THE EFFECT OF MERGER AND ACQUISITION ANNOUNCEMENTS ON STOCK PRICE BEHAVIOUR AND FINANCIAL PERFORMANCE CHANGES: A CASE OF BANKS IN MALAYSIA

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Abstract

This study attempts to examine the effect of mergers and acquisitions completion announcements on the stock price behavior for two anchor banks; Hong Leong Bank Berhad and Arab Malaysian Bank Berhad. The analysis uses the event study technique, the Naïve Model, a model that is based on Market Model with constrained α = 0 and β = 1 to compute the abnormal returns surrounding the mergers and acquisitions completion announcement date; also to evaluate the effect of mergers and acquisitions completion announcement on the banks' return. This study also analyses the financial performance changes to provide a naïve analytical framework by using financial ratios for these two anchor banks. Overall, the result from event study shows that the mergers and acquisitions completion announcements are more likely to be treated as positive information. However, the results from financial performance measures for all the ratios, that are calculated, indicate that there is no improvement in any of the performance measures after the mergers and acquisitions is completed.

Keywords: merger, acquisition, stock prices, financial performance.

INTRODUCTION

Mergers and acquisitions (M&A, hereafter) have always been associated with the strengthening of firms' financial entity and increasing in value. Firms that involved in consolidation program will benefit operationally as well as financially as a result of M&A. According to Ogden, Jen & O'connor (2003); the motives for M&A include, (1) operating synergy; (2) financial synergy and diversification; (3) bankruptcy avoidance; (4) financial slack; (5) hubris; and (6) self-interest of the bidder's management.

There are many researchers have studied the effects of M&A on the value of both target and bidder firms. The evidence on mergers indicates that the stockholders of target firms have earned significant abnormal/excess return[1] not only around the announcement period, but also in the following weeks after the announcement. Jensen & Ruback (1983) review 13 studies that examine returns around takeover announcements and report an average abnormal return of 30% to target stockholders in successful tender offers and 20% to target stockholders

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[1] Abnormal/excess returns represent over and above the return that would have expected in an investment, after adjusting for risk and market performance.

in successful mergers. Jarrell, Brickley, and Netter (1988) also review the results of 663 tender offers made between 1962 to 1985, and noted that premiums averaged 19% in the 1960s, 35% in the 1970s, and 30% between 1980 and 1985. Many other studies also report an increase in the stock price of the target firms prior to the M&A announcement, suggesting either a very perceptive financial market or leaked information about prospective deals.

Nevertheless, evidence on the effect of M&A announcements on bidder firm stock prices is not as clearcut and in fact is contradictory, as the empirical studies have shown mixed results. Desai and Stover (1985), James and Weir (1987), and Cornett and De (1991); among others, report positive abnormal return to bidding firms in banking acquisitions. However, Neely (1987) and Cornett and Tehranian (1992), for example, report negative return to the bidder. Houston and Ryngaert (1994) suggest that samples that emphasize larger acquisitions are more apt to find negative bidder return.

The purpose of this study is to examine the effect of M&A completion announcements on the stock price behaviour for two anchor banks; Hong Leong Bank Berhad and Arab Malaysian Bank Berhad. This study covers the period from 1998 to 2003 and uses event study methodology. This study also uses selected financial ratios to see whether the merger results in improvement in performance measurement of the banks' pre- and post-merger.

This paper is organized as follows: section II presents the literature review on M&A effect. Section III presents the data and methodology use in this paper. Section IV provides empirical results and discussions. Finally, summary of main findings and implication as well as recommendation for further studies are presented in section V.

LITERATURE REVIEW

Fauzias (1992) in testing the efficiency of the Malaysian stock market reaction with regard to acquisition announcement uses the daily common stock returns of Kuala Lumpur Stock Exchange (KLSE) for a period ranging 200 days before and 200 days after the acquisition announcement date. In her study, Fauzias suggests that the bidder could have overestimated the value of the shares, which may result in paying too much for the assets. The increase in share prices prior to the announcement may also be due to the information leakage, which forces prices to move up before the announcement is made.

Another study also done by Fauzias (1993) examines the effects of acquisition announcement on the price behavior of the Malaysian bidders and target firms by employing three alternative models, (1) one factor market model; (2) Capital Asset Pricing Model (CAPM); and (3) the regression estimation of $\alpha = 0$ and $\beta = 1$ in the model. The results show that the target's insignificant negative returns and the bidder's significant negative returns after the announcement date.

A recent study by Fauzias and Ruzita (2003) show that all of the information of three announcements in corporate restructuring significantly conveyed to the market for each announcement. The results indicate that the market react to initial restructuring announcement, increase in the second announcement, but produce mixed results in the third announcement.

Houston et al. (2001) examine the factors that explain merger gains in 64 large banks and find that the bulk of the gains are from cost reductions particularly through reduction in geographical overlapping. Rhoades (1998) also investigates the efficiency effect of bank mergers by using case studies of nine mergers in America. He employs the same basic analytical framework

in all of the case studies, such as financial ratios, econometric cost measures and the effect of the merger announcement on the stock of the acquiring and acquired firms. All nine of the mergers resulted in significant cost cutting in line with pre-mergers projections. Four of the nine mergers were clearly successful in improving cost efficiency but five were not. The most frequent and serious synergies experienced in bank mergers that increase bidder returns relative to non-financial mergers was unexpected difficulty in integrating data processing systems and operations. While, Kim and Singal (1993) use the direction of the post-merger price change as an indicator for efficiency effect or market power effect. Their results show that share price increases after merger, therefore the market power effect exists.

DATA AND METHODOLOGY

This study uses 121 daily closing prices of the anchor banks and daily closing price index of the Kuala Lumpur Stock Exchange Composite Index (KLCI) surrounding the M&A completion announcement. Data on prices is collected from Thomson Datastream. The event dates are defined as the dates of announcement on the M&A completions, namely 30 October 2000 and 20 December 2001 for Hong Leong Bank Berhad and Arab Malaysian Bank Berhad, respectively. The KLCI data is used to proxy the market return (R_M). These data are to be used to examine the market reaction to the events based on the abnormal performance of the individual bank's stock surrounding the announcement.

Following Fauzias and Rasidah (2004), the Market Model with constrained $\alpha = 0$ and $\beta = 1$ is used to measure the abnormal performance. According to this model, the abnormal return (AR) for the individual bank for each day t is $AR_t = R_t - R_{M,t}$, where as the combined

reaction to both bank M & As have abnormal returns calculated as, $AR_t = \frac{1}{2} \sum_{i=1}^{2} AR_{i,t}$. The cumulative abnormal returns (CAR) are the sum of the abnormal returns that is $CAR_s = \sum_{t=K}^{L} AR_t$ where K to L are the days surrounding the announcement which in this study will be set at 60 days prior to until 60 days after the announcement.

To test significance of the AR and CAR values, the methodology again follow Fauzias (2003) in calculating the t-value of the two measures. The t-value of the abnormal return is equal to $t = \frac{AR_t}{\sigma_{AR,t}}$, where

$$\sigma_{AR,t} = \left[\frac{1}{N-1} \sum_{t=K}^{L} (AR_t - \overline{AR})^2 \right]^{1/2}$$ with

AR is the average of the ARs over the period (N = number of days from t = K until t = L). Whereas, the t-value for the CAR statistics is given as, $t = \frac{CAR}{\sigma_{CAR}}$, where $\sigma_{CAR} = \sigma_{AR}\sqrt{N}$ where N is the number of days in the CAR statistics.

In all cases the null hypotheses that the M&A completion announcement does not have any significant influence of the bank's stock return (i.e., H_0: AR = 0 and CAR = 0) are to be tested at 5 percent significant level.

Financial Performance Measurement

In studying the issue on financial performance changes, this study focuses on selected financial ratio of both Arab Malaysian Bank Berhad and Hong Leong Bank Berhad based on a pre-merger performance and compares it with the post-merger performance. A range of financial performance from the merger group that spans different

types of performance measures are studied: share performance, profitability, efficiency, and liquidity risk (following Fauzias and Rasidah, 2004).

In order to compare the bank's efficiency before and after the M&A, the method follows D'Souza et al. (2001) in excluding the financial year of itself from the analysis. Specifically, for the case of Hong Leong Bank Berhad the pre-merger year is the financial year ended 31 March 2001 while the post-merger year is the financial year ended 31 March 2003. Accordingly, for the Arab Malaysian Bank Berhad, the pre-merger year is the financial year ended 31 June 2000 while the post-merger year is the financial year ended 31 June 2002.

To compare the banks' efficiency before and after the M&A, yearly accounting data are collected from various sources including annual reports, Investor's Digest, and the KLSE online database. Specifically, for the case of Hong Leong Bank the pre-merger performance is from data for 1999 and 2000 while the post-merger performance is based on data in 2001 and 2002 because the bank has financial year ended in March and the M&A announcement take places on October 2000. Accordingly, for the Arab Malaysian Bank, the pre-merger performance is based on data in 2000 and 2001 while the post-merger performance is based on data in 2002 and 2003 because the financial year ended in June and the announcement take places on December 2001.

The decision to limit the data to 2 years is because; (1) post-merger data for Arab Malaysian Bank is limited to 2 years because data for financial year 2004 is not yet available, (2) the same number of sample (year) is needed in a paired-sample t-test, and (3) more compatible comparison between the two banks.

Table 1 provides the definitions of the ratios that are used in this study to examine whether the performance of the banks improves after the M&A exercise is completed. Several ratios seem to require further interpretation with respect to ability to measure the respective performance. In the profitability category, Fauzias and Rasidah (2004) explain that ROA evaluates the efficiency of the institution in utilizing its asset in creating income while ROCE evaluates the efficiency of institution in capitalizing its invested capital. Similarly in the efficiency category, Overhead Efficiency ratio evaluates the efficiency of the institutions in capitalizing its human resource capacity (productivity). Furthermore, they explain that the Asset to Liability ratio serves to evaluate the ability of the institution in meeting its financial obligation, the Loan to Deposit ratio is to evaluate the efficiency of the institution in creating income (loans) from its liability (deposits), and the Loans to Total Assets ratio evaluates whether the institution is aggressive or conservative in taking risk.

Table 1: Definitions of ratios used to measure the bank performance

Performance Measure	Ratios	Definitions
Share performance	Earning per share, EPS	Net Profit of the institutions divided by the number of common shares outstanding
	Book value per share	Shareholder's fund divided by the number of common shares outstanding
Profitability	Return on Asset, ROA	Net income of the institution divided by the total asset.
	Return on capital employed, ROCE	Net income plus interest expense divided by total liability plus shareholder's fund.
	Return on equity, ROE	Net income of the institution divided by the shareholder's fund.
Efficiency	Overhead efficiency	Gross income of the institution divided by the overhead expenses.
	Cost to income	Total expenses (interest expense plus overhead) divided by gross income.
Liquidity	Asset to liability	Total asset divided by the total liability of the institution.
	Loans to deposits	Total loans divided by total deposits of the institution.
Credit risk Performance	Loans to assets	Total loans divided by total assets of the institution. The ratio of non-performing assets to total loans

Source: All ratios are adopted from Fauzias and Rasidah (2004).

EMPIRICAL RESULTS AND DISCUSSIONS

Table 2, 3 and 4 present the summary of the significant test results of both the Abnormal Returns (AR) and Cumulative Abnormal Returns (CAR) for the (-60 days, +60 days) event windows. Especially, table 4 presents the combined effect of both merger and acquisitions. Table 2 and 3 show the significant test results for the (-60, +60) event window for the individual banks and Table 4 shows the results for both bank mergers combined. In each table, results separating the pre- and post-completion announcement are also shown. The overall results indicate that the M&A completion announcements are more likely to be treated as positive information. Results in Table A1 indicate that in the case of Hong Leong Bank, the ARs from the broader event window 55 percent of the time, 53 percent of which take place post-completion announcement. Table 2 shows that of the percentage of significant positive ARs are only slightly higher (54 percent) compared to the significant negative ARs and most (83.33 percent) of the significant positive ARs are for the pre-announcement period. While the results for Hong Leong case are less consistent with the positive effect of a M&A, the case for Arab Malaysian bank is more indicative of positive reaction to merger.

Table 2: Summary of the significant test results on the anchor bank's AR and CAR from broader event window due to the announcement on the completion of the merger and acquisition exercise of Hong Leong Bank Berhad on 30 October 2000

Panel A: Event Window of (-60,+60)					
Abnormal Returns			**Cumulative Abnormal Returns**		
(-60, +60), σ_{AR} = 0.0195			**(-60, +60), σ_{CAR} = 0.0195$\sqrt{121}$**		
Day	AR values	Sig t	Day	CAR	Sig t
-60	0.0506	2.5955	None		
-40	-0.0401	-2.0591			
-39	0.0554	2.8418			
-20	-0.0487	-2.4994			
-18	0.0595	3.0547			
-15	0.0421	2.1622			
-8	0.0440	2.2568			
1	-0.0506	-2.5962			
24	0.0493	2.5303			
25	-0.0450	-2.3068			
60	-0.0359	-1.8411			

Panel B: Event Window of (-60,0)					
Abnormal Returns			**Cumulative Abnormal Returns**		
(-60, 0), σ_{AR} = 0.0208			**(-60, 0), σ_{CAR} = 0.0208$\sqrt{61}$**		
Day	AR values	Sig t	Day	CAR values	Sig t
-60	0.0506	2.4378	-8	0.2800	1.7275
-40	-0.0401	-1.9340	-7	0.2772	1.7102
-39	0.0554	2.6691	-5	0.2703	1.6676
-20	-0.0487	-2.3476			
-18	0.0595	2.8691			
-15	0.0421	2.0309			
-8	0.0440	2.1197			

Panel C: Event Window of (0, +60)					
Abnormal Returns			**Cumulative Abnormal Returns**		
(0, +60), σ_{AR} = 0.0180			**(0, +60), σ_{CAR} = 0.0180$\sqrt{61}$**		
Day	AR values	Sig t	Day	CAR	Sig t
1	-0.0506	-2.8104	None		
20	-0.0305	-1.6935			
24	0.0493	2.7391			
25	-0.0450	-2.4972			
41	0.0303	1.6831			
54	-0.0359	-1.9930			

Note: For the (-60,+60) event window, the AR and CAR values are significantly different from zero at $\alpha \le 5$ percent and $\alpha \le 1$ percent when t-stats ≥ 1.658 and t-stats ≥ 2.360, respectively. For the (-60, 0) and (0, +60) event windows, the AR and CAR values are significantly different from zero at $\alpha \le 5$ percent and $\alpha \le 1$ percent when t-stats ≥ 1.671 and t-stats ≥ 2.390, respectively.

Table 3: Summary of the significant test results on the anchor bank's AR and CAR from broader event window due to the announcement on the completion of the merger and acquisition exercise of Arab Malaysian Bank Berhad on 20 December 2001

Panel A: Event Window of (-60,+60)					
Abnormal Returns			Cumulative Abnormal Returns		
(-60, +60), σ_{AR} = 0.0251			(-60, +60), σ_{CAR} = 0.0251√121		
Day	AR values	Sig t	Day	CAR	Sig t
-55	0.0521	2.0712	None		
-35	0.0515	2.0502			
-30	0.0465	1.8498			
-28	0.1299	5.1700			
-12	0.0429	1.7077			
-5	-0.0495	-1.9683			
26	0.0775	3.0832			
32	0.0608	2.4213			
33	0.0571	2.2708			
56	0.0762	3.0338			

Panel B: Event Window of (-60,0)					
Abnormal Returns			Cumulative Abnormal Returns		
(-60, 0), σ_{AR} = 0.0265			(-60, 0), σ_{CAR} = 0.0265√61		
Day	AR values	Sig t	Day	CAR values	Sig t
-55	0.0521	1.9614	None		
-35	0.0515	1.9416			
-30	0.0465	1.7518			
-28	0.1299	4.8961			
-5	-0.0495	-1.8640			

Panel C: Event Window of (0,+60)					
Abnormal Returns			Cumulative Abnormal Returns		
(0, +60), σ_{AR} = 0.0237			(0, +60), σ_{CAR} = 0.0237√61		
Day	AR values	Sig t	Day	CAR	Sig t
26	0.0775	3.2704	None		
27	0.0408	1.7218			
32	0.0608	2.5683			
33	0.0571	2.4087			
56	0.0762	3.2180			

Note: For the (-60,+60) event window, the AR and CAR values are significantly different from zero at $\alpha \leq 5$ percent and $\alpha \leq 1$ percent when t-stats ≥ 1.658 and t-stats ≥ 2.360, respectively. For the (-60, 0) and (0, +60) event windows, the AR and CAR values are significantly different from zero at $\alpha \leq 5$ percent and $\alpha \leq 1$ percent when t-stats ≥ 1.671 and t-stats ≥ 2.390, respectively.

Table 4: Summary of the significant test results on the AAR and CAAR of both anchor banks from broader event window due to the announcement on the completion of their merger and acquisition exercises

Panel A: Event Window of (-60,+60)					
Average Abnormal Returns			**Cumulative Average Abnormal Returns**		
(-60, +60), σ_{AAR} = 0.0162			**(-60, +60), σ_{CAAR} = 0.0162√121**		
Day	**AAR values**	**Sig t**	**Day**	**CAAR**	**Sig t**
-60	0.0325	2.0094	None		
-39	0.0299	1.8472			
-30	0.0353	2.1840			
-28	0.0637	3.9398			
-18	0.0348	2.1532			
1	-0.0273	-1.6850			
25	-0.0268	-1.6585			
26	0.0442	2.7288			
32	0.0343	2.1209			
33	0.0332	2.0536			
56	0.0406	2.5087			
Panel B: Event Window of (-60,0)					
Average Abnormal Returns			**Cumulative Average Abnormal Returns**		
(-60, 0), σ_{AR} = 0.0167			**(-60, 0), σ_{CAAR} = 0.0167√61**		
Day	**AR values**	**Sig t**	**Day**	**CAR values**	**Sig t**
-60	0.0325	1.9525	-23	0.2168	1.6673
-39	0.0299	1.7949	-17 to -6	0.2171	1.6692
-30	0.0353	2.1222		to 0.2358	to 1.8129
-28	0.0637	3.8283			
-18	0.0348	2.0923			
Panel C: Event Window of (0, +60)					
Average Abnormal Returns			**Cumulative Average Abnormal Returns**		
(0, +60), σ_{AAR} = 0.0158			**(0, +60), σ_{CAAR} = 0.0158√61**		
Day	**AR values**	**Sig t**	**Day**	**CAR**	**Sig t**
1	-0.0273	-1.7478	None		
25	-0.0268	-1.7204			
26	0.0442	2.8306			
32	0.0343	2.2000			
33	0.0332	2.1302			
54	0.0406	2.6022			

Note: For the (-60,+60) event window, the AR and CAR values are significantly different from zero at $\alpha \le 5$ percent and $\alpha \le 1$ percent when t-stats ≥ 1.658 and t-stats ≥ 2.360, respectively. For the (-60, 0) and (0, +60) event windows, the AR and CAR values are significantly different from zero at $\alpha \le 5$ percent and $\alpha \le 1$ percent when t-stats ≥ 1.671 and t-stats ≥ 2.390, respectively.

Table 2 shows that the percentages of positive ARs due to the M&A completion announcement are somewhat less than those for Hong Leong Bank both in term of the whole period positive ARs (51 percent) and post-announcement positive ARs (46 percent). Nonetheless, Panel A of Table 3 indi-cates that 90 percent of the significant re-sults are for positive ARs and 44 percent of it is for the positive ARs post-completion. In only one case is the negative ARs signifi-cantly different from zero. Panel C of Table 3 shows that all of the significant effects are associated with positive ARs and therefore

consistent with the earlier statement that the completion of the M&A exercise has been considered as more positive information by the market. With respect to the CARs of both M&A completion announcements, only the CARs of the Hong Leong's M&A indicate some significant positive results but again all of them are from the pre-M&A completion window.

Both results suggest that there are significant leakages in information about the M&A completion but this comes at no surprise because the market could easily anticipate the completion of a progressing M&A. Similar significant CARs prior to the event date are earlier found in Fauzias (2003) suggesting that the leakage of information is not unique to this case only. If this is the case, then this result can be considered as supporting the positive influence of an M&A on stock return.

In attempt to examine whether the market agree with the central bank's proposition that the M&As are capable of strengthening the banks financial health, the combined effect of both M&As are analyze and the results are reported in Table 4. Together, the M&As seem to justify the central bank's objective as 82 percent of the significant ARs are positive. While Panel B of Table 4 shows that all of the significant pre-completion ARs are positive, Panel C of the same table shows that 67 percent of the significant ARs are positive. Meanwhile, the

CAR results in Panel B shows that in 21 percent of the days prior to the event date the CARs are significant and positive. None of the CARs for the whole (-60, +60) event window and post-announcement window is significant.

Since another objective of this study is to test if there is any significant change in the performance of an individual bank, paired-sample t-test is deemed appropriate. The results are reported in Table 5.

The results of in Table 5 for Hong Leong Bank suggest that even though none of the differences are significant, overall the bank's performance deteriorates after the M&A particularly as measured by the share performance, efficiency and also liquidity ratios. However, the negative effect of the M&A completion on Hong Leong Bank's performance is less severe compared to that on Arab Malaysian Bank. For all the ratios that are calculated, the t-test results show that there no improvement in any of the performance measures after the M&A is completed. Furthermore, the deterioration in the bank liquidity is significant ($\rho \leq 0.05$) both when measured with Loans to Deposits and Loans to Assets ratios. Based on the results from the two banks, it may be concluded that the M&As do not produce the expected results to improve the performance of these local banks.

Table 5: Results of the t-test comparing the bank performance pre- and post-merger.

Performance Measure	Ratios	Hong Leong Bank			Arab Malaysian Bank		
		Pre	Post	t-value	Pre	Post	t-value
Share performance	Earning per share, EPS	0.345	0.280	0.236 (0.852)	0.856	0.241	1.265 (0.426)
	Book value per share	3.590	2.030	2.2941 (0.262)	1.915	1.590	1.000 (0.500)
Profitability	Return on Asset, ROA	1.025	1.370	-0.600 (0.656)	1.130	0.410	2.057 (0.288)
	Return on capital employed, ROCE	0.045	0.035	[a]	0.050	0.025	1.667 (0.344)
	Return on equity, ROE	10.530	13.065	-0.408 (0.753)	21.940	7.970	2.179 (0.274)
Efficiency	Overhead efficiency	5.765	5.435	0.351 (0.785)	na	na	Na
	Cost to income	0.645	0.560	0.586 (0.662)	na	na	Na
Liquidity	Asset to liability	1.110	1.120	-1.000 (0.500)	1.075	1.055	[a]
	Loans to deposits	0.720	0.615	2.333 (0.258)	0.925	0.500	15.909 (0.040)
	Loans to assets	0.575	0.475	3.333 (0.186)	0.700	0.040	66.000 (0.009)

Notes: [a] Standard error = 0, thus no t-test, na = data not available. The "pre" and "post" figures are the average of the two years prior to and two years after the M&A is completed.

CONCLUSIONS, IMPLICATIONS AND FUTURE RESEARCH

Based on the results of the individual anchor banks, due to the announcement on the completion of the M&A exercise, the overall sample results indicate that the M&A completion announcements are more likely to be treated as positive information. Even though in Hong Leong Bank case the results are less consistent with the positive effect of M&A. This evidence also suggests that there might be a leakage of information, as the market could easily anticipate the information of the completion of a progressing M&A. Meanwhile, the results also in line with the aim of central bank's proposition that the M&As are capable of strengthening the local banks' financial entity.

Overall, the results particularly as shown through the combined M&A analysis are supportive of argument that M&A in banking industry provides positive effects in this case based on the perception of the market. This evidence provides justification to the central bank's proposition to consolidate program for domestic banking sector to improve their financial strength. It is also consistent with the results found by Houston et al (2001) for the combined bidders and targets and for M&A in the 1990s sub-sample.

However, the overall results from financial performance measures using selected financial ratios to compare the banks' performance show that there is no significant difference between pre-and post-merger period in the level of efficiency and the financial performance for these two anchor banks. For all the ratios, that are calculated, the t-test results show that there no improvement in any of the performance meas-

ures after the M&A is completed. To conclude, the M&A do not produce the expected results to improve the financial performance of these two banks. For future research, it would be meaningful if the analysis would be done for all ten anchor banks in Malaysia and also extend the years after the mergers exercise.

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