

STOCK PRICE REACTION TO MERGER AND ACQUISITION ANNOUNCEMENT: EVIDENCE FROM COLOMBO STOCK MARKET

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ABSTRACT

This study examines, Stock Price Reaction to Merger and Acquisition Announcement in the Sri Lankan context for the period of 2009 to 2014. It was analysed using 26 offeror companies and 40 offeree companies listed on the Colombo Stock Exchange. To examine the reaction of share prices to the announcement of Merger and Acquisition the standard event study was done. In addition, it was also examined using accounting study that is financial ratios of two years before the announcement date and two years after the announcement date were analysed. Analysis shows that the announcements of merger and acquisition have a negative impact on the firm performance from the offeree side and there is a positive impact on the firm performance from the offeror side.

Key Words: Merger and Acquisition, Firm performance, offeree, offeror

1. INTRODUCTION

Mergers and acquisition (M&A) are an eternal hot topic in both capital market and academic field. Although the research in M & A has lasted for over 30 years, little attention has been paid to the emerging markets like Sri Lanka. The need for empirical investigation of M & A performance in emerging market is a major motivation of this research. Mergers and acquisitions are among the most effective ways to expedite the implementation of a plan to grow rapidly. Companies in all industries have grown at lightning speed, in part because of an aggressive merger and acquisition strategy.

The terms "merger" and "acquisition" are often confused and used interchangeably by business and financial executives. On the face of it, the difference may not really matter since the net result is often the same: Two companies (or more) that had separate ownership is now operating under the same roof, usually to obtain some strategic or financial objective. However, the strategic, financial, tax and even cultural impact of the deal may be very different, depending on how the transaction is structured.

With reasonable years' development of capital market, Sri Lanka M & A have experienced its inception, growth & development. Especially with the dramatic change of the business environment after the entering of WTO, corporations in Sri Lanka have begun to endorse M & A as a creative & a strategic means to grow, compete & enhance shareholder wealth.

It was interesting to note that a number of acquisitions and mergers were taking place in Sri Lanka. SLT acquired Mobitel (October 2002), after the acquisition, Mobitel became Sri Lanka Telecom Mobitel, Dialog changed its design and company name (2009), Airtel made a change with logo and design (2010), NDB after the merger in the insurance sector became as AVIVA NDB (1999), and some of the repositioning practices of FMCG brands like Dettol, Lifebuoy and insurance brand like Union Assurance with new logo and emotional value proposition. JKH has acquired Asian Hotels (October 2003) and Phoenix and Jewel knit have merged to form a group of their own by the name of Brandix (2004). A couple of years back, when HNB attempted to acquire Sampath Bank, a lot of publicity were given to the fact (2000).

In many cases, companies resort to mergers or acquisitions because they believe that it is the easiest and fastest way to grow. Even though this view is acceptable to a certain extent, many acquisitions do not produce the expected results. This is because there are problems of post-acquisition integration and failure to achieve the results projected. Vanik had bad experiences in integrating some of its acquisitions. On a global scale the merger between AOL and Time Warner Group proved to be a flop. Acquisitions and mergers are also forms of fulfilling managerial egos as they lead to the creation of large corporate empires. One wonders whether the building of such empires serves any purpose to the shareholder, if shareholder value is not enhanced, as a result of these changes.

There are many researches in relation to merger and acquisition. Talat and Mian (2012) have investigated the relationship between corporate governance profile of acquiring firms and operating performance changes associated with merger and acquisitions in Pakistan. Frans and Nick (2011) have contributed to the existing academic literature by increasing the knowledge based on whether corporate governance (different board structures) played a role in M & A and how better corporate governance can improve the performance (i.e long term value creation) of M & A and firms.

Chetan, Ning & Liping (2012) have studied the effects of mergers for the security holders of bidding and target firms provides clear evidence that these business combinations create large benefits for shareholders and bondholders of target firms, but impose marginal losses for shareholders and, on average, no gains or bondholders of acquiring firms. Ignacio (2004) has performed an analysis of shareholder value creation upon the announcement of M & As involving European Union firms.

Baker, Pan & Wurgler (2009) have showed using a large and unique patent-merger data set over the period 1984 to 2006, that companies with large patent portfolios and low R&D expenses are acquires, while companies with high R&D expenses and slow growth in patent output are targets. Further, technological overlap between firm pairs has a positive effect on transaction incidence, and this effect is reduced for firm pairs that overlap in product markets. They also showed that acquires with prior technological linkage to their target firms produce more patents afterwards.

Abraham (2012) studied the series of M & A taking place in the financial sector in Ghana showed improved performance in the post-merger time period as compared to the pre-merger period. The majority of academics has utilized objective measures or financial indicators, including the acquirer's stock market returns (Sudarsanam and Mahate, 2003; 2006) or profitability gains (Chatterjee and Meeks, 1996; Sharma and Ho, 2002).They concluded that synergies obtained from combining innovation capabilities are important drivers of acquisitions.

However, Since the Sri Lanka is presently facing an emerging economic condition and environment; it feels the necessity of seeing the effects of the merger and acquisition of listed companies in the Colombo Stock Market. The merger and acquisition is not a routine activity in the business entity, but it might have some major impacts on the financial decision of both the investors and management of the entities. M & A transactions are regarded as opportunities bearing considerable risks. The M & A environment is always a fast-paced, complex world where transactions can be arranged in a relatively short period while value involved sometimes exceeds billions of Rupees. A merger generally requires the active participation of all decision makers, managers, directors & shareholders. In this study, the researchers have investigated the M & A and the firm performance in the context of Sri Lanka Stock Market.

2. RESEARCH METHODOLOGY

2.1. Data

Data for this study were collected from the Colombo Stock Exchange and statements published by the companies regarding tender offer or mergers. The sample consists of 26 tender offer companies and 40 offeree companies during

the period 2009- 2014. A tender offer (Offeror) company is defined as an individual or a company, whether incorporated under the companies Act, No.17 of 1982, or not. Offeree (target) company is defined as a listed public company whose shares are the subject matter of an offer.

2.2. Methodology

2.2.1. Event Study

In order to examine the impact of the announcement of a merger and acquisition on the stock return, the standard event study was used.

Abnormal return (AR) is calculated as below:

Abnormal Returns = Actual Returns- Expected Returns

$$AR_{it} = R_{it} - E(R_{it})$$

$$E(R_{i,t}) = \alpha + \beta_i * R_{m,t}$$

Where:

- AR_{it} = The abnormal return for company I in period of it
- R_{it} = The actual return for company i period t
- E(R_{it}) = The expected return for company i in period t
- R_{m, t} = The return of market portfolio
- α = The constant (estimated regression intercept of share i)
- β_i = The estimated systematic risk of share i

Estimate period is from t= -180 to t= -60. The event period was taken : t= -30 to t= +30 , relative to the event day t = 0 (the date of the announcement of merger and acquisition).

Cumulative Abnormal Return is calculated by using the following equation.

$$CAR_t = AR_t + CAR_{t-1}$$

2.2.2. **Accounting Study**

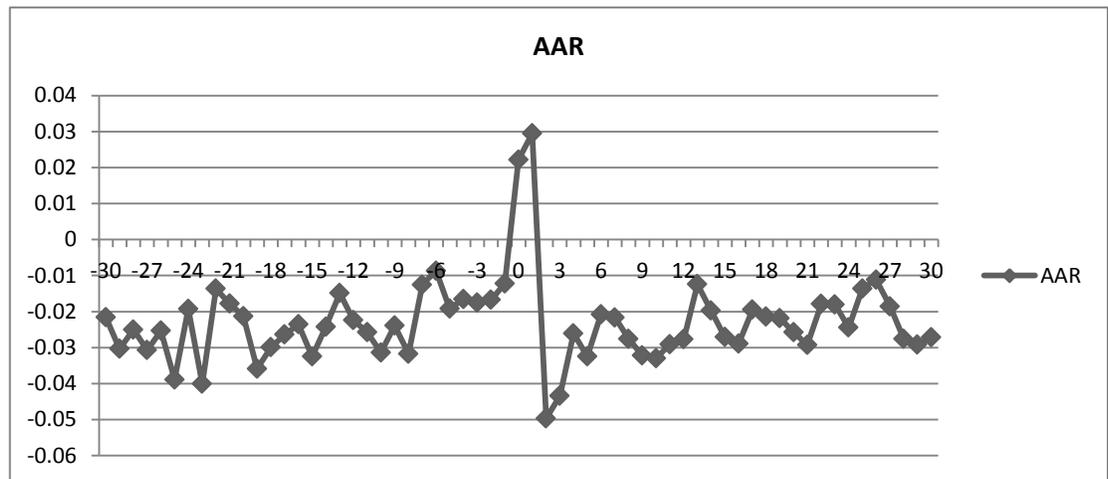
Table.1 Financial Ratios

Indicators	Constructs(Variable)	Indicators	Measures
Profitability Indicators	Return on Asset	ROA	$\frac{\text{Net income before taxes}}{\text{Total assets}}$
	Return on Equity	ROE	$\frac{\text{Net income before taxes}}{\text{Total equity}}$
	Net Profit Margin	NPM	$\frac{\text{Net income before taxes}}{\text{Total revenue}}$
Operating Indicators	$\frac{\text{Total Expenses to}}{\text{Total Assets}}$		$\frac{\text{Total Expenses}}{\text{Total Assets}}$
Solvency Ratio	$\frac{\text{Total Equity to Total}}{\text{Assets}}$		$\frac{\text{Total Equity}}{\text{Total Assets}}$
	Earnings Per Share	EPS	$\frac{\text{Earnings}}{\text{No. Of Ordinary Shares}}$
	Dividend Per Share	DPS	$\frac{\text{Paid Dividend}}{\text{No. Of Ordinary Shares}}$
Leverage Ratios	Debt Ratio		$\frac{\text{Total Debt}}{\text{Total Assets}}$
	Debt Equity Ratio		$\frac{\text{Total Liabilities}}{\text{Shareholde's Equity}}$
Firm Size			Total Assets

3. RESULTS

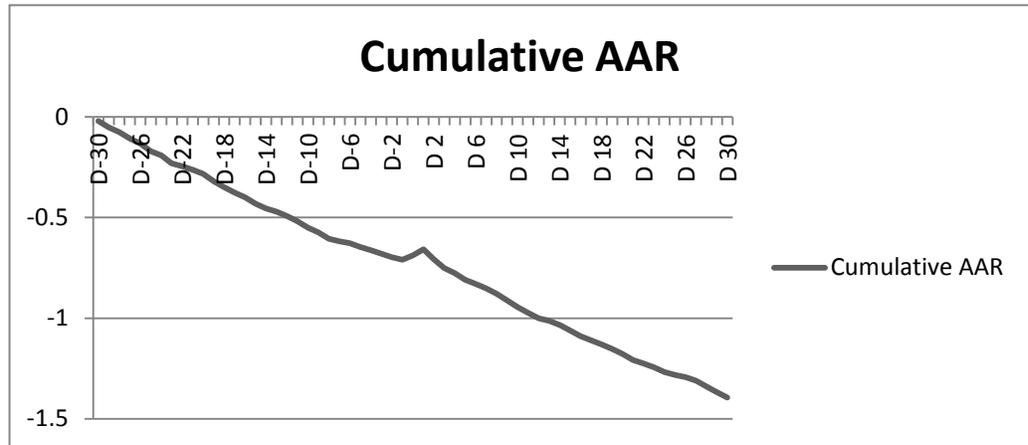
The announcement effect of the M& A was tested using event study. Event study was done separately for both companies that involve in M&A. To ensure the effect and trend of the share prices of the target companies for the announcement of merger and acquisition cumulative abnormal return trend was used. It was observed a significant positive reaction to announcement of M&A on the event day in the case of offeree companies. It can be observed in the Figure 1.

Figure 1: Average Abnormal Return (AAR) for the Period of 2009 to 2014 in Offeree



However, it was observed that a significant negative reaction followed by the announcement. And it was fluctuating with the negative values for the rest of the day of the event window. Figure 2 shows it clearly. The average abnormal return for the period of 2009 to 2014 for the offeree companies were continuously declining. This indicates that these companies have already negative average abnormal return and even though they are going for the merger and acquisition to resolve this, they don't get the advantage by doing this. According to the results, we could say that the merger and acquisition activity is not advisable in the case of offeree companies.

Figure 2: Cumulative Average Abnormal Return (AAR) for the Period of 2009 to 2014 in Offeree



In the case of offeror company, it has reported a significant positive average abnormal return on the event date. It was also noticed a positive reaction after the announcement date. It is notable more positive average abnormal returns than before the announcement of merger and acquisition. It shows a positive increment after the announcement of merger and acquisition.

It is clear from the figure 3 which shows a positive impact for the offeror company after the announcement of the merger and acquisition. Hence, the offeror company shows the different result than the offer company.

Figure 3: Average Abnormal Return (AAR) for the Period of 2009 to 2014 in Offeror

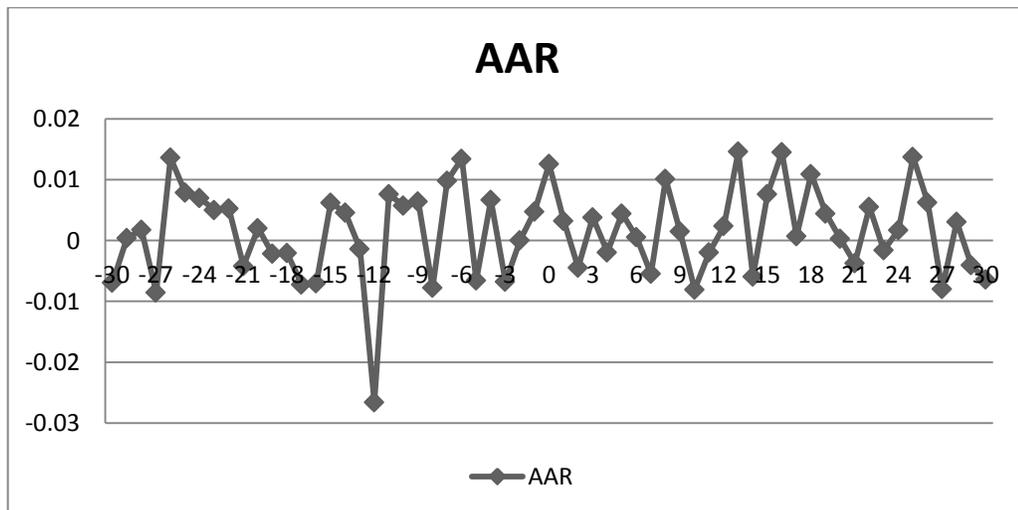
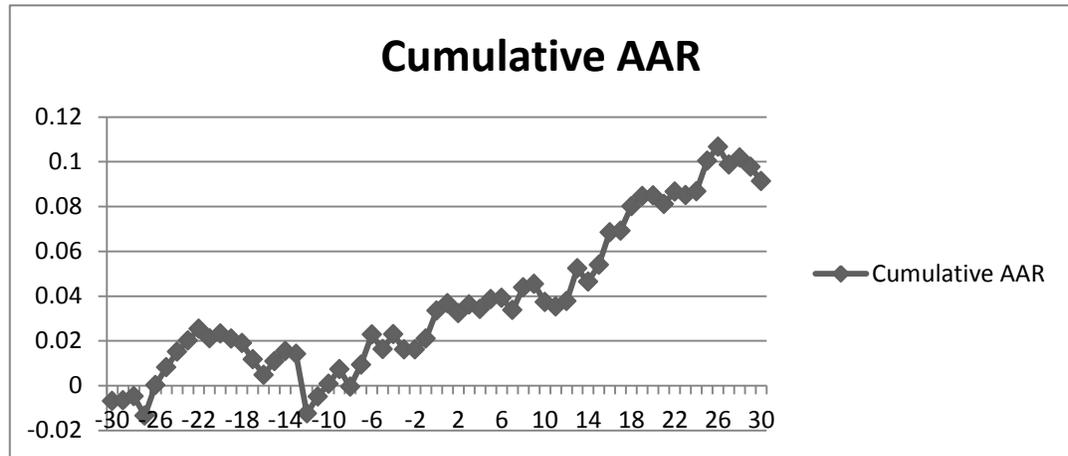


Figure 4: Cumulative Average Abnormal Return (AAR) for the Period of 2009 to 2014 in Offeror



3.1. Accounting Study

Accounting study was done by using eleven financial ratios calculated for four years, before announcement two years and after announcement two years. After observing all the financial ratios of the relevant companies of M&A, It was proving the results of event study.

4. CONCLUSION

Mergers and Acquisitions (M&A) are becoming more important and effective tools to cater the increased competition, rapid expansion of external markets and economic survival of firms. In order to remain competitive and grow profitably, the corporations or the companies around the world are aggressively trying to build new competencies and capabilities through M&A.

This study examines that how would be the stock price reaction to Merger and Acquisition announcement from the offeree side and from the offeror side. In the event study, It was calculated the average abnormal returns and cumulative average abnormal return for both sides (offeror and offeree). Results show that there is a negative effect for the offer or the target Company after the announcement of merger and acquisition. It means they do not get the significant advantage by going for the merger and acquisition. The cumulative average abnormal return is continuously declining for the offeree side during the study period.

Results of offeror side that show the positive effect for the offeror company after the announcement of the merger and acquisition. The results of offeror side indicate the different conclusion than the offeree side during the study period.

The results of this research have confirmed from the both studies that there is a negative impact for the firm performance from the offeree side and there is a positive impact for the firm performance from the tender offer company (offeror) side.

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