

Empirical evidence based on accounting studies finance essay

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ABSTRACT

Merger and acquisition aim at facilitating two companies achieve certain financial objectives. The dissertation aims at giving an insight about the motives of mergers and acquisitions which includes motives that aim at increase or decrease of the shareholders' value and also its impact on the shareholders' value. The motives of the mergers and acquisitions include synergy, diversification, growth, economies of scale and scope, improvement of managerial efficiency, reduces competition, market expansion and acquiring new technology etc. Further, studying the effect of motives on Mergers and Acquisitions and also providing a deeper knowledge about it and examining them from the point of view of the four approaches involved in the literature review. Lastly, this dissertation includes the study of two cases involving a merger and an acquisition of two companies using the quantitative method i. e. an accounting study which examines the pre and the post M&A financial performance of the companies involved. It also includes comparing the post financial performance with a competitive

company in the same industry. The two cases studied involved acquisition of BellSouth by AT&T and merger of T-Mobile and Orange Mobile with their financial performance being compared with their competitors i. e. Verizon and O2 respectively. According to the findings in the literature review, the company performs better before a merger and acquisition but the acquiring company has to bear loss after the M&A.

TABLE OF CONTENTS

Page No.

Acknowledgments 2

Abstract 3

Chapter 1. Introduction 8

1. 1. Background of mergers and acquisitions 91. 2. Definition of Mergers 121. 2. 1. Types of Mergers 121. 3. Definition of Acquisitions 131. 3. 1. Types of Acquisitions 141. 4. Benefits of Mergers and Acquisitions 141. 5. Drawbacks of Mergers and Acquisitions 161. 6. Aim of the dissertation 171. 7. Research Methodology 18

Chapter 2. Literature Review

2. 1. Motives behind Mergers and Acquisitions 192. 2. The effects of the motives in Mergers and Acquisitions 26: post M&A performance2. 2. 1. Empirical evidence based on accounting studies 262. 2. 2. Empirical evidence based on event studies 272. 2. 3. Empirical evidence based on clinical studies 272. 2. 4. Empirical evidence based on executive of surveys 28

Chapter 3. Research Methodology

3. 1. Overview of an Accounting Study Research Methodology 303. 2. Source of data 323. 3. Limitations of the study 33

Chapter 4. Case Studies Analysis 34

4. 1. Overview of AT&T acquisition of BellSouth 344. 1. 1. The motives of AT&T acquisition of BellSouth 344. 1. 2. Effects of AT&T acquisition of BellSouth: Financial 35performance4. 1. 3. Comparison of AT&T post financial performance with its 38competitors4. 2. Overview of T-Mobile and Orange Mobile Merger 434. 2. 1. The motives of the T-Mobile and Orange merger 44 4. 2. 2. Effects of T-Mobile and Orange merger: 45Financial performance4. 2. 3. Comparison of T-Mobile post-merger performance 47With its industry competitors

Chapter 5. Conclusion and Recommendations of the study

5. 1. Conclusion 515. 2. Recommendation for further study 53

Appendix

Appendix 1. 1. Definition of CAPM 54Appendix 1. 2. Procedure of a merger 54Appendix 1. 3. Historical development of AT&T 56Appendix 1. 4. Historical development of BellSouth 57Appendix 1. 5. Historical development of T-Mobile 57Appendix 1. 6. Historical development of Orange Mobile 58

References 59

List of Tables:

1. Types of waves 112. Comparison among each research approach 283. Formulas of key financial ratios 32

List of Figures:

Figure 1: Key figures and ratios of BellSouth from 2004-2005 35
 Figure 2: key figures and ratios of AT&T from 2004-2005 37
 Figure 3a: key growth rate of Verizon from 2006-2009 38
 Figure 3b: key growth rate of AT&T from 2006-2009 39
 Figure 4a: Profitability ratios of Verizon from 2006-2009 39
 Figure 4b: Profitability ratios of AT&T from 2006-2009 40
 Figure 5a: liquidity ratios of Verizon from 2006-2009 40
 Figure 5b: liquidity ratios of AT&T from 2006-2009 41
 Figure 6a: Activity ratios of Verizon from 2006-2009 41
 Figure 6b: Activity ratios of AT&T from 2006-2009 42
 Figure 7a: key figures and ratios of T-Mobile from 2008-2011 45
 Figure 7b: key figures and ratios of Orange Mobile from 2008-2011 46
 Figure 8a: key figures and ratios of O2 from 2010-2011 47
 Figure 8b: key figures and ratios of everything and everywhere from 2010-2011 49

CHAPTER 1: INTRODUCTION

Introduction

The chapter presents the overview of the thesis which includes background of the study, motivation behind taking this research, research questions, problem statement, aims and objectives of the study, significance of the study, research methodology used and organization of thesis.

Background of the Study

M&A have evolved in five stages in the past, triggered by various economic factors. The factors that play a key role in designing the process of M&A between companies or organisations include the growth in the GDP, interest

rates and monetary policies which are a part of macroeconomic environment.

First Wave Mergers :

They commenced from the year 1897 to 1904. Companies that enjoyed monopoly over their lines like electricity, railroad etc. merged during this phase . They were mostly horizontal mergers that took place during the aforesaid time period between heavy manufacturing companies. Most of the mergers during this period resulted in a failure due to inefficiency. The slowdown of the economy in 1903 and the stock market crash in 1904 were the reasons of the failure. Also, the anticompetitive mergers were halted by the Sherman act, thus the legal framework didn't support it either.

Second Wave Mergers:

The second wave commenced from 1916 to 1929, where it focussed on oligopolies. This wave was a result of the economic boom post world war I. The government policy encouraged firms to work in unison and also lead to technological developments of railroad and transportation by motor vehicles. They were horizontal and conglomerate in nature. Investment banks played a pivotal role in the merger during this phase. This phase ended with great depression and stock market crash in 1929.

Third Wave Mergers:

The nature of the mergers during this phase (1965-1969) was conglomerate. They were inspired by high stock prices, interest rates and strict enforcement of antitrust laws. Now, the firms were financed by equities unlike in the case of two wave mergers. The period noticed the poor

performance of the conglomerates resulting in the splitting of the merged firms in 1968 with the plan of Attorney General. Mergers like INCO-ESB merger; United Technologies and OTIS Elevator merger and the merger between Colt Industries and Garlock Industries had set precedence in 1970's.

Fourth Wave Mergers:

This phase commenced from 1981-1989 was characterised by acquisition targets wherein the targets were larger in size than that in the third wave merger. This involved mergers between oil and gas industries, pharmaceutical industries, banking and airline industries. It ended with anti-takeover laws, financial institutions reform and the gulf war.

Fifth Wave Mergers:

The fifth wave phase from 1992-2000 was a result of globalization, stock market boom and deregulation. It involved banking and telecommunications industries. These involved debt finance. Their motive was long term profit. This resulted with the burst in the stock market bubble. Thus, as a conclusion there have been many factors that contributed in the development of the evolution of M&A. Concluding that with the existence of production units the M&A would continue to exist with the expanding economy.

Aim of the study :

The various aims of the dissertation are as follows: Firstly, to know the basic meaning of a merger and an acquisition. Secondly, to know why would two companies opt for a merger or an acquisition i. e. the motive behind a merger or an acquisition. This explains the factors that would lead two companies to merge or take over another company. Thus, I will look at the

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various factors like role of synergy, agency problem, cash flow, and increase in the market power, regulation, economic factors and government influence which influence the managers to merger their company with another company or acquire another one. There are different motives like growth, synergy, and economies of scale etc. to shareholders, managers, promoters and customers which are also discussed in this report. Also, the effects of the motive of Mergers and Acquisitions on the company post it are also investigated. To do the investigation I'll take into consideration two case studies, which are as follows: Case study 1: This includes the study of the acquisition of BellSouth by AT&T. Case study 2: This includes the study of the merger of T-Mobile and Orange. M&A are almost two similar corporate actions involving combining two individual firms into one single entity leading to operational advantages such as improvement in company's performance and increase of long term shareholder's funds. An entrepreneur may use internal expansion or external expansion to grow its business. They are explained as follows:

- Internal expansion: In this the firm grows over the time, which includes expansion through acquisition of new assets, by replacing obsolete technological equipment's and establishing new lines of products.
- External expansion: This involves growing through corporate combinations by acquiring another running business. Combinations like mergers, amalgamations, acquisitions and takeovers are important features of corporate restructuring. These combinations have come into existence because of the enhanced competition, free flow of capital across countries, breaking of trade barriers and globalisation of business. These strategic decisions enhance production and marketing operations which lead to

growth of the company. It is a beneficial mean for companies to grow to expand the customer base, gain strength, cut competition or enter a new market or product segment. M&A are almost two similar corporate actions that involve combination of two companies where one is absorbed by the other. In both the actions the weaker company loses its identity and the other one retains it.

1. 2. MERGERS

According to the Oxford Dictionary " merger" means " combining of two companies into one". Fusion of two or more entities where the identity of one or more is lost. The assets and the liabilities of the companies are vested into another company and the shareholders of both the companies with at least nine-tenth of the shares become shareholders of the new entity formed. All the assets, stocks and liabilities of one company are transferred to the merged company. Example of a merger is when Daimler-Benz and Chrysler ceased to come together in 1998 to form a new company called Daimler Chrysler, Merger through absorption: Tata Fertilizers Ltd.(TFL) by Tata Chemicals Ltd. (TCL) where the assets and liabilities of TFL were transferred to TCL, Merger through Consolidation:. Merger of Hindustan Computers Ltd, Hindustan Instruments Ltd, Indian Software Company Ltd and Indian Reprographics Ltd into an entirely new company called HCL Ltd.

1. 2. 1. TYPES OF MERGERS:

Horizontal Mergers: Two companies that share the same product lines and market, in direct competition merge together. Aim of this merger is to achieve the economies of scale by cutting down on duplicated expenses of

both the companies. Examples of horizontal mergers are: Unilever acquired Lipton tea in 1972The formation of Brook Bond Lipton India Ltd. through the merger of Lipton India and Brook BondThe merger of Bank of Mathura with ICICI (Industrial Credit and Investment Corporation of India) Bank in 2001The merger of BSES (Bombay Suburban Electric Supply) Ltd. with Orissa Power Supply CompanyThe merger of ACC (erstwhile Associated Cement Companies Ltd.) with Damodar CementVertical Mergers: It refers to a situation where the product manufacturer and the supplier of raw materials or inputs merge to form a new entity. It is beneficial as it makes the company cost efficient by streamlining its production and distribution cost. An example of vertical mergers is: Time Warner Incorporated, a major cable operation, and the Turner Corporation, which produces CNN, TBS, and other programming. In this merger, the Federal Trade Commission (FTC) was alarmed by the fact that such a merger would allow Time Warner to monopolize much of the programming on television. Ultimately, the FTC voted to allow the merger but stipulated that the merger could not act in the interests of anti-competitiveness to the point at which the public good was harmed. Market Extension Merger: When two companies that merge together sell same products in different markets. Example of Market Extension Merger: The acquisition of Eagle Bancshares Inc. by the RBC Centura. Eagle Bancshares is headquartered at Atlanta, Georgia and has 283 workers. It has almost 90, 000 accounts and looks after assets worth US \$1.1 billion. Major benefit of this merger was that RBC continued to grow in the North American Market. Further, it could grow in the financial market of Atlanta which is the upcoming leading market in the USA.

Product Extension Merger:

It is merger of two companies dealing in two related products operating in the same market. Example: Mobilink Telecom Inc. acquisition by Broadcom.

Conglomeration: When two companies with uncommon business areas merge. For example: DCM and Modi Industries.

1.3 ACQUISITIONS

It is the purchase of one company by the other either by buying its assets or purchase of its shares. Since 1990, the number of mergers and acquisitions has doubled. Companies choose this way to grow as it increases the number of shares, achieve synergies in operations, access to new technology and a myriad of other reasons. Though it has its own drawbacks as the two companies work culture might clash, key employees might leave and costs of operations might increase rather than fall. The companies making a strategic decision of acquisition have atleast one of these archetypes:

Improving performance of the target company
Removing excess capacity from an industry
Creating market access for products
Acquiring skills or technologies

Types of Acquisitions:

The two kinds of strategies that can be applied in acquisition are as follows:

Friendly Takeover: In friendly takeover, one company acquires the other by cooperating with one another and settling matters mutually. Hostile

Takeover: In hostile takeover the information on the takeover is unknown to the company bought. Thus, it is a forceful agreement.

Benefits of Mergers & Acquisitions:

M&A is beneficial to all shareholders, managers and promoters. The main benefits of M&A are:

Greater Value Generations:

M&A often lead to greater value generations for the company, generally it is expected that this phenomenon leads to the shareholder value of the firm to increase which is more than the sum of the shareholder values of the individual parent companies. The concept can be explained as; when the two companies come together they tend to produce at a larger scale leading to increase in the output production. Thus, there are high chances that the cost of production per unit of output gets reduced.

Gaining Cost Efficiency :

M&A also helps in gaining cost efficiency by the implementation of the economies of scale, also a result of the cutting down of the double efforts by both the firms.

Increase in Market Share :

The M&A also leads to increase in market share leading to tax gains and revenue enhancement.

From Managers point of view:

They are concerned with improving the operations of the company, growth of the company providing better deals to raise their status, perks; they might have shares in the company and other fringe benefits. When there's a guaranteed outcome of the stated things, the managers support the merger.

From Promoters point of view:

Increase the size of the company, financial structures and the financial strength. The closely held private limited companies can get converted into public limited companies due to mergers without contributing much of wealth and promoters losing control over the company.

From consumer's point of view:

We can measure the benefit of the merger by the increase or decrease of the economic and productive activities which directly affect the degree of welfare i. e. provision of minimal wellbeing of the consumers by changes in the quality of products, price level and after sales service. The aim is not always increasing market growth it can depend on the level life cycle production is at.

Drawbacks of M&A:

M&A lead to concentration of economic power and these merged entities lead to a dominant position of market power. Also, after merger because of the dominance the entity suffers from deterioration in the performance over the years. The disadvantages of mergers and acquisitions are as follows:

Monopoly: Two companies that merge together tend to lead to reach the domination position hence create a monopoly in the market. Corporate debt levels can rise to dangerous levels as it might have a backer and also the amount of loans taken by the company. Damages the morale and the productivity of the firms. Managers have to forego long term investments to get short term profits. It is possible that lesser dividend is given to the shareholders if the company is making losses, also less returns on

investments if the company is not making enough profits. Corporate raiders control to make quick profits, strip assets from the target and destroying company leading to throwing people out of work. It is possible that a company doesn't throw the people out for example Virgin doing low cost flights to North of England when used to do trains, they instead became unemployed.

1. 7. RESEARCH DESIGN

This section is the blueprint of collection, study and analysis of primary and secondary data, which involves obtaining appropriate answers to the research questions. The research methodology used in the dissertation is an accounting study, which is explained further. The company's i. e. T-Mobile, BellSouth, AT&T, O2, Orange Mobile and Verizon's annual reports and some online data are used for the analysis of the company before and after the merger. This research also involves the study of the changes in financial performance due to Mergers and Acquisitions. Thus, this involves calculation of these three financial ratios i. e. profitability ratios, liquidity ratios and activity ratios and then comparing the company after the merger or acquisition with another company in the same industry; this is done to control the factors like firm specific, industry specific and economic worldwide. According to Leedy (1997) "research methodology is the foundation of any research project as it directs the research endeavour". Firstly, to become familiar with the research topic the researcher has to have knowledge of the existing published work. The literature review chapter further ensures that the research questions are answered, where the gaps

are covered by the further analysis by studying the primary data empirically (Passmore, Dobbie, Parchman & Tysinger, 2002).

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CHAPTER 2: LITERATURE REVIEW

2. 1. Motives behind Mergers and Acquisitions:

The past studies and researches done show that Mergers and Acquisitions have various motives, where Andrade et al. (2001) summarised it as "Efficiency-related reasons that often involve economies of scale or other synergies; attempts to create market power, perhaps by forming monopolies or oligopolies; market discipline, as in the case of the removal of incompetent target management; self-serving attempts by acquirer management to over-expand and other agency costs; and to take advantage of opportunities of diversification, like by exploiting external capital markets and managing risk for undiversified managers" George Coontz'04 states "The motive is to increase profitability and shareholder wealth by an increase in the price of the stock. An increase in price means an increase in the shareholders wealth." There are various reasons for mergers and acquisitions, which are as follows:

Growth:

The most common reason for merger is growth. It can be divided into two broadways:

Internal growth:

It is much cheaper and less risky for a company to merge and expand internally. It is much faster to grow by acquisition than internally.

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External growth:

Diversification is an external growth strategy. If an organisation operates in a volatile industry then it might opt to hedge the fluctuations by undertaking a merger. This also involves geographical diversification i. e. when one company acquires or merges with another company in some other country or location. It means expansion in the current market and in the new market, also by increasing the product range and services.

Synergy:

Another reason for merger is synergic benefits. This is the most commonly used word in Mergers and Acquisitions, for increasing performance and reducing cost of operations by combining the business activities. Two businesses merge together if they have complementary strengths and weaknesses i. e. it follows the financial maths $1+1=3$. This shows that the value of the two firms combined is much more than the two of them operating independently. Can be written as, $Val(A+B) > Val(A) + Val(B)$ There are two forms of synergies derived from: Cost economies: They help eliminating duplicate cost factors such as redundant personnel and overhead. These lead to lower per unit costs. Revenue enhancement: This is when one company's marketing skills combine with the other company's research process to significantly increase the combined revenue. Synergies are positively correlated to Mergers and Acquisition. This means higher the synergy, higher the target gains as well as the acquiring firm's shareholders benefits (Berkovitch & Narayanan, 1993). There are three types of synergies:

Operational synergy:

This is achieved by earning operational profits which is done by linking assets of the companies together to be used for various purposes.

Operational synergy can be achieved by one company by opting for a merger or an acquisition by eliminating its weakness i. e. for example if a company has a strong production department it can acquire a company with a good supply chain thus resulting in the company to be stronger. As stated in Copeland et al. (2005, p 762) , " The theory based on operating synergies assumes that economies of scale and scope do exist in the industry and that prior to the merger the firms are operating at levels of activity that fall short of achieving the potential of economies of scale". In other words, operational synergy can be achieved by economies of scale or economies of scope.

Financial synergy:

This includes when two companies after a merger or an acquisition achieve high return on equity, right to use larger and cheaper capital market.

Mergers and acquisitions also provide tax benefits, which is a financial synergy. Example of financial synergy: Mitsubishi and Bank of Tokyo. When the capital of two unrelated companies is combined and results in the reduction of cost and a higher cash flow that is also called financial synergy (Fluck & Lynch, 1999; Chatterjee, 1986). It is stated that " financial synergy, on average, tends to be associated with more values than do operational synergies "(Chatterjee, 1986, pg. 120)

Managerial Synergy:

When two companies come together it is possible that one of the company's has better and well skilled managers than the other company. Thus, the managerial synergy helps in forming a new firm with expertise and thus leading to an improved performance of the company.

Diversification:

Diversification is when that a company goes through a Merger or Acquisition with a company which is from an unrelated industry. This helps in reducing the impact of one particular industry on the profitability of the new entity and also spreads risk in terms of climatic change and consumers tastes.

Diversification has not been very successful except for a few companies like General electric, which grew and enhanced the shareholders wealth. The reason of engaging in M&A is to reduce the top managers' employment risk, such as the risk of losing job and risk of losing professional reputation (Amihud & Lev, 1981). Many large firms seek to achieve diversification by M&A, rather than internal growth. (Thompson, 1984; Levy & Sarnat, 1970). According to Seth et al. (2000. p 391) " In an integrated capital market, firm level diversification activities to reduce risk are generally considered non-value maximising as individual shareholders may duplicate the benefit from such activities at lower cost."

Economies of scale & Economies of scope :

Size is one of the important factors in M&A. A larger company benefits more from a merger in the form of cost reduction than a small company. The purchasing power and the company's negotiation power improves after the

merger i. e. the larger the company higher the chance to negotiate the price of products with suppliers and to ensure to not spoil the relations with the suppliers although the orders maybe inbuilt. This basically concludes that new entity reduce the duplicate operations lowers costs thus higher profits. The economies of scale refers to the average unit cost of production going down as production unit increases (Brealey et al. , 2006 ; Seth, 1990). The economies of scale is the goal of horizontal and conglomerate M&A. An economy of scope implies higher the number of products the less is the cost of production. The feature of economies of scope is more suitable for vertical M&A in seeking vertical integration (Brealey et al., 2006). In addition, complementary resources between two firms are also the motive for M&A. It means that smaller firms sometimes have components that larger ones need, so the large company's acquisition of the small company often take place (Brealey et al., 2006).

Increase market share and revenue:

M&A leading to an increased power of the new entity in the market. This helps in increasing market share. It also improves the investment opportunities of the firm; a bigger firm has an easier time raising capital. eg. Premier and Apollo tyres. According to Seth (1990, p. 101), market power is "The ability of a market participant or group of participants to control the price, the quantity or the nature of products sold, thereby generating extra-normal profits". According to Zheer & Souder (2004) , increased market power and increased revenue growth are the most common objectives for the firms participating in M&A. They can be achieved through horizontal M&A. Andrade et al.(2001) stated market power may be increased by

forming monopolies or oligopolies. Increased power results in being more competitive in the market and increased the revenue growth is achieved by taking the highly elastic products and lowering their prices. New growth opportunities come from the creation of new technologies, products and markets (Sudarsanam, 2003). Thus, these results in strengthening the financial position resulting in an increase in the profitability of the firm along with shareholders' wealth.

Increase supply chain pricing power:

If a company buys its supplier it helps in reducing the cost of the company to a large extent which is due to the profits of the suppliers being absorbed, increases efficiency only producing products required ("Just in time" process). This is known as a vertical merger and leads to company buying products from the distributors at a lower price.

Eliminate competition:

Mergers and acquisitions eliminate the competition and increase firms' market share. A drawback is that shareholders need to be paid a huge amount of premium to convince the other company to accept the offer. It is very common that the acquiring company's shareholders sell their shares which leads to reducing the price the company pays for the target company.

Acquiring new technology:

A large company can buy a small company with unique technologies and develop a competitive edge. This is the need of the competitive market.

Procurement of production facilities:

This is one of the reasons of mergers and acquisitions. It's a backward integration. When the acquiring firm take the decision of merging with a firm that supplies raw material which helps in safe guarding the sources that supply the goods or the primary products. It helps in reducing the transportation cost and economies in purchase of goods. Example: Videocon takes over Thomson picture in China.

Market expansion strategy:

Mergers and Acquisitions eliminate the competition and protect the existing market. The firm gets a new market to promote its products i. e. existing or obsolete. Example: to increase market in India Lenovo takes over IBM.

Financial synergy:

It may be the reason for a merger or an acquisition; following are the reasons for a financial synergy:

Better credit worthiness :

It helps the company to purchase goods on credit, raise capital in the market or obtain bank loan easily.

Reduces cost of capital:

The cost of capital reduces after mergers because the big firms are safe and they expect lower rate of return on capital.

Increase debt capacity:

Since a merger result in the rise in earnings and cash flows, this leads to increase in the capacity of the firm to borrow funds i. e. debts.

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Rising of capital:

Better reputation and credit worthiness with the increase in the size of the company helps in raising the capital easily at any time.

Taxes:

The profitable companies generally buy the companies which are loss making, so that it reduces their tax liabilities. In United States they limit the profitable companies to buy the companies in loss. Example: Ahmedabad cotton mills merged with Arvind mills, Sidapher mills merged with Reliance industry.

2. 2. THE EFFECTS OF MOTIVES ON MERGERS AND ACQUISITIONS

After studying the various motives of Mergers and Acquisitions, now I further study the effect of the motives on Mergers and Acquisitions, i. e. the post-Merger and Acquisition. According to Burner (2002), there are four approaches (i. e. accounting studies, event studies, survey of executives and clinical studies) to measure post M&A performance. Accounting and event studies are quantitative approaches and survey of executives and clinical studies are qualitative approaches.

2. 2. 1. EMPIRICAL EVIDENCE BASED ON ACCOUNTING STUDIES

Accounting studies is one of the methods used to examine the changes in the financial performance of the companies before and after a merger or an acquisition. More specifically, the changes of net income, profit margin, growth rates, return on equity (ROE), and return on asset (ROA) and liquidity

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of the firm are the focus of accounting studies (Bruner 2002; Pilloff, 1996). Dickerson et al. (1997) are the first researchers to study the relationship between M&A and the profitability for the UK firms (1948-1977). According to their findings there is no evidence available to prove that M&A brought any benefits to the financial performance of firms based on the measurement of profitability. Conversely the growth rate and the profitability was lower after the M&A than before M&A. Also, after controlling some uncertain factors that might affect profitability, Dickerson et al.(1997) found that M&A had a negative effect on the acquirer's profitability by measuring return on assets (ROA) in both the short term and long term period. This is consistent with Meeks (1977), whose studies indicated that the ROA for firms decreased after M&A in the UK. However, Dickerson et al did not investigate the nature of the acquired firm i. e. whether it is horizontal, vertical or conglomerate. Firth (1980), after studying the various other researchers results, concluded that based on accounting studies, generally speaking, acquired companies don't have great profitability and have low stock market ratings before M&A, but obtain a great deal of profit after engaging in M&A. In contrast, acquiring companies generally have average or above average profitability prior to M&A, whereas they suffer a reduction in profitability after M&A. Ghosh (1997) is the first researcher to examine the correlation between post-merger operating cash flow and the method of payment used in M&A for the acquiring company for 315 mergers over the period from 1985 to 1995. His research showed that the acquiring firm paid with cash and then it was compared with the company in the same industry, the cash flow increased significantly with an improved asset turnover after the M&A.

2. 2. 2. EMPIRICAL EVIDENCE BASED ON EVENT STUDIES:

According to Bodie, et al. (2005, p381), an event study " Describes a technique of empirical financial research that enables an observer to assess the impact of a particular event on a firm's stock price". For example study of share and dividend changes. The standard event study includes the use of Sharpe's (1963) market model and capital asset pricing model (CAPM)[1] (Dimson & Marsh, 1986). Based on event studies , Firth (1980) studied 496 targets and 434 acquirers in the during the period from 1969-1975 and the result stated a conflict in terms of shareholders returns to acquiring firms. He found that in the UK after the takeover the share price and the profitability of an acquiring firm declines. Langeteig (1978) used a three factor performance index to measure long term stockholders gains from M&A. He concluded that post-merger the excess returns were insignificantly different from zero and provided no support for mergers. The acquired and the bidder had an average excess return of 12. 9% and 6. 11% respectively.

2. 2. 3. EMPIRICAL EVIDENCE BASED ON CLINICAL STUDIES:

It provides a blueprint for comparing the discounted value of cash flows and divestiture to the pre-acquisition value. They originate from anthropology, sociology and clinical methods in the 1920's. It is also called a case study, which is an in- depth study by one person through field interviews with executives and knowledgeable observers and is a form of quantitative descriptive research (Bruner, 2002).

2. 2. 4. EMPIRICAL EVIDENCE BASED ON SURVEYS OF EXECUTIVES STUDIES:

The surveys of executives in the form of a questionnaire, asking questions regarding motives of M&A or whether they are beneficial for shareholders or not. The post-merger performance can be inferred from the questionnaire (Bruner, 2002). As in CFERF(Canadian financial executive research foundation) executive research report, " Finance executives have shown in this study that organizations can improve their chances of successfully merging firms by incorporating people related risks into the evaluation, due diligence and deal structuring phases of M&A activity". In Ingham et al. (1992), where they surveyed 146 of UK's top 500 companies during the period from 1984-1988 on the basis of a questionnaire. However in case of the profitability of acquiring firms, whether it increased or not post M&A, they found different results. From the short term point (0-3years), 77% of the managers claimed that short term profitability increased whereas long term i. e. over 3 years, 68% said the profitability increased. There is one problem in this survey, which is that it considers only private companies other than the other financing companies.

TABLE 2. COMPARISON AMONG EACH RESEARCH REPORT

STRENGTHS

WEAKNESSES

EVENT STUDIES

It is a direct forward looking measure creating value for investors, where the expected future cash flow is the present stock price. There are various

assumptions made regarding the functioning of the market, rationality, absence of restriction on arbitrage which is not unreasonable for most of the stocks on an average over time as a result of the researches. Some companies are vulnerable to specific events, researchers and large numbers of people deal with this problem.

ACCOUNTING STUDIES

It is the certified and audited accounts which are used by investors as an indirect measure of economic value creation. Different reporting practices. Different time period Principles and regulations different for different companies. In case of historic cost approach, inflation and deflation is a sensitive issue. Inadequate disclosure of the accounts by the companies. Different accounting practices in different countries.

SURVEY OF MANAGERS

It gives an insight of the success of the acquisition that may not be known in the stock market. Includes the study of managers whose area of interest is not focused on the creation of economic value. Historical results are not good predictors Participation is very low i. e. 2-10% which makes them vulnerable to criticisms.

CASE STUDIES

Inductive research to examine new patterns and behaviour by restructuring an actual experience. The research reports can be difficult to abstract large implications from numerous reports where hypothesis testing limits the researches ability to increase the size of the research

Source: " Does M & A Pay? A survey of evidence for the decision maker" (Bruner, 2002, p. 16).

CHAPTER 3: RESEARCH METHODOLOGY

3. 1. OVERVIEW OF AN ACCOUNTING STUDY

RESEARCH METHODOLOGY

A company taking over other company will need to evaluate the company to determine whether it is beneficial or not. The main idea is to find the worth of the company; both the companies will have different ideas to evaluate the merger. Naturally, the seller would value the company at the highest price as possible, whereas the buyer will value it at the lowest price possible. The company's operations need to be valued by taking some of the accounting procedures into account; it also helps in knowing the impact of mergers and acquisitions on the cost, revenues, profits etc. of both the companies.

[2]Firstly, I will consider the company's financial statements, balance sheet, profit and loss accounts and the content in the annual reports. Using this data I will calculate the financial ratios i. e. profitability ratios (net profit margin, gross profit margin, return on asset and return on equity), liquidity ratios (current ratio and liquid ratio) and activity ratios (total asset turnover and inventory turnover). These financial ratios help in analysing the company's performance and various other factors indicating the progress. There are many appropriate ways to value the company, it can be by either comparing two companies in the same industry or there are some more ways of valuing the companies which are discussed as follows:

1. Profitability Ratios:

It is to measure the overall performance of the company; the success of a company and the goal is to obtain sufficient profit in the end. It is used for the analysis of the trend, the operating profitability and efficiency is observed by the gross profit margin ratio and also the return on assets and equity analyses the manager's efficiency in manufacturing and purchasing costs, it also reflects the perspective of the shareholders. It also helps in knowing the return on sales using the figures of net profit margin, this is used for two companies in the same industry in different years, also tells the profit earned in respect to the sales.

2. Liquidity Ratios:

It consists of current ratio and liquidity ratio. These ratios measure the liquidity of the firm i. e. how they meet their creditor's demands. Liquidity arises when the cash inflow is not the same as cash outflow. Example: If cash inflow from sale is unequal to the cash paid to the employees or suppliers etc. then the problem of liquidity arises. Also, in calculation of quick ratio, inventory is not included as it is the least liquid current asset.

3. Activity Ratios:

It measures the efficiency of the company to use the assets. Total asset turnover ratio helps understanding how efficiently different companies use its assets whether in the same industry or taking into account two different years. The inventory turnover ratio tells how efficient the working capital management is as it indicates both liquidity and operational efficiency. Secondly, since the absolute ratios don't have any meanings the major point

is to observe the changes in the ratio from one country to another or comparisons among various companies. Lastly, the profitability of the company is affected by various factors like firm-specific, industry-specific and economic-wide factors. The profitability change of the acquiring company and the benchmark group i. e. the post-merger and long term data is available to the acquirers as the target companies are de-listed after the M&A (Sudarsanam, 1995). In the dissertation, I take the benchmark groups as the top two competitors of the company. It involves calculating the financial ratios and analysing them, this is one of the easiest tools to compare two companies, also during the observation period the benchmark group is not acquired or made large.

Table 3: Formulas of key financial ratios

Key growth rates

Turnover $\frac{\text{Changes in turnover}}{\text{Net profit}}$

Profitability ratios

Net profit margin = $\frac{\text{net profit after tax}}{\text{sales}}$ Gross profit margin = $\frac{\text{gross profit}}{\text{sales}}$

Return on Asset (ROA) = $\frac{\text{net profit before interest}}{\text{sales}}$ Return on

equity (ROE) = $\frac{\text{net profit after tax}}{\text{equity}}$

Liquidity ratios

Current ratio = $\frac{\text{current assets}}{\text{current liabilities}}$ Quick ratio = $\frac{(\text{current assets} - \text{inventories})}{\text{current liabilities}}$

Activity ratios

Total asset turnover = sales / total assets
Inventory turnover = cost of sales / inventories

3. 2. SOURCE OF DATA:

The data i. e. the financial reports of the companies including the balance sheet, profit and loss account and the cash flow statement is compiled from the reports available online on the company's website. These statements are used to know the financial performance of the company before and after a merger or an acquisition.

3. 3. LIMITATIONS OF THE STUDY:

Since the data is collected from the secondary sources i. e. the financial reports of the companies so it is possible that they are bias because of the accounting techniques. Also, there can be some limitations related to the some aspects of financial reports not being analysed properly despite of studying and analysing all the key ratios. The results of other studies like clinical study, survey study, event study when compared to the accounting studies results have different conclusions about the effect of M&A. For example: while studying a clinical study, one of the factors that could affect the changes in production and performance can be organizations managerial and mechanism practices (kalpan, et al., 1997) which is not a factor that is examined in accounting studies.

CHAPTER 4: CASE STUDIES ANALYSIS

4. 1. Overview of AT&T acquisition of BellSouth Corporation

BellSouth was acquired by AT&T on 29th December 2006 with an aim to control more than half of the telephone and the internet services in the U. S. It was approved by Federal Communications System (FCC), and was worth \$ 86 billion approximately (or 1. 325 shares of AT&T for each share of BellSouth on the close of trading date). This resulted in AT&T being the nation's largest provider of business voice, data /internet and wireless services. Thus, it leads to own both yellowpages. com and Cingular wireless, leading to the expansion of the telephone and the data network all over the country covering 22 states.[3]

4. 1. 1. The motives of AT&T acquisition of BellSouth

AT&T provides smartphones, next-generation TV services and also sophisticated solutions for multi-national businesses. It aims at providing innovative, reliable, high quality products and services prioritising the customer's satisfaction and bringing them together even if they are at different parts of the world. It achieves its aim by using innovative ideas in the communications and entertainment industry. It fulfils the growth motive as it lead to providing the nation's fastest mobile broadband network, providing large coverage for U. S. wireless carrier and also the largest Wi-Fi network in United States. Also, it's the only 100 per cent IP-based national U. S. television service provider. It has a " three-screen" strategy that provides services across the mobile device, TV and the PC. More than 1200 AT&T real yellow pages are published and distributed annually. It also fulfils the motive

of diversification as it was ranked No. 4 on the DiversityInc top 50 lists in 2011 for its diversity and inclusion initiatives and it was also ranked as no. 2 for supplier's diversity in the same year. It is also No. 1 among 75 American companies which were awarded for exceptional learning and development programs. It was also awarded various awards for recognising women talents in different fields. Also, was recognised for its exemplary achievements as the corporation of the year including Asian, Black, Hispanic and native American-owned provider in its supply chain. It was also awarded for its emphasis in managing its technology.

4. 1. 2. Effects of AT&T acquisition of BellSouth: Financial Performance

Figure 1: Key figures and ratios of BellSouth from 2004-2005 (in \$ millions)

2004

2005

Sales

20, 300

20, 547

PBIT

5, 289

4, 670

Changes in sale

-

247

PAT

4, 758

3, 294

Gross Profit

12, 780

12, 480

Equity

23, 066

23, 534

Total Asset

59, 339

56, 553

Retained Earnings

19, 267

20, 383

Gross profit Margin

0. 629

0. 607

ROE

0. 206

0. 1399

ROA

0. 0873

0. 07607

Total asset turnover

0. 342

0. 363

Current Asset

5, 613

4, 209

Current Liability

10, 370

11, 286

Current Ratio

0. 54

0. 37

Analysis:

The key indicators of the growth rate are sales, net profit and the changes in the turnover. As in the figure 1 the sales increase from the year 2004 to 2005 by \$247 million but there is a decrease in the profits of the company where profit before interest and tax and profit after tax both decrease by \$619 million and \$1465 million respectively. The profitability can be studied by looking at the gross profit margin, ROE (Return on equity) and ROA (Return on asset), all the figures are decreasing from the year 2004 to 2005, thus showing that the company suffers losses. This ratio indicates the effect of changes in sales, equity and assets on the gross profit, PBIT and PAT respectively. According to Walton & Aerts (2006), the margin ratios are used to study the trend analysis and to do comparisons among companies and also helps in studying the operating profitability and efficiency. Hence the figure shows inefficient operating profitability and efficiency. The liquidity ratio i. e. the current ratio studies how a company meets its creditor's demands. There is a decrease in the current ratio from 0. 54 to 0. 37 . the ideal current ratio is 2: 1, thus by a decrease in this ratio we observe that the

company is unable to meet its short term debt i. e. the demand of the creditors which is due to the decrease in the current asset and an increase in the current liability from the year 2004 to 2005. The activity ratio which is the total asset turnover ratio is increasing from 0. 342 to 0. 363, thus showing that the company's assets are used efficiently by the management. To summarize, BellSouth didn't perform good financially before the merger.

**Figure 2: Key figures and ratios of AT&T from 2004-2007
(in \$ millions)****2004****2005****2006****2007****Sales****40, 733****43, 764****63, 055****1, 18, 928****PAT****5, 887****4, 786****7, 356****11, 951****PBIT****5, 901****6, 168****10, 288****20, 404****Changes in sale**

-

(1, 101)

2, 570

55, 273

Gross Profit

23, 372

24, 755

35, 706

72, 873

Equity

40, 504

54, 690

1, 15, 540

1, 15, 367

Total Asset

1, 10, 265

1, 45, 632

2, 70, 634

2, 75, 644

Retained Earnings

28, 806

29, 106

30, 375

33, 297

Gross profit Margin

0. 57

0. 565

0. 566

0. 613

ROE

0. 145

0. 087

0. 206

0. 103

ROA

0. 0535

0. 0423

0. 038

0. 074

Total asset turnover

0. 369

0. 301

0. 233

0. 431

Current Asset**9, 962****14, 654****25, 553****24, 686****Current Liability****20, 355****25, 418****40, 482****39, 274****Current Ratio****0. 4894****0. 577****0. 631****0. 629****Quick Ratio****-****-****0. 613****0. 60****Inventory****-**

-

756

1, 119

Analysis:

The key indicators of growth rate are sales, change in inventory and the net profit. Looking at the figure 2, it can be seen that sales increase steadily from 2004 to 2005 which is a remarkable increase from 2005 to 2006 i. e. after the acquisition and then leading to a major increase of 87. 66% . Also the profit and the changes in inventory increase remarkably indicating that it was beneficial for the firm to acquire BellSouth. The gross profit margin, ROE and ROA figures from the above table indicate that the increasing trend of the gross profit margin shows an improvement in the operating efficiency over the years. The ROE tells the benefit to the shareholders it had an increasing trend from 2004 to 2005 with a great hike in the year 2006, but further lead to a decrease in 2007 from 0. 206 to 0. 103 , thus showing a slight decrease in the profitability. The ROA shows a significant increase over the years thus showing that the company managed its assets quite well. The liquidity ratio, the current ratio and the quick ratio measures the company's ability to meet its creditor's demands. The figures in the above table indicate that the company is able to meet its creditor's demands sufficiently with an increase in it over the years. The activity ratio, i. e. the total asset turnover ratio indicates how well the assets are managed, thus the figures indicate a good management of assets over the year 2004 to 2007.

Thus, the figure 1 and figure 2 show an improvement in the profitability, efficiency and managing skills of the companies over the years.

4. 1. 3. Comparison of AT&T with its competitor post acquisition:

Verizon

Verizon Communications Inc., known as Verizon provides a global broadband and telecommunication service. It originated in 1983 as Bell Atlantic in New York City. In 2000, after acquiring the independent phone company GTE it continued to run by the name of Verizon. It is one of the top competitors to AT&T in the telecommunication industry.

Figure 3a. Key growth of Verizon from 2006-2009**Year****Turnover****(\$ million)****Net Profit****(\$ million)****Gross Profit****PBIT****2006****88, 182****6, 197****52, 873****8, 154****2007****93, 469****10, 358****55, 922****14, 545****2008****97, 354****12, 583****58, 347**

15, 914

2009

1, 07, 808

10, 358

63, 509

11, 568

Source: Compiled from Verizon's annual reports from 2006-2009

Figure 3b. Key growth of AT&T from 2006-2009

Year

Turnover

(\$ million)

Net Profit

(\$ million)

Gross Profit

PBIT

2006

63, 055

7, 356

72, 873

10, 288

2007

1, 18, 928

11, 951

72, 127

20, 404

2008

1, 24, 028

12, 867

74, 472

23, 063

2009

1, 23, 018

12, 535

72, 613

21, 492

Source: Compiled from AT&T's annual reports from 2006-2009

The data of the key growth of Verizon (Fig. 3a) shows an increasing turnover from the year 2006 to 2009 from \$88, 182 million to \$1, 07, 808million. In the case of AT&T (Fig. 3b) shows that the key indicator of growth the turnover of the company is steadily increasing from the year 2006 to 2008 with an insignificant fall in the year from \$1, 24, 028 million in 2008 to \$12, 30, 18 million in 2009. Both the companies show a consistent increase in the revenue over the years where the revenue growth of Verizon is 22. 25% and

of AT&T is 95.096 % respectively. Thus, AT&T has better growth rate over the six years; hence it achieves the revenue synergy. With regard to the net profit, both Verizon and AT&T have increasing net profits over the four years, where the net profit of both the companies decrease insignificantly in the year 2009 from 2008, with AT&T having more profit than Verizon. Therefore, AT&T maintains a steady net profit over the years.

Figure 4a. Profitability Ratios of Verizon from 2006-2009**Year****Net profit****Margin****Gross profit****Margin****Total****Assets****Equity****ROA****ROE****2006****0. 070****0. 599****1, 88, 804****48, 535****0. 043****0. 128****2007****0. 1108****0. 598****1, 86, 959**

50, 581

0. 288

0. 204

2008

0. 129

0. 599

2, 02, 352

78, 905

0. 202

0. 159

2009

0. 096

0. 589

2, 27, 251

84, 367

0. 137

0. 123

Source: Compiled from Verizon annual reports from 2006-2009

Figure 4b. Profitability Ratios of AT&T from 2006-2009

Year

Net Profit

Margin**Gross Profit margin****Total****Assets****Equity****ROA****ROE****2006****0. 116****1. 156****2, 70, 634****1, 15, 926****0. 038****0. 0635****2007****0. 1005****0. 606****2, 75, 644****1, 15, 747****0. 074****0. 1032****2008**

0. 104

0. 600

2, 65, 245

96, 750

0. 087

0. 1329

2009

0. 102

0. 590

2, 68, 752

1, 02, 325

0. 079

0. 1225

Source: Compiled from AT&T annual reports from 2006-2009

Comparing the net profit margin and the gross profit margin of the two companies over the four years, the average net profit margin of Verizon and AT&T is 0. 101 and 0. 106 respectively and the average gross profit margin is 0. 596 and 0. 738 respectively. Thus, showing that companies make profits on the total assets and shareholder's equity possessed. Thus, AT&T has a better market strategy than Verizon. At the same time the ROA and the ROE of the two companies were positive with an increasing trend. Though the average ROA is 0. 167 and 0. 0695 respectively showing the return on asset of AT&T is not as good as that of Verizon. The financial position of AT&T <https://assignbuster.com/empirical-evidence-based-on-accounting-studies-finance-essay/>

Company has a positive indication but the financial status after the acquisition is poor as that of the competitor company.

Figure 5a. Liquidity Ratios of Verizon from 2006-2009**Year****Current asset****Current liability****Inventories****Current Ratio****Quick Ratio****2006****22, 538****32, 280****1, 514****0. 698****0. 65****2007****18, 698****24, 741****1, 729****0. 756****0. 686****2008****26, 075****25, 906**

2, 092

1. 007

0. 926

2009

22, 608

29, 136

2, 289

0. 776

0. 697

Source: compiled from Annual reports of Verizon from 2006-2009

Figure 5b. Liquidity Ratios of AT&T from 2006-2009

Year

Current asset

Current liability

Inventories

Current ratio

Quick ratio

2006

2, 553

40, 482

756

0. 063

0. 044

2007

24, 686

39, 274

1, 119

0. 629

0. 601

2008

22, 556

42, 290

862

0. 533

0. 513

2009

24, 334

36, 705

885

0. 663

0. 639

Source: compiled from Annual reports of AT&T from 2006-2009

From the prospective of the Liquidity, the current ratio and the quick ratio followed an increasing trend for both Verizon and AT&T from 2006-2009 , where the average current ratio of the respective companies is 0. 81 and 0. 472 respectively and the average quick ratio being 0. 74 and 0. 45 respectively. From the year 2006-2009, the current assets of Verizon is the almost the same of the year 2006 and 2009, whereas the current liability has decreased. In case of AT&T, his current assets increased majorly in 2007 leading to a steady increase till the year 2009 whereas the current liabilities have decreased by 9. 33% over the four years. As the average ratios of Verizon are better than that of AT&T, the short term liquidity of the company was worse than its competitor after the acquisition.

Figure 6a. Activity Ratios of Verizon from 2006-2009**Year****Total Asset****Turnover****2006****0. 467****2007****0. 499****2008****0. 481****2009****0. 474****Figure 6b. Activity Ratios of AT&T from 2006-2009****Year****Total Asset Turnover****2006****0. 233****2007****0. 431****2008****0. 367****2009**

0. 401

From the above figures 6a and 6b, it is observed that the total asset turnover ratio of both the companies Verizon and AT&T are steadily increasing with an average total asset turnover to be 0. 48 and 0. 35 respectively. However the average of AT&T was lower than that of Verizon thus proving that AT&T did not utilize its total assets efficiently after the acquisition.

Summary

According to the Verizon's annual report, there is a good operating and financial discipline seen in the business, with maximising the cash flow and the return to the shareowners. Also, by the end of this year there is an extraordinary growth seen by introducing video sharing, conferencing and 4G connections. According to the AT&T annual report, the company did improve increasing the efficiencies over the board, adjusting cost structure, increasing cash flow and raising dividends as compared to the last year. By comparing the various financial performance indicators of AT&T with its competitor Verizon, it has been concluded that AT&T did not show a commendable performance after the acquisition. It has a consistent revenue growth, net profit margin and gross profit margin, but it underperformed its competitor in ROE, ROA, liquidity ratios and total asset turnover. Thus proving the results of Dickerson et al. (1997), Meeks (1977), Firth (1980) and Caves (1989) to be consistent as in the empirical literature review claiming that the profitability of the acquiring company is lower after the M&A than before the M&A.

4. 2. T-MOBILE AND ORANGE MOBILE MERGER AN OVERVIEW

http://static.guim.co.uk/sys-images/Guardian/Pix/maps_and_graphs/2009/09/08/Mobile_Shares.gif

SOURCE: OFCOM In December 2009, Consumer Focus and the

Communications Consumer Panel had sent a joint letter to the Competition

Commissioner, Neelie Kroes asking for the merger by the authorities in the UK. On 1st March 2010, the European Commission approved the merger with

a condition that the combined company sells the 25% of the spectrum it owns on the 1800 MHz radio band and amend a network sharing agreement

with smaller rival. In 2010, Deutsche Telekom's T mobile and Orange mobile combined together by becoming a part of the joint venture with France

Telecom's UK mobile network provider. They merged under the new parent

company called " Everything Elsewhere" on 11th may 2010, which was announced on the British High Streets. Despite the merger they continued to

co-exist in the UK market. This took place on the 1st April 2010. On 8th September 2009 the BBC news stated that " It would be UK's largest provider

overtaking the Telefonica's O2, with about 37% of the mobile market."

According to the financial times " The mobile phone operator formed by the merger of Orange and T-Mobile two years ago has been forced to sell the

spectrum by European competition authorities." It covers around 30million customers, i. e. more than half of the UK's adult population. The CEO of the

company Tom Alexander said that " This is the first major consumer benefit of the merger between Orange and T-Mobile, and it delivers an unrivalled

and unique experience that no other operator can offer."[4]

4. 2. 1. The motives of T-Mobile and Orange Mobile merger

The main aim behind the merger was to create the country's largest mobile phone operator covering 37% of the market, leapfrogging rivals Vodafone and O2. This deal led to unemployment as the two companies rationalised their networks. Also, it helped in cost saving by closing down the high street retail stores worth £3.5bn. France Telecom's chief financial officer Gervais Pellissier said the deal would "on the one hand fundamentally change our respective positions in the UK and on the other hand bring substantial benefits to consumers in the UK". His opposite number at Deutsche Telekom, Timotheus Höttges, added that the merger was "the first step towards creating the new mobile champion in the UK". On August 21, 2012, according to the financial times, 4G mobile broadband will reach Britain the next month and also the company aims at providing 4G mobile and phones broadband devices in UK by the next year. The deal helped the T-Mobile to be at par with its competitors and helps Orange to improve its margins by pooling its wireless assets with T-Mobile. Prior to the deal Orange had 13,000 current generation or 2G masts and 7,000 that carry mobile broadband. Or 3G signals-Mobile has 10,000 2G masts and 7,000 3G masts, post deal the combined group expects 14,000-16,000 masts, or 32,000 i.e. at least 5,000 fewer than what it is now. It was seen that the joint venture would result to indebtedness of £1.25bn which will be represented as two shareholder loans of £625m i.e. the shareholders create 90% cash from this venture. Even the revenue synergy is met as the joint venture led to an increase in the revenue to £9.4bn from £7.7bn. Also, it would lead to some

operating cost savings too which is due to the IT cuts, store closures and job cuts.

4. 2. 2. Effects on T-Mobile and Orange Mobile post-merger: Financial Position

Figure 7a. Key figures and ratios of T-Mobile from 2008- 2011(Millions £)

2008

2009

2010

2011

Revenue

18, 201

18, 220

4, 269

3, 824

Revenue growth rate

-

0. 104%

(76. 56) %

(10. 42)%

Net profit

2, 004

4, 510

2, 983

1, 648

Equity

59, 010

60, 136

59, 328

57, 963

Operating profit

2, 076

5, 000

2, 564

2, 066

Current Asset

5, 401

13, 510

13, 218

11, 587

Total Asset

1, 09, 059

1, 08, 342

1, 00, 084

98, 430

Current Liability

17, 111

14, 760

15, 281

13, 630

Net Profit Margin

0. 110

0. 248

0. 699

0. 431

ROE

0. 034

0. 247

0. 699

0. 431

ROA

0. 114

0. 274

0. 601

0. 540

Total Asset Turnover

0. 167

0. 168

0. 0426

0. 0388

Current Ratio

0. 316

0. 92

0. 86

0. 85

Figure 7b. Key figures and ratios of Orange Mobile from 2008-2011 (in millions, euros)

2008

2009

2010

2011

Revenue

46, 712

44, 845

45, 503

45, 277

Revenue growth rate

-

(3. 99)%

1. 46 %

(0.49) %

Net profit

4,418

3,402

4,877

3,828

Equity

30,543

29,577

31,549

29,592

Operating profit

9,754

7,650

7,562

7,948

Current Asset

15,456

13,452

15,130

18,535

Total Asset

93, 652

90, 910

94, 276

96, 083

Current Liability

26, 338

22, 093

23, 591

26, 172

Net profit Margin

0. 09

0. 075

0. 107

0. 0845

Total Asset Turnover

0. 49

0. 49

0. 482

0. 471

Current Ratio

0. 59

0. 61

0. 64

0. 71

ROE

0. 145

0. 12

0. 15

0. 13

ROA

0. 104

0. 084

0. 080

0. 083

Before the merger both the T-Mobile and Orange Mobile's financial figures represented a healthy performance where the revenue, net profit ROE, ROA, total asset turnover and the current ratio are increasing (Figure 7a &7b). However, after the merger, the revenue, net profit, total asset turnover ratio, ROE are observed to be decreasing for both the companies. Whereas, only the ROA and the current ratio seem to be increasing in case of Orange Mobile. Thus, it can be concluded that the financial position of both the companies was better before the merger. Thus, proving the results of Firth (1980), who supported that" the acquiring companies generally have average or above average profitability prior to M&A, whereas they suffer a reduction in profitability after M&A" to be consistent along with the results of Dickerson et al. (1997) and of Meeks (1977).

<https://assignbuster.com/empirical-evidence-based-on-accounting-studies-finance-essay/>

4. 2. 3. Comparison of T-Mobile post financial performance with its Industry competitors

As explained earlier it is essential to compare the company with its competitor i. e. O2 (Telefonica Europe).

O2- Telefonica Europe

It is a European broadband and telecommunication company which trades under the name O2. It originated as a collection of worldwide telecommunication companies, which by 1990 were classified as BT wireless and a global mobile data business known as Genie Internet, classified under British telecommunication. It provides both fixed and mobile telephony in United Kingdom, Ireland, Germany, the Czech Republic and Slovakia.

**Figure 8a. key figures and ratios of O2 from 2010-2011
(Millions of euros)**

2010

2011

Revenue

60737

62837

Revenue growth rate

-

3. 458%

Net profit

10072

6187

Operating profit

16474

10064

Equity

31684

27383

Current asset

21054

20823

Total asset**129775****129623****Current liabilities****33492****32578****Net profit margin****0. 166****0. 098****Total asset turnover****0. 468****0. 4847****Current ratio****0. 629****0. 639****ROE****0. 639****0. 226****ROA****0. 127****0. 077**

Source: compiled from annual report of O2 telefonica Europe from 2010-2011

Analysis of Orange Mobile with O2:

After the T-Mobile and Orange Mobile merger, the revenue of Orange-Mobile decreased by 0.49% this can be due to the increase in the VAT and due to situation in France and Egypt also a decrease in revenue in home communication services, whereas the O2 had a revenue growth of 3.458%.

Even though it was a small decrease in the revenue, comparing the two companies O2 has much better sales than Orange. Thus, Orange doesn't achieve the revenue synergy after the merger. In terms of profitability, the net profit of both the companies is decreasing from 2010 to 2011.

Comparing the figures individually O2 has higher net profit as compared to Orange. It can be seen that Orange was making losses and was not performing up to the mark when compared to its peers after the merger with the limited two year time period. Also, the ROE and ROA of Orange remain almost the same from 2010 to 2011 i. e. post-merger though there is a decrease in these ratios in case of O2. Thus, showing Orange gets better return on asset and equity as compared to its competitor. O2 has current ratio average as 0.634 and Orange Mobile has the average as 0.675. Thus, indicating not a very big difference in the two companies to comment that which has better position to meet its creditor's demands than O2. The average total asset turnover ratio is 0.4765 and 0.476 of Orange and O2 respectively. The total asset turnover ratio is decreasing for Orange and increasing for O2 from 2010 to 2011. Even though the decrease in the ratio

in case of Orange mobile was just 0. 01. Thus, Orange mobile even after the merger wasn't better than the O2.

Figure 8b. Key figures and ratios of Everything and Everywhere from 2010-2011. (In £ millions)**2010****2011****Revenue****5, 298****6, 784****Revenue growth rate****-****28. 04%****Net profit****(84)****(104)****Operating profit****(40)****(68)****Equity****12, 252****11, 251****Current asset****1, 932****1, 691**

Total asset**16, 202****15, 262****Current liability****3, 386****2, 692****Net profit margin****(0. 016)****(0. 15)****Total asset turnover****0. 326****0. 445****Current ratio****0. 57****0. 628****ROE****(0. 0068)****(0. 00924)****ROA****(0. 00246)****(0. 00445)**

Source: Compiled from " Everything everywhere" annual reports from 2010-2011

Analysis of comparison of Everything Everywhere with O2

As seen from the above tables, both the companies have a revenue growth which is 3.458% and 28.04 % of O2 and Everything Everywhere respectively. Thus, the company formed by the merger fulfils the revenue synergy. With regard to profitability, the net profit of the merged firm is negative thus showing a very poor state of the company with net profit margin, ROE and ROA being negative too. Thus, concluding that the company merged company is making losses on the assets and the shareholders equity it possessed after the merger. From the prospective of the liquidity ratios, it is seen that the current ratio of both the companies is increasing where it is slightly more for O2 than that of the merged company which doesn't affect the comparison majorly thus, both the companies are able to fulfil its creditor's demands almost equally. The activity ratio, i. e. the Total asset turnover ratio is increasing consistently for both the companies, where the average total asset turnover ratio is 0.476 and 0.3855 of O2 and the merged firm Everything everywhere respectively. Thus, the merged company did not use its total assets sufficiently and its peers were better at it.

Summary

From the above analysis, it was concluded that the financial status of Orange Mobile was better before the merger, which lead to a decline following the merger with T-Mobile forming " Everything Everywhere" showing an inferior financial performance. The merger was not profitable for the shareholders,

and did not create any value. Thus, the result is consistent as per the findings of Firth (1980) who stated that the acquiring companies generally have average or above average profitability prior to M&A, which leads to a reduction in profitability after the M&A. The results are consistent for both Dickerson et al.(1997) and Meeks (1977). Everything Everywhere, the joint venture sees a fall in the turnover, margins and income per customer as the telecoms watchdogs cuts to call charges begin to bite. Ofcom reduced the price of calling mobile phones. It also leads to a fall in the number of customers. (www. guardian. co. uk) Zaheer & Souder (2004) indicated that the success of M&A depends on the ability to integrate the target, especially when the degree of integration is high. This could be seen in the merged companies.

CHAPTER 5: CONCLUSION, LIMITATIONS AND RECOMMENDATION OF THE STUDY

5. 1. CONCLUSION

With an increasing trend of mergers and acquisitions and the increasing competition and the development of globalization aiming at achieving certain strategic and financial motives. The dissertation is about the overall review by studying the empirical literature including the motives of mergers and acquisitions which could be categorised into three parts: Increase shareholders value is one of the major motives which include synergy, increased market power, increased revenue growth, economies of scale, scope and managerial efficiency. Secondly, the motives that decrease the shareholders' value like agency motive, free cash flow and managerial hubris. Thirdly, motives that have an uncertain impact on the shareholders i. <https://assignbuster.com/empirical-evidence-based-on-accounting-studies-finance-essay/>

e. diversification. Then is the effect of the motives of mergers and acquisitions. There are four methods which can be used for this empirical study, they are: Accounting studies, Event studies, Survey of executives and Clinical studies. Also, the findings of the Mergers and Acquisitions from US and UK are also explained in the literature review. The method used in the dissertation report is the accounting method followed by the pre-merger and acquisition analysis with a final post-merger and acquisition comparison of the company with its competitors. To study the motives, effects and the literature review completely there is a need to examine the empirical evidence which was done by taking the following: Acquisition of BellSouth by AT&T, Merger of T-Mobile and Orange forming "Everything Everywhere". In case of the acquisition of BellSouth by AT&T, AT&T purchased BellSouth with the motive of growth and diversification with the increase in the managerial skills. But after analysing the pre and post-acquisition conditions of both the companies, it is observed that the companies had better financial position did improve after acquisition but its competitor Verizon had a better financial status than AT&T after acquiring BellSouth. The financial performance of AT&T was compared to Verizon, the telecommunication company to control firm specific, industry-specific, economic wide factor that may affect the financial performance of the firms involved. The revenue synergy and the diversification motive were met as the services were spread all over the world covering 22 states. It is observed that the firm is achieving profits after the acquisition but the return on asset and to the shareholders of AT&T is less as compared to that of Verizon. Hence, the results of the two companies post-acquisition are consistent to the findings stated in the literature review.

by Dickerson et al.(1997), Meeks(1977), and Caves (1989) which stated that the profitability of the acquiring company after the M&A is lower than that it was before the M&A. In case of the merger between T-Mobile and Orange, it is observed that it has a similar pattern as that of the acquisition between AT&T and BellSouth. Where the financial status of the company was better before the merger. Thus proving the financial findings in the empirical literature review are consistent.

5. 2. Recommendation of the further study

The dissertation concentrates on the post M&A and to examine the further scope by comparing with a competitive firm in the same industry. The performance can be measured by four methods including accounting method, event study, clinical study and the survey of executives where only the accounting method is used to study the motives and effects of M&A, thus there can be different results obtained by using the other three methods. Also there can be various factors that affect a M&A are the accounting methods, impact on M&A (friendly or hostile), size effect, type of target (public or private or subsidiary) etc. that need to be studied. Thus, there can be a deeper investigation of this topic taking into consideration a different method and various factors affecting it.

APPENDIX

APPENDIX 1. 1: DEFINITION OF CAPM

The model used for the pricing of risky securities, explaining the relationship between risk and the expected return is known as CAPM i. e. Capital Asset Pricing Model. Capital Asset Pricing Model (CAPM)The risk free rate

represents the time value of money, which is compensation on the investment for the investors over a period of time. Where the other half of the formula represents the risk i. e. the additional risk to the investor, β representing the risk measure which helps in analysing the returns to asset to the market over a period of time and also to the market premium.

APPENDIX 1. 2: PROCEDURE OF MERGER

1. Searching for merger partner: The first step is to search for merger partners which involves using the public and the private sources to analyse the company, this is done by the top managers, where the company to be merged with can be in the same industry or in a diversified field. 2.

Agreement between the two companies: The merger starts with the agreement between the two companies involved which involves the transaction to be legally sanctioned by the court under section 391 of Companies Act 1956. 3. Scheme: The scheme is to be prepared by the companies before they decide to merge. Different companies have different merging schemes. Some of the things involved in a merger are as follows:•

Merging company's statistics. • Terms of transfer of assets and liabilities from transferor to transferee. • Conditions involved for conducting the business after the merger. • Information about the share capital of the companies going to merge i. e. capital, paid up capital and issued capital. • The profit sharing ratios of the companies and the conditions attached to it. • The composition of the employees of the company and the funds for the employees like gratuity funds, provident funds etc. • Treating the debit balance of the companies getting merged. • Income tax dues, contingencies or any other accounting entries. 4. Approval by the board of directors: Both

the companies going to merge, i. e. the transferor or the transferee, there board of directors must approve to all the terms and conditions for them to merge.

5. Approval of scheme by financial Institutions: After the scheme has been approved by the financial institutions, debenture holders, banks the board of directors approves the scheme as they are used to raise the funds.

6. Application to the court: After the approval by the financial institutions the next step is to send an application to the court, the application sent is made under some laws for example: under section 39(1) of Indian companies act 1956 to the high court for the decision of the merger of the two companies.

7. Approval by the court: When the court receives the application then the final decision is made whether to approve the scheme of the merger or not.

8. Transfer of assets and liabilities: The high court can give the orders to transfer assets from one company to the other. By this the assets and liabilities of the transferor company shall automatically get transferred to the transferee company.

9. Allotment of shares to shareholders of the transferor company: After the virtue of the scheme, according to the profit sharing ratio decided in the agreement the shares of the transferor company get transferred to the transferee company.

10. Suggestion to stock exchanges: After the merger becomes effective the company should apply to list the new shares on the stock exchange; this is done by the company which takes over the assets and liabilities of the transferor company.

11. Public announcement: Public announcement are mandatory in mergers. For example if it's India, then the announcement is to be made under SEBI regulations.

APPENDIX 1. 3. Historical development of AT&T

Telephone was invented by Alexander Graham Bell in the year 1876, it was the foundation of the best and the most reliable telephone service brand which was named as AT&T. Then in 1984, the SBC communication Inc. (formerly known as Southwestern Bell corp.) was born through an agreement between AT&T and the U. S. department of Justice. Twenty one years later, SBC communication Inc. led to be the global communications provider by acquiring Telesis Group (1997), Southern New England Telecommunications (1998) and Ameritech Corp. (1999), this was due to the dramatic changes that triggered due to the Telecommunications Act of 1996. Then by 2005, SBC Communications Inc. acquired AT&T Corp., thus forming the new AT&T. (www. att. com)

APPENDIX 1. 4. Historical development of BellSouth Corporation

It is an American Telecommunication company based in Atlanta, Georgia formed in 1983. After the U. S. department of Justice forced the American Telephone and Telegraph Company to divest itself of its regional telephone companies on January 1, 1984 it was one of the seven original Regional Bell operating companies. In 1992, this company was formed by combining two companies, Southern Bell based in Atlanta and South Central Bell based in Birmingham, Alabama. Services provided include telephone and DSL/Dial-Up internet services in states of Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina and Tennessee. It provided satellite television with the DirecTV and cable television was provided in limited markets as BellSouth Entertainment Americast. It began as the 12th largest corporation

in the United States, with \$11billion in assets, 13. 4 million telephone lines and 131500 employees.

APPENDIX 1. 5. Historical Development of T-Mobile

T-Mobile is a mobile network and a mobile broadband operator in the UK. It was started by the now-defunct Mercury Communications which was named as Mercury One2One, a GSM mobile network. Later it was known as One2One, which was then purchased by Deutsche Telekom in 1999 and was rebranded as T-Mobile in year 2002. It offers both pay as you go and pay mobile contract phones. (www. wikipedia. com)

APPENDIX 1. 6. Historical Development of Orange Mobile

It originated in the UK in 1990 with the formation of " Microtel Communications Ltd." In July 1991, the Hong Kong based conglomerate – Hutchison Whampoa through a stock swap deal with BAe, acquired 65% of the controlling stake in Microtel. On 28th April 1994, the orange brand was launched in the UK mobile phone market. In April 1996 it was listed on the London Stock Exchange and NASDAQ, being the youngest company to enter the FTSE 100. In 1999, it was launched in Austria, Belgium and Switzerland and was licensed to various operators in Hong Kong, Israel, Austria and India. It represents the flagship brand of the French telecom group for mobile, landline and internet businesses and is known as a French multinational telecom company with 226 million customers as of December 2011.