



INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN ACCOUNTING, FINANCE AND MANAGEMENT SCIENCES



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To Link this Article: <http://dx.doi.org/10.6007/IJARAFMS/v2-i4/9988> DOI:10.6007/IJARAFMS /v2-i4/9988

Received: 11 October 2012, *Revised:* 15 November 2012, *Accepted:* 29 November 2012

Published Online: 25 December 2012

In-Text Citation: (Juma et al., 2012)

To Cite this Article: Juma, O. N., Wawire, P. T., Byaruhanga, J., Okaka, O., & Odera, O. (2012). Impact of Bank Mergers on Shareholders' Wealth: A Review of Literature. *International Journal of Academic Research in Accounting Finance and Management Sciences*, 2(4), 204–215.

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Vol. 2, No. 4, 2012, Pg. 204 - 215

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Impact of Bank Mergers on Shareholders' Wealth: A Review of Literature

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Abstract

The main motive of any Merger and Acquisitions (M&As) is to increase of the wealth for the shareholders which in turn forms the main goal of any firm. The main categories of motives identified include those that increase shareholder value and those that destroy shareholder value. Motives which increase shareholder value include; synergy, achievement of economies of scale and scope, increased market power and revenue growth, improvement of managerial efficiency. Motives which decrease shareholder value include managerial hubris, agency and diversification. There are three main types of M&As which are horizontal, vertical and conglomerate. The study lastly examines the methods of financing M&As, the relative size and the number of bidders of the target firms.

Keywords: Mergers, Acquisitions, Organisational Factors

Introduction

The goal of any profit-seeking organization is to preserve and create wealth for its owners (ECB, 2010). The main motive of any M&As is to increase of the wealth for the shareholders which forms the main goal of a firm (Pandey, 2009; McGuigan et al., 2012). The quest for productive opportunities leads firms to search for new products and markets via M&As (Penrose, 1959). Firms must try to position themselves in the intermediation channels which clients are likely to be using in the future,

not necessarily those they have used in the past. This requires strategic repositioning and restructuring which can be achieved through M&As (Ingo, 2004).

The motives of M&As are important when analyzing the success or failure of a merger. M&As performs a significant role in the majority of companies' strategies. The motives for the M&As can be defined as the acquirers of corporate and business strategic objectives, which are varied in different companies (Wang, 2007). The main categories of motives identified include those that increase shareholder value and those that destroy shareholder value (see Andrade et al., 2001; Berkovitch & Narayanan, 1993; Wang, 2007).

Motives Which Increase Shareholder Value

This category of motives includes those which can benefit the shareholders' wealth. Empirical evidence concludes that these motives mainly include the synergy effect improvement of managerial efficiency, achievement of economies of scale and scope, increased revenue growth and market power (Wang, 2007).

Synergy Motive

According to Campbell & Goold (1998) synergy originates from the Greek word "synergos" which means walking together. Its business usage refers to the ability of two or more business units to generate greater value working together than they could do working apart. Sirower (1997) defines synergy as an increase in competitiveness and resulting cash flows beyond what two firms are expected to accomplish independently. Synergy exists in M&As when the value for the combined entity exceeds the sum of the values of the two firms (Seth, 1990). Frensch (2007) defines synergy as the positive or negative efficiency effects resulting from the partial or full integration of the merging firms. This is the most popular motive for M&As. It refers to acquiring or merging with resources of two separate firms and thus it contributes to the value of the newly combined firm greater than that of two separate firms. It is the ability of a corporate combination to be more profitable than the individual profits of the firms that are combined (Gaughan, 2005). One important source of synergy is from the transfer of some valuable intangible assets such as know-how, between targets and acquirers (Seth et al., 2000).

Carpenter & Sanders (2007) report five sources of synergy; reducing threats, increased market power, cost savings, increased financial strength and leverage capabilities. The anticipation of synergistic benefits provide incentives for companies to incur expense for M&As process and still pay a premium over the market value to target shareholders. The synergistic effect should be greater than the expense to justify going forward to undertake an M&As. If the synergistic effect is less than expenses, then, the bidding firm will have overpaid the target (Gaughan, 2005).

Evaluating synergy effects from M&As deals has become one of the major tasks of managers. From the perspective of the relationship between target and total gains, they are positively correlated in synergy motivated M&As. Therefore, the higher the synergy, the higher the target gains as well as the acquiring firm's shareholders benefits (Berkovitch & Narayanan, 1993). Empirical results suggests that synergy motive has positive effects on targets, acquirers and total gains on the new company (see Berkovitch & Narayanan, 1993; Gondhalker & Bhagwat, 2000; Sudarsanam et al., 1996). Gaughan (2005), identifies two types of synergy; operational and financial synergy.

Operational Synergy refers to the efficiency derived in gains or operating economies that are derived in horizontal and vertical mergers. Operational synergies often come from a reduction in costs that result from corporate combination and economies of scale (Gaughan, 2005). Operation

synergies represent the achievement of production and/or administrative efficiencies (Chatterjee, 1986). Operating synergies can further be divided into two; revenue enhancing and cost reducing synergies. Combinations that increase the ability of the resulting entity to generate more revenues are beneficial. If after combination, a company has increased revenues greater than merely combining the revenues of the merging firms, and then perhaps revenue-enhancing synergies explain growth (Gaughan, 2005). Piloff & Santomero (1996) argue that M&As activities can be more efficient if redundant facilities are eliminated. De Young et al. (2009) contend that M&As can increase firm size and firms with large sizes can increase market power in determining higher prices or generating profits.

Financial Synergy refers to the possibility that the cost of capital can be reduced by combining two or more firms. One form of synergy is to purchase a target at bargain basement prices. When the ratio of the market value of a firm's securities to the replacement costs of its assets (q-ratio) is low, the acquirer is considered successful in buying the target (Copeland et al., 2005). Compared to external financing, the lower cost of internal financing is a major source of financial synergy. The saving of transaction costs from economies of scale is also regarded as a benefit of financial synergy (Copeland et al., 2005). Sudarsanam (2003) notes that the costs saving is one aspect of value creation in M&As. Financial synergy on average, tends to be associated with more value than operational synergies (Chatterjee et al., 1986). The overreaching reason for combining with another organization is that the union promotes attainment of strategic goals more quickly and with less risk than if a company were to act independently. Value is created when organizations join forces that genuinely enhance the capacity of the combined organization to grow and prosper. Marks & Mirvis (2010) found that in 90% of all combinations, initiatives associated with generating revenue drove more value than any other action.

Achievement of Economies of Scale and Scope

Most companies pursue M&As so as to save on production costs because low costs are vital for a firm's profitability and success. Economies of scale and scope can help decrease cost of production (Brealey et al., 2006). Achieving economies of scale is the goal both for horizontal and conglomerate M&As. On the other hand, economies of scope are attributed to an increase in the variety of products leading to the declining production costs. Economies of scale and scope can result in companies creating value. Firms are aware of diseconomies which may result from diffusion of control, the effectiveness of communication and the complexities of monitoring (Sudarsanam, 2003). Kaur & Kaur (2010) assert that M&As in the banking industry are aimed at achieving economies of scale and scope. M&As assist in the diversification of products which help reduce risk as well (Piloff & Santomero, 1996).

Increased Market Power and Revenue Growth

Market power is the ability of a market participant or a group of participants to control the price, the quantity or the nature of products sold, thereby generating extra-normal profits (Seth, 1990). Increased market power and revenue growth are the most common motives for firms participating in M&As (Zaheer & Souder, 2004). Increased market power can help companies compete effectively and revenue growth can be achieved by lowering the prices of products which are highly price sensitive. New growth opportunities emerge from the creation of new technologies, products and markets (Sudarsanam, 2003). As a result, the financial position of the acquiring firm will

be strengthened by increased market power and revenue growth thereby increasing profitability (Gaughan, 2005).

Growth that facilitates payment of dividends and the maximization of shareholder value is a valid goal to pursue (Gaughan, 2005). Firms can either grow through; (a) organic growth or internal expansion, and (b) M&As. M&As can enable a company to more quickly respond to perceived opportunities in the market place. With M&As, a company is able to acquire a ready-made business rather than have to develop one from the ground. Since M&As offer a faster way to grow, companies often make deals to enable them grow faster than they otherwise would. Not all M&As create shareholder value; in fact some destroy the same value (Petitt et al., 2002). Although the share prices of target firms rise after the disclosure of an intended M&As, the share prices of most acquiring firms decline (Jensen & Ruback, 1983).

Improvement of Managerial Efficiency

Gaughan (2005) observes that this can be a reasonable motive for M&As by large companies with deep layers of managerial skills when a target company is one that lacks such resources. As small companies grow, they have an increased need for broader range of managerial expertise and depth. In order to improve managerial efficiency, a company may prefer to merge or acquire or be acquired so as to improve efficiency by restructuring operations (Copeland et al., 2005). A larger company may be able to provide such managerial depth and may already have in place the management structure to meet the company's future needs (Gaughan, 2005). Martin & McConnell (1991) indicate that the improvement of managerial efficiency in M&As may be attributed to two methods.

On the one hand, the market for corporate control performs a significant role in improving the managerial efficiency of target firms; in that, potential bidders may pose a threat on managers' positions and monitor their performance (Jensen & Ruback, 1983). Thus, senior top executives will improve managerial efficiency or avoid dismissal after M&As and minimize non-value maximizing behaviour (Alchian & Demsetz, 1972). On the other hand, when the threat of M&As cannot minimize the manager's non-value maximizing behaviour, the acquirer will replace the management of the target company (Martin & McConnell, 1991). The improved managerial efficiency assists manager's work to maximize the shareholder value. M&As may not however be the only way to improve the management's efficiency, but sometimes may be the most practical and simple method (Brealey et al., 2006).

Motives Which Decrease Shareholder Value

As opposed to the theories based on synergy effects, a number of theorists argue that the motives including hubris, agency and diversification are the potential responses to shareholder wealth destruction for M&As (Wang, 2007).

Managerial Hubris

The hubris hypothesis states that managers frequently overestimate the ability to exploit synergies (Roll, 1986). Roll (1986) suggests that managers' expectations are symmetrically erroneous with an upward bias because the stock market price serves as a down side cut-off point. This leads to excessive bids in which acquisition price may be paid thus it is less likely that shareholders will benefit from an acquisition (Bosecke, 2009).

According to Seth et al.(2000), managerial hubris contains two major issues; the hubris hypothesis and the managerialism hypothesis. Managers are considered to have incentive to create

economic value and have the ability to assess the potential value of the target (Seth et al., 2000). When the management of the bidder underestimates the value of the target firm and usually overestimates the value of potential synergies, the hubris hypothesis takes place (Berkovitch & Narayanan, 1993). Bidders may thus pay more than the current market price of the target due to the hubris factor (Roll, 1986; Seyhun, 1990). Thus, there will be zero correlation between the target and the total gains since target gains are merely transfer of wealth from the acquirers (Gaughan, 2005; Berkovitch & Narayanan, 1993).

From the perspective of managerialism hypothesis, managers prefer to take on M&As at the expense of the shareholders in order to maximize their own competence (Caves, 1989). Markets tend to be neutral or react negatively with regards to bidders when they announce such M&As (Gaughan, 2005). Sirower (1997) asserts that M&As performance is strongly dependent on the synergy potential (motive), the premium paid and the integration process. If the premium paid is higher than the synergy potential, the value creation of the merger or acquisition is negative. If the synergies are realized too late, then the discounting of future synergistic gains increases the performance improvements to pay back premium. The realization of synergy effects depends on the effectiveness of the integration process. The realized value then corresponds to the value creation potential minus the synergy effects that have not been realized (Frensch, 2007).

Managements' acquisition of a target may be motivated by a desire to maximize shareholder value. However, other motives may include desire to enter a target's industry or to become 'the largest firm in the business', the extent to which these motives perform a role vary from one deal to another. It is thus of some interest that much evidence support the hubris hypothesis. The questionably high premiums paid for some firms imply some element of hubris (Hitt et al., 2001).

The Agency Motive

In some circumstances, the agency problem might force managers to engage in M&As (Frensch, 2007). With the separation of ownership and control, the agency problem implies M&As occur when managers want to increase their wealth at the expense of the acquirer's shareholders benefits (Berkovitch & Narayanan, 1993). Agency problem can stimulate competition among companies but cannot be itself eliminated by the competition, and the gains to the target shareholders increase with the competition (Berkovitch & Narayanan, 1993). In contrast to the synergy motives, when the agency motive is the main motive behind M&As, the returns to the target is positive whereas the returns to the bidder is more negative, thus returns to the newly created company is negative (Gondhalker & Bhagwat, 2000). According to Gupta & Misra (2007), good managers run firms with efficient incentive and monitoring systems which work to ensure that corporate policy is focused on maximizing value. In contrast, some managers may initiate mergers in an attempt to maximize personal gains, potentially to the detriment of the firms' shareholders. Mehran & Peristiani (2006) found that agency problems are an important factor contributing to management- initiated buyouts, particularly when managers and stockholders disagree on how excess cash should be used.

Diversification Motive

According to Berger & Ofeck (1995), diversification can serve as a motive for conglomerate M&As but has an uncertain effect, that is, either value creation or value destruction on the shareholder value. Potential benefits of diversification include; greater operational efficiency, less incentive to forego positive net present value (NPV) projects, greater debt capacity and fewer taxes. In addition, the value of the bidding firm is increased through diversification in terms of economies

of scale, scope and market power. However, the potential cost of diversification involve the cost of undertaking value destructing investments, resources which are allocated from better-performing departments to poor ones, are not sufficiently used and there is a conflict of interest problem among diverse managements (Berger & Ofeck, 1995).

Graham et al. (2002) contend that corporate diversification destroy firm value. The destruction effects of diversification stem from over-investment and subsidization of failing segments (Stulz, 1990). Berger & Ofeck (1995) examine at the effects of diversification on firm value and conclude that diversification destroys firm value. Furthermore, Seth et al. (2000) indicate that “in an integrated capital market, firm-level diversification activities to reduce risk are generally considered non-value maximizing as individual shareholders are able to duplicate benefits from such activities at lower costs”. Similarly, diversifying firms move from a business/product/market domain in which they are relatively well established with critical resource (such as experience, supply chain partners and reputation) to a domain in which they are likely to have less of these resources (Hitt et al., 2006). Berger & Ofeck (1995) conclude that there is no clear prediction about the overall value of diversification. The relationship between motives of M&As and gains to the target, the bidder and the newly created firm can be summarized as:

Table 1. The Relationship between the Motives of M&As and the Gains

Theory	Combined Gains	Gains to Target	Gains to Bidder
Efficiency and Synergy	Positive	Positive	Non-negative
Agency	Negative	Positive	More negative
Hubris	Zero	Positive	Negative

(Adapted from Weston et al., 2004)

Types of Mergers

There are three main types of M&As which include horizontal, vertical and conglomerate mergers (Okonkwo 2004; Gaughan, 2007; Weston et al., 2004; Sing & Montgomery, 1987; Brealey et al., 2006). Chatterjee (1986) notes that each type of M&As may bring the different synergies and links horizontal mergers with collusive synergies, vertical mergers with operational synergies and conglomerate mergers with financial synergies. Horizontal mergers involve two or more companies that operate in the same business and are direct competitors. Such mergers are always intended to create economies of scale, scope and strengthened market power. Horizontal merger may result in anti-competitive impact on prices and investment, and reduction in costs (Pezendolfer, 2003; Sing & Montgomery, 1987; Weston et al., 2004).

Weston et al. (2004) identify vertical mergers which occur when two or more companies in a particular industry but in different stages of production process combine their operations. One of the prime motivations for such M&As is the prevention or elimination of potential hold-up problems which might otherwise diminish the efficiency and effectiveness of the operations (Hitt et al., 2001).

Conglomerate mergers occur when unrelated firms or companies in different products, markets combine to enter into different activity fields in the shortest time span and reduce financial risks by portfolio diversification (Okonkwo, 2004; Gaughan, 2007; Weston et al., 2004). Weston et al. (2004) propose three groups of conglomerate mergers; product extension, market extension and pure conglomerates. Each of such serves different goals than either vertical or horizontal mergers; for example an establishment of internal capital market and risk reduction through diversification.

Amihud & Lev (1981) state that conglomerate mergers lead to lower risk and may thus be perceived better by the shareholders owing to their ability to produce higher profits and/ or lower losses. Shareholders would prefer such mergers as it would mean the added advantage of diversification for them by spreading the diversifiable risks.

Discussions

Organizational Factors

Method of Financing

M&As may be paid for in several ways. Transactions may use all cash, all equity or a combination of both. Equity backed transactions may use the stock of the bidder as well as other securities such as debentures; stock may be common or preferred (Gaughan, 2007). Myers & Majluff (1984) observe that financing acquisitions with stock is equivalent to issuing stock. Finkelstein & Halebian (2002) investigate the independent effect of payment on shares and found no significant relationship between stock market returns and the payment method. Hayward & Hambrick (1997) illustrate the effect of the method of payment on the stock performance. The method of payment does not affect the overall merger gains (DeLong, 2001; Becher, 2000).

Sirower (1997) ascertains that the use of cash for an acquisition results in better performance than the use of stock. Al-Sharkas et al. (2010) indicate that patterns in returns are driven by the method of payment. Mergers financed with stock appear to have lower returns than those financed with cash (Zopounidis et al., 2008). Chang (1998) determines evidence of positive abnormal returns for acquiring firms dependent on the method of payment. Chevalier & Redar (2008) state that bidder returns are low when transactions are financed with stock than alternative combined or cash offers. Chevalier & Redar (2008) confirm that choice of method of payment has an impact on the profitability of a takeover. Al- Sharkas et al. (2010) report that target, bidder and the combined firm's returns are positively related to cash financed mergers. Wang (2007) finds that cash offers generate consistently higher abnormal returns than do stock exchanges.

Relative Size

Frensch (2007) asserts that the characteristics of the target that have been found to influence M&As include success; the relative size and the combination potential which also determines the synergy potential of a target. Agrawal et al. (1992) disclose no evidence for size related performance effects. Sirower (1997) identifies no consistent evidence on the effect of relative size of the target on performance.

Finkelstein & Halebian (2002) observe that there may be a size effect leading to larger acquirer gains if the target is relatively large. Frensch (2007) detects that relative size of the acquisition target improves M&As success. If the target is small, all the structures of the bidder are imposed on the target and the change requirements are very asymmetrical. The danger is that such action (organization structure changes) will create unnecessary confusion at the subsidiary level and the lack of knowledge at the parent company level (Frensch 2007).

Moeller et al. (2005) reveal that acquisitions of large targets are more successful than those of small targets. One of the reasons could be that strategic preparation is a success factor for integrations and those companies prepare more carefully the integration of large acquisition targets. Shelton (1988) observes that increased relative size yields higher value creation for the acquirers. Larsson & Finkelstein (1999) reveal that with increased firm size, the combination potential of the two firms and thus the potential for synergies increase. Very small as well as very large acquisitions

yield negative performance effects. Acquisitions that are too small are not worth the efforts, while larger acquisitions may be the case of "... biting more than one can chew" (Kusewitt, 1985).

Kyei (2008) concludes that large acquisitions have statistically no impact on the long-term share price returns of the Johannesburg Stock Exchange (JSE) listed firms. Moeller et al. (2005) demonstrate that large firms destroy shareholder value while small firms create wealth. Gorton et al. (2009) observe that smaller acquirers realize large abnormal returns than large bidders. Average target size therefore appears to perform an important role in determining acquirer's shareholders' returns (DePamphilis, 2010).

Number of Bidders

It is important to consider the number of bidders that a target receives prior to the merger. Consistent with this is the overpayment hypothesis which suggests that if multiple firms bid for the same target, then the returns to the winning bidder will be lower because this bidder is overpaying for the target so as to win the deal (Al-Sharkas et al., 2010). If this hypothesis holds true then bidders who face competition get lower returns, while target firms will experience higher returns when there are multiple bidders since an increase in competition for the target firm drives up the merger premiums (Al-Sharkas et al., 2010).

Sing & Montgomery (1987) identifies that single bid acquisitions suggest abnormally higher dollar value than multiple bid acquisitions. This is consistent with the overpayment hypothesis which predicts that if more than one bidder bid is on the target, the winning bidder will overpay for the target so as to win the deal. As a result, the bidder returns will be lower in this case.

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