The impact of Mergers and Acquisitions on Corporate Financial Performance in India

Dr. K. B. Singh

Abstract - Mergers & Acquisitions (M&A), as a corporate restructuring activity in India has exhibited explosive growth in recent years and has become an important corporate strategy in the financial and economic environment all over the world. Since 1991, Indian industries have been increasingly exposed to both domestic and international competition. The Indian economy has undergone a major transformation and structural change following the economic reforms, size and competence have become the focus of business enterprises in India. Hence, in recent times, companies have started restructuring their operations around their core business activities through (M&A). M&A is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long term profitability (Seth, 1990). Even though M&A have been an important element of corporate strategy all over the globe for several decades, research on M&As has not been able to provide conclusive evidence on whether they enhance efficiency or destroy wealth. Therefore M&A related issues have drawn considerable interest from practitioners and academicians across the globe. Researchers (Yook, 2004; Dickerson, Gibson, & Tsakalotos, 1997; Paufter, 2003; Cochran & Wood, 1984) have documented that there are two main streams in the existing post-acquisition performance literature. One is the stock market approach which uses stock market valuation to determine post-acquisition performance (Paufter, 2003; King, Dalton, Daily, & Covin, 2004), and the other is the accounting data approach which directly focuses on a company’s profitability through accounting and cash flow ratios (Healy, Palepu, & Ruback, 1992; Ghosh 2001). Our study uses long-term pre- and post-merger financial data to assess firm operating performance. According to Bromley (1986), in many cases, accounting performance measures are better than market-based measures because they are used more frequently by managers to make strategic decisions. A sample of 20 pair of public listed companies which have undergone M&A during 2005 were taken for analysis. We use averages of the financial ratios data of three years prior to (Pre-merger) and three year subsequent to the merger (Post-merger). These ratios were compared and tested for any statistical significant difference, using paired ‘t’ test. The study found that there was a long-term improvement in financial performance of merging companies. Thus we conclude that mergers and acquisitions is an effective methods of corporate restructuring, and should become an integral part of the long-term business strategy of corporates in India.

Key words: Mergers and acquisitions; M&A; takeovers; corporate financial performance; India.

I. INTRODUCTION

Over the last two decades, Mergers and Acquisitions (M&A)-related issues have drawn considerable interest from practitioners and academicians. As a result, scores of empirical studies have documented various aspects of M&A activity, including trends in such M&A activities, characteristics of the transactions, and corresponding gains or losses to shareholders. While the majority of the existing empirical evidences focus on the stock returns surrounding the announcement dates, a smaller body of research has examined the long-run post-acquisition stock returns and operating performance.

In Indian industry, the pace for mergers and acquisitions activity picked up in response to various economic reforms introduced by the Government of India since 1991, in its move towards liberalization and globalization. The Indian economy has undergone a major transformation and structural change following the economic reforms, and “size and competence” have become the focus of business enterprises in India. Indian companies realised the need to grow and expand in businesses that they understood well, to face growing competition; several leading corporates have undertaken restructuring exercises to sell off non-core businesses, and to create stronger presence in their core areas of business interest. Mergers and acquisitions emerged as one of the most effective methods of such corporate restructuring, and became an integral part of the long-term business strategy of corporates in India.

A survey among Indian corporate managers in 2006 by Grant Thornton found that Mergers & Acquisitions are a significant form of business strategy today for Indian Corporates. The three main objectives behind any M&A transaction, for corporates today were found to be:

- **Improving** Revenues and Profitability
- **Faster growth** in scale and quicker time to market
- **Acquisition** of new technology or competence

<table>
<thead>
<tr>
<th>Table 1: Objectives of Indian Corporates for M&amp;As</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objective behind the M&amp;A Transaction</td>
</tr>
<tr>
<td>To improve revenue &amp; Profitability</td>
</tr>
<tr>
<td>Faster growth in scale and quicker time to market</td>
</tr>
<tr>
<td>Acquisition of new technology or competence</td>
</tr>
<tr>
<td>To eliminate competition &amp; increase</td>
</tr>
</tbody>
</table>

Indian Journal of Research in Management, Business and Social Sciences (IJRMBSS) 13
II. OBJECTIVES

1. To analyzes the profitability of merged companies by comparing key financial ratios during pre and post merging year.
2. To analyze the change in financial leverage due to M&A.

III. RESEARCH METHODOLOGY

Sample: A list of companies involved in mergers during the year 2005 were compiled from Capitaline and Prowess database and the same was cross-checked from the websites of BSE and NSE (for names of name changes and delisted companies). To such a list, the screening criteria were applied to arrive at the final sample. These criteria were: merger cases, where at least two years of data were not available for pre-merger period and at least four years data for post-merger period, were removed from the study sample. Also companies where the target or acquirer were a foreign listed company was omitted and those acquirers which went for multiple mergers were also removed. The final sample size for the study was 20 public listed companies from a total of 58 companies which have undergone M&A during the period of the study.

We have taken sample firms of the year 2005, as the long-term financial performance is tested for 3 years post mergers and abnormal economic time period of recession starting around the year 2008 is avoided.

Research Hypotheses: To test the objectives mentioned above, the following hypotheses were formulated:

(i) H0: Mergers in India have no impact on the operating performance of acquiring firms.

H1: Mergers in India have impact on the operating performance of acquiring firms.

(ii) H0: Mergers in India have no impact on financial leverage of acquiring firms.

H2: Mergers in India have impact on financial leverage of acquiring firms.

We have adopted the methodology of comparing pre- and post-merger performances of acquiring companies, using the following financial ratios:

- Operating Profit Margin (Profit Before Depreciation, Interest and Tax/Net Sales)
- Gross Profit Margin (Profit before Interest and Tax/Net Sales)
- Net Profit Margin (Profit after Tax/Net Sales)
- Return on Networth (Profit after Tax/Networth)
- Return on Capital Employed (Profit before Interest and Tax (PBIT)/Capital Employed)
- Debt-equity Ratio (Book value of Debt/Book value of Equity)

The pre-merger (for three years prior to merger) and post-merger (for three years after the merger) averages of the above financial ratios were compared and tested for differences, using paired ‘t’ test for two samples. The observations of each pair of firms in the sample are not independent, since the acquiring firm retains its identity before and after merger. Therefore, paired ‘t’ test was considered appropriate to measure merger induced operating performance changes. Year of completion of merger, denoted as year 0, has been excluded from estimation. The pre-merger calculation has been done for both the acquired and the acquirer for the period (-3 to -1) years and it is the sum of their operating ratios for each year. Post the merger, the operating ratios for the combined firm were taken for (+1 to +3) years.

IV. LITERATURE REVIEW

There is a substantial body of literature that examines the performance of M&A deals both for the acquiring firms and target firms. There are generally three approaches followed in the literature for examining the performance of M&A transactions. The most common approach is the investigation of gains and losses to shareholders around the deal announcement date. Evidence shows that target shareholders generally earn significantly positive abnormal returns (AR) but the acquirers’ shareholders earn, on an average, a zero abnormal return at the acquisition’s announcement, but considerable variation exists in these results (Andrade et al., 2001; Fuller et al., 2002; and Bruner, 2002).

Most of these long-term studies conclude that the acquiring firms experience significant negative abnormal returns over one to three years after the merger (Agrawal et al., 1992; Gregory, 1997; Agrawal and Jaffe, 2000; and Andrade et al., 2001).

Most of the US based studies either report an improvement in operating performance (Linn and Switzer, 2001; and Heron and Lie, 2002), or an unchanged performance (Moeller and Schlingemann, 2005). Results from the studies on other markets are also inconsistent. Sharma and Ho (2002) find insignificant changes in acquirers’ post-acquisition operating performance for Australian firms. Asian studies also present inconsistent results (Sharma and Ho, 2002; and Rahman and Limnack, 2004). Rahman and Limnack (2004) show that operating performance improves significantly for Malaysian acquirer.
V. RESULTS AND INTERPRETATION

<table>
<thead>
<tr>
<th>Financial Ratios</th>
<th>Pre-merger (3 yrs before) mean</th>
<th>Post-merger (3 yrs after) mean</th>
<th>t-stat (paired)</th>
<th>P-value (2-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit margin</td>
<td>21.385</td>
<td>23.225</td>
<td>1.211</td>
<td>0.231**</td>
</tr>
<tr>
<td>Gross Profit Margin</td>
<td>19.447</td>
<td>17.658</td>
<td>1.023</td>
<td>0.514**</td>
</tr>
<tr>
<td>Net Profit Margin</td>
<td>15.455</td>
<td>18.584</td>
<td>2.115</td>
<td>0.034*</td>
</tr>
<tr>
<td>Return on Net worth</td>
<td>21.247</td>
<td>24.541</td>
<td>2.682</td>
<td>0.018*</td>
</tr>
<tr>
<td>Return on Capital Employed</td>
<td>20.24</td>
<td>21.65</td>
<td>3.457</td>
<td>0.076*</td>
</tr>
<tr>
<td>Debt-Equity Ratio</td>
<td>1.685</td>
<td>2.422</td>
<td>2.314</td>
<td>0.009*</td>
</tr>
</tbody>
</table>

Source: Authors calculation from Prowess.

**Significant at 5% significance level
**Not significant at 5% significance level

The comparison of the pre-merger and post-merger operating performance ratios for the entire sample set of mergers showed that there was an increase in the mean operating profit margin (21.385% to 23.225%), but the decline was not statistically significant (t-statistic value of 1.211). Similarly there was an increase in net profit margin (15.455% to 18.584%), return on Net worth (21.247% to 24.541%) and return on capital employed (20.24% to 21.65%) and these increase are statistically significant (t-statistic values of 2.115, 2.682 and 3.457 respectively). However gross profit margin (19.447% to 17.658%) declined the decline was not statistically significant in the post-merger period (t-statistic values of 1.023). There was a marginal but statistically significant increase in leverage after the merger (1.685 vs. 2.422), confirmed by the high t-value of 2.314.

The results suggest that operating financial performance of all mergers in the sample from Indian industry had increased following mergers, as there was an increase in both the profitability ratios and returns on net worth and invested capital. The results are comparable to those obtained by Ramakrishnan (2007) who found that most mergers during 1995-2005 in India have resulted in improving operational efficiencies. The results above also agree with the results of research studies in USA and Europe on operating performance of acquiring firms - that the operating performance of acquiring firms had either stagnated or declined after mergers.

Based on the results of the analysis, the alternate hypothesis H1: Mergers in India have impact on the operating performance of acquiring firms is accepted, since mergers were found to positively impact the performance in terms of both profitability and returns on investment. However, the analysis of debt-equity ratios suggest that during post merger period leverage has increased and this increase has been statistically significant. Therefore the alternate hypothesis H2: Mergers in India have impact on financial leverage of acquiring firms is accepted.

VI. CONCLUSION

An analysis of pre- and post-merger operating performance ratios for the entire sample set of mergers shows that while there was significant increase in the mean operating profit margin, net profit margin ratios, return on net worth and return on capital employed after the merger. These results corroborate with some of the general research results on post-merger operating performance in other countries, which suggested that the operating performance increases after mergers, for acquiring firms.

VII. REFERENCES


---

1 Dr. K. B. Singh , Assistant Professor, Dept. of Management, Birla Institute of Technology, Mesra (Noida Campus). kbsingh@outlook.com