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Post Merger Financial Performance: A Study with Reference to Select Manufacturing Companies in India

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Abstract

Mergers and acquisitions (M&A) are the inorganic growth strategies which have got its significance in today's corporate world due to intensely competitive business environment. The present paper intends to study the trend in merger and acquisition (M&A) particularly with reference to manufacturing companies. While M&A is considered as one of the strategies for growth, the companies are expected to perform post M&A so that those are proved successful. From the literature review it is found that there is no conclusive evidence about the impact of M&A on corporate performance. Moreover in recent period M&A deals have gone up manifold and regulations relevant for M&A have also undergone change. Hence there is a need to look into the trend of M&A and the post M&A performance of companies. The present study is an attempt to find out the difference in post merger performance compared with pre merger in terms of profitability, liquidity and solvency. The scope of the study is limited to manufacturing sector companies in India. The statistical tools used are descriptive statistics, paired sample t-test.

Keywords: Mergers, Acquisitions, Financial Performance

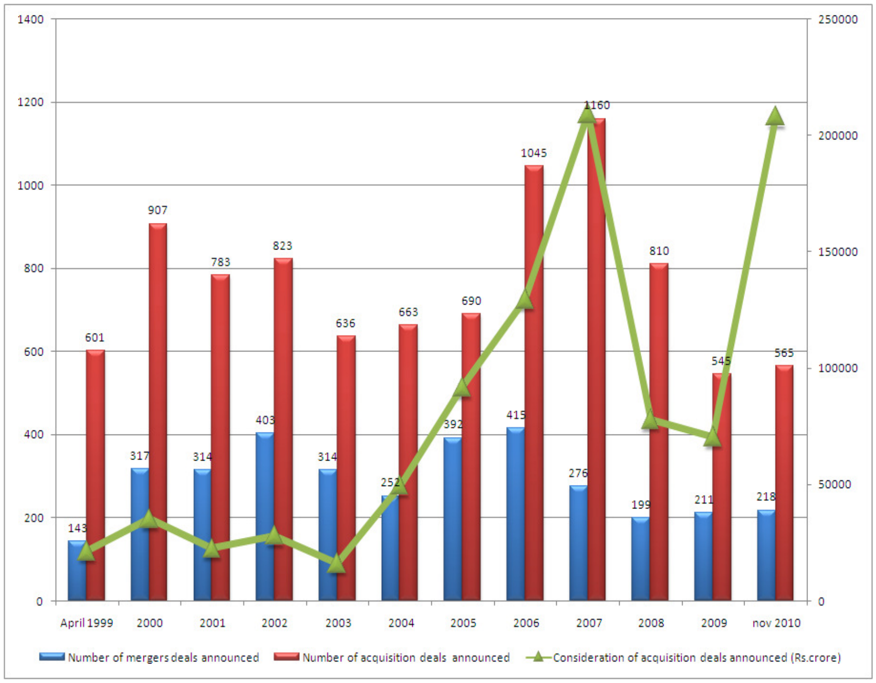
1. Introduction

Today, the business environment is rapidly changing with respect to competition, products, people, markets, customers and technology. It is not enough for the companies to keep pace with these changes but is expected to beat competitors and innovate in order to continuously maximize shareholder value. Growth is inevitable for the companies to keep pace with the changes. Growth strategy is divided into two types viz. organic and inorganic. Mergers and acquisitions (M&A) are the inorganic growth strategies for achieving accelerated and consistent growth. It has gained importance throughout the world in the current scenario due to globalization, liberalization, technological developments and intensely competitive business environment. The increased competition in the global market has prompted the Indian companies to go for mergers and acquisitions as a significant strategic alternative to survive and grow.

1.1. Merger and Acquisition Trends in India

The trends of mergers and acquisitions in India have changed over the years. M&A activities have also become increasingly global due to the growing global competition among many other reasons.

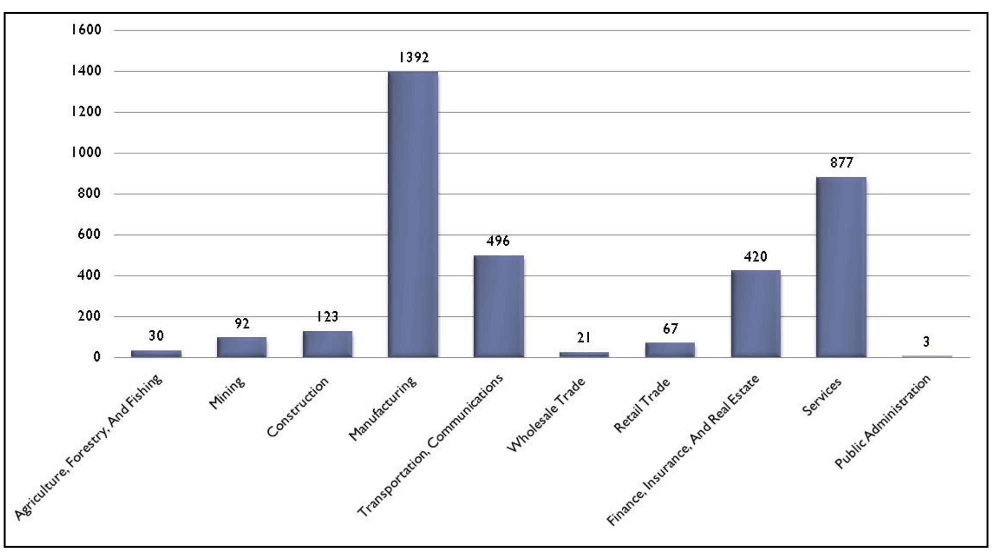
Figure 1: Volume of Mergers and Acquisitions deals announced in India



Source: CMIE Business Beacon Database

The total number of acquisitions from 1st April 1999 to 30th November 2010 is 9,228, highest being 1,160 in 2007. The total number of merger deals is 3,454, highest being 415 in 2006. The lowest consideration amount is `15,925.28 crore and highest is `2, 09,247.97 crore, total amount being ` 9, 58,147.28 crore. M&A is prevalent in all the sectors but compared to other sectors the manufacturing sector has the highest number of M&A deals. Manufacturing industries accounted for the most of M&A deals in these years with 40% share out of total.

Figure 2: Sector wise Volume of Deals



Source: Emerging Markets Information Service (EMIS) Data Base

2. Previous Research

Study of both Indian and International research papers are made on the works relating to post merger corporate financial performance. As surveyed through literature most of the work has been done in USA & UK apart from Malaysia, Japan, Australia, Greece, Canada, Taiwan, Thailand and India. But few works are done with respect to India. Many studies have been made on the effects of mergers and acquisitions on share prices, shareholder wealth, and the pre and post merger operating and financial performance of the target and bidder firms. There is no conclusive evidence whether M&A enhances efficiency or not. The literature review is classified into three viz. 'Studies using Accounting Measures', 'Studies using Event Studies' and Studies using Multiple Performance Measures'.

2.1. Studies using Accounting Measures

Cornett and Tehranian, (1992); Switzer (1996) cited from Ramakrishnan, (2008); Ghosh (2001) found merged firms show significant improvements in operating performance. Pawaskar (2001) observed the shareholders of the acquirer companies increased their liquidity performance after the merger. Ramaswamy and Waegelein (2003) found that there is improvement in post-merger operating financial performance measured by industry-adjusted return on assets. Rahman and Limmack (2004) found that there is improvement in long run operating cash flow performance of companies. Kumar and Rajib (2007a) estimate the impact on the shareholder value after merger has been completed using accounting measure. Using book value of asset and sales model, corporate performance improves after merger. Kukalis (2007) found that the acquirer company's pre-merger performance partially outperformed the post merger performance of merged company. Vanitha and Selvam (2007) also agree financial performance of merged companies improves. Ramakrishnan(2008) shows that mergers in India have resulted in improved long term post merger firm operating performance compared to pre-merger period.

Dickerson, Gibson and Euclid (1997) observed that acquisition growth is much lower than internal growth but there is an additional and permanent reduction in profitability following acquisition. Yook (2004) states that the acquiring firm experience reduced operating performance after acquisition. Tambi (2005) states that merger neither provides economies of scale nor synergy. Mergers were failed to provide any positive contribution in terms return on capital employed. Ooghe, Laere and Langhe (2006) found that the profitability, liquidity and solvency of combined company declines. The negative performance is not different from control firms. Pazarskis, Vogiatzogloy, Christodoulou, and Drogalas (2006) found that the profitability of a firm that performed an M &A is decreased due to merger/acquisition event. Kumar (2009) show that on average, the post-merger profitability, assets turnover and solvency of the acquiring companies show no improvement when compared with pre-merger values. Mergers usually do not lead to improvement of the acquirer's financial performance.

Mantravadi and Reddy (2008) found that mergers have positive impact on profitability of firms in the banking and finance industry. Pharmaceuticals, textiles and electrical equipment sectors saw a marginal reduction in performance in terms of profitability and returns on investment. For the Chemicals and agri-products sectors, performance after mergers declined, both in terms of profitability margins and returns on investment and assets

2.2. Studies using Event Study Methodology

The approach for the examination of abnormal stock returns to the shareholders of both bidders and target around the announcement of an offer and includes both successful (i.e. completed transactions) and unsuccessful M&A is called event studies, event being the M&A announcement.

Asquith, Bruner and Mullins (1983) found that mergers are positive net present value activities for bidding firms. Loderer and Martin (1992) found that the cumulative abnormal return is statistically significant giving positive returns to acquiring firm shareholders. DeLong (1999) affirm that bank mergers that focus both geography and activity are value-increasing. Jakobsen and Voetmann (2003) state that bidding firms do not under perform relative to the market. Moellera, Schlingemannb and Stulz (2004) observe that the announcement returns for acquiring-firm shareholders higher irrespective of the form of financing and whether the acquired firm is public or private. Leeth and Borg (2004) observe that the acquisitions from 1905 to 1930 raised shareholder wealth. Fields, Fraser and Kolari (2007) found that there is a positive bidder abnormal return for bancassurance mergers. Tsung-Ming and Hoshino, 2000 cited from Ramakrishnan (2008) show that the stock market reaction to acquisition announcement is positive. Chakrabarti (2008) found that the average Indian acquirer gains in value both on announcement as well as over the long-run post takeover period and these gains are statistically significant. Boubakri, Dionne and Triki (2008) suggest that M&A create value in the long run as buy and hold abnormal returns are positive and significant. Anand and Singh (2008) found merger announcement in the Indian banking industry has positive and significant shareholders wealth effect both for the bidder and target banks. Soongswang (2009) observe that Thai takeovers create values of the successful bidding firm's shareholders. Dutta and Jog (2009) shows that there is long term abnormal return for Canadian acquirers. Kyriazis (2010) found that the cumulative abnormal return is statistically significant giving positive returns to acquiring firm shareholders

Kumar and Eckbo (1983) state that there is no significant evidence that horizontal merger reduce the value of the competitors of the merging firms. Agrawal, Jaffe, Mandelker (1992) found that the stockholders of the acquiring firm experience a statistically significant wealth loss after merger. DeLong (1999) gives opposite view that diversifying mergers do not create value. Rosa, Engel, Moore and Woodliff (2003) views that over the long-term, in the post-announcement period, acquiring firms earn lower returns relative to those earned in the pre-acquisition performance but their relative performance remains exceptionally good, on average. Mueller and Sirower (2003) shows that merger destroy more of the value of the bidding firms than the amount paid as premium to the target. Rajib (2007a) found that corporate performance do not improves after merger using market value model.

Dennis and Mcconnell (1986) found that acquired firm's stockholders and bondholders receive significant gains in mergers which is not the case with such stakeholders of acquiring companies. Leeth and Borg (2000) state that target firm gained from the takeovers, while acquiring firm just break even and combined gains were small. The cumulative abnormal return is positive to the target firm shareholders. Fuller, Netter and Stegemoller (2002) found that the bidder shareholders gain when buying a private firm or subsidiary but when purchasing a public firm. The greater the return, the larger the target, and bidder offers stock. Gregory (2005) states that acquirer cash flows appear to be positively associated with long run performance. Boone and Mulherin (2008) found that there is an inverse relation between bidder returns and takeover competition.

2.3. Studies using Multiple Performance Measures

Several studies are based on multiple performance measures which may not be classified purely related to accounting measures or event studies. Shick and Jen (1974) put forward that all significant positive merger benefits occur during the first year. Johnson and Meinster (1975) using multivariate regression found that acquisitions have favorable effect on bank performance. Katsuhiko and Noriyuki (1983) found that the financial performance of Japanese manufacturing companies using the rate of return on equity increased after merger. Goyal (2002) affirm that there is a significant, positive co-movement in vertical merger activity and wealth effects. There are efficiency gains from such mergers. Kithinji and Waweru (2007) view that the performance ratios that have legal implications (capital adequacy and solvency ratios) improved after the merger. Fan and Santos, Errunza and Miller (2008) observe that international diversification does not destroy value.

Carline, Linn, and Yadav, (2001) found that the performance of merged firms improves significantly following their combination. Buyers, targets, combined underperform their peers in five years before merger, and outperform their peers in five years after. Kithinji and Waweru (2007) found that profitability ratios of the merged banks declined. Becker, Goldberg and Kaen (2008) using event study and accounting approach found that the stock price and operating performance of the acquirers underperformed compared to firms that did not engage in merger activity. Adavikolanu and Korrapati (2009) states that the returns to the acquirers were marginally negative from the serial acquisition of technology firms.

3. Hypothesis

Based on the research gap areas from the literature survey, the following research hypothesis is tested:

H_o: There is no difference in the post merger financial performances in manufacturing sector companies in India.

H_a: The long term post merger financial performances changes in the post merger period in manufacturing sector companies in India.

4. Research Methodology

The study is carried out over various years under consideration using Accounting Based Approach using different financial parameters.

I. **Profitability parameters** are Return on Capital Employed (ROCE): EBIT/Capital Employed (Kumar, 2009); Return on Net Worth (RONW): Profit after Tax /Net Worth (Saboo and Gopi , 2009).
II. **Liquidity parameters** are Current Ratio: Current Assets/Current Liabilities (Kumar and Rajib, 2007a); Quick Ratio: Quick Assets/ Quick Liabilities (Kumar and Rajib, 2007a); Networking Capital/Sales: (Current Assets minus Current Liabilities) by Sales (Kumar and Rajib, 2007a).
III. **Leverage parameters** are Total Debt Ratio: Total Debt to Total Assets (Kumar and Rajib, 2007a); Interest Coverage Ratio: Earning before interest and taxes (EBIT)/Interest (Kumar and Rajib, 2007a; Kumar and Bansal, 2008)

4.1. Hypotheses Testing

Average pre merger and post merger financial performance ratios is compared to see if there is any significant change in financial performance due to mergers and acquisition, using "paired two sample t-tests"

$$t = \frac{\bar{x} - \mu_0}{\frac{s}{\sqrt{n}}}$$

Where,

s is the standard deviation of the sample and n is the sample size.

The degrees of freedom used in this test is n – 1

4.2. Scope and Sample

The study is confined to the merger cases in sectors – other than banking and finance – during the period from 2003-04 to 2006-07. Mergers involving firms in banking and financial services industries (BFSI) are not considered due to the fact that these industries performance is generally affected by other economic environmental factors compared to manufacturing sectors. Financial performance measures as mentioned earlier are also not appropriate for firms in BFSI sector. The time period is chosen in such a manner so that there is three year time to judge the post merger performance. Hence only such merger cases are considered where data are available for both the companies from 3 year prior to and 3 year after merger. The year when merger took place is not considered for analysis.

Initially 1193 merged companies were found in CMIE prowess. After applying the filtration as discussed above, finally 115 mergers cases were found relevant to our study.

Table 1: The Sample of Merger Deals

Year	Target	Acquirer	Total Deals	Final Sample
2003-04	61	45	61	28
2004-05	87	63	87	47
2005-06	86	64	86	32
2006-07	74	59	74	8
TOTAL	**308**	**231**	**308**	**115**

Source: Compiled from CMIE Prowess Database

4.3. Sources of Data

- Bombay Stock Exchange and National Stock Exchange Publications
- Business Beacon, CMIE Prowess, EMIS Database
- Securities Exchange Board of India (SEBI) Reports

5. Results and Discussions

The study is carried out for each year separately and then by combining the financial performance over the years. The following tables provide the results of different tests followed by observations about the differences in financial performance between pre and post merger periods.

Table 2: Paired Sample t test Results of 2003-04 Merger Deals

Financial Ratios	Paired Difference		
	Mean*	**t value**	**Level of Significance**
Pre merger current ratio-post merger current ratio	-1.211	-0.941	0.355
Pre merger quick ratio-post merger quick ratio	-0.954	-0.989	0.332
Pre merger networking capital/sales ratio-post merger networking capital/sales ratio	-0.245	-1.680	0.105
Pre merger total debt ratio-post merger total debt ratio	0.011	1.960	0.060
Pre merger interest coverage ratio-post merger interest coverage ratio	-364.331	-1.327	0.196
Pre merger return on capital employed ratio-post merger return on capital employed ratio	-0.210	-2.182	0.038
Pre merger return on net worth ratio-post merger return on net worth ratio	-0.074	-0.430	0.671

* The negative sign in the value indicate there is an overall increase in the particular performance parameter in post merger period compared to pre merger period. This note is applicable to Tables 2 to 6.

- The liquidity ratios like current ratio, quick ratio, and net working capital/sales ratio improved after merger but it is statistically insignificant.
- In case of the leverage ratios, the debt ratio declined in the post merger period. But it is not statistically significant. Interest coverage ratio has increased, but it is not statistically significant too. The mean of interest coverage ratio shows very high figure, it may be because of outliers.
- The good sign is that the profitability ratios have increased during the post merger period. It is statistically significant in case of ROCE and statistically significant in case of RONW.

Table 3: Paired Sample t test Results of 2004-05 Merger Deals

Financial Ratios	Paired Difference		
	Mean	**t value**	**Level of Significance**
Pre merger current ratio-post merger current ratio	-0.002	-0.015	0.988
Pre merger quick ratio-post merger quick ratio	0.078	0.994	0.326
Pre merger networking capital/sales ratio-post merger networking capital/sales ratio	0.016	1.006	0.320
Pre merger total debt ratio-post merger total debt ratio	0.000	-0.202	0.841
Pre merger interest coverage ratio-post merger interest coverage ratio	-.563.082	-1.020	0.313
Pre merger return on capital employed ratio-post merger return on capital employed ratio	-0.149	-5.976	0.000
Pre merger return on net worth ratio-post merger return on net worth ratio	-0.142	-6.670	0.000

- The liquidity ratios like current ratio improved after merger but it is statistically insignificant. But the quick ratio, and net working capital/sales ratio has declined.
- In case of the leverage ratios, the debt ratio increased in the post merger period. But it is statistically insignificant. Interest coverage ratio has increased, but it is statistically insignificant too. The mean of interest coverage ratio shows very high figure, it may be because of outliers.
- The profitability ratios have increased during the post merger period. It is statistically significant in case of both ROCE and RONW.

Table 4: Paired Sample t test Results of 2005-06 Merger Deals

Financial Ratios	Paired Difference		
	Mean	**t value**	**Level of Significance**
Pre merger current ratio-post merger current ratio	-0.03	-0.15	0.88
Pre merger quick ratio-post merger quick ratio	-0.12	-0.59	0.56
Pre merger networking capital/sales ratio-post merger networking capital/sales ratio	0.00	-0.03	0.97
Pre merger total debt ratio-post merger total debt ratio	-0.02	-3.81	0.00
Pre merger interest coverage ratio-post merger interest coverage ratio	0.11	0.04	0.97
Pre merger return on capital employed ratio-post merger return on capital employed ratio	-0.05	-2.14	0.04
Pre merger return on net worth ratio-post merger return on net worth ratio	1.79	0.96	0.35

- The liquidity ratios like current ratio, quick ratio, and net working capital/sales ratio improved after merger but it is statistically insignificant.
- In case of the leverage ratios, the debt ratio increased in the post merger period and it is statistically significant. Interest coverage ratio has decreased, but it is statistically insignificant. The mean of interest coverage ratio shows very high figure, it may be because of outliers.
- ROCE have increased and statistically significant but in case of RONW it has decreased after mergers.

Table 5: Paired Sample t test Results of 2006-07 Merger Deals

Financial Ratios	Paired Difference		
	Mean	**t value**	**Level of Significance**
Pre merger current ratio-post merger current ratio	0.085	0.623	0.553
Pre merger quick ratio-post merger quick ratio	0.019	0.150	0.885

Table 5: Paired Sample t test Results of 2006-07 Merger Deals - continued

Pre merger networking capital/sales ratio-post merger networking capital/sales ratio	0.009	0.235	0.821
Pre merger total debt ratio-post merger total debt ratio	-0.011	-2.049	0.080
Pre merger interest coverage ratio-post merger interest coverage ratio	-18.210	0.227	0.827
Pre merger return on capital employed ratio-post merger return on capital employed ratio	-0.018	-0.434	0.678
Pre merger return on net worth ratio-post merger return on net worth ratio	-0.020	-0.831	0.433

- The liquidity ratios like current ratio, quick ratio, and net working capital/sales ratio has declined after merger but it is statistically insignificant.
- In case of the leverage ratios, the debt ratio increased in the post merger period which means the debt has increased after merger. It is statistically significant. Interest coverage ratio has increased, but it is statistically insignificant. It shows negative performance of the companies after merger deals. The mean of interest coverage ratio shows very high figure, it may be because of outliers.
- The good sign is that the profitability ratios have increased during the post merger period but those are not statistically significant.

Table 6: Paired Sample t test Results for all Merger Deals from 2003-04 to 2006-07

Financial Ratios	**Paired Difference**		
	Mean	**t value**	**Level of Significance**
Pre merger current ratio-post merger current ratio			
Pre merger quick ratio-post merger quick ratio	-0.232	-0.953	0.342
Pre merger networking capital/sales ratio-post merger networking capital/sales ratio	-0.053	-1.323	0.189
Pre merger total debt ratio-post merger total debt ratio	-0.003	-1.360	0.176
Pre merger interest coverage ratio-post merger interest coverage ratio	-320.072	-1.363	0.176
Pre merger return on capital employed ratio-post merger return on capital employed ratio	-0.127	-4.742	0.000
Pre merger return on net worth ratio-post merger return on net worth ratio	0.420	0.803	0.423

- The liquidity ratios like current ratio, quick ratio, networking capital/sales improved after merger but it is statistically insignificant.
- In case of the leverage ratios, the debt ratio has increased in the post merger period. But it is statistically insignificant. Interest coverage ratio has increased, but it is statistically insignificant too. The mean of interest coverage ratio shows very high figure, it may be because of outliers.
- The good sign is that the profitability ratio ROCE have increased during the post merger period and is statistically significant. In case of RONW it has reduced but it is statistically insignificant.

Table 7: Summary of t test result pre and post merger performance

Particulars	**2004**	**2005**	**2006**	**2007**	**All Years**
Sample Size	28	47	32	8	115
Post merger current ratio	+	+	+	-	+
Post merger quick ratio	+	-	+	-	+
Post merger net working capital/sales	+	-	+	-	-
Post merger total debt ratio	-*	+	+ *	+*	+
Post merger interest coverage ratio	+	+	-	+	+

Table 7: Summary of t test result pre and post merger performance - continued

Post merger return on capital employed	+*	+*	+*	+	+*
Post merger return on net worth	+	+*	-	+	-

Source: Evaluated from test undertaken
The sign + refers to increase in ratio
The sign - refers to decrease in ratio
The sign * refers to statistically significant

- The good sign is that the profitability ratio ROCE have increased during the post merger period and is statistically significant. In case of RONW it has reduced but it is statistically insignificant.

From the Table 7 it is observed that for the combined cases of mergers, return on capital employed has gone up in the post merger period. Ignoring statistical significance, the liquidity, debt ratio, and interest coverage ratio have gone up whereas working capital turnover and return on net worth have declined.

6. Limitations of the Study

- Only manufacturing sector companies are considered for the study.
- The period of study is up to 2006-07, since 3 year post merger performance data are required for the study.
- Only long term performance measures are considered. Short term returns as a result of announcements of M&A (event studies) are not considered.
- The performance is not compared with the control firms
- Multiple mergers (same company making more than one M&A deals within the sample period) (within 3-4 years) could not be excluded from sample as it reduced the sample size.

7. Summary and Concluding Remarks

The liquidity position of the companies has improved but it is not statistically significant. The finding is similar to Pawaskar (2001). The solvency position in terms of networking capital/sales has decreased, but it is not statistically significant. Kumar Raj (2009) has also found that the solvency position of companies reduces after merger. The debt ratio has increased but along with it the interest coverage ratio has increased, but both are not statistically significant. Ravenscraft and Scherer (1987); Singh (1975) cited from Daga (2007); Newbould (1970); Meeks (unknown) cited from Daga (2007) views companies experience a decline in profits each year after the merger. But the paper finds a different result. The profitability position of the companies has increased in terms of return on capital employed and decreased in terms of return on net worth. But the good thing is that the increase has been statistically significant and decrease has been statistically insignificant. The financial performance of the companies' improved after merger in terms of current ratio, quick ratio, return on capital employed, interest coverage ratio. But most of the results are not statistically significant. The not so significant improvement in financial performance put a question mark on the motive behind mergers. Also, the financial performance may not be the only parameter for M&A success. The future scope of study is to compare the performance of companies taking the firms involved in merger activities and the firms without the merger deals. Study can also be extended to the cases of acquisitions.

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