. Earning Performance Before and After Takeover

## CONCLUSIONS

This study has shown that the acquisition of a public listed companies did not result in improvement in the earning performance after the takeover. In contrast to the actual performance of the companies, the investor's perception on the value of the target increased. A low debt ratio gives greater capacity of the target firm's ability to borrow. With tax deductible interest, increase in debt capacity increases the after tax value of the firm. However, this finding imply an increase reliance on debt by the new management did not produce good earning performance, which is not consistent with the financial synergy.

The decline in earning performance ratio could be explained by the fact that all the takeovers except one are of a conglomerate type. By its nature, operational synergy and managerial economics of scale are less evident in a conglomerate type of merger. In fact it seems that the corporate level or holding company management did not effectively monitor the management of the individual firm within the conglomerate, or reduce the owner - agent problem of the target firms. Nevertheless, the market perception on the value of the targets increased after the takeover, indicating the market's positive reactions on the new management. Thus, it appears that the investors assessment of future prospects of the target firm is higher than its past and actual earning performance. The fact that most of these acquisitions have been financed by the issue of shares by the bidder to the target's shareholders, it could result in dilution on earning performance. Nevertheless, we do believe that the success of individual acquisition will depend upon the relative abilities of the new management in achieving operational efficiency and for making the shifts in their product markets required by the changing economic environment as professed by Weston and Mansighka (1971) which will then be reflected in its actual earning performance and the value of the firm.

**APPENDIX 1. List of Target and Bidder Companies**

TARGET COMPANIES		BIDDER COMPANIES		
Name	Date of Acquisition	Name	Types of Merger	Method of Payment
1. Central Sugar Bhd (Malayan United Industries Bhd Manufacturing Bhd)	8th January '80	Malayan United	Conglomerate	Shares and cash
2. Keramat Tin Bhd Dredging Bhd	13th June '80	Malayan Tin	Horizontal	Shares
3. Synthetic Resin Bhd (Sateras Resources Bhd)	7th Nov '80	Pegi Malaysia Bhd	Conglomerate	Shares
4. George Kent Bhd	27th May '81	Johan Holdings Bhd	Conglomerate	Cash
5. Dunlop & Estate Bhd Holding Bhd	15th June '82	Multipurpose	Conglomerate	Shares and cash
6. Dunlop Malaysian Industries Bhd	7th March '85 plantation Bhd	Consolidated	Conglomerate	Shares
7. United Estate Project Bhd (Sime-UEP Bhd)	21th Jan '85	Sime Darby Bhd	Conglomerate	Shares

REFERENCES

- Copeland, T.E., & Weston, J.F. 1988. *Financial Theory and Corporate Policy* United States of America: Addison-Wesley.
- Dale, P.M. 1973. A financial survey of mergers during the year 1968-70. *The International Journal of Management Science* 1( 3 ): 305-315.
- Fauzias, Mat-Nor. 1993 (June 22-25). An empirical study on the effect of acquisition announcement: *The Malaysian Experience Fifth Annual PACAP Finance Conference*. K.L.
- Fauzias, Mat-Nor. 1993 (July). Acquisition announcement and stock price behaviour: The Malaysian Experience. *Jurnal Pengurusan*, 12: 83-109.
- Fama, E.F. 1980. Agency Problems and the Theory of the Firm. *Journal of Political Economy* 88: 288-307.
- Haley, C.W. & Schall, L.D. 1979. *The Theory of Financial Decisions*. United States of America: McGraw-Hill Book Company,
- Jensen M.C. & Meckling, W.H. 1976. Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure. *Journal of Financial Economics*(3): 305-360.
- Jensen M.C. & Ruback R.S. 1983. The Market for Corporate Control - The Scientific. *Journal of Financial Economics* 11: 225-249.
- Lewellen, W.G. 1971 (May). A Pure Financial Rationale for the Conglomerate merger. *Journal of Finance*, 521-537.
- Mueller, D.C. 1977. The Effects of Conglomerate Mergers: A Survey of the empirical evidence. *Journal of Banking and Finance* 1: 315-347.
- Mueller, D.C. 1969(Nov). A Theory of Conglomerate Mergers: Quarterly. *Journal of Economics*, 643 - 659.

Fauzias Mat Nor & Shamsubaridah Ramlee  
Department of Finance  
Faculty of Business Management  
Universiti Kebangsaan Malaysia  
43600 UKM Bangi, Selangor Darul Ehsan  
Malaysia

