PROPOSED MERGER AND EXECUTED MERGER: WHICH ANNOUNCEMENT IS MORE INFLUENTIAL IN SHARE PRICING?

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Abstract

The objective of this study is to examine the effect of merger announcements on the share prices of acquiring firms listed at The Karachi Stock Exchange. A sample of 13 merger announcements during year 2000 to 2012 is taken. Two types of merger announcements have been bracketed; one is proposed merger and the other is executed merger. In order to examine the effect of merger announcements on share prices, event study methodology is used. Market model is used to calculate abnormal returns. Moreover t-test is applied to test the significance of abnormal returns. On the basis of result, it is concluded that both types of merger announcement affect the share prices of acquiring firm. However, market reaction to these announcements is not immediate.

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Introduction

Intense competition has led many firms to ensure maximum efforts to strengthen their survival in current financial scenario (Bernard, Fuentelsaz & Gomez, 2013). That's why merger and acquisition (M&A) have gained significant grounds at corporate level. There are several driving forces of mergers identified so far by researchers such as attaining efficiency (Thompson, Wallis & Flecker, 1991); increase of reputation (Dranove & Shanley, 1995); having more market coverage, dominant position in market and leveraging of competencies (Went, 2003); getting synergistic benefits (Arnold & Parker, 2009); and profitability improvement (Bernard, Fuentelsaz & Gomez, 2013).

Contrary to the merger events occurring in other countries, the number of mergers in Pakistan has not been so high. However, recent examples of this activity in Pakistan indicate the oncoming change in the domain of mergers and necessitate investigation of probable effects from Pakistani perspective. These recent examples include interest shown by foreign firm to acquire 49.1% shares of Meezan bank and announcement about the merger plan of Wateen telecom and Qubee wireless business (Alam, 2013; Jamal, 2013). Moreover, globalization has put the firms of Pakistan in competition with international firms. Now a days, many foreign firms are exporting their home made goods to the markets of Pakistan. On the other hand, firms of Pakistan are facing many problems in local market in the form of too high production cost due to inflation hype, energy crisis and traditional technology (Khattak, Arslan & Umair, 2011; Masood & Shah, 2012). These conditions breed a competitive disadvantage for firms of Pakistan in comparison with the foreign ones. For survival, the firms of Pakistan may choose merger in future as a last resort.

Market responds to the announcements related to M&A. The type of market response, positive or negative, depends upon the predictions asserted by the market. M&A announcements affect the share prices (Asimakopoulos & Athanasoglou, 2013; Hagendorff, Collins & Keasey, 2008; Scholtens & Wit, 2004). Change in market price of shares leads to a change in the existing value of investment. Naturally, investors do not welcome decline in the value of their investment and seek to identify and underline the factors and events that can cause change in the value. Therefore, it is not marginal to investigate either merger announcements affect the share prices of KSE listed firms or otherwise.

The present study identifies the response of market (KSE) to merger announcements made at two different occasions of time scale. The first occasion is announcement of proposed merger by corporate officials and the second is completion of merger. Since not many researchers in Pakistan have reported the effect of the phenomenon under investigation in the context taken up by the researcher, the present study carries significant results. The rationale for taking two points of times is to find whether market gives weight to either or both the announcements. As announcement of merger decision may not always lead to completion of merger as already declared. Therefore, it is viable to examine whether or not market reacts to such types of announcements and to identify the nature of market reaction.

Literature Review

M&A

There are different motives and consequences of M&A. According to Thompson, Wallis and Flecker (1991), the reason for M&A is to attain economies of scale by elimination of less efficient business units. Dranove and Shanley (1995) confirmed that reduction of costs is one motive behind merger. Moreover, they identified that enhancement of reputation is also a motive behind M&A. Acquirers get more benefits in purely related acquisition as compared to unrelated acquisition (Flanagan, 1996; Wilcox, Chang & Grover, 2001). It is the relatedness that leads to higher benefits and M&A between related firms is comparatively more successful.

Went (2003) identified some other reasons for mergers other than efficiency gains. He underlines that competitive reasons also serve as a driving force of merger. Firms desirous of more market coverage and dominant position in market usually go for M&A. He furthers the idea that merger leads to the leveraging of competencies. Arnold and Parker (2009) observed that firms' merge in order to get synergy benefits. Moreover, Bernad, Fuentelsaz and Gomez (2010) observed that merger leads to an increase in productivity in the long run.

Furfine and Rosen (2011) concluded that mergers increase the default risk. Default risk increases due to three factors. The first is high level of idiosyncratic risk. The second is CEO's larger share of option based compensation that outweighs the benefits of asset diversification. The third is the poor stock performance of acquiring firm. In addition to this, Thorbjornsen and Dahlen (2011) studied consumer reaction to M&A. They found that when M&A is acquirer dominant, consumers of target brand react negatively to the brand of acquirer. Consumers devalue brand of acquirer and have intentions to switch to some other brand in reach.

Andreou, Louca and Panayides (2012) found no evidence with respect to perk benefits and empire building as driving forces of merger. They concluded that M&A leads to synergistic gains. Additionally, Halkos and Tzeremes (2013) concluded that M&A does not lead to operating efficiency gains when a country is facing fiscal crisis. Moreover, merger of two efficient businesses does not ensure cost efficiency gains.

M&A Announcement effects

In the past, many researchers studied the announcement affects of M&A. According to Wilcox, Chang and Grover (2001), increase in market value as a result of M&A activity is the same for both large and small size firms. M&A announcement not only affects the share prices but also the price of bond. Penas and Unal (2004) studied the reaction of bond market on merger announcements and found that bondholders of both target and bidder firms gain considerable positive returns after the announcement. The positive market reaction is due to benefits of mergers such as too big to be fail status, diversification and synergy.

Scholtens and Wit (2004) found that target firms, as a result of M&A announcement, experience higher significant positive returns as compared to bidder firms. However, wealth effect of announcement is not same for all countries. In addition to this, Hagendorff, Collins and Keasey (2008) concluded that regime's level of investor protection determines the returns realized by bidder firms as a result of Merger announcement. Bidder firms realize higher return when target firm is in low investor protection regime. Market becomes optimistic in assessment and believes that bidder firm will easily gain benefits of merger. On the other hand, in case of target firm in high investor protection regime, lower returns are realized due to pessimistic assessment of market.

Mai, Ness and Ness (2009) identified that short selling of acquiring firm's share increases significantly after the M&A announcement. Increase in short-selling is an indication that market expects share price of acquiring firm to decrease. Al-Khasawneh and Essaddam (2012) found that target firm always experience positive returns after the announcement of M&A. However, in case of acquiring firm, markets reaction to M&A announcement depends upon the category of efficiency of acquiring firm. The worth of a low-efficient acquirer is further devalued in case of acquisition of a moderately efficient target.

Asimakopoulos and Athanasoglou (2013) found that M&A announcement creates value for share holders of target firm. Value is created because market reaction to M&A announcement exerts an upward pressure on the share price of the target firm. However, this announcement does not create value for acquirer shareholders. In addition to this, Dutordoir, Roosenboom and Vasconcelos (2014) found that market reacts more positively when bidding firm makes synergy disclosures with M&A announcement. Without synergy disclosures, M&A announcement leads to negative market reactions with respect to bidding firms stock.

Method

Data Description

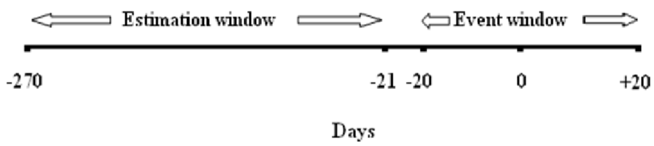
Two types of merger announcements are taken in this study. The first is final official declaration of proposed merger and the second is announcement of completion of merger. A sample of 13 KSE listed firms having both types of announcement is taken from a time period of year 2000 to 2012. Firms are selected irrespective of the sector as the motive of this study is to see how market in general reacts to merger announcements.

Event Study

Event study methodology is the appropriate methodology to investigate the effect of information on share prices. Fama, Fisher, Jensen and Roll (1969) used this methodology to examine how rapidly share prices adjust to new information arriving in the market. Merger announcement is also a information, so event study methodology is used in this study.

An Event window of 41 days is used in this study, which includes announcement day, 20 days before and 20 days after the announcement (see Figure 1). Days before announcement are taken in order to identify information leakage, if any. Moreover, days after event are taken to examine how long market reacts to information.

Figure 1.
Estimation and event window



Event study approach involves the significance test of abnormal returns; therefore, market model is used for calculation of abnormal returns. Return of individual stock is related to return on benchmark market portfolio is this model. This model is as follows

$$R_{i,t} = \alpha_i + \beta_i R_{m,t} + \varepsilon_{i,t}$$

Here, R_{it} represents the return on stock'i' at time 't'; α and β are the parameters; R_{mt} is the return on benchmark market portfolio 'm' at time 't'. In this study, Karachi Stock Exchange 100 index is used as benchmark market portfolio. Moreover, ε_{it} is the error term. R_{it} and R_{mt} are calculated using following formulas

$$R_{i,t} = \left(\frac{P_{i,t} - P_{i,t-1}}{P_{i,t-1}}\right)$$

$$R_{m,t} = \left(\frac{KSE_t - KSE_{t-1}}{KSE_{t-1}}\right)$$

Here, P_{it} is the share price of stock 'i' on day't' and $P_{i,t-1}$ is the share price of stock 'i' on day t-1. KSE_t is the KSE 100 index value on day't' and KSE_{t-1} is the KSE 100 index value on day t-1. For estimation of parameters, returns of individual stocks are regressed with return of KSE 100 index in estimation window. Estimation window used is day -270 to -21. After obtaining parameters, abnormal return for each stock is calculated using following equation.

Table 1

	Final Declaration of Merger			Execution of Merger	
Day	ASAR	t_{bmp}	Day	ASAR	t_{bmp}
-20	0.413	1.248	-20	-0.136	-1.268
-19	-0.014	-0.193	-19	0.030	0.221
-18	-0.215	-1.386	-18	0.074	0.313
-17	0.115	0.610	-17	0.353	0.930
-16	0.335	1.094	-16	0.118	0.343
-15	-0.060	-0.360	-15	-0.113	-0.783
-14	0.009	0.081	-14	0.012	0.049
-13	0.231	0.860	-13	0.092	0.429
-12	-1.522	-1.193	-12	0.495	1.412
-11	-0.437	-1.322	-11	0.223	0.679
-10	-0.187	-0.521	-10	-0.039	-0.140
-9	-0.335	-1.360	-9	0.102	0.332
-8	-0.272	-0.742	-8	-0.004	-0.031
-7	0.194	0.571	-7	-0.097	-0.411
-6	0.052	0.208	-6	-0.302	-0.848
-5	0.119	0.529	-5	-0.110	-0.371
-4	0.153	1.088	-4	0.482	1.563
-3	0.043	0.209	-3	0.491	**2.484***
-2	0.146	0.367	-2	-0.226	-0.839
-1	-0.136	-0.503	-1	0.256	1.003
0	0.308	0.857	0	-0.152	-0.705
1	0.069	0.269	1	0.020	0.104
2	-0.024	-0.085	2	-0.644	-1.854
3	-0.468	-0.866	3	0.271	0.813
4	0.123	0.484	4	-0.181	-1.464
5	0.383	1.400	5	0.251	1.377
6	0.251	1.181	6	-0.301	-1.280
7	0.575	1.845	7	-0.394	**-2.569***
8	0.122	0.632	8	-0.758	-1.161
9	0.086	0.312	9	-0.160	-0.700
10	0.221	0.999	10	0.167	0.755
11	0.916	1.458	11	-0.192	-1.478
12	-0.412	-1.057	12	-0.011	-0.034
13	-0.104	-0.423	13	0.057	0.256
14	-0.247	-1.100	14	-0.014	-0.112
15	0.373	1.220	15	-0.226	-0.693
16	-0.555	-1.684	16	-0.042	-0.222
17	-0.159	-0.804	17	-0.344	-1.818
18	-0.015	-0.063	18	0.038	0.385
19	-0.337	**-2.236***	19	-0.402	-1.853
20	0.281	1.007	20	0.360	1.637

* Siginiifcant at 5 percent

T-test is again used for the second sample to examine the announcement affects of merger completion on share prices. Abnormal return on day 3 before announcement and day 7 after announcement are found to be significant. So, null hypothesis is rejected and alternate hypothesis is accepted. Merger completion announcement also affects the share prices. Significant return observed on 3 days before announcement is positive in sign. It indicates two things. Firstly, there is information leakage and insiders use the private information. Secondly, positive return is realized before announcement. However, significant return observed on day 7 after announcement is negative in sign that indicates that market responded negatively with a delay.

Discussion

Firms opt M&A for the attainment of benefits. Whenever M&A is initiated, market is responsive. Market formulates different expectations about the future prospects of M&A announcing firm. In case of positive anticipation market engenders positive reaction and vice versa. Market reaction determines change in stock price that results in change in value of investors' investment. Investors do not like decline in value of their investment that's why they try to understand and assess all those factors and events that could affect value of their investment.

Results of test showed that both types of announcement affect the share prices. Delayed market reaction is found for both types of announcement. However, there is comparatively more delay in case of announcement of proposed merger. Market reacts negatively to both the announcements. In addition to this, there is information leakage in market as significant abnormal return is observed before official announcement of completion of merger. This indicates that insiders use private information and generate abnormal return before announcement.

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