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The Effect of Mergers and Acquisitions on Bank Performance in Egypt

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Abstract

Recent economic reforms in Egypt have significantly improved its macroeconomic indicators and financial sector. Banks have witnessed significant merger and acquisition activity as a result of these reforms in attempts to privatize and strengthen the banking sector. This study measures the performance of Egyptian banks that have undergone mergers or acquisitions during the period 2002-2007. This is done by calculating their return on equity using the Basic ROE Scheme in order to determine the degree of success of banking reforms in strengthening and consolidating the Egyptian banking sector. Our findings indicate that not all banks that have undergone deals of mergers or acquisitions have shown significant improvements in performance and return on equity when compared to their performance before the deals. Furthermore, extensive analysis was performed yielding the same results. It was concluded that mergers and acquisitions have not had a clear effect on the profitability of banks in the Egyptian banking sector. They were only found to have minor positive effects on the credit risk position. These findings do not support the current process of financial consolidation and banking reforms observed in Egypt, and provide weak evidence to support their constructive role in improved bank profitability and economic restructure.

JEL classification

G21; G34

Keywords

Mergers and Acquisitions; Egypt; Banks; ROE; Performance Measurement; Reforms; ROA

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1 Introduction

The world of finance is expanding and consolidating at an exponentially increasing speed. During the last decade we have seen the formation of many continental trade agreements and expansion in international trade volumes and transactions worldwide. This integration has strengthened financial markets and has given rise to the combination of numerous financial activities to offer even more choices of investment. Recently, banks have sought expansion through waves of mergers and acquisitions (M&A) along the years, starting with the United States and Europe and then spreading to other countries around the world (Focarelli, Panetta and Salleo, 2002:1048). Most studies of bank M&A have focused on the United States as it was the first country to witness bank M&A in the late 19th century (Hubbard, 2001:7). More recent studies have analyzed bank M&A in Europe especially after the consolidation of the European economies and the unification of their currency (Yener et al., 2004:5; Lindblom et al., 2002:52). Yet, until now, it has been quite rare to find research into bank M&A in the developing countries of the Middle East and North Africa region because such expansion activities were non-existent until recently. This delay in expansion activities may be greatly blamed on the protective regulations in these areas which have inhibited growth of the banking sector and also due to large public sector interference. Nevertheless, with increased liberalizations and economic reforms in some countries in the region, more and more banks are engaging in expansionary activities including mergers and acquisitions. For this reason, it has become important to analyze bank M&A in the region and to determine how liberalization and economic reforms have affected the banking sector.

This paper analyzes M&A in the Egyptian banking sector over the period 2002-2007. This may well be one of the first explorations into this market. The paper begins by introducing M&A in terms of history, benefits and drawbacks along with results of relevant previous research from the United States and European Union with regards to bank M&A. The paper continues with a brief overview of economic reforms in Egypt in general and the banking reforms in specific. These banking reforms have allowed banks to engage in voluntary M&A which has led to high consolidating activity in the banking sector. The sample and methodology of analysis are then introduced along with the results of whether recent M&A in the Egyptian banking sector, spurred by the banking reforms, have actually improved bank performance for those banks involved. The paper concludes by a discussion and interpretation of the results and how they reflect the effects of the Egyptian banking reform program.

2 Bank M&A Drivers in the Egyptian Economy

The need for Egypt's economic reforms spurred from its economic slow-down and below-average performance in the period 2000-2003. During this period, economic growth averaged 3% per year down from an average of 5.75% five years earlier. Egypt was also facing a decline in investments along with a rise in inflation reaching WPI of 21.7% in 2004 up from 10.3% in the previous year. It was also facing high unemployment of 10% in 2003 (Srinivasan 2005: 3 - 4; IDSC 2005: 6 - 7). Egypt was, and still is, considered to have an underdeveloped financial sector due to the presence of a large amount of money outside the banking sector. It is estimated that only 25% of Egyptians collect regular salaries and only 10% of the population have a bank account. (MENA-OECD 2006: 4; Kalhoefer and Salem 2008: 5). Another factor attributing to the previously mentioned decline in economic performance was the existence of a highly interfering public sector in all sectors of the economy; especially in the banking sector (Srinivasan 2005: 6).

Egypt's economic reform has been quite effective in changing the previously mentioned negative indicators. According to AmCham (2005) Egypt ranked first in economic reform worldwide in 2005. GDP growth reached 5.1% in 2004 - 2005 and is expected to reach 8% in 2008 (up from previously targeted 6%). Another component of the reform was the privatization of state-owned enterprises by removing them from public sector control and into the management of holding companies (MENA-OECD 2006: 2). A great share of the improvements in economic performance is attributed to the banking sector reforms, leading to an increased mobilization of savings and channeling of capital into the economy through the capital market and other investments (SIS 2008; Kalhoefer and Salem 2008).

The latest banking sector reforms began in 2004 in hopes of strengthening the sector and increasing its robustness to be able to face global and regional competition and to act as a base and infrastructure for the overall economic reforms in the country. The banking reforms focused on privatizing and consolidating the banking sector, addressing non-performing loans (NPL), financial and managerial restructuring of public banks, privatization of a number of state-owned banks and improving Central Bank supervision of the sector (AmCham 2005: 4; Srinivasan 2005: 22). Additionally, the reforms intended to implement the Unified Banking Law and increase minimum-capital requirements in accordance with the Basel II Standards (IDSC 2005: 6).

Mergers and Acquisitions (M&A) are considered two methods of corporate takeover along with proxy contests and leveraged buyouts. M&A have played a critical role in the success of many modern organizations. Their role in boosting the size of start-ups and increasing their market capitalization allow them to compete with much larger and well established companies. Engaging in M&A gives companies the advantages of speed to positioning, speed to market and speed to becoming a competitive company, rather than the slower method of building internally (Carey 2001: 3 - 4). One of the main reasons of undergoing M&A is seeking to achieve different types of synergy, which is defined as the enhanced economic value created by the merger of buyer and seller (Achtmeyer 1994: 107). Other benefits and goals of M&A include market penetration, vertical expansion to control supply and distribution sources, market entry, identifying asset potential and economics of scale. (Eccles, Kersten and Wilson 2001: 56).

Although lots of M&A activities can be observed all over the world, by far not all of them are successful. Some studies conclude that approximately half of M&A fail to meet their set objectives (Hubbard 2001: 11; Eccles et al. 2001: 68). Some research attributes M&A failures to reasons such as mismatches between target and acquirer companies in terms of size, diversification into unrelated industries or cultural barriers where employees find themselves working under new work legislations, different working practices or company procedures. (Eccles et al. 2001: 68, Hubbard 2001: 13). M&A success depends on factors like the industry or management preferences. Some companies prefer to build internally rather than buying or acquiring especially in cases where management realizes that they have the needed product or process knowledge and can easily capitalize on an opportunity without going through a buying process. Another discouraging fact about M&A is that they are much more visible to the general public and may involve the stockholders (Carey 2001: 4).

The before mentioned Banking reforms have had a driving effect on the banking sector, encouraging much consolidation and M&A activity. Beginning with the increase in minimum capital requirement which spurred a wave of domestic M&A followed by the sale of large public sector holdings in joint venture banks which encouraged cross-border M&A for strategic investors looking to enter into the Egyptian market. Previous research has been conducted on bank M&A results. Initially it is important to highlight Chavaltanpipat, Kholdy and Sohrabian's (1999) results that recent bank M&A have yielded less shareholder value than those M&A concluded in the 1980s. Focarelli et al. (2002) and Neely (1987) find that recent bank M&A in the United States have yielded modest shareholder value improvements around

time of announcing the deal (Neely 1987: 72). Other results show that cases of bank M&A where targets and buyers are of similar overall size, risk attitudes and other orientations were more likely to result in positive shareholder value than those with mismatches in the given criteria (Yener and Ibáñez 2004: 4; Ramaswamy 1997: 700). It is also mentioned that consolidation between banks with matching strategic characteristics result in positive shareholder value creation in the United States, yet positive performance may not be ensured if they face cultural barriers (Ramaswamy 1997: 702, Yener et al. 2004: 6).

According to Yener et al. (2004) and Focarelli et al. (2002), previous studies investigating the effect of bank M&A on performance tend to follow two main empirical methods. The first group is comparing pre- and post-M&A performance using financial and accounting data, while the second group uses an event-study type methodology. In that case the changes in the prices of specific financial market assets (usually share prices of the involved companies) around the time of the announcement of the merger are analyzed. For this paper, ROE was chosen as a measure as it is considered a critical performance indicator by both investors and management (Lindblom and Von Koch 2002: 52, 56). Hopkins and Hopkins (1997: 642) state that the ultimate measure of the strength of any financial institution is the ROE. ROE also helps to make a fair comparison of banks differing in size and structure. It has also been used by Yener et al. (2004), Focarelli et al. (2002) Hopkins et al. (1997) and Lindblom et al. (2002) to measure profitability.

In addition, the ROE is used due to the availability of accounting data for pre- and post-M&A, and to be able to obtain accurate results, free from the excessive fluctuations of the Egyptian stock market which do not offer a fair indicator of performance or market value. Another reason for using financial and accounting data is that management seeks to improve accounting profitability through M&A; therefore accounting measures would be best suited to evaluate these improvements (Ramaswamy 1997: 706).

3 Sample and Methodology

In this analysis of banks that have recently undergone M&A in the Egyptian banking sector during the period of banking reforms, the sample included registered M&A taking place in the Egyptian banking sector during the period from 2004-2007. The sample focused on acquiring banks, not target banks, due to the unavailability of financial information. The sample was composed of 10 banks in total and was divided based on the home-country of the acquiring bank, producing two main groups; Cross-Border M&A and Domestic M&A. Of the sample banks, 4 had undergone Domestic M&A (namely National Société Générale Bank (NSGB), Banque Misr, Arab African International Bank and the National Bank of Egypt) while the remaining 6 had undergone Cross-Border M&A in the Egyptian banking sector (namely Blom Bank, Audi Bank, Union National Bank, Ahli United Bank, Intresa San Paolo (San Paolo at time of M&A), and Piraeus Bank). Table 1 provides the list of acquirers, targets, dates and value of M&A.

Table 1: Selected Banks from recent Mergers and Acquisitions in Egypt

Date	Acquirer	Target	Value (L.E. Million)
Sept 04	Banque Misr	Misr Exterior Bank	N/A
Jun 05	Piraeus	Egyptian Commercial Bank	133
Sept 05	NSGB	Misr International Bank	2,204
Sept 05	Arab African International Bank	Misr American International Bank	240
Oct 05	National Bank of Egypt	Mohandes Bank	N/A
Dec 05	Blom Bank	Misr Romania Bank	498
Mar 06	Audi Bank	Cairo Far East Bank	94
Aug 06	Union National Bank	Alexandria Commercial and Maritime Bank	245
Aug 06	Ahli United Bank	Delta International Bank	583
Dec 06	Intresa San Paolo	Bank of Alexandria	9,215

Source: *CASE (2008).*

Although the size of the sample was relatively small compared to other studies conducted in the United States or Europe, it must be noted that the total number of M&A in the Egyptian banking sector is not quite as large as other countries, with the total number of banks at time of publication totaling to 40 banks (Central Bank of Egypt, 2008).

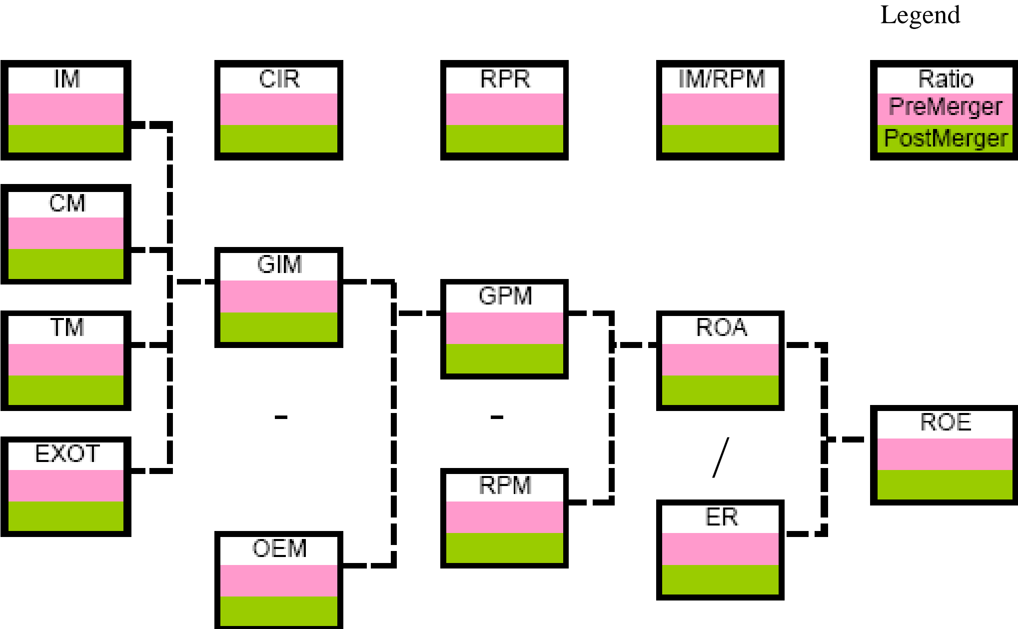
Using this sample, pre- and post-M&A financial performance of acquirer banks was measured using ROE as a dependent variable[1]. Mean ROE was calculated for a period of two years before and after the merger. This time range was chosen based on Yener et al.'s (2004) suggestion that two years is sufficient to avoid alteration and inaccuracy of results. He explains that longer time spans may negatively affect accuracy of results due to effects of other external economic factors. This is supported by Achtmeyer's (1994: 107) suggestion that benefits of M&A do not take more than two years to materialize.

For extensive analysis, Schierenbeck's Basic ROE Scheme Diagram was applied as shown in Kalhoefer and Salem (2008) to trace and further assess the results found. The Scheme involves using numerous financial ratios as shown in Table 2 and Diagram 1.

Table 2: Ratios and Abbreviations used in Basic ROE Scheme

Ratio	Abbreviation Used	Gross Profit Margin	GPM
Interest Margin	IM	Risk Provision Margin	RPM
Commission Margin	CM	Return on Assets	ROA
Trading Margin	TM	Equity Ratio	ER
Extraordinary and Other Income Margin	EXOT	Return on Equity (Pre-Tax)	ROE
Gross Income Margin	GIM	Cost Income Ratio	CIR
Operating Expenditure Margin	OEM	Risk Provision Ratio	RPR

Diagram 1: Explaining the Tracing Procedure of the Basic ROE Scheme



[1] ROE was calculated as Net Profit after tax / Shareholder Equity using individual accounting data of each bank's official audited financial statements which are considered secondary data.

4 Analysis and Assessment

Analyzing the aggregated results using the means for Pre- and Post-Merger Ratios (Table 3), the most important ratio ROE increased on average by more than 14%, which is a significant change. It can be seen that neither Gross Income nor Operational Expenditure Margin show significant or diverting changes, so these are not main drivers for the improvement. In addition, the Equity Ratio also didn't change significantly. A decrease of the Equity Ratio would – ceteris paribus – lead to an increase of the Return on Equity. For example the Pre-Tax ROE was found to have increased from 12.61% to 14.45%, a relative change of 14.59%. Initially this is considered quite a significant change in bank profitability considering the magnitude of a merger or acquisition on a bank. Yet it is important to realize that extreme results exist, such as UNB's decrease in Pre-Tax ROE by approximately 19.35% and Piraeus's impressive increase in Pre-Tax ROE by 254.17%. Such extreme cases do not provide sufficient evidence to suggest a common performance or profitability trend.

Table 3: Total Mean for Pre- and Post-Merger Ratios

TOTAL MEAN	Pre-Merger	Post-Merger	Change	Relative Change
Pre-Tax ROE	12.61%	14.45%	1.84%	14.59%
ROA	1.15%	1.20%	0.04%	3.84%
Interest Margin	1.85%	1.79%	-0.07%	-3.59%
Commission Margin	0.97%	0.78%	-0.19%	-19.85%
Trading Margin	0.14%	0.12%	-0.02%	-12.29%
EXOT Margin	-0.01%	0.14%	0.15%	1341.49%
Gross Income Margin	2.96%	2.83%	-0.13%	-4.37%
Operating Expenditure Margin	1.20%	1.16%	-0.04%	-3.41%
Gross Profit Margin	1.76%	1.67%	-0.09%	-5.04%
Risk Provision Margin	-0.60%	-0.47%	0.13%	22.08%
Equity Ratio	8.68%	8.21%	-0.47%	-5.39%
Cost-Income	41.66%	40.57%	-1.09%	-2.62%
Deposit/TA	72.89%	67.66%		
Loans/TA	42.26%	40.46%		

This has encouraged further analysis of the results in more details by dividing the results according to their previous classification of Domestic and Cross-Border M&A. It was expected to find a clear trend for either Domestic or Cross-Border cases of M&A with regards to bank profitability, but no clear trend was found (Tables 4 and 5).

Table 4: Mean for Pre- and Post-Domestic Merger Ratios

Domestic Mean	Pre-Merger	Post-Merger	Change	Relative Change
Pre-Tax ROE	12.93%	14.44%	1.50%	11.61%
ROA	1.08%	0.93%	-0.15%	-13.68%
Interest Margin	1.83%	1.70%	-0.13%	-7.24%
Commission Margin	1.20%	0.90%	-0.30%	-25.04%
Trading Margin	0.16%	0.15%	-0.01%	-8.73%
EXOT Margin	-0.23%	0.03%	0.26%	115.04%
Gross Income Margin	2.96%	2.78%	-0.18%	-6.22%
Operating Expenditure Margin	1.09%	1.11%	0.02%	2.19%
Gross Profit Margin	1.87%	1.67%	-0.21%	-11.09%
Risk Provision Margin	-0.79%	-0.73%	0.06%	7.56%
Equity Ratio	7.38%	5.40%	-1.98%	-26.80%
Cost-Income	38.64%	40.48%	1.84%	4.77%
Deposit/TA	80.72%	68.16%		
Loans/TA	39.95%	34.47%		

For extensive examination of individual banks' performance pre- and post-M&A, the position of each bank on an Equity-Ratio ROE Graph was plotted. The Equity Ratio-ROE graph (Diagrams 2 and 3) shows how profitable a bank is in relation to its bankruptcy risk. This was done through Dynamic Analysis, which describes how each bank changed following the merger or acquisition.

Table 5: Mean for Pre- and Post-Cross-Border Merger Ratios

Cross-Border Mean	Pre-Merger	Post-Merger	Change	Relative Change
Pre-Tax ROE	12.29%	14.47%	2.18%	17.72%
ROA	1.23%	1.46%	0.24%	19.29%
Interest Margin	1.88%	1.88%	0.00%	-0.03%
Commission Margin	0.75%	0.66%	-0.09%	-11.47%
Trading Margin	0.12%	0.10%	-0.02%	-17.16%
EXOT Margin	0.21%	0.24%	0.03%	15.26%
Gross Income Margin	2.95%	2.88%	-0.07%	-2.53%
Operating Expenditure Margin	1.31%	1.21%	-0.11%	-8.04%
Gross Profit Margin	1.64%	1.67%	0.03%	1.90%
Risk Provision Margin	-0.41%	-0.20%	0.21%	50.20%
Equity Ratio	9.97%	11.02%	1.04%	10.46%
Cost-Income	44.68%	40.65%	-4.03%	-9.02%
Deposit/TA	65.07%	67.16%		
Loans/TA	44.56%	46.45%		

Those banks lying in the upper right corner are those which are able to achieve high ROE while having a low bankruptcy risk reflected by the relatively high Equity Ratio. On the other hand, those in the lower left corner are those that are unable to achieve high ROE and have high bankruptcy risk reflected by the low Equity Ratio.

Diagrams 2 and 3 show the Pre-Merger and Post-Merger positions of the 5 banks per diagram:

Banks that have moved from Pre-Merger corner 1 (Diagram 2) to Post-Merger corner 3 (Diagram 3) are those that have been able to maintain high ROE after the M&A, yet faced a decrease in Equity Ratio because of the M&A (UNB, NSGB, and AAIB).

- Banks that have moved from 2 to corner 1 are those that have not been able to improve their high ROE, but were able to decrease their bankruptcy risk through increasing their Equity Ratio (BLOM).

- Banks that have moved from corner 3 to corner 2 are those that been able to improve their low ROE while maintaining relatively constant Equity Ratio (Piraeus).
- Banks that have moved from corner 3 to corner 4 are those that have not been able to improve their low ROE, but were able to decrease their bankruptcy risk through increasing their Equity Ratio (Audi).
- Banks that have remained constant show no significant reaction to M&A deals regarding Equity Ratio and ROE (NBE, Banque Misr, San Paolo, Ahli United).

Diagram 2: Five Bank Pre- & Post-Merger Equity-Ratio ROE Graph

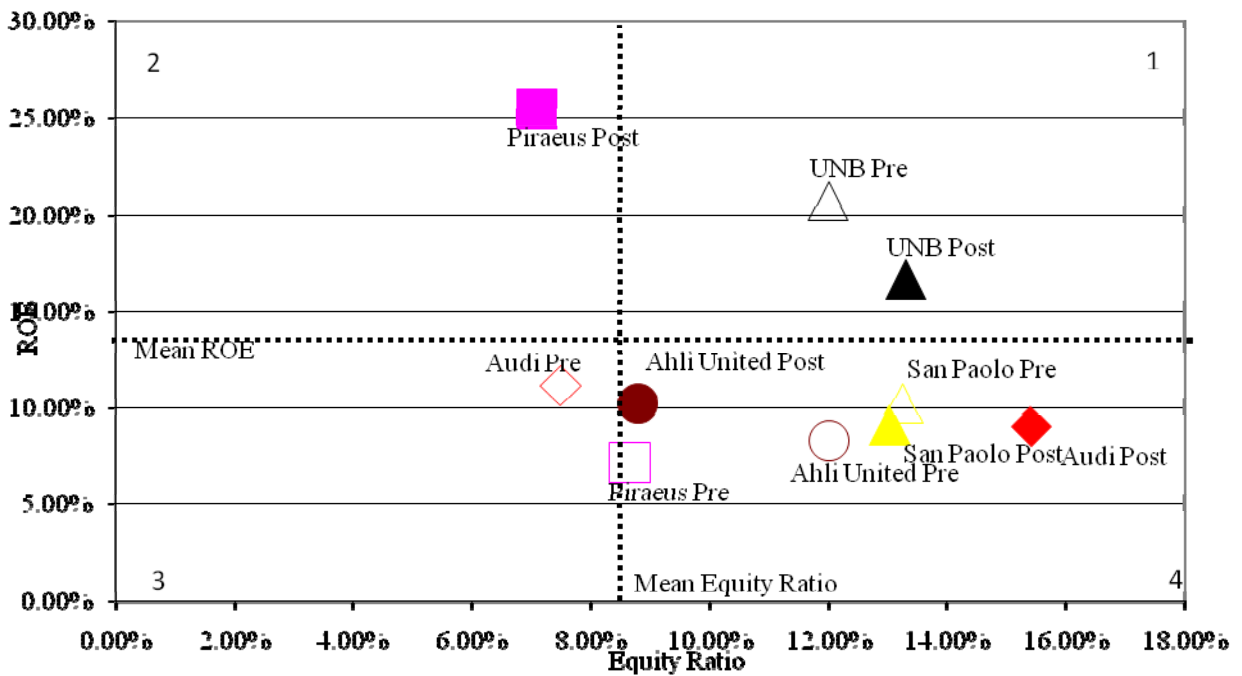
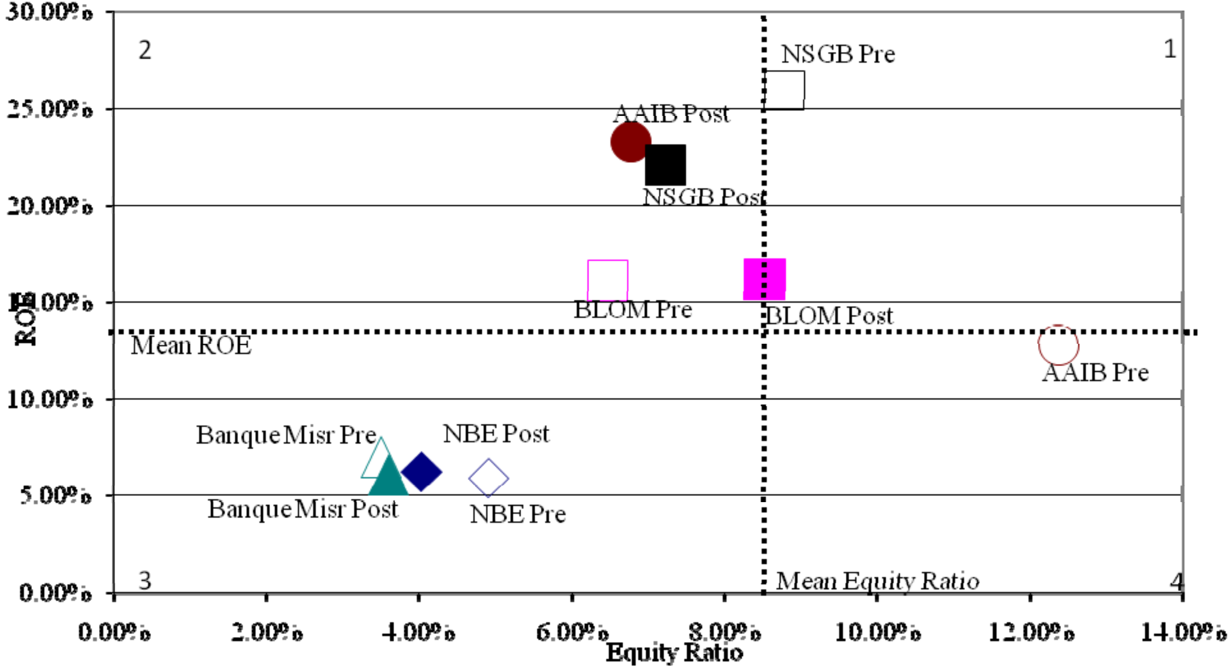


Diagram 3: Five Bank Pre- & Post-Merger Equity-Ratio ROE Graph



It can be interpreted from these results that M&A had no clear impact on the performance of involved banks whether domestic or cross-border as measured through ROE. Returning back to the fact that these M&A were a direct result of economic reforms in general and banking reforms in particular in the Egyptian economy, it can be concluded that banking reforms in Egypt have not been entirely successful in increasing bank profitability. On the other hand these M&A were found to have a positive effect on decreasing NPL in the Egyptian banking sector as a whole. In general they have led to a positive effect on banks through encouraging consolidation and easing the process and regulations governing the issue of M&A, yet they have not been able to achieve a clear significant increase in bank profitability in the broad manner. A possible reason why some of the analyzed banks have not shown similar profitability improvements as those witnessed in the United States and European Union could be the result of the not-so-mature economy of Egypt compared to those of the United States and European Union.

The complete findings of this paper suggest that bank M&A in Egypt does not result in improved ROE. These findings are in contradiction to Yener et al.'s (2004) results that bank M&A in the European Union resulted in improved ROE as well as other studies stating that reforms in the United States in the late 1980s and similar reforms in the European Union in the early 1990s resulted in increased banking consolidation which led to improved bank performance (Yener et al., 2004:5; Focarelli et al., 2002:1049, 1063).

Owing to the scarcity of research into the Egyptian banking sector in general (especially research after the more recent reforms) and the effects of reforms on bank M&A and performance in particular, this study is interesting in itself. It fills a gap of research and proves that the application of United States and European studies cannot automatically be applied to the Egyptian environment.

Deeper analysis of M&A performance pre- and post-M&A with regards to comparisons between relative size of target and acquirer were not feasible. Neither was research into the relation between strategies used by each company and its effect on profitability post-M&A. These analyses were not possible because of the lack of financial databases containing financial statements of the target firms that became eliminated after the M&A. No target firms' financial statements were available for analysis or comparison.

Another limitation existed in terms of available information for selected banks. Financial statements for San Paolo for year 2004 and Ahli United Bank for year 2007 were unavailable for analysis. For this reason they were subtracted from the denominator of the mean ROE when calculating in order to avoid inserting an unrealistic zero value for ROE for those two years. This method of omission assumes that these two banks had the same average ROE as the rest of the banks in these two missing years.

In further research, it could be interesting to determine if strategies undertaken by those banks that showed profitability and were involved in M&A had a role in their positive performance. Based on the findings of this paper, it might suggest that positive bank performance found can be attributed to having similar strategies in asset structure, diversity of loans or credit risk strategies. Research into negative bank performance might include analyzing the presence of cultural barriers between target and acquirer banks which may have led to the failing performance. Further research can also be done to determine whether those M&A that were found profitable will be sustainable in the long run. Such research can conclude more accurately whether the banking and economic reforms have been at least successful on the long run or not.

5 Conclusion

While recent reforms in the general economy and the banking sector in specific have greatly improved Egypt's macroeconomic indicators and have encouraged consolidation of banks, those banks that have undergone mergers and acquisitions on average were not found to by as profitable as expected or suggested by studies conducted in the United States or the European Union. Measurement of the profitability of Egyptian banks that have been involved in M&A during the period 2002-2007 was achieved by calculating their ROE using the Basic ROE Scheme. Through the analysis, sufficient evidence to conclude that mergers and acquisitions have clear effects on the profitability of banks in the Egyptian banking sector was not found. Only minor positive changes to risk provisions reflecting improved credit risk positions were found. These findings suggest that the process of financial consolidation and banking reforms have not completely achieved their desired results in improving the banking sector.

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