
From:

Mergers and Acquisitions: Issues and Perspectives from the Asia-Pacific Region

©APO 2009, ISBN: 92-833-7031-3

Dr. Ganesh Chand served as the volume editor.



Published by the Asian Productivity Organization

1-2-10 Hirakawacho, Chiyoda-ku, Tokyo 102-0093, Japan

Tel: (81-3) 5226 3920 • **Fax:** (81-3) 5226 3950

E-mail: apo@apo-tokyo.org • **URL:** www.apo-tokyo.org

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M&A

Mergers and Acquisitions

*Issues and Perspectives from
the Asia-Pacific Region*



ASIAN PRODUCTIVITY ORGANIZATION

Selected papers from the APO Study Meetings on Mergers and Acquisitions for Higher Corporate Value held in Malaysia, 31 July–3 August 2007, and in Indonesia, 19–22 August 2008.

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ISBN: 92-833-7031-3

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FOREWORD

Merger and acquisition (M&A) transactions have reached unprecedented levels over the past few years, and their occurrence in APO member countries has also been on the rise. M&As are attractive as they create synergies and economies of scale by expanding operations and markets and contribute to eliminating inefficiencies and increase productivity and profitability. M&As are also powerful and pervasive, they may have other intended and unintended effects at the macro and micro levels. Company stock prices, for example, can change markedly due to attempted or actual M&As. Companies not directly involved in M&As can also be influenced by their occurrence elsewhere in the economy. Higher employee earnings in merged companies, for example, increase the demand for other goods and services when employees spend their incomes.

Large M&As may affect the entire economy. They may lead to significant changes in the structure of employment, employee earnings, and investor behavior. Given the complexity of M&A transactions and the massive effects on businesses, industries, and economies, it is therefore important that policymakers and regulators understand their implications. Likewise, executives need to understand the nature of the acquired business, corporate governance, and different organizational cultures, systems, and financial practices so that effective results can be achieved and the post-M&A integration challenges minimized.

The APO organized two study meetings on the topic of M&As in 2007 and 2008 to emphasize their significance to the member countries as well as deal with some of the issues raised above. The meeting in 2007 was held in Kuala Lumpur where participants representing industry, unions, government, and academia examined various aspects of M&As. A follow-up meeting was convened in 2008 in Yogyakarta, Indonesia. This volume presents selected papers from both meetings. Since the context in which businesses operate have changed so drastically over the past two years, those papers will have special relevance in today's changed context, as many businesses are more cautious, while those well endowed can seize the downturn as an opportunity to make further acquisitions.

I sincerely hope that this new publication will act as a catalyst for further research and publication on M&As in the region. The APO thanks volume editor Dr. Ganesh Chand as well as the authors of each chapter for their contributions.

Shigeo Takenaka
Secretary-General
Tokyo
June 2009

PREFACE

The ongoing economic crisis, originated from the United States, is hitting not only the origin, but also dozens of Asian, European, and Latin American countries. It is evolving into an unprecedented global human catastrophe. During this global economic crisis, sensible business leaders pay doubled attention to corporate restructuring. Mergers and acquisitions (M&A) are one broad avenue toward the restructuring success. Therefore, “to do M&A or not?” is a big question facing business leaders, particularly those of fortunate corporations with healthy performance, and those of heavily beaten companies that are desperately searching for ways to survive.

Even though M&A is of great significance to the involved companies’ survival and sustainable development, the outcome of M&A has many faces. Briefly speaking, two categories can be sorted out from hundreds of M&A cases in the past century. Successful M&A makes winners in multiple aspects: shareholders, management, employees, consumers, communities, governments, and even the economy as a whole. Failed M&A results in losses from different areas: the acquirer and often the acquired, the new entity, and employees of both sides; but also perhaps the community, the governments, and even the economic power of each associated nation are also hurt to a certain extent. Can corporate executives make M&A decisions without careful planning and evaluation from multiple perspectives?

Looking back at the last 100 years in the global community, an analysis of M&A practices must be more than just a study of failed cases. Why? Even though this book, based on the APO Study Meeting on Mergers and Acquisitions held in 2007 and 2008, cannot provide a complete answer to the question of what makes a successful M&A, one may gain some hints from on-going M&A practices, particularly cross-border ones involving Asia-Pacific companies.

Existence of companies before and after M&A actions depends on multiple factors. At the top of the priority list stands the ultimate goal. Another determining factor is the environment, which is a portfolio of wishes or perspectives of several closely or remotely associated parties: local communities, consumers, employees, investors, regulators, governments, even society at large, and the global economy.

Therefore, the newly created M&A entity needs an ultimate goal that is upgraded from solely the goals of the companies

involved. And if the new goal fits well in the newly modified environment it determines largely if the M&A can generate a long and healthy new life. Otherwise, if the goal of the proposed M&A is just to benefit executives and a few big shareholders without taking care of the interests of the majority of related parties, the integration may yield a very different outcome from what decision makers had wished. Discovery of the recipe for successful M&A practices is still in the infant stage. But the lessons from failures are enormous. Before proceeding to M&A action, can decision makers afford not to think carefully and figure out how to avoid failed paths others have taken in the past?

If starting from historical facts, Moo-Kyum Kim (*Trends and Practices in the Global Market*) provides a well categorized time series of the historical M&A activities of the century-long past, first in the West only, gradually going international and global involving companies from all continents. Ganesh Chand (*Perspectives on Mergers and Acquisitions*) paints a complete picture to which M&A planners may refer. With detailed analysis of each perspective of the mentioned party, he gives the final weight to the state policy over M&A. A large part of this book is devoted to M&A cases in selected nations: Japan (*Reasons for the Rising Trend of M&A Activity amongst SMEs in Japan* by Yoshihiro Yasumaru), Malaysia (*Malaysian Best Practice for Cross-Border Acquisition* by Fazilah Abdul Samad and *Current Trends and Practices in the Malaysian Financial Services Industry* by Shamshubaridah Ramlee and Rasiah Mohd Said), Philippines (*Philippines: Banking Industry Mergers* by Maria Victoria R. Castillo), and Thailand (*Mergers and Acquisitions in Thailand* by Pravit Khaemasunun and Pirinee Pringsulaka). For a conceptual exercise in evaluating growth potential in M&A, Ping Ching Terence Fan has cooked a dish in *Creating Value Through Mergers and Acquisitions: A Conceptual Primer*. Integration is the completing phase of an M&A case, which Christopher Kummer addresses in *Post-Merger Integration*.

This book, if wisely read, can point to some opportunities for future M&A, particularly cross-border ones involving Asia-Pacific companies; it also marks some pits and traps M&A planners need to avoid.

Viktoria Dalko
Instructor / Professor of Finance
Harvard University/City University of New York
USA

CHAPTER 1

CREATING VALUE THROUGH MERGERS AND ACQUISITIONS: A CONCEPTUAL PRIMER

Ping Ching Terence Fan
Assistant Professor
Singapore Management University
Lee Kong Chian School of Business
Singapore

INTRODUCTION

In the same spirit as Arthur Lewis' famous quote that "there is nothing more practical than a good theory," this paper provides a timeless, conceptual view on how mergers and acquisitions can create value for corporations and their stakeholders. The perspective taken is that of an operating company seeking to merge with or acquire another such company and gaining managerial and operational control of the combined entity. In particular, a number of scenarios on the relative size and industry focus of the two operating companies will be considered, and the key assumptions under which value will be created in the process explored.

In this paper, corporate value is loosely defined as a long-term profit measure. It is assumed that companies acquire their production inputs at market prices. Some basic assumptions are that corporate managers work toward maximizing the long-term profit of a company, and that capital markets are efficient. The long-term profit measure of a company is intimately tied to its market value in the event of a merger or takeover. Companies have a range of options on how to use or distribute their profits (including as bonus payments to employees, and as dividends to shareholders).

As this paper aims to be a conceptual primer on how mergers and acquisitions create corporate value, the details on the financial transactions, the role of minority shareholders, and transaction costs incurred in the operational integration of the companies involved are not taken up. Instead, the pre-merger profit measure is compared with the long-term post-merger profit

measure – if the latter is higher than the former, corporate value is considered to have been created through the merger and acquisition process, otherwise it has not.

To guide the discussion of this paper, I use the perspective of a cake bakery shop called BigCakes as an anchor. A similar perspective applies to other industries. In this cake bakery business, the sole proprietor initially owns a shop that buys ingredients such as eggs and flour, converts these into cake batter, bakes the batter into cakes in its oven, and sells directly to its customers. Slowly, as profits grow, the owner recognizes several choices as to how to use them. In general, BigCakes can:

- keep accumulating cash
- distribute part or all of its profits to the owner
- expand its business (either by making and selling more cakes in the same shop or by opening more shops)
- develop a new business (e.g., trading baking equipment, opening an on-line cake-ordering and transaction servicing business, etc.)
- acquire or merge with another existing business

Any decision to acquire or merge with another company should also include a close examination of various options. In this paper, a series of merger and acquisition opportunities will be presented, and the conditions under which each opportunity can create corporate value will be discussed. To distinguish each one of these opportunities or scenarios from one another, a catch phrase will be used to describe each strategy. Unless stated otherwise, consider each of these opportunities or scenarios to be independent of each other.

Buy and Hold

Suppose the owner of a smaller cake shop, SmallCakes, is thinking about retirement and is open to selling the business. SmallCakes bakes cakes that are considerably smaller than those of BigCakes and uses a slightly different set of ingredients and baking equipment. Moreover, SmallCakes is located in different neighborhood from BigCakes, and caters to a different clientele.

When the owner of BigCakes considers whether to buy SmallCakes, he/she would consider the opportunity cost of the investment. For instance, instead of buying SmallCakes, can the owner use the same resources to open a second shop and

achieve a greater profit? If the owner of BigCakes is interested in learning how to make smaller cakes, can the owner experiment on his/her own instead of acquiring the know-how and equipment by buying SmallCakes? In other words, the owner of BigCakes needs to understand the trade-offs between growing his/her own business *organically* versus growing through an *acquisition* (or *merger*). As such, some other relevant characteristics of the business, including customers' purchasing behavior, the time to grow the business, and resource limitations, as described in Figure 1, should be considered.

	Favors Organic Growth	Favors Merger or Acquisition
Customer behavior	<ul style="list-style-type: none"> - Low switching cost - Low acquisition cost - High-growth customer base 	<ul style="list-style-type: none"> - High switching cost - High acquisition cost - Low-growth customer base
Time to grow	<ul style="list-style-type: none"> - Longer time frame to grow - More uncertainty allowed 	<ul style="list-style-type: none"> - Shorter time frame to grow - Less uncertainty allowed
Resource limitations	<ul style="list-style-type: none"> - Few resource constraints - Has own technology 	<ul style="list-style-type: none"> - Limited input resources - Needs to acquire new technology

Figure 1. Some Considerations between Organic Growth vs. Mergers and Acquisitions

In addition to the financial conditions of both businesses as they are, the true potential of both BigCakes and SmallCakes should be considered. Is there a growing customer preference (beyond the existing customers of both companies) for either styles of baking? Is the total demand for cakes satisfied by the existing cake shops? In deciding on this acquisition decision, it is important to consider the longer-term growth potential beyond the current state of affairs of the businesses.

Assuming that both SmallCakes and BigCakes are debt-free and profitable, the least (and a relatively risk-free way) the owner of BigCakes can do in an acquisition is to buy SmallCakes and keep operating it as a separate subsidiary. In this manner, the total accounting profit for the post-acquisition BigCakes would include the profit previously accrued to SmallCakes, and hence more than the profit of the pre-acquisition BigCakes. In this definition, BigCakes' total value can be enhanced. The profit enhancement from the perspective of BigCakes Company alone is shown in Figure 2. Certainly, as far

as society is concerned, the total profit contributed by both the BigCakes and SmallCakes operations remains the same before and after the acquisition, and there is no material operational integration of the two (unless BigCakes decides otherwise).

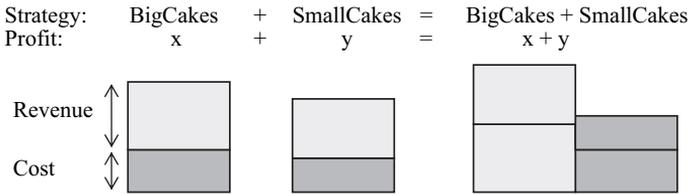


Figure 2. BigCakes Buys and Holds SmallCakes

Ford, the U.S. automobile manufacturer, has bought and kept different brands of automobiles in Europe and other parts of the world, including the iconic Jaguar. While there are some operational changes to these new acquisitions, the separate brands and automobile designs are maintained to cater to their respective followers.

Buy and Copy-Paste

An important assumption in the Buy and Hold strategy above is that both SmallCakes and BigCakes are profitable businesses. If resource inputs are scarce (e.g., shop spaces are scarce) and the total market is not growing significantly, it may still make sense for BigCakes to acquire SmallCakes given that the latter is loss-making. Assuming that the customers of SmallCakes spend about the same amount (individually and in aggregate) and have similar tastes as the customers of BigCakes, and that SmallCakes does not face much competition from other bakeries in its vicinity, BigCakes can, at the very least, copy what it does in its own business to the former SmallCakes shop – effectively converting SmallCakes into a second branch of its own.

Since BigCakes already operates a profitable venture, it is reasonable to contemplate that another branch of BigCakes utilizing the shop location of SmallCakes could also be a profitable venture. In this way, the loss-making business can be transformed into a profitable one, and corporate value created

(both to the acquirer and to society). Figure 3 shows how this transformation can add to the profit of BigCakes.

One of the world’s largest banking groups, HSBC, has over the past few decades bought controlling stakes in a number of banks worldwide that faced some liquidity or profitability issues. In time, the group has transformed many of these acquisitions into profitable or at least self-sustaining entities. As bank licences usually require a long time for regulatory approval, acquisitions represent a relatively rapid avenue for cross-border growth.

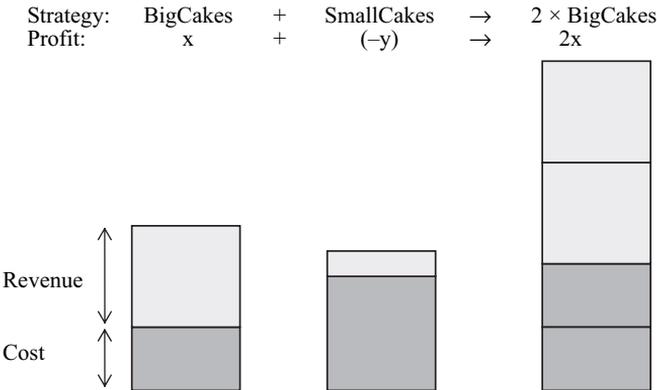


Figure 3. BigCakes Buys and Copy-Pastes Its Model to SmallCakes

Buy and Close

If SmallCakes has been located next to BigCakes, it would have been competing directly with the latter for customers. The fact that SmallCakes is loss-making would no doubt comfort the owner of BigCakes, but it may continue to stay in business in the hope to break even or poach BigCakes’ staff away. In this case, to avoid cut-throat price competition that would erode BigCakes’ profit, it may make sense to buy SmallCakes out and simply close it down, thereby allowing BigCakes to sell to all the customers. This assumes that BigCakes has the production capacity to cater for customers who would otherwise have patronized SmallCakes. Figure 4 shows how this Buy and Close strategy would work.

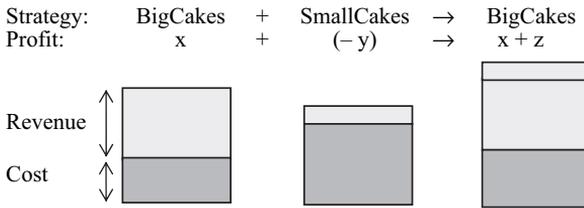


Figure 4. BigCakes Buys and Closes Down Nearby SmallCakes

As this would reduce the level of competition to the consumers, government authorities might oppose this type of merger or acquisition in select industries. Understandably, a government should not subject its citizens to undue price pressures from an unregulated monopoly. In the 1990s, Boeing and McDonnell Douglas were the two dominant airframe manufacturers in the U.S. Faced with increasing competition from a rising airframe manufacturer called Airbus in Europe, McDonnell Douglas resorted to aggressive marketing and pricing campaigns to win orders. With increasing competition from its domestic rival, Boeing decided to acquire McDonnell Douglas; the latter agreed to be taken over. The proposed acquisition was approved as Airbus was shown to be a potent competitor that would reduce Boeing’s excessive pricing power. Upon completion of the acquisition, Boeing shut down the production of all but the smallest commercial airplanes designed and manufactured by McDonnell Douglas; these smaller airplanes also ceased production within the next few years.

Buy and Squeeze

After BigCakes applies its business model at the newly acquired SmallCakes Shop (from the Buy and Copy-Paste strategy), it can in fact further increase its profit when it recognizes certain operational synergies between the two shops. For instance, provided that one shop has enough capacity to bake cakes for both shops (e.g., large enough oven space, etc.), it is possible to have one shop bake cakes for both, and then simply transport the necessary proportion of cakes to the other shop. In doing so, as long as the transport cost is low and transport does not impair the quality of the cakes being transported, BigCakes can save on the cost of creating two sets of cake batches, and of supervising employees in handling the batter and the oven. The idle oven

could also be sold, or returned to the lessor thereby reducing costs that would have to be incurred irrespective of production volume. In the same vein, now with two shops under one name, the owner of BigCakes can simply use one set of advertisements (while printing both addresses in it) instead of two. These cost savings can be obtained within reasonable changes in the actual level of production – these are, therefore, considered savings in fixed costs. In contrast, variable costs are those cost items that vary directly as the production level changes.

As the fixed cost is reduced for the combined production, the cost per unit of production falls – this is indicative of the economies of scale in the bakery business. As long as the demand for the cakes is not price elastic (e.g., the number of cakes sold does not increase disproportionately as the price of cakes decreases), it makes sense for BigCakes to maintain the same prices while achieving reductions in its fixed costs. In other words, BigCakes can appropriate the gains from economies of scale (as opposed to passing the gains to the customers in the form of lower prices).

Figure 5 shows the impact of the economies of scale in expanding BigCakes’ model to the former shop of SmallCakes, taking into account the impact of reduction in fixed costs. If resources are not scarce (and entrance not regulated), BigCakes could conceivably achieve scale improvements by organically opening more of its own shops instead of acquiring SmallCakes and converting the latter into its own business format.

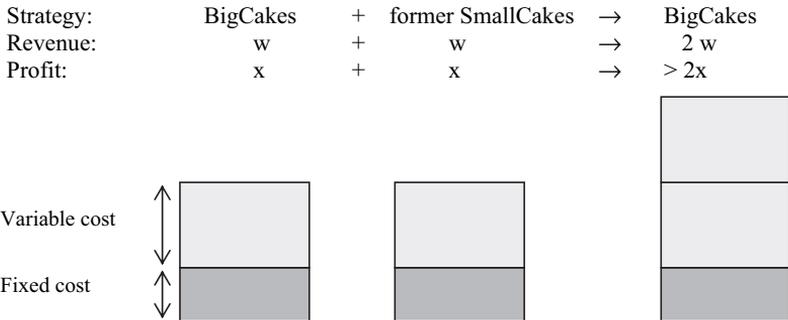


Figure 5. BigCakes Buys (Copy-Pastes itself to SmallCakes) and Squeezes SmallCakes

Buy and Squeeze More

In addition to reductions in fixed costs, the adoption of BigCakes’ business model (cake menu, ingredients, services, branding, etc.) to formerly SmallCakes’ shop can result in further reductions in variable costs as well. Now with more input resources being procured under a single management, it is conceivable that this may increase the bargaining power and logistic efficiency (e.g., all eggs can be delivered in one trip to the consolidated oven as opposed to two trips to the two locations), resulting in a reduction in the price of eggs and flour. Figure 6 shows the impact of such reductions in variable costs.

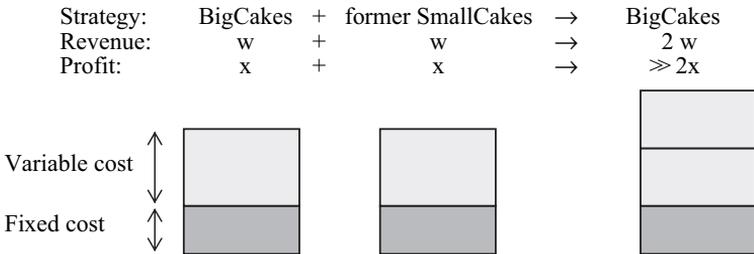


Figure 6. BigCakes Buys (Copy-Pastes) and Squeezes SmallCakes More

As a result of combined reductions in fixed and variable costs, there has been a proliferation of bakery chains, fast food chains, department store chains, etc. Many of these chains have also allowed individual investors to put in their own capital and operate their own stores as franchises. In the same manner, companies with large infrastructure costs such as airlines, banks, and telecommunications continue to grow in size in search of ever-greater profitability.

Buy and Cross-sell

Even in the absence of any cost savings, there may be a case for mergers or acquisitions. Suppose that BigCakes has bought SmallCakes located in a different neighborhood but decided to maintain the distinctive cakes the latter makes. It may be worthwhile to cross-sell each other’s cakes (since the customers likely come from different neighborhoods as well), and hence

the total revenue can be raised without increasing much of the total cost.

In the 1990s, legislative changes in the U.S. permitted banks and insurance companies to merge. This prompted a wave of mergers, including one between Travelers Insurance and Citigroup to form one of the world's largest financial institutions. One of the key arguments for such mergers rested on the cross-selling abilities of the combined entities – insurance policies could now be sold in the numerous “brick-and-mortar” bank branches.

CONCLUSION

While this paper has discussed numerous scenarios under which mergers and acquisitions *can* create value for the acquiring or merging companies, it does not assert that all such attempts would indeed create value in the end. In fact, mergers and acquisitions are complicated affairs. In addition to the details of a negotiated financial transaction (which itself may involve paying out a substantial part of the expected gains to the existing shareholders), the actual task of integrating management control and operational processes can be an arduous and fruitless endeavor. Any unexpected hiccup in this process can derail or at least defer projected gains from a merger and acquisition attempt. The literature is littered with examples of failed mergers and post-acquisition divestments.

This paper provided a timeless, conceptual view on how mergers and acquisitions can create value to corporations and their stakeholders. Given the right conditions, an acquirer can consider many strategies to enhance corporate value through mergers and acquisitions: from a relatively passive buy-and-hold strategy to an intensive buy-and-squeeze (-more) strategy to take advantage of inherent cost synergies.

CHAPTER 2

TRENDS AND PRACTICES IN THE GLOBAL MARKET

Moon-Kyum Kim

Professor

Department of Entrepreneurship

and Small Business

Soongsil University

Republic of Korea

M&A AS A MEANS OF GLOBALIZATION

Merger and acquisition (M&A) activities have increased rapidly since 2000. Historically, M&As have shown a cyclical pattern. There have been six waves of M&As for the past 100 years; these are those of the early 1900s, 1920s, 1960s, 1980s, 1990s, and 2000s.

The history of M&A waves goes back to the 1890s. This first wave was largely characterized, both in the U.S. and Europe, by the consolidation of industrial production. This M&A wave formed intended monopolies through horizontal integration within industries. Horizontal integration led to the creation of many giant companies that exerted monopolistic market power in their respective industries. As a result, large companies could secure their capacities for mass production that led to an abundant supply of goods. The great merger wave for monopolistic purposes came to an end around 1903–5 when the equity market crashed.

The second wave began as a response to the enforcement of anti-trust legislation, which was the result of public concern over the first great merger wave. The anti-trust movement was aimed at breaking monopolies so that dominant firms were broken up and firms pursued expansion through vertical integration. Companies tried to achieve economies of scale by vertical integration and the resulting collective production system. The second wave was characterized as a first move toward an oligopoly structure in which two or more companies dominated a market. General Foods Co. and IBM are taken as representative

examples of this. The second wave started in the late 1910s and continued until 1929 when the stock market crashed.

The third M&A wave began around 1965. Due to the worldwide economic depression of the 1930s and the subsequent Second World War, there was no significant emergence of M&A activity in this period. The third wave started in the mid-1960s and ended in 1973, when the oil crisis pushed the world economy into another recession. The pattern of this third wave focused on diversification and the development of large conglomerates. In the U.S., the beginning of the third M&A wave came together with the antitrust regime in 1950s. Heavy anti-trust regulation caused U.S. firms to pursue diversification through undertaking M&As. The new anti-trust regulation made horizontal expansion more problematic. Firms chasing rapid growth were left with the only option of taking over companies outside their own industries. During the 1960s, companies tried to find growth opportunities in new product markets unrelated to their core business in order to enhance company value and reduce earnings volatility. Companies like Textron, ITT, and Litton Industries are cited as typical examples of the third wave of M&As.

The fourth M&A wave was set off by environmental transition such as changes in antitrust policy, the deregulation of the financial services sector, the creation of new financial instruments and markets (e.g., the junk bond market), as well as technological progress in the information and telecommunications industry. The main driver of the fourth M&A wave was “selection and focus” aimed at restructuring through M&A strategies. This fourth wave was characterized by unprecedented hostile takeovers and going-private transactions benefiting more efficient capital markets and new financial strategies such as leveraged buyouts (LBOs) and management buyouts (MBOs). New financial instruments such as junk bonds played a key role in M&A activities along with leveraged buyouts. Also, an increasing number of cross-border M&As took place in this time period. The fourth wave was the reversal of the previous wave’s inefficient unrelated diversifications. A less-stringent antitrust environment, more competitive capital markets, and improved shareholder control mechanisms urged companies to de-diversify and refocus on their core business.

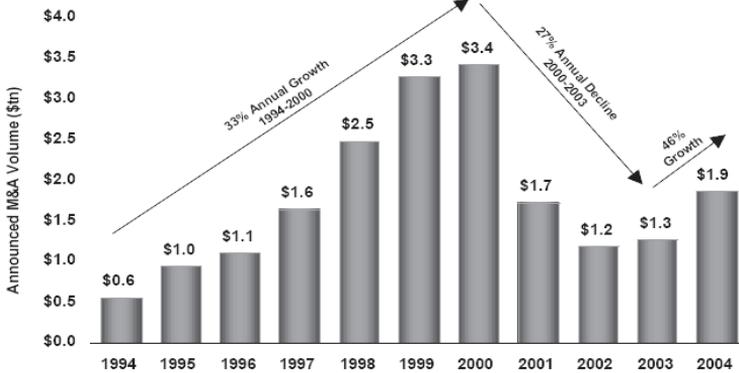
Under this circumstance, hostile raiders were ready to do the restructuring of those companies that were not fast enough to reorganize their operations. The conglomerate structure was increasingly perceived to be inefficient because of its inflexibility to react to industry shocks caused by deregulation, political events, social policy changes, and economic factors. A combination of industrial shocks, the limiting of managerial discretion, and the trend of dismantling conglomeration were the main factors responsible for the takeover wave of the 1980s. The surge in M&A activity was further promoted by intensifying disclosure of corporate information to the market, which also forced companies to focus on maximization of shareholder value. The most important factor of M&A in the reversal of the diversification wave was the emergence of strong institutional investors and the shift in power from corporate stakeholders to shareholders. This was also reflected by the advent of hostile takeovers. Hostile takeovers and going-private transactions of the 1980s were regarded as a way to reduce agency-related corporate inefficiencies through corporate governance. The fourth wave started in 1978, when the stock market had recovered from the preceding economic recession, and ended in 1989.

The fifth takeover wave started in 1993. Like all previous waves, it surged along with an economic boom and halted as a consequence of the equity market collapse in 2000. This wave was characterized by mega-deals reorganizing entire industries. Remarkably, there were many mega-merger activities within a specific industry among leading companies in the industry. The magnitude of the fifth wave was unprecedented both in terms of takeover value and the number of M&A deals. According to the Thomson Financial Securities Database, during this wave, 119,035 M&A deals were recorded in the U.S. and 116,925 deals in Europe (including the U.K.), which were more than three times and almost 10 times higher in the U.S. and Europe, respectively, than during the fourth merger wave. Monetary value of the fifth wave was huge; as Figure 1 shows, its total (global) value added up to about USD15 trillion, more than five times the combined total of the fourth wave.

A first obvious feature of the fifth takeover wave was its international nature. Remarkably, the volume of M&A in Europe

was about as large as its U.S. counterpart, and an Asian M&A market also emerged. A substantial proportion of M&As comprised cross-border transactions, reflecting the growing globalization trend of product, service, and capital markets. Domestically oriented companies resorted to M&As abroad as a means to survive tough international competition created by globalization. Some companies were eager to expand to foreign countries through M&As to exploit differences in tax systems, and to capture rents resulting from market inefficiencies such as national controls over labor markets. Second, trends such as deregulation and privatization triggered cross-border acquisitions in the financial, utilities, and telecommunication industries. Third, the huge costs of R&D activities and the fact that the payoff of R&D only emerges over the long run gave further motivation to cross-border M&As in high-tech industries such as biochemistry and pharmacy.

Volume of M&A Activity



Source: Thomson Financial Securities Database

Figure 1. Volume of M&A Activity

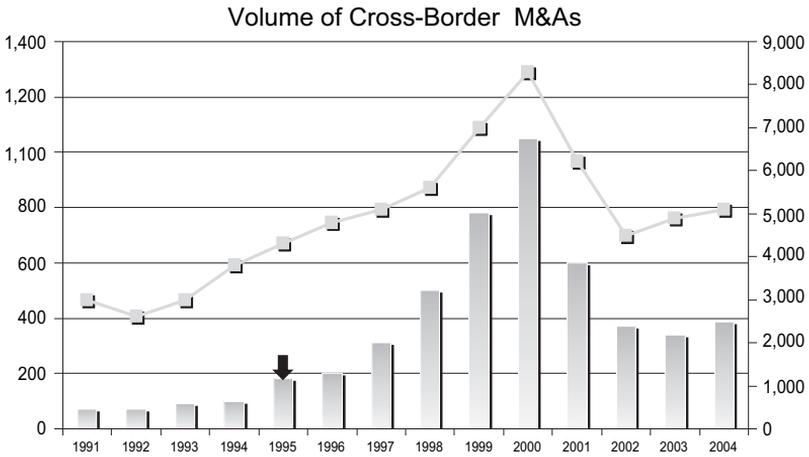
The Thomson Financial Securities Database shows that during the fifth wave, both cross-border and domestic M&A activity tended to occur between firms in related industries. Although the number of divestitures in the 1990s remained high, their proportion in M&A deals gradually decreased. The

dominance of industry-related (both horizontal and vertical) M&As and the steady decline in the relative number of divestitures during the fifth wave indicate that the main M&A motive was not specialization or corporate restructuring. Rather, M&A became a means of globalization to pursue growth in global markets. Expansion with M&A, often taking the form of mega-deals, requires substantial financing so that firms raise money by issuing equity or debt. The fifth wave benefited the bull market of the 1990s and the overwhelming use of equity as a method of payment in M&A deals.

The sixth wave began in mid-2003. M&A activities increased in the U.S., Europe, and Asia following the trend of international industry consolidation of the 1990s. This wave coincided with the gradual recovery of economic and financial markets after the downturn that began in 2000. According to the Thomson Financial Securities Database, the volume of M&As rose by 71% in 2004 over the 2002 level. In 2004, acquisitions by U.S. companies amounted to USD1.1 trillion. European M&A activities followed a similar trend. Since the beginning of 2002 until mid-2005, cross-border acquisitions accounted for more than 43% of the total value of all M&As by European firms and 13% of the total value of all M&As by American firms. The annual volume of cross-border M&As by Chinese companies grew more than six times between 2002 and 2005. China, India, and Middle East companies entered this stage of M&A as new major players. The telecommunication industry also experienced intensive M&A activity. Most M&As among the largest European telecommunication companies were cross-border M&As. Apart from the telecommunication industry, vigorous M&A activity was observed in the oil and gas, retail, pharmaceutical, utility, and sportswear industries. Comparing to the 1990s and 1980s, the hostile takeover activity in the 2000s decreased in the U.S. and Europe. The Thomson Financial Securities Database records 28 contested takeover attempts launched by U.S. acquirers in 2002–2005. Hostile takeovers were strong in Japan and China.

Although it is early to draw conclusions on the driving forces behind this new wave of M&A, some trends are already emerging. First, growth in M&A activity is largely being fed by transactions that had been delayed in the preceding period due

to the downturn of financial markets and increased uncertainty following the 11 September 2001 terrorist attacks. Second, the supply of potential target firms has been increased by some governments selling their share stakes in major national companies. This is especially the case in Asia, and more specifically in China. Third, new players from Asia entered the field of global M&A. In 2004, one-third of the total M&A activities occurred in Asia. Finally, the recent waves of the 1990s and 2000s are particularly remarkable in terms of size and geographical expansion. For example, the number of cross-border M&As in 2004 increased by 21.2% while the growth of domestic M&As stayed around 9.3%. As Figure 2 shows, the volume of cross-border M&A activities peaked in 2000 and declined until 2002, then resumed an upward trend.



Source: UNCTAD – Cross-border M&A database

Figure 2. Volume of Cross-Border M&As

As discussed above, M&A activities came in waves at specific periods of time. The number and volume of M&A activities have been continuously rising through time. So has the proportion of cross-border M&As. Around 25 to 30% of total M&A activities between 1987 and 1999 were cross-border M&As. Also, M&A activities were concentrated in specific industries. In the 1990s, M&As were concentrated in the telecommunications, media, and

banking industries while in the 1980s M&A was more prevalent in the oil & gas and textile industries.

It is notable that acquiring companies often could not achieve much value increases, while target companies enjoyed much value elevation with an M&A. The fact that many companies tried to acquire other companies through M&A without much value increase indicates that M&As were pursued with a long-term growth purpose rather than for chasing short-term profits.

M&A ACTIVITIES OF GLOBAL LEADING COMPANIES

It is necessary to review cross-border M&A activities that leading global companies performed in the period 1995–2004 to have an overall picture of their growth strategy in the global market. Table 1 lists the five leading global companies involved in M&As in 10 major industries (of which seven are manufacturing and three are service industries). Of the 50 companies included in Table 1, 35 are western companies and 15 are Asian companies.

Table 2 shows the number of mega-deals of the five leading companies in 10 major industries. It shows that the M&A activities of these companies coincided with the worldwide M&A trends as discussed earlier. First, M&As were concentrated in specific periods of time. Also, M&A activities were concentrated in specific industries, which is similar to the pattern of the worldwide waves. Such industries as oil, banking, and pharmaceuticals started to experience an M&A boom from 2004 after the first M&A boom ended in 2002.

Table 2 also indicates that the leading companies in the computer and steel industries did not show much M&A activity until 2000, after which there was an increasing trend. The communications, advertising, and semiconductor industries recorded their peak M&A activities in the period 2000–02, after which they began to shrink. The leading companies in the home electronics industry have not, however, seen any M&A activity during the past 10 years.

Table 1. M&As by Five Global Leading Companies in 10 Major Industries

Industry	Global Five Leading Companies (Nation)				
Oil	BP (E)	Exxon Mobil (U.S.)	Royal Dutch Shell (N)	Total (F)	Chevron (U.S.)
Steel	Arcelor-Mittal* (L/N)	Nippon Steel (J)	JFE (J)	POSCO (K)	BaoSteel (C)
Auto	GM (U.S.)	Daimler-Chrysler (G)	Toyota (J)	Ford (U.S.)	Volkswagen (G)
Communication	NTT (J)	DT (G)	Verizon (U.S.)	Vodafone (E)	FT (F)
Bank	Citigroup (U.S.)	Fortis SA/NA (N/B)	HSBC (E)	BNP Paribas (F)	BOA (U.S.)
Advertising	Omnicom (U.S.)	WPP (E)	Interpublic (U.S.)	Publicis (F)	Dentsu (J)
Pharmaceutical	Pfizer (U.S.)	Johnson & Johnson (U.S.)	GlaxoSmith Kline (E)	Novartis (S)	Roche (S)
Computer	IBM (U.S.)	HP (U.S.)	Dell (U.S.)	NEC (J)	Fujitsu (J)
Semiconductor	Intel (U.S.)	Flextronics (Si)	Samsung (K)	TI (U.S.)	Infineon (G)
Home Electronics	Matsushita (J)	Hitachi (J)	Sony (J)	Toshiba (J)	Samsung (K)

* Arcelor-Mittal was merged in 2006

B: Belgium, C: China, E: England, F: France, G: Germany, J: Japan, K: Korea, L: Luxemburg, N: Netherlands, S: Swiss, Si: Singapore

Table 2. Number of Mega-Deals of Five Leading Companies

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Total
Oil				1	5	3	3	6	1		3	22
Steel		1	1	1	1	1	2			2	3	12
Auto		1		7	5	10	4	1	1		1	30
Comms		3	1	2	6	9	7	3	2	1	1	35
Banking		2	4	6	11	5	7	1	1	11	4	52
Adver	2	1	3	6	6	10	4	3	2		1	38
Pharm	3	3	5	4	2	5	5	6	3	1	7	44
Computer	3		2	1	2		2	3	1	7	5	26
Semicon	2	1	3	1	1	4	4	5		1		22
H Elec												0
Total	10	12	19	29	39	47	38	28	11	23	25	281

* Shaded areas show the concentration of M&A activities.

The concentration of M&A activities in specific industries may indicate that there is a strong relation between the degree of oligopoly in the industry and M&A activities. However, it is not entirely clear whether oligopolies arising out of M&As are the result of deliberate strategies and competencies of the leading global companies, or the result of changing industrial environment (such as market, competition, legal system, entry barriers, and technological development).

FACTORS DRIVING CROSS-BORDER M&A ACTIVITIES IN THE GLOBAL MARKET

There are two main factors driving cross-border M&A activities. As illustrated in Figure 3, these are industrial *environment* factors and *strategic* factors.

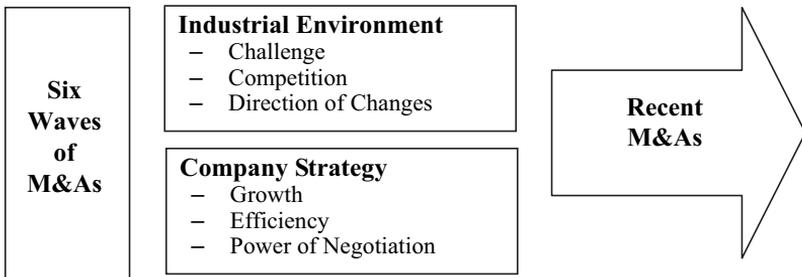


Figure 3. Factors Driving M&A – Conceptual Framework

Industrial Environment

The motivations for M&As reported by the leading global companies are generally classified into six categories:

- degree of oligopoly within an industry
- excess production capacity
- deregulation
- customer relation
- separation of production and product design
- R&D investment

Oligopoly and Excess Production Capacity

Global M&A data for the 2001–4 period show that the high degree of oligopoly triggered greater M&A activities in such

industries as oil, steel, automobile, telecommunications, and banking. The pattern of M&As in industries with a high degree of oligopoly seems to have a domino effect. For example, as BP and Amoco had merged, Exxon took over Mobil to become the largest oil company in the industry. Such an M&A domino effect was also present in the automobile and banking industries.

Excess capacity

Recent data shows that the lack of an excess capacity did not seem to directly prompt M&As. Companies resolved the problem of capacity by moving their production facilities to other countries or outsourcing.

Deregulation

Deregulation of industries is regarded as a major factor bringing about M&As. The Glass-Steagall Act, passed in 1933 to regulate the American banking industry, was abandoned in 1998. Mergers in the oil industry, heavily regulated by the Sherman Antitrust Act, were allowed selectively in 1998. M&A activities rise when regulation is weakened or abrogated. The average number of annual M&A activities increased more than twice after regulations were weakened or abandoned in the U.S. This phenomenon was evident in such industries as oil, steel, pharmaceutical, telecommunications, and banking. In contrast, M&As had been prominent during earlier times in the advertising industry where government regulation had not been strong.

Service Characteristic for Customer Relation

Another notable feature of M&A activity is that there is a tendency to have more M&A activities in industries where the output possesses the characteristic of a service. Companies in service industries try to get new customers by acquiring other existing companies rather than through developing a new customer market base by themselves. Sales in service industries tend to depend upon long-term customer relationship. Thus, M&A activities have been more evident in industries such as banking and telecommunications, in which customer relationship plays an important role in boosting sales. Data show that between 1996 and 2005, service industries were involved in M&A activities at almost twice that of manufacturing

industries; the average number of M&As was 23 in manufacturing and 41 in the service industry. M&A activities, however, were also prominent in industries in which traditional manufactured goods are combined with service attributes. M&A activities in the computer industry, for example, doubled as it adopted service attributes of IT service and consulting.

Functional Specialization

Less M&A activities are observed in industries in which functional specialization or differentiation is executed by technological innovation. Functional specialization or differentiation implies a separation between product planning/design, and production. It is expected that functional specialization leads to less M&A because restructuring within an industry is progressed in conjunction with functional specialization. Leading companies in Europe and the U.S. have tried to maintain their leading positions by focusing on specialization and differentiation in technology rather than expanding production capability through M&As. Many such companies transferred simple production components to developing countries but retained product planning and design functions. Thus, industries such as home electronics and computer show a relatively low degree of M&A.

R&D Cost

It is notable that R&D cost does not have much impact on M&A activities even though R&D cost often has been proposed as a factor driving M&A. Academic research has not found any clear relationship between M&As and R&D costs. Recent M&As accomplished by leading global companies do not seem to show major meaningful relationships with R&D costs.

Strategic Factors

Growth Strategy

Leading global companies have used M&As as a means of achieving growth, oligopoly, and globalization. Such companies have achieved higher growth rates than the market rates. As Table 3 shows, the growth rates of the five leading global companies between 2000 and 2004 exceeded the market growth rates in all 10 industries except computer.

Table 3. Growth Rate (%) of Five Leading Companies, 2000–4

Industry	Market Growth	Five Leading Company Growth	Industry	Market Growth	Five Leading Company Growth
Oil	41.3	310.2	Advertising	18.0	282.0
Steel	32.2	264.0	Pharmaceutical	37.1	170.0
Auto	10.7	47.2	Computer	0.2	0.0
Communications	18.7	726.0	Semi-conductor	6.31	24.5
Bank	10.0	524.0	Home Electronics	11.97	19.2

Leading companies try to reach the goals of growth, oligopoly, and globalization through M&A. Organic growth produces a relatively smaller expansion of market share and globalization than that achieved through M&A. As such, M&A is a good strategy to achieve greater market share and global growth. Mergers between Mittal (Netherlands) and Inland (U.S.) in the steel industry, Vodafone (England) and Mannesmann (Germany) in the telecommunications industry, and Ford and Volvo in the automobile industry are some good examples of M&As for growth.

The leading companies taking M&A as a means of rapid growth have three strategic goals. These are to:

- enjoy first mover advantage in rapidly growing markets,
- reduce uncertainty in R&D investment, and
- obtain knowledge, human resources, know-how, and experience that cannot be easily realized through strategic alliances or foreign direct investment.

There is, however, evidence that Asian companies still seem to prefer organic growth to inorganic growth using M&A.

Oligopoly Strategy

Leading companies tend to use M&A to secure business resources by establishing an oligopoly power in a specific market. In a market where competition is severe, companies try to reach a certain size to achieve economies of scale in a short time period in order to survive. M&A is a good way to seize production capacity and customers in a short time period.

Mergers between BP (England) and Amoco (U.S.) in the oil industry, Johnson & Johnson (U.S.) and DePuy (Swiss) in the pharmaceutical industry, and DT (Germany) and One2One (England) in the telecommunications industry are good examples of M&As aimed at securing oligopolistic structures.

The market share of companies with a high record of M&A activities increased notably during the 2000s. The market share of the two largest companies increased in industries displaying high M&A activities, while the market share of the two leading companies in the home electronics industry, in which M&A activities were least during 2000s, declined.

Globalization Strategy

The oligopoly strategy is closely related to globalization strategy. Globalization strategy is aimed at creating global oligopolies. The leading global companies used M&A as a vehicle to acquire global networks of target companies at once. Companies with a network in a specific area become targets of M&A even though they do not operate their businesses in the specific area. M&As between western companies and those in emerging markets have been intense since 2003. The extent of M&As between western and emerging market companies was only 12.8% until 2000, but increased to 28.8% by 2003. When the global networks of the acquiring and target companies do not overlap, M&A is regarded as the best way to expand a company that does not have operating experience in a target area. M&A activities in the emerging markets are significant in most industries except for advertising and home electronics. Daimler-Chrysler (Germany) and Mitsubishi (Japan) in the automobile industry and IBM (U.S.) and Daksh eServices (India) in the computer industry are typical examples of M&As for globalization.

SUMMARY

M&A activities have come in waves at specific periods of time. The number and volume of M&A activities are continuously increasing through time. The percent of cross-border M&As have also increased in recent years. Around 25% to 30% of total M&A activities were cross-border M&As in the period 1987–

1999. M&A activities have also been found to be more prevalent in certain industries.

Recent M&As undertaken by leading global companies seem to have been aimed at establishing a global oligopolistic structure. This was done in two steps. The first step was cross-border M&As between western companies in Europe and the U.S. to increase efficiency and clear up over-capacity problems. This corresponded with the first through the fifth waves of M&A. The first step M&A was prompted by external factors such as excess-capacity problems, weakened regulation, and restructuring. When the EU became a single market in 1993, there were active M&As between the U.S. and Europe, and within Europe. This period coincided with the fifth wave of M&A, which led to an oligopoly structure in Europe and the U.S.

The second step M&A was strategic movement of leading companies into the emerging markets. Emerging markets were growing rapidly; so were cross-border M&As involving western and emerging market firms. This tended to create global oligopolistic structures. Notable leading companies that had already secured oligopoly structures in Europe and the U.S. entered the emerging markets through M&As to resolve the problem of low profitability and to overcome the limits of growth. M&A was the preferred strategy rather than direct investment in the emerging markets.

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CHAPTER 3

MALAYSIAN BEST PRACTICE FOR CROSS-BORDER ACQUISITION

Fazilah Abdul Samad
Head of Department
Department of Finance and Banking
University of Malaya, Malaysia

INTRODUCTION

Mergers and Acquisition activities have increased as part of a worldwide trend in corporate restructuring. A common phenomenon all over the world is the acquisition waves that accompany strong economic growth in the nations or regions concerned. In such situations, firms with ample financial slack acquire other firms to seize external opportunities provided by the economic environment. By acquiring their counterparts, firms expect to enhance shareholder wealth through ways that would not be possible otherwise. Increased market power, overcoming entry barriers, speed to market, and diversification are popular rationales for firms to embark on acquisitions. Many firms, both large and small, have undergone M&A exercises in order to remain competitive against the onslaught of global conglomerates. Malaysia is no exception to this trend.

As domestic competition heats up and globalization opens new doors, some firms go further with acquisitions by carrying them out across national borders. The OLI Paradigm provides a framework to explain why firms choose cross-border acquisitions rather than alternatives such as exporting, licensing, and strategic alliances. While acquisitions are intended as a means for value creation, not all of them end up being so. Research suggests that only 20% of all mergers and acquisitions are successful, 20% are clear failures, and approximately 60% produce disappointing results. Nevertheless, in the reality of today's competition, most firms find themselves engaging in acquisitions or at least considering undertaking one. Despite the gruesome consequences to which bad acquisitions can lead, the issue here is not whether firms avoid the practice but how they can make the most out of it when the necessity to acquire arises.

This paper discusses aspects of cross-border M&A through examining a three-party transaction between firms in Malaysia and Singapore. In doing so, the paper identifies certain key issues related to M&As that real-life corporations deal with in an M&A decision situation. The case study – involving the three corporations Scomi, Habib, and Chuan Hup Holdings – will also consider whether this case can be considered as a Malaysian best practice for cross-border acquisition.

The paper first identifies the general traits of successful acquisitions or those that can qualify acquisitions as best practices. It then analyzes whether the case study measures up to those traits. While studies are abundant on Western, more specifically, American, cases of acquisitions, not much work has been done on their Malaysian counterparts. As corporate cultures, ownership structures, and legal framework for securities vary from country to country, there is a justifiable need for country-specific studies on acquisition best practices. For this paper, this particular transaction was selected as the case study for its unique qualities as issues raised in this are issues of critical importance in any discussion of M&A. In addition, *The Edge* newspaper of Malaysia nominated the acquisitions as 2005's second-best M&A deal. As more and more Malaysian firms are expected to follow in Scomi's footsteps to grow and anticipate globalization, this case study may provide an example of a best practice for cross-border acquisition in the Malaysian context.

LITERATURE REVIEW

As much as 45% of acquisitions in recent years have been made across country borders (Schmidt, 2002). Cross-border acquisition occurs when a firm headquartered in one country acquires a firm headquartered in another country. Historically, American firms have been the most active acquirers of companies outside their domestic market (Seth, Song, and Pettit, 2002). However, in today's global economy, firms throughout the world are choosing this strategic option with increasing frequency. The true motivation for cross-border acquisition is the traditional one: to build shareholder value, i.e., to maximize the firm's share price. If a firm's share price is a combination of its earnings

and the market's opinion of those earnings (the price-to-earnings multiple, P/E), then management should strive to grow both.

Management's problem, however, is that it does not directly influence the market's opinion of its earnings. Over the long term, the market – investors, analysts, and institutional stakeholders – will look to the ability of management to deliver on the promises made in meetings, advertisements, annual reports, and at stockholders' meetings. Yet, the opinion of markets as reflected in P/E ratios is infamously fickle. The astronomically rising share prices of many dotcom firms before the bubble burst are obvious examples. Nonetheless, management does directly affect earnings. Increasing the earnings per share (EPS) is within the direct control of the firm. Because competition is fierce, margins are under continual pressure, and the growth potential of earnings is limited in many domestic markets, modern managements cannot ignore the fact that they need to look beyond their respective country's borders for value and growth. In addition to the desire to grow, firms are motivated to undertake cross-border acquisitions by a number of other factors, as summarized by UNCTAD (United Nations Conference on Trade and Development, formerly the U.N. Center for Transnational Corporations) in Figure 1 (UNCTAD, 2000: 154).

Cross-border acquisitions have significant advantages. Foremost, they are a quick solution to entry barriers. In fact, acquisitions may provide the fastest, and often the largest, initial international expansion of any of the alternatives (Hitt and Pisano, 2003). Second, cross-border acquisitions may be a cost-effective way of gaining competitive advantages through access to technology, brand names valued in the target market, and logistical and distribution advantages, while simultaneously eliminating local competition. Third, international economic, political, and foreign exchange conditions may result in market imperfections, allowing target firms to be undervalued.

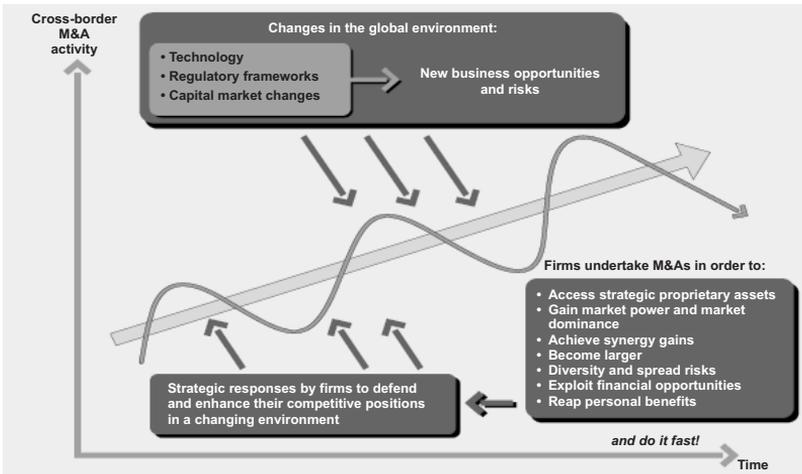


Figure 1. The Driving Forces of Cross-Border Acquisitions

Nevertheless, compared to domestic ones, cross-border acquisitions typically carry additional disadvantages. International negotiations for acquisitions can be exceedingly complex. It is estimated that only 20% of cross-border bids lead to a completed acquisition, compared to 40% for domestic acquisitions.¹ Dealing with the legal and regulatory requirements in the target firm's country and obtaining appropriate information to negotiate an agreement frequently present significant problems. The problems of integrating the two firms often are more complex than in domestic acquisitions – dealing not only with different corporate cultures, but also with potentially different social cultures and practices.

It is noted that acquisitions do not consistently produce above-average returns for the acquiring firm's shareholders. Nonetheless, some firms are able to create value when utilizing an acquisition strategy. Research suggests that there is a pattern of actions that can improve the probability of acquisition success (Hitt, Ireland, Harrison, and Best, 1998). The Hitt, et al, study shows that when the target firm's assets are complementary to the acquirer's assets, an acquisition is more successful. With complementary assets, integrating two firms' operations has a higher probability of creating synergy. In fact, integrating two firms with complementary assets frequently produces unique

capabilities and core competencies. The acquiring firm can maintain its focus on core businesses while leveraging the complementary assets and capabilities of the acquired firm.

The study also shows that friendly acquisitions facilitate integration of the firms involved. Through friendly acquisitions, firms work together to find ways to integrate their operations to create synergy. In hostile takeovers, animosity frequently results between the two top management teams, a condition that in turn affects working relationships in the newly created firm. Thus, more key personnel in the acquired firm may be lost, and those who remain may resist the changes necessary to integrate the two firms. From a financial viewpoint, it is often that the premium paid for an acquisition is lower because the deal is friendly.

Effective due diligence processes – involving the deliberate and careful selection of target firms and an evaluation of the relative health of those firms (such as financial health, cultural fit, and the value of human resources) – contribute to successful acquisitions. Through effective due diligence, the firm with strongest complementarities is acquired and overpayment is avoided.

Financial slack in both the acquiring and acquired firms also has frequently contributed to success in acquisitions. Financial slack provides access to financing for the acquisitions. When substantial debt is used to finance the acquisition, firms with successful acquisitions reduce the debt quickly, partially by selling off assets from the acquired firm, especially non-complementary or poorly performing assets. By doing so, they maintain a moderate level of debt after the acquisition and keep debt costs low. Firms do not allow debt costs to prevent long-term investments such as R&D.

Another attribute of successful acquisitions is an emphasis on innovation. Significant and continuous investments in R&D activities show a strong managerial commitment to innovation, a characteristic that is increasingly important to continuing competitiveness. Additionally, flexibility and adaptability are essential to successful acquisitions. When executives of both the acquiring firm and the target firm have experience in managing change and learning from acquisitions, they will be more skilled at adapting their capabilities to new environments. As a result, they will be more adept at integrating the two organizations,

which is particularly important since no two firms have exactly synonymous organizational cultures.

Attributes of Successful Acquisitions

Table 1 presents the attributes and results of successful acquisitions, as evidenced by previous research and acquisition case studies.

Table 1. Attributes and Results of Successful Acquisitions

Attributes	Results
Acquired firm has assets or resources that are complementary to the acquiring firm's core business.	High probability of synergy and competitive advantage by maintaining strengths.
Acquisition is friendly.	Faster and more effective integration and possibly lower premiums.
Acquiring firm conducts effective due diligence to select target firms and evaluate the target firm's health.	Firms with strongest complementarities are acquired and overpayment is avoided.
Both firms have financial slack.	Financing is easier and less costly to obtain.
Merged firm maintains a low to moderate debt position.	Lower financing cost, lower risk (e.g., of bankruptcy), and avoidance of trade-offs that are associated with high debt.
Acquiring firm has sustained and consistent emphasis on R&D and innovation.	Maintains long-term competitive advantages in markets.
Acquiring firm manages change well and is flexible and adaptable.	Faster and more effective integration facilitates achievement of synergy.

THE CASE STUDY

Our case study involves three companies:

- Scomi Group Berhad (Scomi), an investment holding company with core businesses in the oil and gas industry
- Habib Corporation Berhad (Habib), which began as a small, family-owned and managed retail outlet in Penang's jewelry corner known as Pitt Street; it was later listed on the Second Board of the Bursa Malaysia in 1998 and thereafter graduated to the Main Board in 2001
- Chuan Hup Holdings Limited (CHH), which was incorporated in 1970 as Chuan Hup Marine (Private) Limited, a provider of tug and barge services to the PSA in Singapore. In 1983, it converted into a public limited

company and was admitted to the Singapore Stock Exchange.

In Scomi's case, its proposed investment into Habib was to provide Scomi with the opportunity to expand its marine vessel transportation business, both in the transportation of bulk aggregates and offshore support services in the oil and gas industry. As Habib's major shareholder, Scomi would have direct access to a fleet of 75 marine vessels owned by Chuan Hup's six subsidiary companies and a further 80 marine vessels, including new builds, held through its interest in CHO and PTRT, listed on Singapore Stock Exchange and Jakarta Stock Exchange, respectively. In addition, Scomi could also leverage off CHO's overseas market access in Southeast Asia with future plans to penetrate into Mexico and West Africa through a UK-based offshore support services operator. With regard to its marine vessel transportation business, Scomi's decision to acquire Habib was made much based on the perceived opportunities arising from national and regional trends in the energy sector as explained later.

Additionally, in 2003 and 2004, there were 15 new oil discoveries in Malaysia. Massive contracts were expected to follow as other new fields were developed. Up to 2015, about MYR15 billion worth of oil and gas contracts were expected to be up for grabs. There were around MYR3 billion worth of energy transportation contracts in the country for 2005 alone. Scomi saw that its investment in Habib would give it an excellent position to tap the Malaysian oil and gas marine sector given the fact that there was a shortage of Malaysian-flagged vessels.

Due to the recent astronomical rise in the global price of crude oil, coal emerged as one of the preferred, alternative energy sources. In the ASEAN region, most countries began rebalancing their power needs between gas and coal. Coal was expected to increasingly be an important source of power. The trend of diversifying into coal is already visible in Malaysia. Three new coal-fired power plants are to be built up over the next four years and coal is set to form 37% of fuel mix by 2010, compared to 16% in 2005. CHH had the largest long-term coal charter contracts in Indonesia, the main source country of

Malaysia's strategic coal stockpile. Well aware of Habib's plan to invest in CHH, Scomi saw that its investment in Habib would enable the firm to gain access to CHH's resources, thus becoming a major regional player in the coal transportation industry.

The main reason for Scomi to use Habib to take control of CHH's assets and businesses was its gearing. Scomi's gearing ratio at the time of the deal announcement was 1.7 times; the firm planned to bring it down to a less-than-one level.² In contrast, Habib is a firm with almost no gearing – its debt-to-equity ratio as at 31 December 2004 was just 0.04 times.² Habib would acquire a debt of SGD280 million due to its investment in CHH and the debt would be recovered within five years – meaning Habib would be a firm with no gearing in five years' time. This is due to Habib's particularly low degree of leverage prior to the exercise and to the fact that the CHH's subsidiaries and associated firm to be acquired hardly had any gearing and were capable of generating strong cash flows. CHO and PTRT were both cash-rich companies, with MYR95.7 million and MYR91.9 million in their coffers as of December 31, 2004.³

Habib was also a willing target. In other words, Scomi's acquisition was expected to be friendly, as the management felt that it was a golden opportunity to get into the oil and gas sector, particularly with shareholders such as Scomi, which has the expertise.⁴ In friendly acquisitions, the target is less likely to be over-demanding both in terms of price and future operations in the post-transaction firm. Furthermore, the earnings potential for Habib was expected to grow significantly. Simply judging from CHH's businesses to be acquired and the earnings they generated in 2004, Habib expected to make profits of MYR71 million. On an earnings per share (EPS) basis, this worked out to MYR0.12. Despite the fact that Habib's paid-up capital would balloon to MYR588 million from MYR74 million, this EPS would still be three times what it would earn if Habib's jewelry business were maintained.³

Thus, we propose that the tripartite transaction between Scomi, Habib, and Chuan Hup should be considered as a best practice for an M&A exercise. Table 2 summarizes the findings.

Table 2. Attributes of Scomi’s Successful Acquisitions

Attributes	Scomi’s Practice
Acquired firm has assets or resources that are complementary to the acquiring firm’s core business.	Scomi acquired Habib to gain access to CHH’s marine vessels. This provided support for the expansion of Scomi’s core marine transportation business. Scomi Marine (the resultant firm) itself subsequently disposed its non-core jewelry business.
Acquisition is friendly.	Habib saw Scomi’s proposal as a golden opportunity to get into the oil and gas sector. Habib then willingly negotiated and made agreements with Scomi in a relatively short period of time – meaning, the acquisition was friendly.
Acquiring firm conducts effective due diligence to select target firms and evaluate the target firm’s health.	CHH was selected because it had the strongest complementarities to Scomi’s ambition of becoming a major regional player in the transportation of bulk aggregates and offshore support services. (Detailed analysis on whether or not Scomi overpaid for this investment is given below).
Both firms have financial slack.	For the issued MYR500 million nominal value medium-term notes, Malaysian Rating Corporation Berhad (MARC) gave a rating of AA- which reflected the agency’s confidence in Scomi’s credit. On the other hand, Habib itself was a firm with almost no gearing, while CHH was unquestionably a cash-rich firm.
Merged firm maintains low to moderate debt position.	Habib’s debt from its investment in CHH is anticipated to be recovered speedily on account of Habib’s low degree of original leverage and CHH’s strong cash flow. Additionally, the proceeds from the divestment of the non-core jewelry business were intended to be utilized to repay borrowings of Scomi Marine and thus improve its gearing.
Acquiring firm has sustained and consistent emphasis on R&D and innovation.	Scomi’s commitment to R&D was highlighted when the firm launched its Global Research & Technology Centre (GRTC) while nearing the conclusion of its acquisition exercise. Scomi’s investment cost for GRTC is approximately MYR6 million, and operating cost is estimated to be within the region of MYR2 million to MYR3 million per year.
Acquiring firm manages change well and is flexible and adaptable.	Two out of the three subsidiaries that handle Scomi’s core business operations are inorganic. KMC Oiltools is the resultant firm of Scomi’s acquisition of Oiltools International Limited, while OilServe is Scomi’s joint venture with Crest Petroleum Berhad. Scomi’s success with both subsidiaries has proven the qualities of the firm’s change management, flexibility, and adaptability.

Was the Right Price Paid?

Because of the complexity and importance of valuing ordinary shares, various techniques for accomplishing this task have been developed over time. These techniques fall into one of two general approaches:

- The discounted cash flow (DCF) approach, where the value of an ordinary share is estimated based upon the present value of some measure of cash flow. This approach includes the free cash flow model.
- The relative approach, where the value of an ordinary share is estimated based upon its current price relative to variables considered to be significant for valuation. This approach includes price-to-earning (P/E), price-to-cash flow (P/CF), price-to-sales (P/S), and price-to-book value (P/BV) multiples.

In valuing Habib's ordinary shares for the case in point, the discussion of equity valuation techniques, given in the Appendix of this paper, considers specific models under both approaches and presents them as complementary, not competitive.

Evaluation of Scomi's Exercise Price

Table 3 summarizes the results of price calculations using various valuation techniques given in the Appendix. The average value is 0.8063.

Table 3. Summary of Calculated Prices Using Various Valuation Techniques

Valuation Technique	Calculated Price (MYR)
Free Cash Flow Model	0.7866
P/E Multiple	0.3938
P/CF Multiple	0.6255
P/S Multiple	0.9847
P/BV Multiple	1.2409
Average	0.8063

At the time the intended transaction was announced (14 February 2005), the market price for a common share of Habib was MYR2.46. Figure 2 shows the share price trend.



Figure 2. Habib's Market Price – February 2005

Scomi's exercise price was MYR1.15 per new common share. This represented a premium of MYR0.34 or approximately 42% over the average of the calculated prices. Yet the same price of MYR1.15 represented a discount of MYR0.09 or approximately 7% from the price calculated using the P/BV Multiple. The MYR1.15 price also represented a discount of MYR1.31 or approximately 53% from the market price at the time of the deal's announcement. Here the valuation technique and the assumptions that were actually utilized by Scomi during its due diligence process to arrive at its exercise price are especially relevant.

Furthermore, the relationship between the size of the premium and the success of the deal is not linear. Eccles, et al (2001), found that in half of the cases, the acquirer paid a low premium, and the total return on investment one year later was negative, while in the other half, the acquirer paid a high premium, yet the total return one year later was positive.

The question, then, is not whether acquirers pay too high a price in an absolute sense. Rather, it is whether they pay more than the acquisition is worth to them. What one firm can afford will differ from what another can. The right price is relative – that is, there is no single correct price for an acquisition. The key to success in buying another firm is to know the maximum price one can pay and then having the discipline not to pay more.

CONCLUSION

This paper has presented the general traits of successful acquisitions that give them the status of best practice. The paper then compared the case of Scomi, Habib, and CHH with the traits of best practice, and found that the transactions involving Scomi, Habib, and CHH are worthy for classification as a Malaysian best practice for acquisitions. The paper also found that the price paid was 34% higher than the average price that was calculated using various valuation techniques. In this paper, no account has been taken for the value of synergy and control. The premium, therefore, could have reflected, in part at least, the value of synergy and control. Overall, this study provides an example of a successful cross-border acquisition in Malaysia that can be considered as a best practice.

APPENDIX: VALUING THE PRICE PAID

Free Cash Flow Model (FCFM)

FCFM is the most popular way to compute the value of equity. In this technique, one needs to forecast cash flow available to equity holders (free cash flow, FCF) and then discount the expected cash flows at the cost of equity capital.

Forecasting FCF¹

Table A1. Projection of Free Cash Flow (MYR) for Habib

Year	Net earnings	Depreciation	Capital expenditure	Change in working capital	FCF
2004	3,044,780	1,474,232	5,511,463	6,671,933	5,679,482
2005	3,805,975	1,842,790	6,889,329	7,005,530	5,764,966
2006	4,757,469	2,303,488	8,611,661	7,355,806	5,805,101
2007	5,946,836	2,879,359	10,764,576	7,723,596	5,785,216
2008	6,838,861	3,311,236	13,455,720	8,109,776	4,804,181
2009	7,864,691	3,807,953	16,819,650	8,515,265	3,368,258
2010	9,044,394	4,379,146	19,763,089	8,941,028	2,601,479
2011	10,401,053	5,036,018	23,221,630	9,388,080	1,603,521
2012	11,961,211	5,791,420	25,543,793	9,857,484	2,066,322
2013	13,755,393	6,660,133	28,098,172	10,350,358	2,667,712
2014	15,818,702	7,659,153	30,907,989	10,867,876	3,437,742
Average	9,019,458				

The following assumptions for the free cash flow projection were made:

- Net earnings were expected to increase by 25% per year from 2005 to 2007 and by 15% from 2008 to 2014.
- Depreciation was assumed to grow by 25% per year from 2005 to 2007 according to historical trend. However this growth rate will be at 15% from 2008 to 2014.
- Capital expenditure was expected to grow by 25% per year from 2005 to 2009, by 17.5% from 2010 to 2011, and by 10% from 2012 to 2014.

¹ FCF = net earnings + depreciation – capital expenditure + change (reduction) in working capital

- Since there have been great fluctuations in working capital in the past few years, the reduction of net working capital is assumed to be maintained at 5% per year from 2005 to 2014.

Estimating the Cost of Equity

The cost of equity is estimated by the cost of debt plus a premium of 2%. Habib's maximum cost of secured term loans in year 2004 is used as the cost of debt. Since the cost of debt, noted in Habib's 2004 Annual Report, is 8.15%, the cost of equity is estimated at 10.15%.

Estimating the Terminal Value²

Terminal value = MYR9,019,458 x 9.5820 = MYR86,424,451

² Terminal value = 10 years (2005-2014) average of net earnings x P/E_{industry}.

Discounting FCF and Terminal Value at Cost of Equity

Table A2. Computation of Discounted Free Cash Flow and Terminal Value

Year	FCF	Discounting Factor	Discounted FCF
2005	5,764,966	1.1015	5,233,741
2006	5,805,101	1.2133	4,784,547
2007	5,785,216	1.3365	4,328,785
2008	4,804,181	1.4721	3,263,483
2009	3,368,258	1.6215	2,077,222
2010	2,601,479	1.7861	1,456,510
2011	1,603,521	1.9674	815,048
2012	2,066,322	2.1671	953,503
2013	2,667,712	2.3870	1,117,580
2014	3,437,742	2.6293	1,307,459
Total of Discounted FCF			25,337,877
Year	Terminal Value	Discounting Factor	Discounted Terminal
2014	86,424,451	2.6293	32,869,388

Valuation of Habib's Ordinary Share Using FCFM

Using FCFM, the value of Habib's ordinary share is as follows:

$$\begin{aligned}
 \text{Price} &= \frac{\text{(total of discounted FCF + discounted terminal value)}}{\text{number of ordinary shares}} \\
 &= (\text{MYR}25,337,877 + \text{MYR}32,869,388) / 74,000,000 \\
 &= \text{MYR}0.7866
 \end{aligned}$$

Comparable Firms for the Relative Approach

In contrast to the various DCF techniques that attempt to estimate a specific value for an ordinary share based on its estimated growth rates and its discount rate, the relative valuation techniques implicitly contend that it is possible to determine the value of a firm by comparing it to similar firms on the basis of several relative ratios.

Firms in the same industry are normally the ideal candidates for comparable firms, especially in a narrowly defined industry such as Habib's. At best, there are two similar competitors of Habib listed in Bursa Malaysia: Degem Berhad (Degem) and Poh Kong Holdings Berhad (Poh Kong). Based on market capitalization, Habib is the smallest among the three (Table A3).

Table A3. Computation of Weight³

	Market Capitalization (MYR)	Weight
Degem	85,050,000	0.3179
Habib	62,530,000	0.2337
Poh Kong	119,951,069	0.4484
Total	267,531,069	1.0000

Price-to-Earnings (P/E) Multiple

For the P/E multiple technique, it is essential to compute P/E ratios for each firm and for the industry as a whole. From Table A4, it can be seen that P/E ratios varied widely across firms: the lowest was 4.94 for Poh Kong, while the highest was 20.56 for Habib.

Table A4. Computation of P/E_{industry}⁴

	Price per share (MYR)	EPS (MYR)	P/E	Weight	P/E × Weight
Degem	1.3500	0.1676	8.05	0.3179	2.5607
Habib	0.8450	0.0411	20.56	0.2337	4.8054
Poh Kong	1.3700	0.2772	4.94	0.4484	2.2159
			P/E _{industry} = 9.5820		

³ Market capitalization = number of issued and fully paid common shares × price per common share. Data of the number of issued and fully paid common shares are obtained from respective firms' 2004 Annual Reports. Price per common share refers to the closing price in Bursa Malaysia as at 30 December 2004.

⁴ Data of earnings per share (EPS) are obtained from respective firms' 2004 Annual Reports.

Using P/E multiple technique, the value of Habib’s common share is as follows:

$$\text{Price} = \text{EPS} \times \text{P/E}_{\text{industry}} = \text{MYR}0.0411 \times 9.5820 = \text{MYR}0.3938$$

Price-to-Cash Flow (P/CF) Multiple

The growth in popularity of this technique can be traced to concern over the inclination of some firms to manipulate EPS, whereas cash flow values are generally less prone to manipulation. The specific cash flow measure used is typically earnings before interest, tax, depreciation, and amortization (EBITDA).

Table A5. Computation of MC/EBITDA_{industry}⁵

	Market Capitalization (MYR)	EBITDA (MYR)	Weight	(Market Capitalization/ EBITDA) × Weight
Degem	85,050,000	17,773,598	0.3179	1.5212
Habib	62,530,000	6,684,268	0.2337	2.1865
Poh Kong	119,951,069	16,716,116	0.4484	3.2174
MC/EBITDA _{industry} = 6.9251				

Using P/CF multiple technique, the value of Habib’s common share is as below:

$$\begin{aligned} \text{Price} &= (\text{EBITDA} \times \text{MC/EBITDA}_{\text{industry}}) / \text{number of common shares} \\ &= (\text{MYR}6,684,268 \times 6.9251) / 74,000,000 \\ &= \text{MYR}0.6255 \end{aligned}$$

Price-to-Sales (P/S) Multiple

A similar procedure as in the P/CF multiple can be adopted to value Habib’s ordinary share using P/S multiple.

⁵ Data of earnings before interest, tax, depreciation and amortization (EBITDA) are obtained from respective firms’ 2004 Annual Reports.

Table A6. Computation of MC/Sales_{industry}⁶

	Market Capitalization (MYR)	Sales (MYR)	Weight	(Market Capitalization/ Sales) × Weight
Degem	85,050,000	135,338,251	0.3179	0.1998
Habib	62,530,000	114,420,418	0.2337	0.1277
Poh Kong	119,951,069	173,881,479	0.4484	0.3093
MC/Sales _{industry} = 0.6368				

Using P/S multiple technique, the value of Habib's common share is as follows:

$$\begin{aligned}
 \text{Price} &= (\text{Sales} \times \text{MC/Sales}_{\text{industry}}) / \text{number of common shares} \\
 &= (\text{MYR}114,420,418 \times 0.6368) / 74,000,000 \\
 &= \text{MYR}0.9847
 \end{aligned}$$

Price-to-Book Value (P/BV) Multiple

Here also, a similar procedure as in the P/CF multiple can be adopted to value Habib's common share using P/BV multiple.

Table A7. Computation of MC/BV_{industry}⁷

	Market Capitalization (MYR)	Book Value (MYR)	Weight	(Market Capitalization/ Book Value) × Weight
Degem	85,050,000	63,000,000	0.3179	0.4292
Habib	62,530,000	74,000,000	0.2337	0.1975
Poh Kong	119,951,069	87,555,525	0.4484	0.6143
MC/Sales _{industry} = 1.2409				

Using P/BV multiple technique, the value of Habib's common share is as follows:

⁶ Data of sales are obtained from respective firms' 2004 Annual Reports.

⁷ Data of book value (BV) are obtained from respective firms' 2004 Annual Reports.

$$\begin{aligned}\text{Price} &= (\text{Book Value} \times \text{MC/BV}_{\text{industry}}) / \text{number of} \\ &\quad \text{common shares} \\ &= (\text{MYR}74,000,000 \times 1.2409) / 74,000,000 \\ &= \text{MYR}1.2409\end{aligned}$$

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CHAPTER 4

ACQUISITIONS BY EMERGING MARKET FIRMS IN DEVELOPED MARKETS: SOME EVIDENCE FROM INDIAN M&As IN DEVELOPED COUNTRIES

Ashutosh Kumar Sinha
Doctoral Student
Corporate Strategy & Business Policy Area
Indian Institute of Management Bangalore
India

INTRODUCTION

With the process of liberalization initiated in many hitherto closed economies, an increasing number of firms from developed markets have sought growth in emerging markets. Firms hailing from emerging markets have also shown interest in acquiring firms in developed markets mainly to develop new resources and capabilities (Hoskisson, et al, 2004). New technological capabilities are also required by these firms to defend the home turf from developed market firms initiating operations in emerging markets as a result of the post-liberalization opening up of the emerging economy (Cantwell, 1992; Wright, et al, 2005).

This paper sees India as an example of an emerging market. It aims to provide an understanding of how the extant literature on M&A stands when applied in the context of emerging-market firms making acquisitions in developed markets. One major issue is to understand the extent to which the character of an emerging market needs to be factored in when conventional corporate wisdom in M&A is applied to acquisitions made by emerging market firms in developed markets.

Foreign acquisitions by Indian firms reveal some interesting features. The value as well as the number of acquisitions made by Indian firms has shown a steady increase over the last few years. A study by MAPE Advisory Group reveals that from January 2000 to March 2006, Indian firms have acquired 244 foreign firms. The number of outbound cross-border deals exceeded the number of inbound cross-border deals in 2005,

when the total value of such deals was more than USD3.5 billion for acquiring a total of 104 firms. In terms of the number of deals for the same period, the Software/BPO and the Pharmaceutical/Healthcare sectors account for more than 50% of the acquisitions. Considering the value of the deals, about 20% are accounted for by the Oil & Gas sector. Investments by Indian firms are mostly in developed markets, especially Europe (~40%) and North America (~34%). Most of the acquisitions are related to the business of the acquiring firm. There are a large number of deals of values less than USD10 million, but the number of high-value deals is increasing. Most of the deals are financed through cash as the acquiring firms take advantage of a booming capital market besides avoiding regulatory hassles associated with stock transactions. Foreign Currency Convertible Bonds have emerged as an instrument of choice for raising funds for making foreign acquisitions.

The next section of this paper considers the literature on M&A relating to performance and organizational learning, as well as in the context of emerging markets. Testable hypotheses are developed in the process. In subsequent sections of the paper, the data used in this study is described, the hypotheses developed are discussed, and results are presented and discussed.

M&A LITERATURE AND HYPOTHESES

Post-Merger Performance

Some of the literature on post-merger performance supports the idea that post-merger performance is positive. Healey, Palepu, and Ruback (1992), using an accounting approach, came to the conclusion that the merged firms showed significant improvement in their operating cash flow returns. Lubatkin (1987) also found permanent gains in stockholder value for the stockholders of both the acquiring as well as the acquired firm.

Much of the literature, however, indicates that the gains from acquisition accrue in a disproportionate manner to the acquiring and the acquired firms. The general consensus emerging is that the target firm benefits more than the acquirer firm (Singh & Montgomery, 1987). Agarwal, Jaffe, and Mandelkar (1992) have reported that market-wide and

economy-wide adjustments show negative returns resulting in wealth loss for the acquirer firm. Ghosh (2001), upon adjusting for superior pre-acquisition performance of acquirers by using control firms matched on performance and size, does not find evidence of superior operating performance for merging firms in the post-acquisition period. The target firms capture most of the synergistic gains from acquisition at the cost of the acquiring firm (Bradley, et al, 1988). Mergers involving cash rather than stock and cash tender offers have been reported to be associated with higher post-merger performance when compared to a control group (Loghran & Vjih, 1997).

Meta analyses of post-merger performance conclude that acquisitions either have no significant effect, or a small negative effect, on the acquiring firm's financial performance in the post-announcement period. The variables given importance in these studies have not been fully able to explain the M&A phenomenon, which suggests that non-financial motives have not received full attention in theory (King, et al, 2004).

Emerging Markets and M&A

An emerging market may be defined as “a country with rapid pace of economic development and government policies favoring economic liberalization and adoption of free market system” (Arnold and Quelch, 1998; Hoskisson, et al, 2000). Though there is no consensus on a standard list of such countries, some of the features common to such countries include difficulty in garnering external financial assistance as macroeconomic stability is difficult to achieve, missing institutional features (such as a shortage of skilled labor, infrastructure problems, and thin capital markets), difficulty in enforcing property rights even though they have been legislated, and lack of strong legal frameworks (Hoskisson, et al, 2000).

The emphasis of firms from emerging markets acquiring firms in developed markets is mainly exploration rather than exploitation (Wright, et al, 2005). New technological capabilities are sought (Cantwell, 1992), and this exercise may also develop potential absorptive capacity of such firms (Zahra & George, 2002). This enables such firms to attain global competitiveness in the long run, and transfer the newly developed capability to

the home country, thereby enhancing competitive advantage of the firm.

The exploitative mode of operation is also difficult for firms from emerging economies entering developed markets as they suffer from “liabilities of origin” emanating from lack of patient capital and global managerial talent in the home country context, the problems associated with socio-political legitimacy in the host country context, and the issues of securing cognitive legitimacy within the organizational context (Ramachandran et al, 2007).

The firms exploring developed markets through acquisitions could also face a higher amount of uncertainty that could affect their performance. The competitive advantage obtained in the home country through networks and close business-government ties may not be possible in the developed markets. The institutional requirements, including that of corporate governance, may be difficult to implement for the firm in developed markets (Hoskisson, et al, 2000). Further, if a firm attempts exploration, but was focused on exploitation earlier, the social capital of existing routines that served the firm well in its home environment may become a liability in its attempts to learn (Nahapiet and Ghoshal, 1998; Wright et al, 2005). On balance, however, firms exploring the developed markets would perform better than the firms directly opting for exploitation, as they would be better able to develop new capabilities allowing them to attain comparatively better resource utilization.

Therefore, our first set of hypotheses may be stated as follows:

Hypothesis 1: Acquisition of firms in developed markets by emerging market firms would be associated with lower post-acquisition returns.

Hypothesis 1a: Acquisition of firms in developed markets by emerging market firms for market access alone would be associated with lower post-acquisition returns.

Hypothesis 1b: Acquisition of firms in developed markets by emerging market firms for access to new technology would be associated with higher post-acquisition returns.

ORGANIZATIONAL LEARNING AND M&A

The capability that a firm has developed for managing the acquisition process plays an important role in determining the post-merger performance of firms (Zollo and Singh, 2004). Prior experience of acquisitions obtains knowledge to the acquiring firm regarding the choice of targets, the timing of acquisitions, when to opt for financial or legal resources outside the firm, and the key success factors regarding integration.

The number of acquisitions made by a firm and the post-acquisitions were found to have a “U-shaped” relationship (Haleblian and Finkelstein, 1999). An acquisition made for the first time by a firm may induce overconfidence so that costly mistakes may be made easily. However, as the firm gains more experience, key success factors emerge and are adopted by the firm with increasing efficacy.

The time elapsed between acquisitions has also received attention of scholars. A short time between acquisitions was not conducive to better performance as expected from “experienced acquirers,” while a very long period between acquisitions also gave rise to the same result leading to an inverted U shaped relationship (Hayward, 2002). A too small period would not allow internalization of new knowledge, whereas too long a period would mean that such knowledge had been dissipated as low usage of knowledge had led to attrition of such routines necessary to keep the knowledge alive in the organization.

A high degree of codification of knowledge of previous acquisitions made by the firm was associated with better performance (Zollo & Singh, 2004). Also, small acquisition losses incurred in previous acquisitions are associated with better performance of later acquisitions. Successful acquisitions could promote “satisficing” behavior reducing search for superior solutions, whereas large failures hinder learning as managers, being stakeholders, are averse to questioning their own competence (Hayward, 2002).

In an emerging market, with an emphasis on acquiring capabilities that allow competition in the home country as well as abroad, the success of acquisitions would be of vital importance for success of later acquisitions. Development of such routines and codified information would make up for the

loss of social networks that played a key role in competing in the home country.

Therefore, the second hypothesis may be stated as:

Hypothesis 2: Acquisition of firms in developed markets by emerging economy firms with previous acquisition experience would be associated with higher post-acquisition returns.

Sample & Methodology

Sample

The data for emerging economy firms acquiring firms in developing markets has been taken from India. A two-year period, 2004–2005, was taken up for the pilot study reported in this paper. The Centre for Monitoring Indian Economy (CMIE) database was used to identify firms that had carried out acquisition activity successfully in these two years. A total of 54 acquisitions in 2004 and 78 in 2005 were considered. Validation of the sample was done by taking recourse to the MAPE advisory group report (2006) and Bloomberg database. Only listed firms with sufficient data were selected from the list of firms obtained after validation. Indian firms buying Indian operations of foreign firms were not included in the data. Similarly, Indian firms buying foreign firms whose major activities were based in India were also excluded. Also not included in the sample were Indian firms buying foreign firms through their foreign resident affiliates or holding companies, since the transfer of capital in this case is taking place through a foreign resident (MAPE, 2006).

Capitaline 2000 database was used to obtain stock price information across time and BSE Sensex was used as an index of market returns for the study.

Confounding effects were considered while selecting firms for the study. The date of announcement obtained from the CMIE database and MAPE advisory group report was used to locate abnormal movement of stock prices prior to the date of announcement when compared to the market index. IBID database was used to obtain news relating to these acquiring firms, and it was ensured that the sample included firms that had low confounding effects on impact of announcement of

acquisition. A total of 50 firms were finally selected for the study through this process.

The sample, when considered volume-wise, consisted of 26% firms from pharmaceutical sector, 20% firms from software/BPO sector, 18% firms from the automobile sector, 10% from chemicals and fertilizers sector, 18% from others (including telecom sector), 4% from oil & gas sector, and 2% each from consumer durables and metal & mining sectors. Considering the size of the deal, 10% of the sample consisted of firms with deal size greater than \$100 million, 40% of the firms had a deal size of less than \$10 million, and the rest fell between these two figures. 92% of the firms in the sample undertook acquisitions in the same sector, and most of the firms acquired firms in developed markets – Europe and North America. An analysis of the Indian firms acquiring firms outside over the last six years also shows similar characteristics (MAPE, 2006), and hence the data set was validated.

Methodology

The event study methodology followed in this paper has drawn much from Patell's (1976) study of stock price behavior. Daily stock price data of the acquiring firms from India was used to undertake a preliminary investigation of the returns obtained after such acquisitions.

The technique was developed to identify the impact of a specific event upon a security's rate of return (Fama, Fisher, Jensen, and Roll, 1969). It came into being on account of dissatisfaction of scholars with accounting data with respect to its difficulty in defining substantively, their lack of meaning, and thus their doubtful utility (Ball and Brown, 1968). The method also focuses on the stock prices rather than accounting data as it tries to avoid influences of managerial choices regarding accounting procedures and any manipulation of data (Bromiley, et al, 1988).

Amongst the various models currently in use based on event study methodology, the market model was chosen. This model considers a single factor – the market returns – which relates to the return obtained for any given security. The event date under consideration is defined as the date on which the news regarding acquisition was made public for the first time.

Following McWilliams, et al (1997), the model may be specified as follows:

The expected rate of return on share price of a firm “i” on day “t” is calculated as follows:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_i, \text{ where,}$$

R_{it} = Rate of return on share price of firm “i” on day “t,”

R_{mt} = Rate of return on a market portfolio of stocks,

α_i, β_i = the intercept term and systematic risk coefficient of stock “i,” respectively,

ε_i = the error term with $E(\varepsilon_i) = 0$

The equation above allows us to calculate the expected returns for the stock for the forecast period. The abnormal returns for the firm “i” can be calculated as follows:

$$AR_{it} = R_{it} - (a_i + b_i R_{mt}), \text{ where,}$$

AR_{it} = Abnormal return for the “ith” firm at time “t,”

a_i, b_i = OLS parameter estimates obtained from regression of R_{it} on R_{mt} for the estimation period.

The abnormal return for each firm over the forecast period was standardized, and a cumulative abnormal return calculated for the firm over the same period over both short term as well as the long term (3 days and 60 days from the date of announcement, respectively), to facilitate comparison.

The event definition was defined as the date of announcement of such foreign acquisition by the Indian firm – the event window comprises the single day upon which the announcement of acquisition was made public. The dates obtained from the databases were confirmed with news reports to ensure that no formal public reference to the event had taken place earlier.

Daily stock price data for the year preceding the date of announcement was taken as the estimation window. Gaps in the data due to holidays etc were ignored for the purpose of the study. There was no overlap between the estimation window

and the event window, as the event returns could unduly influence the normal returns in such a case (MacKinlay, 1997).

The stationarity of both the market return and the actual return time series was tested prior to estimation of the model: Augmented DF test was applied to return data for all firms. Next, for each firm, abnormal returns for each day were calculated. Checking for normality of abnormal returns after standardization was done through JB test. This was followed by aggregation of abnormal returns across firms, and significance testing was done. The null hypothesis in this case is that the event has no effect on the behavior of returns for the securities under consideration.

The level of acquisition experience of firms in the sample undertaking acquisitions was also considered in analyzing the results obtained from this study.

RESULTS

The assumption of stationarity of market returns and actual returns for all firms was found valid. However, the assumption of normality of standard abnormal returns failed for about 40% of the firms. The JB statistic value ranged from 0.13 to 81.66, and was less than 5 for 28 firms.

The three-day cumulative abnormal returns were positive at 12.27, but were not found to be statistically significant. The 60-day cumulative abnormal returns were found to be negative with a value of -51.44, but the value was found to be statistically not significant also. Thus Hypothesis 1a [that Indian/emerging market firms acquiring firms in developed markets would not be associated with significant positive returns] is rejected neither for the short run, nor for the long run.

Sectoral comparison of results is only indicative keeping in view the small sample size of firms in each sector. The eight sectors into which the sample was divided are: Oil & Gas, Metal & Mining sector, Healthcare, Software/BPO, Auto, Chemicals & Fertilizers, and Consumer sector. Trends indicate that the software/BPO sector had positive returns both in the short and long run (8.27 and 14.37), the automotive sector had significant negative returns in the short run that changed over to positive returns in the long run (-4.35 and 9.88), and the pharmaceutical and the chemicals/fertilizers sectors both had negative returns in

short run as well as the long run (−4.84 and −27.69; and −3.09 and −18.94, respectively). However, the “t” values for these returns indicate that these are not statistically significant either (Table 1).

Table 1. Short run (3-day), long run (60-day) and overall cumulative return and corresponding “t” values for the sample under study

Sector	3-day Cumulative Return	“t” Value	60-day Cumulative Return	“t” Value
Auto	−4.35	−0.8379	9.88	0.5082
Chemicals/ Fertilizers	−3.09	−0.7978	−18.94	−1.2977
Healthcare	4.84	0.7750	−27.69	−1.1743
Software/ BPO	8.27	1.5099	14.37	0.6906
Others	11.32	2.1785	−5.16	−0.2623
Overall	12.27	1.0018	−51.44	−1.1130

However, when a comparison of firm performance is made over the short run and the long run, a change in character of returns from positive to negative is discerned. Comparing the volume of firms with positive/negative and short/long run returns, we find that 34% of the firms posted consistent positive returns compared to 32% of firms that faced consistent negative returns. 18% of the firms in the sample showed a positive three-day return that later changed to negative 60-day returns. Moreover, 16% of the firms saw the returns switching in the opposite direction.

A preliminary inspection of the firms in these four quadrants revealed that of the firms where short-term negative returns gave way to long-term positive returns, all but one firm had a history of prior acquisition of firms in developed markets. Even a firm that did not have a direct experience of such acquisition had the advantage of acquisition experience at the level of its holding company.

DISCUSSION

The results of the study, not being statistically significant for the short run (3 days) as well as the long run (60 days) for the whole sample, indicate that the hypotheses under consideration cannot be rejected. The post-acquisition cumulative abnormal returns for Indian firms acquiring firms in developed markets may or may not be low, either for firms operating in the explorative mode or in the exploitative mode. The same holds for the results obtained on sector wise analysis – no statistically significant results are obtained for the period under consideration (3 days and 60 days) for the different sectors in the sample. These findings, though suffering from small sample size under consideration, are consistent with the conventional wisdom regarding M&A in developed markets – the acquirer returns are not significantly different from zero or may in some cases be even negative after information regarding acquisition is disclosed.

The trend from positive to negative post-acquisition abnormal returns over time is visible (Figure 1) for the overall sample of firms. A sectoral analysis of the results for the sample also reveals that for some sectors, the short-term character of the cumulative abnormal returns gets reversed in the long term. The auto sector has negative short run abnormal returns being replaced by positive long run abnormal returns, whereas the trend is in the reverse direction for the healthcare sector.

The auto industry has been associated with an exploratory mode of operation when undertaking acquisitions overseas. Firms like Amtek Auto, Mahindra & Mahindra, Sundaram, and Escorts have gained from their overseas experiences in terms of expertise, and have become internationally competitive. The advancement in competence has also helped them secure competitive advantage in the home markets, where they are in a position to compete successfully with the foreign entrants also. These firms have overcome their liabilities of origin in the host country context as well, and the returns in both short and long run corroborate this. Therefore, Hypothesis 1b [acquisition of firms in developed markets by emerging market firms for access to new technology may be associated with higher post-

acquisition returns] may hold promise for further analysis with a larger sample.

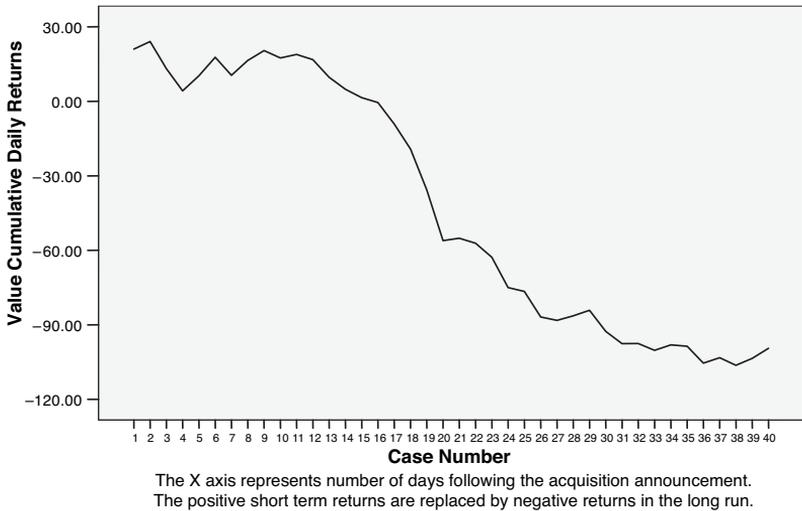


Figure 1. Cumulative Daily Returns

The firms in the healthcare sector in the sample represented by Wockhardt, Dr Reddys, Nicholas Piramal, Jubilant, and Glenmark Pharma appear to have entered the foreign markets mostly in an exploitative mode. The discovery of new molecules in the pharmaceuticals sector is highly capital intensive. Indian firms have also been subjected to protracted legal battles regarding patents, which firms like Dr Reddys have tried to leverage to their advantage. However, the institutional environment has not bestowed legitimacy to these firms as has been in the case of Software sector firms. This means that the host country context of liabilities of origin is yet to be breached by these firms when operating in the developed markets. The market, both in the short run as well as the long run, therefore, has punished the acquisitions made by these firms. The Hypothesis 1b, therefore, needs further testing using a larger sample.

An interesting insight obtained from the study of overall sample of firms that exhibit a change from negative to positive post-acquisition abnormal returns in the long run is that they are

serial acquirers. Firms like Tata Motors, Mahindra & Mahindra, United Phosphorus, TCS, and Foursoft, exhibit negative short-term returns, followed by positive long-term returns for some of their acquisitions. These firms have either made more than one acquisition in the past, or they have had to rely on acquisition expertise through acquisitions undertaken by other firms held by their holding company. They have had expertise generated through experience in acquisition at their disposal to draw upon to make further acquisitions successful. Apparently, the availability of this experience could be discounted by the market in assessment of further acquisitions in the short run giving rise to negative abnormal returns, but when the ideas gained through these experiences are applied to current acquisitions, the market is quick enough to recognize it. The liabilities of origin in the home country context are mitigated through judicious use of such past acquisition experience, resulting in higher long-term returns even though the market had originally held a negative view of the current acquisition. Therefore, Hypothesis 2, when tested against a larger sample, may also indicate that the acquisition of firms in developed markets by emerging economy firms with previous acquisition experience could be associated with higher post-acquisition returns.

It needs to be emphasized, again, that the analysis of trends indicated in the results are only indicative in nature, and need to be augmented through an increase in the size of the sample.

CONCLUSION

In this preliminary study of emerging market firms undertaking acquisitions in developed market, long-term and short-term acquirer returns were analyzed. The extant literature on acquirer returns was found to be valid for Indian firms making acquisitions in the developed markets: the short-term cumulative return for the sample was positive but not significantly different from zero, whereas the long term cumulative return was negative, but also statistically not found to be significant. Similar results were also found across industry sectors for the sample.

The acquisition experience of such firms in developed markets may turn out to be an important factor mitigating the

liabilities of origin faced by emerging economy firms acquiring firms in developed markets. Further research in this direction could be directed along these lines. Also, the pattern of returns for the target firms after announcement of the acquisition could reveal new insights when compared to the acquiring firms.

The study being a pilot, utilized a small sample, but the results obtained have indicated lines along which further research could be carried out, with increases in sample size. The normality assumption that has been violated in 44% of the sample also needs to be factored in. An assumption of the study is that the capital market in India is efficient, which may not be the case for many other emerging markets. But given the time elapsed since formal commencement of liberalization in India in 1991 followed by reforms including establishment of institutions like SEBI, the capital market in India has been assumed to be more efficient than what it used to be. The findings in the study need to be considered in light of these assumptions and shortcomings, which can be overcome in subsequent studies.

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CHAPTER 5

PERSPECTIVES ON MERGERS AND ACQUISITIONS

Ganesh Chand

Director

Fiji Institute of Applied Studies

Fiji

INTRODUCTION

Mergers and Acquisitions (M&As)¹ have differing consequences on different segments of society. Consequently, there are as many perspectives on M&As as there are stakeholders in it. The key stakeholders in a typical M&A activity are the entities involved, consumers (including business consumers of the merged entity's products), resource owners (including raw material suppliers, and workers), the state, civil society, and international community. Each stakeholder has a different perspective on M&A. Some interests of some of the process participants may be complementary to each other while some may be supplementary to each other. Equally is the case that some of the interests of one category of social participants would conflict with that of another. Ultimately, in many cases the state, acting as a "neutral arbiter," becomes the final authority on M&A.

This paper examines perceptions that various stakeholders have of mergers and acquisitions.

PRELIMINARIES AND DEFINITIONS

The economic and social backbone of modern societies is capitalism. Private initiatives undertaken purely for private gains characterize the core of the system that now dominates the world for production, distribution, and consumption. Where private initiatives determine resource allocation, markets play the central role in providing signals to the participants. Such

¹ In this paper, "M&A" should be read as including merger or acquisition.

signals include, primarily, the status of demand and supply of both produced goods/services and naturally occurring resources.

The quest for private gains, and more so the quest for ever-increasing private gains, provides the motivation for the expenditure of time, effort, money, and all other resources. These investments are premised on an expectation of streams of financial gains for the investor. As long as the market determines the extent and sustainability of financial gains, control over the market becomes the crucial factor for any investor.

Thus, the primary aim of investors has always been, and will continue to remain, the control over the market.

Control of the Market

Control of the market comes through various ways. First and foremost, an enterprise would gain total control of the market of a particular product if it became the single supplier of the product. The product could be a produced product, or a naturally occurring product.

Another way in which a participant could gain control of the market is by controlling the purchase side of the equation. If a participant were the only buyer of a product, the participant would have total control over the quantity to be bought. By this, the buyer would also have significant control over the price to be paid for the item.

In large economies, normally total control over supply, or demand, does not occur. Other than for certain services where the state may be the single buyer, most products tend to have more than a single supplier as well as more than a single buyer. Even in cases of a single supplier, for example nuclear offensive or defensive technology, the singleness emerges from a territorial limitation; producers of nuclear offense/defense technology have markets in other countries; the latter is limited only by national laws that would disallow distribution to other buyers of the product.

This is the case for large economies. However, for small economies, the case would be different. Where the market size is small, normally the market itself will tend to lead to highly concentrated markets, often even to single suppliers.

While businesses would aim to enter and control markets in small economies in entirety, modern businesses are not content with the control of a market in a small economy. Businesses can only survive if they are international – and have access to the international markets – for both their outputs as well as raw materials and other inputs.

In a rapidly globalizing world, therefore, unless prohibited by national (or international) laws, the days of absolute monopoly are numbered. But so are the days of absolute multiplicity of producers and/or resource owners.

First, no product available now is one that has no substitute. The presence of substitutes eliminates the possibility of absolute control of a market. Even where there may be legislation prohibiting production of a commodity, substitutes that are not regulated would emerge. One example, highlighted only during the past decade or so, is that of explosives. Where up to recent years, and especially the 1990s, generally the focus of the state had been on devices that could be manufactured by materials used for conventional war machinery, there has been a significant expansion of the list of items that could be used as explosive devices. Now, for example, goods ranging from farm fertilizer to alcohol are treated as possible non-conventional devices in non-conventional wars. This is but an extreme example that serves to highlight the fact that there is no limit to creativity by the human mind. And as long as creativity defines modern society, there can also be no absolute monopoly on the production or supply of any item that has a demand or a market. While national and international laws may expand the possibility for the existence of monopoly, the limitation of national or international regimes to police any legislation disallowing creativity, provides the external limit to the possibility of absolute monopoly.

In this environment, therefore, the tendency is towards higher concentration of the market. Market concentration, measured by standard concentration ratios (i.e., the percentage of the market supply in the hands of a stated number of firms), is what attracts policy makers' interests now. If it is impossible for a firm to gain and maintain absolute control over the market, aiming for the highest possible degree of control of the market

remains its goal. Towards this end, the growth of firms becomes a crucial factor.

GROWTH OF FIRMS

There are two main sources of growth for firms. These are reinvestment/new investment in *new* plant and equipment, and investment in *existing* plant and equipment. The former is referred to as organic growth, while the latter as growth through M&A.

Organic Growth

Reinvestment/new investment in new plant and equipment in the production and distribution chain for a product creates the possibility of capturing a larger market for a firm's product. This includes reinvestment to produce a larger number and/or capacity of plants, and investment in activities that control raw material sources and marketing outlets.

Mergers and Acquisitions

An M&A is investment in *existing* plant and equipment. Such investments are of three types:

- *Mergers*: This involves one firm joining an existing firm to form one entity with a legal identity reflecting the interests of the firms so merging. In mergers, the possibilities of the name of the resulting entity reflecting the names of the merged organizations is strong.
- *Acquisitions*: This involves a takeover by one firm of one or more existing firms in an industry. An acquisition typically requires buying an existing firm and either maintaining the prior legal identity of the firm bought or changing it to that of the buying firm, or to that of a completely new identity. Acquisitions could be voluntary or hostile. A voluntary acquisition occurs when shareholders and management of a firm decide to sell the firm to an acquirer. Hostile acquisition is when a takeover takes place despite opposition from some shareholders and/or management of the target firm.
- *Cross-Border Strategic Alliances*: This involves alliances between firms across borders. An example would be the bestowing of an "exclusive distributor" right by a firm

in one country of its products to a firm in another country. Such alliances increase the stake that firms have in ensuring maintenance or expansion of the producing firm's market share internationally.

Typically there are three forms of M&As:

- *Horizontal M&As*: These are M&As involving actual competitors in the market. A horizontal M&A leads to greater control of the market; the concentration ratio of the industry tends to rise if the M&A involves the larger firms in the industry.
- *Vertical M&As*: These are between firms at different stages in the production process. A vertical M&A increases control over inputs and/or distribution channels. This raises control over the market for both inputs and output, and provides the firms involved greater leverage in the economy.
- *Conglomerate M&As*: These are between firms in unrelated activities. They provide firms greater economic significance.

M&As, therefore, raise the market power of the firms as well as the power of merged/acquiring firms in the economy. While increasing the market power has been adequately recognized as a key strategy of businesses, the latter – rising economic power – has been less recognized as critical for firms.

Economic Power of Firms

The power of firms in an economy is measured by the control a firm has of the economic life of the country. This control could be examined purely in terms of economic indicators such as the proportion of all employment generated by a particular holding company. Other indicators could be the proportion of:

- gross output generated by the holding company;
- export revenue generated by the holding company; and
- research and development contributed to by the holding company.

These are traditional measures. One non-traditional measure is the control over strategic resources and strategic industries that a firm has. Such a resource may be petroleum/energy, minerals,

and even land, while such industries include shipping/transportation, banking and finance, media, information technology, and defense and security industry. Control over these provides the firms an added leverage over policy making in the country. While this may not appear to be a very significant factor in large metropolitan countries, for developing countries, and especially for smaller developing countries, this factor is extremely crucial for the firm involved, other firms in the economy (including those in other industries), as well as for the economy as a whole.

The influence a firm or a holding company has over national economic policy making is rapidly becoming an important source of additional market power of firms. It is now quite well established that some of the positions taken by countries in trade negotiations, including negotiations at the WTO level, are determined by the influence of large corporations.

The impacts of the rising market and economic powers are significant for most stakeholders. Perspectives on the rising market and economic powers of firms through M&As, however, differ.

PERSPECTIVES FROM BUSINESS AS A PARTICIPANT STAKEHOLDER

The overriding view of businesses that successfully carry out an M&A activity is that the activity increases the market and financial power of the firm. This view, however, is not as certain in situations of hostile takeovers – where while the “winners” may hold the view that the activity leads to increased market power, the “losers” may have a totally different viewpoint.

It is argued that a major reason for any net benefit of an M&A is the benefit result from the *synergy effects* of an M&A. The idea behind the synergy effects is that $(1 + 1 = n)$, where $n > 2$; the synergistic effect is $(n - 2)$.

Synergy arises due to numerous factors. Some of the major ones are economies of scale, economies of scope, accounting effects, and management effects (Davies and Lam, 2001).

Economies of scale: M&As allow the combined firm to produce at a lower unit cost of production of a good/service.

This occurs when the firm can spread its costs of management, distribution network, plant and equipment, input purchasing power, and advertising strength over an increased volume of output.

Economies of scope: Economies of scope differ from economies of scale in that the former relates to the gains from producing more than one product while the latter deals with the costs of producing a single product. M&As enable firms to produce joint products. In many circumstances, given the market demand, producing joint products would turn out to be cheaper overall than producing two products separately. M&As can result in gains from production by-products. An increased capacity to produce sugar through an M&A, for example, may also increase the output of molasses, which can make production of alcohol more feasible. Another example of scope economies would be product delivery – where in a single run, two or more products could be delivered instead of making separate runs for each product. M&As make such product bundling easier.

Accounting effect: M&As lead to lower transaction costs in business. This is due to the volume effect. It is, for example, cheaper per dollar borrowed if a large sum were borrowed by a single entity, compared to smaller sums being borrowed by two entities. Similarly, the merged entity has a larger debt capacity. Yet another accounting effect arises when prior market transactions are replaced by internal transactions as an outcome of a vertical merger/acquisition. Transactions internal to a firm generate additional gains as costs of managing transactions fall significantly on account of faster decision making, reduced legal costs and delays, and more generally, lower accounting costs.

Management Effect: M&As normally lead to relatively inefficient managers being replaced by those who are considered efficient managers.² M&As can also produce gains from replacement of the entire management system by a more

² The notion of an “efficient manager,” however, needs to be taken in context of the economic environment within which organizations operate. Someone who is efficient within one economic/business regime may turn out to be ineffective in another. The PR industry also has a significant bearing on the image of a manager.

efficient management system. These raise firm growth potential, and thus strength.

It is believed that these factors generate benefits for the shareholders. Empirical evidence, however, may not be so conclusive. In the U.S., for example, between 1976 and 1990, 35,000 corporate acquisitions were completed, but there was “no clear pattern of performance improvement emerging” (Davies and Lam, 2001: 67). The general pattern found in the U.S. is that acquisitions “have a neutral to negative effect on the shareholder value of acquirors” (Bradley, et al, 1988, and Berkovitch and Narayan, as in Davies and Lam, 2001: 67).

The question, then, is: who benefits from an M&A activity? This remains a major issue relating to M&As. What is known, for sure, is that the management of the acquiring firm is a net beneficiary in terms of the remuneration package.

Whether the benefits trickle down to the non-management employees is also an important consideration. Where the senior management cadre benefits from an M&A, the tendency for the management to agree to better working/remuneration conditions for employees at the headquarters would be strong. This need not be the case for cross-border M&As, but a strong tendency could be that the senior management would tend to seek greater employee allegiance throughout the conglomeration by improving working/remuneration conditions, albeit differentially, throughout the organization. Empirical evidence for the above, however, needs to be established to stamp this as a firm outcome of an M&A transaction.

If, however, shareholders and employees both gained from an M&A transaction, and if these gains were created as synergistic benefits, then the economic, and, therefore, national welfare would also rise.

It is, however, important to keep in mind that the modern business firm’s or conglomerate’s allegiance is not to a territorial boundary; its allegiance is to the entire globe. Thus, it appeared not too painful for a company like Hong Kong’s Jardine Group to change domicile from Hong Kong to Bermuda (Davies and Lam, 2001: 69-71). A modern firm does not, and in fact cannot, afford to see its “citizenship” as its business allegiance. Consider, for example, the U.S. defense industry producers. When the U.S. is at war with other countries, without strict laws, it would

be the U.S. defense industry that would supply weapons to all the parties at war; this is prevented only by strict laws governing the conduct of the U.S. defense producers.

For the business, M&As provide a global competitive strategy. Whether these be within a territorial boundary or across territorial boundaries, maintaining a strong competitive edge is necessary for a business to survive. If it were not to do this, it would itself be either taken over or driven to bankruptcy. Internationally, over the past two decades there has been the emergence of very strong companies, especially in Asia, but also in South America. Asia has a huge advantage over other regions on account of its very large population base. Population is potential market. Capturing a portion of the markets in countries such as China, India, and Indonesia has become a major objective of western transnational enterprises. M&As and strategic alliances provide a useful strategy to do this.

M&A and SMEs

Small and medium enterprises tend to have a larger degree of owner control. This ensures greater owner/shareholder involvement in M&A decisions. For the SMEs, M&As give greater competitive strength to the SMEs.

Fundamentally a firm is a SME on account of certain constraints; often these tend to be either a shortage of capital (and other inputs), or a lack of a market and/or market growth. If an M&A activity can lift these constraints, then M&As would produce a net benefit to SMEs. M&As, therefore, can provide greater strength to the SMEs to stand on their own in the market. In certain situations, this can provide competitive strength against foreign companies as well. In addition, if M&As raise profit (through increased market share or increased prices), the organization's strength grows.

M&A activities, therefore, can be a useful strategy for growth of SMEs.

Productivity and Competitive Effects of M&As

One argument advanced is that M&As follow firms that are less competitive, and where productivity is lower than the market productivity. Low productivity and competitiveness are grounds for shareholders to consider options for better returns. M&A is one such option. Shareholder interest is in the value of the

share. If share values are on the decline, and M&A shows the possibility of containing this, or reversing the trend, then M&A would be an option shareholders would consider.

However, it is not always the case that lower competitive firms are always the targets of M&As. A less competitive firm may be very large, with significant financial leverage. A survival strategy could be for the less competitive firm to take over smaller, higher productivity firm(s) and devour the sources of competition. This is possible if the smaller firm does not have the financial leverage to prevent an acquisition. Where smaller firms show resistance, acquisitions could be hostile. A larger firm, for example, could dump its products at prices below its cost of production, and lower still than the prices that a smaller more productive firm could afford. This could be a temporary measure to get the smaller firm to its knees and prepare the ground for a takeover or merger.

Resistance from the target firms could be on account of loss of control, possible loss of identity, and asset stripping.³ Asset stripping is not limited to private enterprises. For state-owned enterprises, asset stripping could occur before another business acquires the enterprise. In Fiji, for example, the declining National Bank of Fiji was divided into a “good bank” and a “bad bank;” the assets of the bad bank were stripped and sold off while the good bank was made ready for a takeover by an Australian company.

But whatever the cause for an M&A, there are two crucial issues to be considered: productivity gains and competition.

The question to consider is whether an M&A activity would lead to improvements in productivity. Factors that could potentially lead to productivity improvement are numerous. These include economies of scale of a larger operation, economies of scope, and greater market power over input, including financial, purchase.

However, there is no economy-wide empirical evidence that shows conclusively that M&As, as a rule, lead to productivity

³ Asset stripping is when the physical and other assets of the acquired firm are separately sold off and the enterprise is wound up as a productive entity. This kills the identity of the acquired firm. With this is also destroyed the management and shareholder identification with the business.

gains. In fact, M&As may work contrary to expectations. Size may itself become a constraint, and dis-economies of scale may set in. Lower competition may also lead to a relatively more relaxed management, thereby leading to productivity losses. The price paid for an acquisition may have been higher than the real worth of the shares; this occurs where the management of the firm taking over has an inflated estimation of their capacity to generate gains for shareholders on account of market concentration. With the evidence on the ground so far, the final word on productivity gains through M&As has still not been written.

But what is established is that M&As, by their very nature, reduce the number of firms in the industry as well as in economy. If mergers are horizontal, the number of firms in the corresponding industry falls; if mergers are vertical, then the number of firms involved in the production and distribution of a product falls. For conglomerate mergers, the total number of firms in the economy as a whole declines.

The number of firms is one indicator of the degree of competition in the economy. Fewer firms in an industry create stronger tendencies for lower competition within the industry. Fewer firms in the input supply, production, and distribution channels also produce stronger tendencies for a lower degree of competition.⁴ The fact is that a higher concentration ratio indicates greater market power in the larger firms. Market power relates to not only the prices charged, but also to the quantity and quality of products produced.

⁴ Within an industry, the degree of competition has typically been measured by market share and concentration ratio. Market share is the share of the market of the acquiring firm (compared to the pre-acquisition share ratio). Concentration ratio is the percentage of the market held by the largest \times the number of firms. Pre- and post-acquisition figures show the changes and trends in these variables.

CONSUMER PERSPECTIVES

Household and business consumers are primarily interested in four outcomes from the commercial sector. These are:

- lower price of a product
- better quality of the product
- ease of availability of the product (service)
- hassle-free post-purchase service, including repair and maintenance

Consumer perspectives on M&As revolve around these four issues. The issue is whether M&As contribute positively to the above. If they do, then consumers would view M&As positively.

Price Effect

The relationship between market concentration and price levels is well known: the higher the control over the market, the greater the control over the price of the product. M&As, therefore, result in a greater control over the price of the product by the acquiring firm. The issue, then, reduces to whether the acquiring firm utilizes its power of greater control over prices to actually raise product prices. For the firms, increasing prices is not the only decision that they could take. M&A increases the size of the organization, thereby enabling it to reduce unit cost of production. If so, the firm could actually maintain the pre-merger price, or even reduce it.

The price decision is an intricate decision, involving consideration of various factors. What is clear is that the greater the control over the market, the greater is the possibility of price increases.⁵ It is the fear of price increases that pitch consumers against M&As. Consumers individually, and collectively (e.g., consumer bodies), tend to detest M&As. Whether the fears of consumers are well founded needs to be examined on the basis of the real-life conduct of acquiring firms.

In small economies, the problem acquires a greater significance. Given the small market size in small economies,

⁵ Prices are used here to refer to the entirety of what consumers pay for a product. In some sectors, such as banking, price would include not only interest rates, but all fees and charges levied for banking services.

M&As can increase concentration more significantly than what they would tend to do in larger economies. The possibility of the emergence of markets with two or three producers, or even single producers, is much greater in smaller economies than in larger economies. This produces both potentials and threats for consumers. The possible positive outcome of M&A activities in small economies is making it feasible for one or two firms to actually produce any output at all. In the absence of M&A, a few small enterprises may begin operations, but for certain products (especially those that fall in the category of natural monopolies), neither of them may be large enough to survive and grow on their own. M&A can solve the problem of a lack of economies of scale. On the other hand, if the M&A results in highly concentrated markets, then consumers will most likely pay inefficient prices. Such a scenario strengthens the call for state regulatory policy intervention.

Product Quality

A generally accepted view is that the quality of products tends to rise with time, as greater R&D, fostered by competition, begins chipping away poor product performance. The overriding factor in quality improvement remains competition. Firms with better product quality tend to have a competitive advantage over firms with lower product qualities. The degree of competition in an industry and incentives for improvement in product quality are, theoretically, directly related. Thus, if M&A reduces competition, the incentive to improve product quality also declines.

Thus, another reason for the ire of consumers is the perception that M&A will lead to a less rapid improvement in product quality.

Distribution Effect

Competition often tends to create an efficient supply channel. One of the battle weapons for competitors in an industry becomes the continuous attempt to take the product as close to the consumer as possible. Developments like ATMs in the banking industry, online sales, tele-ordering, rapid home delivery, and networks of distributors, are just some of the mechanisms through which businesses compete. This tends to

reduce the transaction costs that consumers need to incur in making their choices and acquiring goods and services.

Concentration of industry and falling competition would create a tendency towards an erosion of the incentive for ever-improving efficiency in supply channels. The growth rate of the number of ATM outlets in a country, for example, is expected to slow down with increasing concentration of the banking industry.

Consumers are aware of the possibility of a worsening efficiency in supply channels in industries that get increasingly concentrated and centralized. This creates a negative perception of M&A in the minds of consumers.

Post-Sale Service

Another key competitive strategy for businesses is to aim for continuously improving post-sale service for products. *Ceteris paribus*, consumers tend to prefer products with a better certainty over features like product warranty and guarantees, as well as a better after-purchase service (like repair and maintenance options and facilities, spare part availability, and product upgrade opportunities). These factors have become essential tools of the competitive struggle for capital.

Falling competition due to M&As can produce the opposite results. Businesses become less responsive to post-sale consumer needs as lower competition provides lower incentives for improving after-sale service. This strengthens the negative perception that consumers have of M&As.

RESOURCE OWNERS' PERSPECTIVES

Resource owners comprise the following: physical resource owners (comprising land owners and raw material owners), financial resource owners, and human resource owners.

Standard theory holds that the lower the competition amongst the purchasers of an input, the lower the employment of the quantity of the input employed and the lower the price paid that is paid for the input. This is shown by the standard neo-classical interaction of input supply and input demand functions, as shown in the following graph. For products produced in a concentrated market, the demand curve for an

input is shown by the marginal revenue product curve, which falls below the demand curve under a perfectly competitive market situation as well as shows lower elasticity of demand.

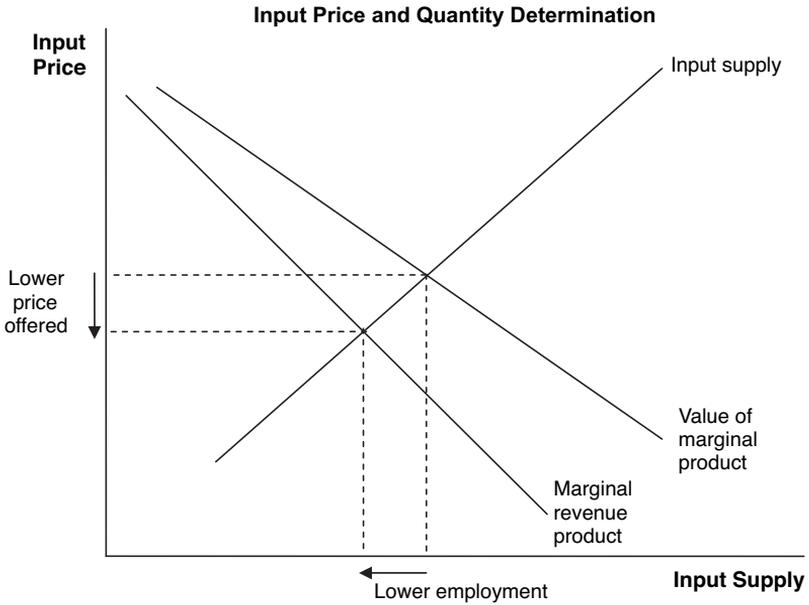


Figure 1. Input Price and Quantity Determination

M&A, therefore, reduces the returns to owners of resources. The only way in which resource owners can counter this trend is to consolidate their own marketing and act as if the resource market was also concentrated. M&As in the product market, therefore, tend to encourage M&As in the input market as well. This contributes to reducing competition in both the product market and the input market.

Labor Employment Effects

Issues concerning employment of workers are some of the most crucial issues when M&A negotiations commence. It is generally accepted that at the commencement of the M&A negotiations, if the parties have strong worker representation, parties propose to maintain employment levels and conditions of employment. However, equally often, and more so for acquisitions than for

mergers, the dominant firm tends to reduce employment to reflect its efficiency drive. The possibility of this is larger if unions are not strong and/or do not willingly agree to the takeover/acquisition/merger. Where the new owner/management is not endorsed or less willingly endorsed by workers/unions, crucial pre-acquisition and post-acquisition integration issues arise.

In some cases, however, the level of employment and/or remuneration can rise. This is the case when the M&A revives poorly performing firms, or where such firms are taken over. Growth in the post-merger entity tends to increase employment of workers. However, an equally strong tendency is for the new entities to aim to improve productivity or workers rather than increase the employment levels as the latter provides an ongoing liability on the organization.

Another employment issue concerns the environment in which the new entity operates. If the economy is expanding, the chances for the new entity growing are greater. With this the employment and remuneration of workers also tend to be greater.

There is also a view, more prevalent in the Third World than the developed world, that cross-border M&As that bring in foreign firms would be better for workers since it would improve the quality of jobs, the technology and thus worker productivity, and remuneration of workers. This view is based on the often-argued basis that foreign firms pay relatively better wages, have a better labor standard, and provide greater training opportunities than local firms.

The perspectives of workers and unions on M&A, therefore, vary. The final word on the actual impact of M&As on employment of workers and worker remuneration, thus, is a matter of the concrete situation and context of each M&A.

INTERNATIONAL IMPACTS AND INSTITUTIONS

M&As have impacts across the globe. If M&As are between large, oligopolistic companies, their impacts can be far reaching. An example is the acquisition of McDonnell Douglas by Boeing, which left only two large players in the airframe production industry. While Europeans gained some concessions from the

acquisition of one American company by another American company under a pre-acquisition deal involving air industry stakeholders, the Third World neither featured seriously in discussions on the deal nor did it gain anything out of it; to the contrary, the rise in the concentration of the market was to a potential detriment of the Third World airline industry.

M&A in strategic industries, such as finance, energy, shipping/transportation, and raw material industries like steel, leave small/developing countries at the mercy of large global giants. Already in many areas Third World welfare is at significant risk through the WTO. It is now well known that the U.S. position on WTO has been established by large American corporations. With industrial concentration, especially of strategic industries, there is continuing impact on Third World welfare. Many corporations, a sizeable proportion of which have been created through mergers and acquisitions, have turnovers and employment that are more than the comparable indicators of individual Third World countries.

To date, international institutions have not put in place concrete policies on global competition generally, and on M&As specifically. There is now an increasing perception that international institutions work for the interests of global enterprises through supporting positions by larger countries, and through a lack of any serious effort to develop global policies on M&A.

There are numerous issues that arise here. The responses to the following questions would shape the perceptions of stakeholders on cross-border M&A as well as on M&As taking place within various countries:

- Should M&As within the Third World become the foundation of a competitive strategy for Third World enterprises against Western world giants?
- Should M&As in the Third World become a strategy for technology transfer from the developed countries to the Third World?
- Are M&As the means through which Third World human resources are transferred to the developed world?
- What impact would the Third World-merged institutions have domestically?

- What impact would the Third World-merged institutions have for the smaller countries (such as those of the Pacific)?
- How should the Third World tackle issues of M&As taking place in the developed world?
- How should the Third World tackle issues of M&As taking place within the Third World?

The answers to these questions depend on concrete situations of different countries.

PERSPECTIVES OF THE STATE

M&As have significant impact on each nation state. States also form their own opinions on M&As. Many states have in place competition policies and/or legislation aimed at preventing the rise of concentrated industries. This indicates the basic approach of these states to M&As. Such a view emerges from the premise that the state is a neutral arbiter in society that ensures a fair balance between the interests of various stakeholders. Concentrated industries are regarded as anti-welfare. States, therefore, aim to prevent concentration of industries.

Yet, M&As have been taking place at a rapid pace throughout the world, including in countries that have strong anti-competition legislation.

For the Third World, an increasingly held view is that M&As provide an entry of foreign capital into the Third World, which in turn transfers technology and generate foreign earnings for these countries. In an era of globalization and intensifying competition, R&D results need to be accessible to the Third World. Such access comes from, *inter alia*, M&As. However, it is generally well accepted that M&As have relatively lower technological advancement impact than greenfield investments. Greenfield investments, especially in leading sectors aimed at producing for the international market are often founded on the latest technologies. M&As, on the other hand, only transfer technology that is already in use. It is for this reason that the Third World prefers green field investments to M&As. But M&As as a means of accessing western technology are still preferred over a lack of access to such technology.

It is also to be noted that after a cross-border M&A involving a Third World nation, there are possibilities that the foreign firm taking over or merging with the local firm would reduce R&D activity in favor of R&D at home or in its other locations. This would reduce R&D activity in the economy. Related to this is the reality of transfer pricing. Unless effective regulatory regimes are in place, cross-border M&As could produce considerable possibilities for transfer pricing.

Cross-border M&As also increase the control of the economy by foreign firms. Many Third World governments have in place very attractive foreign investment policies. However, they get jittery when it is pointed out to them that foreign investment can lead to increasing foreign control of their economies. Some Third World governments are particular about the source of capital for foreign enterprises that are involved in M&As. If capital is raised locally, there is no net foreign exchange effect. However, some governments allow foreign companies to raise capital domestically with the view that irrespective of the source of the initial capital, M&As may result in the transformation of poorly performing local companies into better performing ones. Such productivity improvements could prove beneficial to the economy. For the government, this could become a good source of taxation revenue.

In some contexts, especially for corporations that can effectively compete with those from the developed countries, a state may deliberately encourage M&As as a competitive strategy against foreign companies. Malaysia, for example, encouraged M&A in the banking sector after the 1997 Asian financial crisis in order to counter the impact of international financial houses and to strengthen its financial sector to match the performances of established western financial houses. Similarly Japan encouraged the formation of cartels and concentrated markets as it emerged from the devastation of the Second World War and set its industrialization program in motion.

For First World enterprises, liberalization and M&As provide major opportunities. Corporations that want to reduce costs often relocate certain aspects of their operations to the Third World through either direct investment or through M&A. Minimum wage rates in the Third World are between 10% and 30% of the minimum wage rates in the U.S./UK/Europe. In

addition, many Third World countries provide state infrastructure and tax concessions to attract foreign capital. These benefits to multinational corporations raise production and profits.

The state has a wide range of objectives to meet. There is no single perception or approach to M&As that exist for all states, or for one state across time. Perceptions and priorities keep changing. M&As and their consequences are only some of the issues of commercial and trading policies of governments. Public policy and practice on M&As, therefore, evolve with concrete situations of each country.

CIVIL SOCIETY PERSPECTIVES

There is a wide range of civil society organizations (CSOs) in each country. Other than those involved with economic nationalism on the one hand, or socialist development on the other, a large number of CSOs interested in M&As focus on two major aspects relating to M&As and commercial practices. These concern consumer protection and governance/transparency in commercial decision-making.

Consumer protection issues come to the forefront as concentrated industries produce a lower quantity of output and have prices that would be higher than what would prevail if there was greater competition within the industry. Traditionally, it has been proposed that such industries call for government intervention. One form of government intervention would be to regulate quantities and/or prices. Thus, if M&As result in oligopolies, CSOs normally call for state regulation of industry output and prices.

Issues of governance relate in large measure to consumer welfare as well. CSOs call for policies on M&A to be made transparent, and for any state involvement in M&A activities – either as a regulator or as an arbiter, to be also made transparent. A typical CSO position is that if the state is to encourage concentration through M&As, then the processes through which efficiency losses are to be countered need to be developed and made public and transparent. Another matter that often appears on the CSO agenda is the impact that economic control by merged entities has on economic policy making. Larger

corporations are known to influence not only public policies, but also election outcomes. CSOs, therefore, have often proposed that institutional mechanisms must be in place to ensure that large corporations do not control public policy making, or political processes, or even election outcomes.

In more recent years, CSO involvement with environment degradation and climate change issues has increased. For CSOs active in sustainable development, any likely negative impact of M&As on climate change and environmental sustainability can become a crucial issue.

CONCLUSION

M&As have a wide range of impact. Such impact is not limited to the impact on share values. While the change in share value is the most important consideration for business owners to consider M&As, other stakeholders have different priorities. The number of stakeholders to an M&A activity is potentially very large. This ranges from shareholders to management to workers to resource owners, consumers, the state, NGOs, and the international community. Each of these has its own interest in any M&A activity – irrespective of where this takes place. One cannot claim that the perspective of one stakeholder is correct while that of another is flawed. Each view advanced contains merits as well as demerits. This paper has provided some perspectives that various stakeholders have of M&As. As expected, some perspectives may be complimentary to each other, while others may be contradictory. What matters, ultimately, is that each country's internal public policy making process would determine the fate of any M&A activity.

What is undisputed, however, is that M&A activity is a normal and ongoing part of capitalism. It is also a necessary part of international competition. Furthermore, it is also now accepted that emerging economies need M&A to compete with companies from established economies, as well as to safeguard their strategic industries. M&A can also be a useful strategy for growth of SMEs. But overall, M&As lead to concentration of industry, generally lower consumer welfare, and lower resource owner welfare. Given these, there is a need for the state to create a regulatory framework within which M&As can take place. If

M&As are to achieve certain specified goals/targets, these need to be monitored. The state also needs to put in place an effective competition policy, which may include the state assuming the power to intervene in concentrated industries, or require specified forms of competition. Within the contemporary global context, there is also a need for effective regional and international polices on M&A, and regional/international governance of M&As and competition.

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CHAPTER 6

CURRENT TRENDS AND PRACTICES IN THE MALAYSIAN FINANCIAL SERVICES INDUSTRY

Shamshubaridah Ramlee

Rasidah Mohd Said

Faculty of Economics and Business

Universiti Kebangsaan Malaysia

Malaysia

INTRODUCTION

The waves of M&As, resulting from globalization, have tremendous impact on the economies of both industrialized and newly industrialized nations. M&A activities are driving both profit and non-profit organizations from all sectors of the economy toward consolidation. At the macro level, consolidations are motivated by the changing financial landscape brought by the force of globalization and liberalization. Greater economic openness and financial liberalization permit formation of cross-border conglomerates meeting the increasing demands of multinational corporations (MNCs). Cross-industry consolidations are triggered by domestic deregulations embarked by financial authorities in enhancing financial industry competitiveness.

Formations of conglomerates are further stimulated by advancement in technology that promotes innovative financial solutions. Internal firm-level factors also contribute to the emerging trend. Efforts to gain greater profitability, efficiency, and corporate control motivate firms to consolidate within and across industries. With wider market and diverse clientele, greater scale and scope yield greater efficiency and diversification. Malaysia is no exception where M&As are intensified due to forces of globalization; and with the WTO agreement being in place, enterprises are forced to merge and consolidate in order to defend their business territories.

Bigger, merged, and consolidated Malaysian companies are expected to be able to conduct businesses outside their geographical areas in an effort to increase profitability from

foreign exchange earnings. This paper examines country-specific factors that motivate M&As in Malaysia with a particular reference to the financial sector. It then discusses the stages of evolution of M&A in Malaysia. Finally it discusses selected mergers and acquisition in the financial services industry.

FACTORS INFLUENCING M&A ACTIVITIES IN MALAYSIA

Malaysian M&A activities, as with most of Malaysia's neighbors within the East Asian region, are non-market driven. The 1997 financial crisis exposed the fragilities of the Malaysian banking sector and economy. The competitive landscape in Asia, rapid technological change, and changes in the way intermediation is channeled evoked concern among countries. The Malaysian government saw that the development of the banking system, particularly the domestic banking institutions, as vital in facilitating recovery and contributing to the long-term resilience of the economy. This provided a strong rationale for the Malaysian Central Bank (BNM) to speed up the consolidation process to create a cluster of strong and competitive local banks, and to restore stability to the banking arena. The aim was to create a cluster of domestic banking institutions that could compete meaningfully with their foreign counterparts.

At the international level, the easing of restrictions on foreign entry and the search by global institutions for profit opportunities in emerging economies such as Malaysia, led to the growing presence of foreign-owned financial institutions in the domestic banking system. As a result domestic banks were forced to compete. This could only be possible with a bigger and better run institution. Having 71 banks with 2,712 branches prior to the consolidation waves, Malaysia was regarded as "over banked." Resources were not wisely utilized due to duplication of branches in the same locality. Tapping economies of scale was impossible, which was essential in modern banking with heavy utilization of information technology.

Supporters of M&A assert that efforts to put the financial sector in a healthy prudential stage, hence consolidation, will generate efficiency improvements and increase competitiveness. Many economies are tending toward an easing of regulations and the elimination of obstacles between different market segments in an effort to take advantage of economies of scale. The

changing market demographics, with an aging population profile, leads to consumers borrowing less and investing more. Thus, consumer loan demand has declined and the demand for investment vehicles, such as mutual funds, has increased. Banks, thus, were expected to face a diminished supply of investable funds (deposits) and a lower demand for consumer loans in connection with traditional consumer lending business. The development of securitization would convert many types of consumer loans into debt instruments that will be actively traded in the capital market. This exerted enormous competitive pressure on profit margins in consumer lending, although credit card lending continues to be highly profitable.

Despite the fact that M&A activities in the financial industry are driven by the potential increase in economic value, other non-value maximizing motives also influence the decision to merge among institutions. Empire building is among these reasons, where executives' pecuniary and non-pecuniary benefits are further enhanced through M&As. Banking organizations are better able to attract better skills. Being bigger now, banking organizations are able to acquire smaller profitable firms and escape from being acquired. Another motive for merging among firms is to have access to an extended governmental safety net. It is believed that very large institutions will not be allowed to fail because their failure could cause widespread panic. Hence, governmental protection is extended to shareholders in the bank, while banks are protected through deposit insurance institutions.

BANKING EVOLUTION AND STAGES OF M&A IN THE FINANCIAL SERVICES INDUSTRY

M&A activities evolved from three phases of banking history in Malaysia. The latter as conceptualized by Thakor (2005) is shown in Figure 1. In most countries the banking industry starts with being very fragmented but heavily regulated and protected. In Malaysia during the 1980s the banking industry, comprising many small banks, was poorly diversified geographically with inefficient management, resulting in over capacity. Banks were able to earn high profits. Interest rate ceiling and computation of lending and borrowing cost plus the number of branches per

bank were regulated; banks were under close supervision of the central bank.

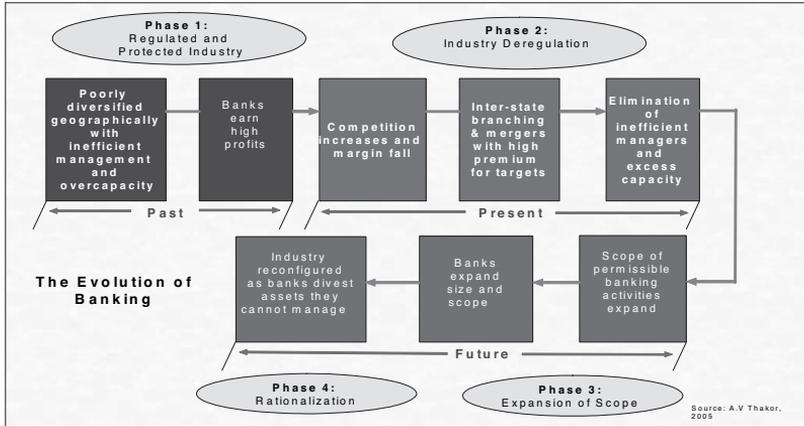


Figure 1. Evolution of Malaysian Banking Industry

In Phase 2 the banking industry was deregulated, and interest rate ceilings and lending/borrowing rates were left for determination by the banks. The central bank merely provided guidelines for computations where strict compliance was relaxed. In 1999 banks were forced to compete in order to survive, hence profit margins began to fall. In an effort to make the industry more efficient, M&A activities began taking place within the industry. In July 1999, six “mega” core banking groups merged from the existing 21 commercial banks, 25 finance companies, and 12 merchant banks.

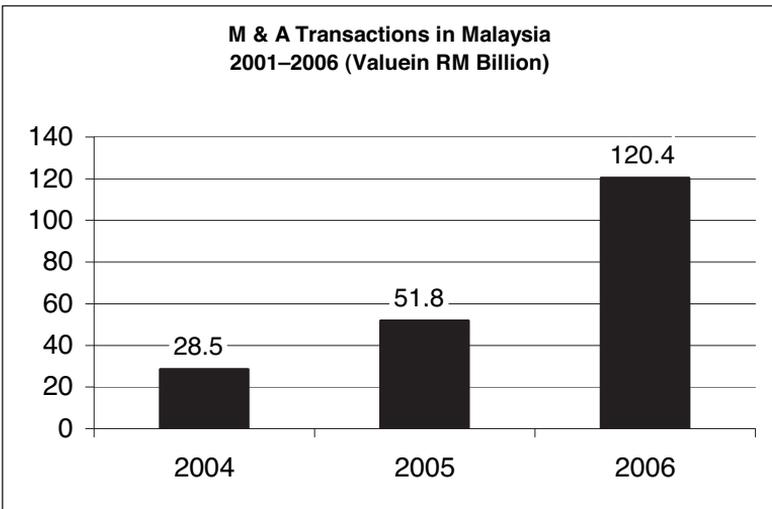
The six core banking groups originally identified by the central bank were Bumiputra Commerce Bank, Malayan Banking, Multi-Purpose Bank, Perwira Affin Bank, Public Bank, and Southern Bank. The exercise helped in the elimination of inefficient managers and excess capacities within the banking sector. By 2002 the whole M&A exercise was completed, ready to put the industry onto the right track again.

By 2003 the banking industry expanded its activities into other related operations. With a leaner and healthier banking industry, the Malaysian banking industry began expanding. Bank conglomeration and consolidation stimulated banking firms to provide underwriting activities, equity participation,

and bank assurance under one roof. Banks expanded their scope of activities both locally and across borders.

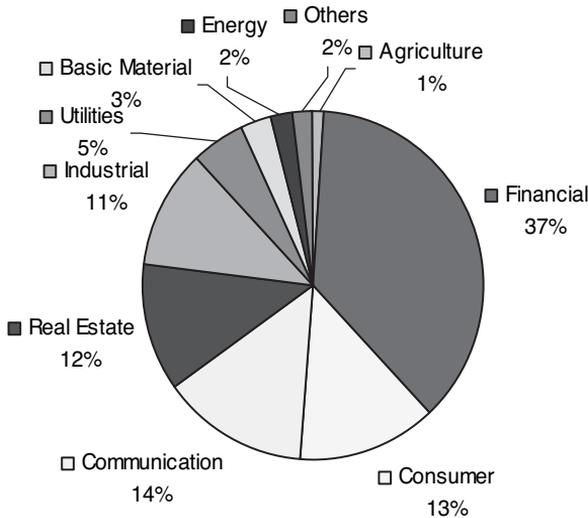
TRENDS IN MALAYSIAN M&A

Merger and acquisition activities involve reallocation of resources within an economy. The objective is not only to achieve economies of scale, but also to ensure that corporate assets are channeled towards their best possible uses. M&A activities accelerated in the 1980s across the globe, with Malaysia being no exception (Metwalli and Tang, 2002). For the period 1990–2000, Malaysia accounted for 41% of the total deals and 38% of the M&A transaction value of target firms in ASEAN (Saw, Ali, and Pillay, 2006). The value of merger and acquisition deals in Malaysia increased by slightly less than two-fold from RM28.5 billion in 2004 to RM51.8 billion in 2005 (Figure 2). More than half of the total value of M&A activities in 2005 was contributed by four sectors: financial services, communication, consumer, and real estate (see Figure 3).



Source: PWC Research and Asian Venture Capital Journal, 2007

Figure 2. The value of M&A Transactions in Malaysia



Source: PwC Alert, Issue No. 57, March 2007

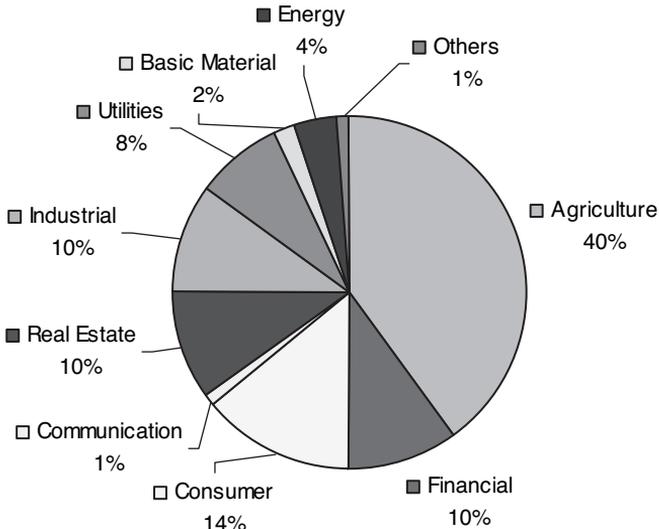
Figure 3. M&A Activities by Sector

Some of the major deals that took place in 2005 were:

- Telekom Malaysia and Khazanah Nasional control of Indonesia's mobile phone operator, Excelcom
- Acquisition of controlling stake in Indonesia's Lippo Bank by Khazanah Nasional
- Scomi Group's acquisition of Singapore's Chuan Hup Holdings offshore oil and gas business
- Tanjong's acquisition from Electricite de France of an Egyptian power plant
- Tenaga Nasional acquisition of the power generation, transmission and distribution company, Northern Utility Resources

In 2006, Malaysia witnessed more than a 100% increase over 2005 in the value of M&A (from RM51.8 billion in 2005 to RM120.4 billion in 2006). This jump was attributed to the M&As in the plantation sector that contributed 40% of total value of the M&As in 2006 (Figure 4). More than 80% of this increase was as a result of the top three deals for the year: Synergy Drive's merger (Sime Darby, Golden Hope Plantations,

and Guthrie); Wilmar International's acquisition of PPB Oil Palms; and MMC taking over Malakof, which positioned Malaysia third in terms of value in Asia Pacific M&A activity, behind China and India.



Source: PwC Alert, Issue No. 57, March 2007

Figure 4. M&A Activities by Sector

Strengthening global network and market presence, obtaining synergistic advantages such as economies of scale, and expanding into down-stream value-added businesses (for example oleo-chemicals, specialty fats, and biodiesel) were among the factors that drove M&As in this sector (Asia Pacific M&A Bulletin, 2006). Besides plantations, there is a diverse range of sectors with M&A activities, ranging from consumer products and retail to financial services, real estate, and engineering. Major M&A transactions announced during 2006 are listed in Table 1.

Table 1. Major M&As Announced During 2006

M&A	Value (RM Billion)
Merger of Sime Darby Bhd, Golden Plantations Bhd, and Guthrie through Synergy Drive Sdn Bhd	31.4
Wilmar International Ltd taking over PPB Oil Palms Bhd	15.2
MMC Corporation Bhd taking over Malakoff Bhd	9.3
Daikin Industries Ltd acquiring OYL Industries Bhd	7.6
Bumiputra-Commerce Holdings Bhd acquiring Southern Bank Bhd	6.4
Genting International PLC acquiring UK's Stanley Leisure	4.4
Parkson Retail Group, Lion Diversified Holdings Bhd, and Amalgamated Containers Bhd	4.3
Usaha Tegas Sdn Bhd, Indonesia's Lippo Group, and Singapore's Overseas Union Enterprise Ltd	4.1
Petroleum Nasional Bhd and Rosneft (Russian oil company)	4.0
Public Bank Bhd and Hong Kong's Asia Commercial Bank Ltd	2.2

Source: PWC Research

Globalization of business has induced a search for competitive advantage that is worldwide in scale. As consumers themselves are going global, companies have followed them as they respond to the pressure of obtaining scale in a rapidly consolidating global economy. The pressure of globalization, therefore, has spurred an increase in cross-border M&A activities. This has become a fundamental characteristic of the business landscape now.

In Malaysia, an increase in cross-border deals was led by foreign acquisition of Malaysian companies. According to Asia Pacific M&A Bulletin, Malaysia saw a 15 times increase (in terms of value) in cross-border M&A activity – from RM2 billion in 2005 to RM29 billion in 2006. Wilmar International's takeover of PPB Oil Palms, and Daikin Industries' acquisition of OYL Industries were among the key cross-border deals in 2006.

Cross-border M&A where Malaysian companies were the acquirers, continued to remain strong as well; it grew by 36% to

RM21 billion in 2006. Key deals included Genting Bhd's takeover of UK's Stanley Leisure, and Usaha Tegas's joint bid for the Singapore property company, Overseas Union.

Apart from the globalization pressure, there are many other reasons that prompt M&A activities. Among them are to achieve a bigger market share, generating synergistic gains and cost savings, and opportunism. In Malaysia, most M&A deals were undertaken either to acquire undervalued assets or to unlock the value of the underlying assets, or to take advantage of the low interest rates, or a combination of these factors. Major domestic M&A transactions in 2006 included MMC taking Malakof private; Multipurpose Holdings' general offer for Magnum Corporation, Khazanah's for Pantai Holdings; the merger of Golden Hope Sime Darby and Guthrie through Synergy Drive; Bumiputra Commerce's acquisition of Southern Bank; and IJM's acquisition of Road Builders.

In 2006, the value of both domestic and cross-border announced deals doubled, with cross-border share of the M&A market increasing to 42% from 34% a year earlier. The total value of announced domestic deals and cross-border deals amounted to RM70 billion and RM51 billion, respectively.

MERGERS AND ACQUISITIONS OF BANKS IN MALAYSIA

As a result of the 1997 financial crisis, the financial industry in Malaysia has been subject to dramatic changes over the past decade. These changes have reduced traditional banking activities, leading banks to merge with other banks as well as with non-bank financial institutions.

The plan to consolidate and rationalize the banking sector was initiated as early as the mid-1980s when the industry was badly hit by the 1985–86 economic recession. The period saw a number of weak commercial banks and finance companies succumb to insolvency and financial distress. One of the banks, United Asian Bank Berhad, was merged with Bank of Commerce (M) Berhad; the name, UAB, was subsequently changed to Bank of Commerce (M) Berhad. Since then, the only market-oriented mergers in the banking sector were between Kwong Yik Bank and DCB Bank, which became RHB Bank

Berhad, and Chung Khiaw Bank and United Overseas Bank (M) Berhad.

The 1997–8 financial crisis gave a much-needed push for the industry to consolidate as weaknesses in the banking system were detected. The merger program undertaken by the Malaysian banking industry, proposed by the central bank, was in tandem with the direction of the global industry. Efficiency gains and economies of scale, coupled with the impending liberalization of the Malaysian banking system, made consolidation inevitable. The Bank Negara (central bank) outlined the merger and acquisition processes as follows:

- The need to structure the mergers in such a way as to reap the maximum synergy from the merger so as to improve the profitability and efficiency of the proposed banking groups;
- The need to ensure minimal disruption in the provision of banking services following the rationalization of branches and employees;
- The need to minimize post-integration costs that may otherwise affect the viability of the merged entity; and
- The need to ensure that each banking group is of a sufficient size. In this regard, upon completion of the merger program, each banking group was to have a minimum shareholder's funds of RM2 billion and an asset base of at least RM25 billion (press release, February 2000).

As at 31 December 2001, 10 banking groups were formed through the merging of 52 banking institutions. The central bank's consent to the new groupings was based on the view that it might pave the way for a strong, efficient, and competitive banking sector, which would be able to handle the assault of globalization and liberalization (BNM, 2001). These 10 banking groups consist of 10 commercial banks, 10 finance companies and nine merchant banks. Table 2 lists these groupings.

Table 2. 10 Banking Groups

Original Banking Group	Merged With	Entity After Merger
Affin Bank Berhad Group <ul style="list-style-type: none"> • Perwira Affin Bank Berhad • Asia Commercial Finance Berhad • Perwira Affin Merchant Bank Berhad 	<ul style="list-style-type: none"> • BSN Commercial Bank (M) Berhad • BSN Finance Berhad • BSN Merchant Bankers Berhad 	<ul style="list-style-type: none"> • Affin Bank Berhad • AFFIN ACF Finance Berhad • Affin Merchant Bank Berhad
Alliance Bank Berhad Group <ul style="list-style-type: none"> • Multi-Purpose Bank Berhad 	<ul style="list-style-type: none"> • International Bank Malaysia Berhad • Sabah Bank Berhad • Sabah Finance Berhad • Bolton Finance Berhad • Amanah Merchant Bank Berhad • Bumiputra Merchant Bankers Berhad 	<ul style="list-style-type: none"> • Alliance Bank Berhad • Alliance Finance Berhad • Alliance Merchant Bank Berhad
Arab-Malaysian Bank Berhad Group <ul style="list-style-type: none"> • Arab-Malaysian Bank Berhad • Arab-Malaysian Finance Berhad • Arab-Malaysian Merchant Bank Berhad 	<ul style="list-style-type: none"> • MBF Finance Berhad 	<ul style="list-style-type: none"> • Arab-Malaysian Bank Berhad • Arab-Malaysian Finance Berhad • Arab-Malaysian Merchant Bank Berhad
Bumiputra Commerce Bank Berhad Group <ul style="list-style-type: none"> • Bumiputra Commerce Bank Berhad • Bumiputra Commerce Finance Berhad • Commerce International Merchant Bankers Bhd 		
Eon Bank Berhad Group <ul style="list-style-type: none"> • Eon Bank Berhad • Eon Finance Berhad 	<ul style="list-style-type: none"> • Oriental Bank Berhad • Eon Finance Berhad • Perkasa Finance Berhad • Malaysian International Merchant Bankers Berhad 	<ul style="list-style-type: none"> • Eon Bank Berhad • Eon Finance Berhad • Malaysian International Merchant Bankers Berhad

Current Trends and Practices in the Malaysian Financial Services Industry

<p>Hong Leong Bank Berhad Group</p> <ul style="list-style-type: none"> • Hong Leong Bank Berhad • Hong Leong Finance Berhad 	<ul style="list-style-type: none"> • Wah Tat Bank Berhad • Credit Corporation (Malaysia) Berhad 	<ul style="list-style-type: none"> • Hong Leong Bank Berhad • Hong Leong Finance Berhad
<p>Malayan Banking Berhad Group</p> <ul style="list-style-type: none"> • Malayan Banking Berhad • Mayban Finance Berhad • Aseambankers Malaysia Berhad 	<ul style="list-style-type: none"> • The Pacific Bank Berhad • PhileoAllied Bank (M) Berhad • Sime Finance Berhad • Kewangan Bersatu Berhad 	<ul style="list-style-type: none"> • Malayan Banking Berhad • Mayban Finance Berhad • Aseambankers Malaysia Berhad
<p>Public Bank Berhad Group</p> <ul style="list-style-type: none"> • Public Bank Berhad • Public Finance Berhad 	<ul style="list-style-type: none"> • Hock Hua Bank Berhad • Advance Finance Berhad • Sime Merchant Bankers Berhad 	<ul style="list-style-type: none"> • Public Bank Berhad • Public Finance Berhad • Public Merchant Bank Berhad
<p>RHB Bank Berhad Group</p> <ul style="list-style-type: none"> • RHB Bank Berhad • RHB Sakura Merchant Bankers Bhd 	<ul style="list-style-type: none"> • Delta Finance Berhad • Interfinance Berhad 	<ul style="list-style-type: none"> • RHB Bank Berhad • RHB Sakura Merchant Bankers Bhd • RHB Delta Finance Berhad
<p>Southern Bank Berhad Group</p> <ul style="list-style-type: none"> • Southern Bank Berhad 	<ul style="list-style-type: none"> • Ban Hin Lee Bank Berhad • Cempaka Finance Bhd. • United Merchant Finance Berhad • Perdana Finance Bhd • Perdana Merchant Bankers Bhd 	<ul style="list-style-type: none"> • Southern Bank Berhad • Southern Finance Berhad • Southern Investment Bank Berhad

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CHAPTER 7

PHILIPPINES: BANKING INDUSTRY MERGERS

Maria Victoria R. Castillo

Head, Service Excellence

*Rizal Commercial Banking Corporation
Philippines*

INTRODUCTION

The financial systems in developed and developing countries have typically been subject to substantial regulation. The basic rationale for this is that both the payments system, and public confidence in financial institutions and instruments on which the financial system is based, bear the qualities of a public good, hence the need for some government intervention to achieve market-enhancing outcomes. Two main reasons for regulating banks are:

- Regulation provides protection against the risk that failure of one bank might lead to failure of other banks, which would lead to financial instability and overall economic disruption, and
- The asymmetry of information between the depositor and the bank means that a retail depositor does not have the capacity to assess the soundness of an individual institution, thus the necessity of providing some protection to depositors.

Entry into the banking sector is one area that continues to be regulated even in the most liberalized or deregulated financial systems. Controls on entry in the form of authorization criteria include minimum capital requirements, and fitness and properness criteria for controllers and managers of banks. Free-banking, or the removal of entry and other restrictions without accompanying prudential regulations, is not deemed as tenable because it could lead to over-competition and excessive risk-taking, and thus compromise the stability and soundness of the banking system.

In the Philippines government policy on domestic bank entry was initially lax in the 1950s and early 1960s, as the Central Bank of the Philippines actively promoted the development of the banking system to finance the reconstruction of the economy after the war. In the mid-1960s the rapid expansion of the banking system led to increased instability. Consequently, the CBP became increasingly concerned over the large number of small banks, and decided to raise minimum capital requirements that essentially prohibited bank entry.

The first attempt to reform its financial system occurred in the early 1970s. Among the measures introduced was a formal moratorium on new bank entry, coupled with a more favorable policy towards branching. Minimum capital requirements were again raised because authorities believed that bigger banks would lead to a more stable banking system. To meet the new requirement, mergers and acquisitions were especially encouraged to further reduce the number and increase the average size of commercial banks.

The Philippines formally embarked on a financial liberalization program in the early 1980s, which included the deregulation of interest rates. However, it was noted that interest rate liberalization did not enhance competition due to the monetary authority's belief that there were not too many banks in the Philippines. The moratorium on foreign banks, which had been in place since the CBP was first established in 1949, was lifted in May 1994 with the passing of RA 7721. This law partially liberalized the entry and scope of operations in the Philippines through one of the following modes of entry:

- Acquire, purchase or own up to 60% of an existing domestic bank.
- Invest in up to 60% of the voting stock of a new banking subsidiary incorporated in the Philippines.
- Establish a branch with a full banking authority

The Asian financial crisis (July 1997) led to systematic failures of financial institutions in Thailand, Indonesia, and South Korea. Only one fairly small and newly upgraded commercial bank failed in the Philippines, although the overall performance of the banking sector took a turn for the worse in the aftermath of the Asian crisis. The Bangko Sentral ng Pilipinas (BSP), formerly

known as Central Bank of the Philippines (CBP), mandated consecutive increases in banks' minimum capital requirements, and declared an indefinite moratorium on the establishment of new banks and branch expansion of existing banks. The new General Banking Law of 2000 (RA 8791) formalized the moratorium of new bank entry by stipulating that no new commercial bank shall be established within 3 years from the effectivity of the act. RA 8791 expanded the coverage of RA 7721 by allowing foreign banks to acquire up to 100% voting stock in one bank. These policies continued to reflect the monetary authority's preference for and strategy of forcing mergers and acquisitions to reduce the number and increase the average size of banks in the Philippines. Consolidation was expected to result in a stronger and more stable banking system.

The monetary board approved the issuance of rules and regulations on mergers and consolidations on 19 April 2000. This was done to foster healthy competition between and among banks, bring about more and better financial services at lower cost, and promote stability and efficiency in the Philippines banking sector. The BSP allowed banks to enter into joint venture agreements with real estate development companies.

METRO BANK & TRUST COMPANY

Metropolitan Bank and Trust Company (Metrobank) was established by a group of businessmen on 5 September 1962 at the Wellington Building in Binondo, Manila. At the onset of the 1970s, Metrobank opened its first international branch in Taipei. The Central Bank, in April 1977, authorized Metrobank to operate a Foreign Currency Deposit Unit (FCDU). In the same year, branches and offices totaled 100 and the bank inaugurated its new head office at Metrobank Plaza in Makati. On 21 August 1981, the Central Bank authorized Metrobank to operate as a universal bank. Following this, it entered the following ventures: the acquisition of majority ownership of Philippine Savings Bank (the second-largest savings bank in the country at that time); the establishment of a joint travel agency venture with Thomas Cook Group in Thomas Cook Phils., Inc. in 1986; and the tying-up with Toyota Motor Corporation of Japan and Mitsui to put up Toyota Motor Philippines in 1988. Metrobank

subsequently entered into joint ventures with several renowned corporations like Sumitomo Bank of Japan to create Sumigin Metro Investment Corporation; the National Mutual Holdings Ltd. of Australia to create Philippine AXA Life Insurance Corporation; and the ORIX Leasing and Finance Corporation of Japan to create ORIX Metro Leasing and Finance Corporation. In September 1982, the number of Metrobank branches, offices and subsidiaries surpassed the 200 mark. A year later, Metrobank topped all the private domestic banks, with total resources of P8.8 billion.

The bank continued to experience steady growth through the years. In September 1989, it increased its authorized capital stock from P2 billion to P5 billion. The bank's total capital funds on June 30, 2006 stood at P57.3 billion. Its consolidated resources amounted to P588 billion as of the same period. As of December 2006, its total assets reached P642 billion.

Metrobank's subsidiaries are Toyota Motor Philippines Corporation, Philippine Savings Bank, First Metro Investment Corporation, Metrobank Card Corporation, ORIX Metro Leasing and Finance Corporation, SMBC Metro Investment Corporation, First Metro Travelex (formerly Thomas Cook (Phils.)), Philippine AXA Life Insurance Corporation, Mirant Global Corporation, Philippine Charter Insurance Corporation, MBTC Technology, Inc., Toyota Financial Services Corporation, Toyota Cubao, Inc., Toyota Manila Bay Corporation, First Metro Securities Corporation, First Metro International Investment Co. Ltd., Metropolitan Bank (Bahamas) Ltd., MB Remittance Center Inc. (U.S.), Metro Remittance Singapore, Metro Remittance UK Limited, Metro Remittance (Italia) SpA, Metro Remittance S.A. (Spain), and MBTC Exchange Services GmbH (Austria).

Metrobank, as the largest Philippine bank, is always trying to stave off competition to stay as the country's largest bank. Its main competitor is Bank of the Philippine Islands, but other major competitors include Equitable PCI Bank, Land Bank of the Philippines, and Philippine National Bank.

BANK OF THE PHILIPPINE ISLANDS

BPI is the oldest bank in the Philippines with a distinguished history that spans over a century. It was established on 1 August, 1851 as the Banco Español-Filipino de Isabel II, the first time when the Philippine peso was printed as *pesos Fuertes*. On 1 January 1912, its name was changed to BPI (Banco de las Islas Filipinas). BPI maintained a leadership position in consumer banking and asset management, corporate finance and bank assurance. BPI's main competitors include Banco de Oro-EPCI, Inc., LBP and PNB. BPI received a multitude of awards, which simply means that they offered different levels of services based on the needs of the potential of BPI's clients. They were first among other banking institutions, established the first ATM system, pioneered the concepts of the banking kiosk in the Philippines, made use of call center and telephone banking, launched BPI Express Credit Gold MasterCard with Paysafe System, and was the first local bank that was offered the most number of third currencies in its products and services.

Upon approval by the central bank, it merged with DBS, encouraging the development of a larger financial institution.

PHILIPPINE NATIONAL BANK

The Philippine National Bank was established as a government-owned banking institution on 22 July 1916 with headquarters in the old Masonic Temple along Escolta, Manila. Its primary mandate was to provide financial services to Philippine industry and agriculture and support the government's economic development effort. It replaced the small P1 million government-owned Agricultural Bank.

With PNB's establishment, Filipinos found a bank of their own, and Filipino farmers could access loans with interest between 8 to 10% per annum. PNB was also authorized to receive deposits, open foreign credits, and rediscount bills. As a government bank, it had also assumed the functions of the central bank until 1949, when the Central Bank was established; upon this, its role as issuer of currency notes, custodianship of bank reserves, sole depository of government funds, and clearing house of the banking system ceased.

In 1980, PNB became the first universal bank in the country. However, it encountered operational difficulties in the mid-1980s as a result of the economic downturn triggered by the assassination of Senator Benigno S. Aquino, Jr., and had to be assisted by the government in 1986. One solution was to privatize the bank.

Privatization started when 30% of its outstanding stock was offered to the public and the bank was listed on the stock exchange in 1989. In 1992, PNB became the first Philippine bank to reach the P100 billion mark in assets. Later that year, a second public offering of its shares was issued to continue its privatization. In 1995, the bank moved to its new headquarters at the PNB Financial Center in Roxas Boulevard, Pasay City. In 1996, the Securities and Exchange Commission approved the bank's new articles of incorporation and by-laws and the change in the status of PNB from a government-based to a private corporation, with the control of the government reduced to 46%.

In early 2000, the Lucio Tan Group became the single biggest private stockholder. The group pumped in nearly P20 billion fresh capital in less than one year – the largest capital build-up to date in the country. This was done to emphasize the commitment of the new stockholders' group to the improvement of the bank's financial condition, which had been incurring losses in operations. In late 2000, when the bank suffered huge withdrawals mainly from the government accounts, the government provided financial assistance of P25 billion. In May 2002, the government and the Lucio Tan Group sealed a Memorandum of Agreement (MOA) that embodied the provisions that helped turn the bank around. It included, among others, the settlement of the government's liquidity assistance by way of increasing the government's stake in the bank from 16.6% to 45% making it equal to the Lucio Tan Group's 45% from 68%. By 2004 PNB was able to get back its momentum towards full rehabilitation. In August 2005, PNB became fully privatized.

BANCO DE ORO – EQUITABLE PCI BANK MERGER¹

The acquisition of Equitable PCI is one of the acquisitions that Banco de Oro (BDO) has been involved with over the last five years. In 2001, it successfully acquired the Philippine subsidiary of Dao Heng Bank, adding on some 12 branches to its branch network. The next year, it acquired the branches of First e-Bank, then owned by First Pacific, the majority shareholder in the Philippine Long Distance Telephone Company. A year later, it acquired the Philippine subsidiary of Banco Santander Central Hispano.

Later on, in April 2005, BDO acquired 66 of the 67 branches of the Philippine subsidiary of United Overseas Bank, after UOB announced the conversion of its operations from retail banking to wholesale banking. BDO's wave of acquisitions has earned it the distinction of being the most aggressive bank in terms of mergers and acquisitions.

However, this title had belonged to Equitable PCI Bank in the 1990s, when its predecessor, Equitable Bank, went on to buy banks such as Mindanao Development Bank and Ecology Bank in the mid-1990s. In 1999, Equitable completed arguably one of the largest bank mergers in Philippine banking history: the merger with the larger Philippine Commercial International Bank, or PCI Bank. The deal sparked the first wave of mergers and acquisitions.

Merger History

The intention of BDO to acquire Equitable PCI was known from January 2004, when BDO tried to acquire the 29% share of the Social Security System (SSS) in Equitable PCI for eight billion pesos. However, a group that included politicians and pension holders managed to get this deal suspended when it questioned the price and terms of the deal.

In August 2005, BDO and SM Investments Corporation, another member of the SM Group, acquired 24.76% of Equitable PCI shares from the Go family, the family that founded Equitable PCI. The acquisition finally settled a dispute between the Gos and a bigger bloc representing the SSS, the Government Service Insurance System (GSIS) and the family of Equitable PCI

¹The details of this are as at June 2007 when the paper was written.

chairman Ferdinand Romualdez, a relative of Imelda Marcos. The SM Group's acquisition of the Go shares increased its stake to 27.26%. It had a 2.5% stake before the acquisition.

During that time, the SM Group hoped that the Supreme Court would have settled with finality the issue over the acquisition of the 29% stake of the SSS. The GSIS and chairman Romualdez both staunchly opposed to the deal. The GSIS would only agree to the acquisition of its shares if its shares were to be bought at 92 pesos per share, the price at which the GSIS originally bought it for, or higher. The SSS deal called for acquisition of its shares for P43.50 per share. However, the SM Group stated that it was amenable to a renegotiation of the share price, saying that it was willing to pay more for the SSS stake.

Subsequent acquisitions of common shares on the Philippine Stock Exchange boosted the stake of the SM Group to 34% by January 2006, making it the single largest shareholder in the bank.

In January 2006, BDO offered to buy the rest of Equitable PCI for 41.3 billion pesos through a share swap option, with BDO as the surviving entity. Under the deal, each Equitable PCI share was to be swapped for 1.6 BDO shares or, in a second option, an independent accounting company was to determine the swap ratio on the book values of both banks under international accounting standards. If approved by two-thirds of Equitable PCI shareholders, this merger of equals would have created the second-largest bank in the Philippines, putting BDO, the survivor of the merger, just below Metrobank but dislodging Bank of the Philippine Islands from the spot. If the deal were approved by the Equitable PCI board, all stakes would have been diluted as the SM Group's stake increased.

However, the GSIS and Romualdez opposed the deal. In fact, a counterproposal was considered by Romualdez in which instead of an acquisition, a merger was proposed, but with Equitable PCI as the surviving entity, rather than BDO.

Standard and Poors stated that if the merger deal succeeded, Equitable PCI's debt rating could have risen, while BDO's ratings would have remained unchanged. Equitable PCI's debt rating then was a B, five notches below investment grade. BDO had a B+ rating.

UBS claimed that Equitable PCI shareholders should have found the deal attractive. It hailed the deal as a win-win situation for both banks. It also claimed that under the timeframe, the merger would have also benefited Equitable PCI since it would have increased its capital adequacy ratio (CAR) without having to raise more capital, making the deal timely under IAS. It also claimed that the share price of Equitable PCI would have increased to as much as P73.60 under the deal, more than the fair value target price of 67 pesos.

If the merger took place, BDO would have moved up into large capitalized company status, defined as a company whose capital stands at a minimum of USD700 million. The merger of both banks would have resulted in the merged company having a market capitalization of two billion dollars. Aside from that, it would also have had to consolidate the large Equitable PCI branch and ATM network under the Banco de Oro banner. This would have created a bank with 685 branches and a wide-reaching ATM network.

Problems with transition could mostly result with the conversion of ATMs. Equitable PCI Fastellers were linked to MegaLink while Banco de Oro Smartellers were linked to Expressnet also, Equitable PCI ATM cards were linked to Visa Electron and/or PLU.S. while Banco de Oro ATM cards were either local or, in the case of the new BDO International ATM Card, linked to MasterCard (branded as MasterCard Electronic), Maestro, and Cirrus. Branch transition and consolidation usually run smoothly, as exemplified by the consolidation of the branches of United Overseas Bank under the Banco de Oro banner.

They're the drunken buyer!

In a turn of events, the Government Services Insurance System (GSIS), a government-owned company, offered to buy the 34% SM Group stake from it at P79.50 per share in cash, earning BDO and the SM Group some eight billion pesos. It is unknown whether BDO, the SM Group, or the SM board members of Equitable PCI Bank agreed, although it is believed that GSIS chairman, Garcia, was trying to turn the tables on Teresita Sy. If the deal succeeded, it could have thwarted any chance of a merger. However, this deal was dogged with allegations that

Garcia was merely hyping the market, causing a rise in the value of Equitable PCI shares, which were then valued at above 80 pesos (as at 24 March 2006).

Interestingly, the Securities and Exchange Commission demanded that Garcia release the identity of the mystery buyer of the GSIS stake in Equitable PCI. The *Philippine Daily Inquirer* (25 April 2006) revealed that the “drunken buyer” was indeed BDO. The term drunken was used because it was believed at the time that Garcia’s claim was merely market hype and that no one would be crazy enough to buy an Equitable PCI share for the price Garcia was asking for, which was 95 pesos, payable in cash. This media report was based on an e-mail that Garcia claimed was sent to him by BDO president Tan, which claimed that Tan and Tessie Sy had at least two secret meetings on the merger in Hong Kong.

The Philippine president also chipped in; in May 2006, President Gloria Macapagal-Arroyo stated that she would support the current stance of the SSS in avoiding any sale negotiations regarding its stake in Equitable PCI until all underlying disputes at the Supreme Court were resolved. As of 24 May 2006, therefore, the merger was put on hold.

The GSIS signed a sale agreement worth 8.7 billion pesos with SM Investments Corporation on 27 September 2006, giving the SM group an additional 12.7% stake in Equitable PCI, raising its stake to 46.7% from 34%. The SSS also pledged to sell its shares in Equitable PCI. This increased SM’s stake to 85.6%, well above the 67% needed to effect a merger with BDO.

In anticipation of the merger, ATR Kim Eng Securities, one of the largest investment houses in the Philippines, raised the target price of BDO stock by 25% to 50 pesos within 12 months (on 9 October 2006). The same investment house also said that if the merger succeeded with BDO as the surviving entity, it would catapult the bank’s stock to blue chip status, as well as possibly lead the Philippine banking industry with a 23% growth in earnings per share in 2007.

On 6 November 2006, the respective boards of BDO and Equitable PCI Bank agreed to the merger of both banks through a modified stock swap deal. Instead of the original 1.6 shares BDO would swap for, it would swap 1.8 shares for every

Equitable PCI share. At BDO's closing price of P44.50 as of that day, the deal was valued at about P80.10 for every share, well above Equitable PCI's closing price then of P72.50. The deal was approved not only by their respective boards of directors, but also by the Securities and Exchange Commission. On December 27, 2006, BDO shareholders approved the merger with Equitable PCI Bank. Equitable PCI Bank shareholders also approved the merger the same day. In order for the merger to take effect, approval from both the Bangko Sentral and the Securities and Exchange Commission was required, which was obtained in early 2007. The physical merger of both banks began before the end of the first half of 2007. Regulatory approval from the Bangko Sentral was granted on 25 April 2007.

At present, BDO and Equitable PCI Bank cardholders (ATM and debit cards) may access each other's ATM networks free of charge. ATM cardholders from both banks can avail of each other's withdrawal, balance inquiry, and cash advance services free of charge. This effectively increases BDO's ATM network to 1,200 ATMs nationwide. BDO and Equitable PCI Bank have also similarly synchronized their home and automobile loan products.

On 31 May 2007, trading of BDO and Equitable PCI Bank shares were suspended, and Equitable PCI Bank de-listed from the PSE in June 2007. The 727 million shares of Equitable PCI Bank were de-listed in the process, with 1.3 billion BDO shares, each having a par value of ten pesos, listed to cover the merger.

CONCLUSION

The BDO-Equitable PCI merger is only one part of the second wave of mergers and acquisitions in the Philippine banking industry, the first one being in the 1990s. Notable acquisitions in the second wave include Citibank's acquisition of Insular Savings Bank and BPI's acquisition of Prudential Bank, as well as the acquisition of International Exchange Bank by Union Bank of the Philippines, and more recently, the acquisition of Philippine Bank of Communications from Philtrust Bank.

The merger was part of a campaign on the part of the central bank, in a complete reversal of stance from the 1990s, to

consolidate the banks. During the term of central bank Governor Gabriel Singson, it urged the creation of more banks, encouraging competition. However, the Asian financial crisis eventually forced the central bank, then under Rafael Buenaventura, to opt for the creation of more financially stable banks, putting in motion the first wave of mergers and acquisitions. The current governor, Amando Tetangco, has maintained the stance of Governor Buenaventura.

Consolidation is now ongoing. Other target banks could include smaller players such as United Coconut Planters Bank, Union Bank of the Philippines, and Allied Bank. Some banks are considering the use of the strategy to maintain their places, most apparent with Metrobank, which is trying to fend off competition to stay as the Philippines' biggest bank.

Analysts who are monitoring the Banco de Oro-Equitable PCI merger are foreseeing the possibility of a three-way merger between Banco de Oro, Equitable PCI Bank, and Chinabank, another SM-controlled bank and the tenth-largest bank in the Philippines. If a three-way merger does push through, it could ultimately create the largest Philippine bank, dislodging Metrobank. BDO's public stand, however, is that it has no intention to include Chinabank in the BDO-Equitable PCI merger deal, saying that its stake in Chinabank is but an investment. It also claims that Chinabank is better off independent rather than under Banco de Oro, specializing in its own field of expertise.

A final word of caution to the central bank's position is, however, needed. The consolidations could trigger a wave of mergers and acquisitions that could result in an oligopoly structure in the industry, with only few competitors. This would create problems of its own for the Philippine economy and society.

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CHAPTER 8

MERGERS AND ACQUISITIONS IN THAILAND

Pravit Khaemasunun

*Lecturer, Assumption University
Thailand*

Pirinee Pringsulaka

*Finance Manager and Head of
Financial Planning and Project Acquisitions
Central Pattana Public Company Ltd.
Thailand*

STATUTORY REQUIREMENTS FOR M&AS

Takeover activities in Thailand are governed by the provisions of the Securities and Exchange Act (the SEC Act) B.E. 2535 and the Public Limited Company Act (PCA) B.E. 2535. A company takeover is realized through share acquisition, merger, or asset acquisition. The law requires that a proposal for merger or acquisition or disposal of material assets of a company be submitted to the shareholders' meeting for consideration. Notice of the meeting must be sent to the shareholders at least seven days before the meeting for all companies except for those that are listed on the stock exchange, which requires 14 days prior notice. The notice must contain reasonable details about the proposal to be considered in the meeting. To succeed, a resolution on such proposals must receive not less than three-quarters of the total number of votes from the shareholders who attend the meeting and have the right to vote (a super-majority vote). In a merger transaction, the PCA also requires the company to make a buy-out arrangement for any dissenting shareholders at a price not less than the last traded price prior to the date the resolution on the merger is passed.

With respect to takeover and change of control, the takeover sections of the SEC Act provide shareholders with adequate information and fair treatment. The rules aim to provide information for investors regarding the change of holding of major shareholders. A person acquiring or disposing of shares, share warrants, or convertible securities which can be converted into shares of companies having their securities listed

on the SET or the Market for Alternative Investment (MAI), or of a public limited company, must file an acquisition or disposition report to the SEC within the next business day when such acquisition or disposition causes the aggregate holding of the same type of security to reach or pass a multiple of 5% of the total number of the issued securities of the business.

Share transactions must be reported each time an acquisition or disposal of securities causes the aggregate holding of the shares to reach or pass a multiple of 5% of the total number of the issued shares of the business.

Each time the acquisition of convertible securities (warrants, convertible debentures) should be reported if it causes the aggregate holding of shares exclusively derived from conversion to reach or pass a multiple of 5% of the total number of the shares of a business sold. The report on disposal of any convertible securities is exempted.

Under section 258 of the SEC Act B.E., persons who acquire or dispose of securities are required to count securities held by persons of the same group, in accordance with section 258. In submitting their report to the SEC, persons who voluntarily belong to the same group as other persons must include the securities holdings of each person in the group and related parties in accordance with section 258.

To provide a balance between shareholder protection, in the event of a change of control of a business requiring the successful bidder to create an equally fair exit for all shareholders, and business efficiency following a takeover, such that the executives can run the business more efficiently, the rules require that any person acquiring shares in order to take over control of the business must make a tender offer which provides a fair exit for all shareholders. In making a tender offer, all security holders must be treated equally, all information must be correct and complete, and all security holders must be given enough time to decide. The law describes the types of tender offers, and other rules relating to the tender offers.

The offeror must make a preliminary purchase report within the next business day following the end of the withdrawing period. If there is no specified final withdrawal date, the report must be submitted three business days before the final offer date. The offeror must make a final purchase report within five

business days following the final offer date. Within six months following the tender offer, the offeror must not acquire any security of the business at a higher price or with better terms than those in the tender offer. Within a year after the tender offer, the offeror must not do anything which deviates significantly from the terms specified in the tender offer statement unless approval has been granted at a meeting of shareholders with voting not less than three-fourths of the total votes of shareholders present at the meeting and having the right to vote, and the SEC having been notified accordingly.

The legislation also carries the obligations where takeovers are through the chain principle.

Over time, business takeover requirements have evolved and become more complex. In determining each case, there has been an increasing demand for quality expertise of regulators as their judgment becomes crucial in the process. The SEC has resolved to set up a Takeover Panel to determine business takeover cases. The panel consists of experts and practitioners in business takeover selected from persons in the SEC appointed list.

TREND AND CASE STUDIES

Between 2001 and 2007, there were 174 tender offers and 192 exemptions from tender offers. Firms make tender offers in order to acquire, to form a strategic partner, or to de-list the company out of the Stock Exchange of Thailand (SET). At the moment, SET has about 540 listed companies, indicating significant activity.

Three-Way Merger of Thai Military Bank, DBS Thai Danu Bank, and Industrial Finance Corporation of Thailand¹

Before the three-way merger, the Thai Military Bank Public Company Limited (TMB), was a Thai local bank offering a broad product range with domestic market expertise, strong depositor base, extensive retail distribution platform, and competitive strength in serving SME and consumer customers. The second company in those merging was the DBS Thai Danu Bank Public Company Limited (DTDB). This bank provided a comprehensive range of commercial banking products and services with strengths in unique Bangkok-focused customer base and distribution network, high quality SME and consumer oriented franchise, and strong credit culture. The DTDB also enjoyed strong support from its parent, PBS Bank Limited (PBS), which is one of the largest financial services groups in Asia. DTDB had benefited from the transfer and sharing of expertise and technology from PBS. The third organization, the Industrial Finance Corporation of Thailand (IFCT) was a specialized financial institution set up to provide financial support and other services for the private industrial enterprises for the economic and industrial development as well as to assist in capital market development. IFCT had strong product expertise in project and industrial finance and unique, high quality established corporate and SME customer relationships.

The merger among TMB, P1DB, and IFCT created TMB. The TMB became the fifth-largest banking group in Thailand by asset size (THB700 billion). The reasons for the merger included:

- *Increase scale, customer base, and competitive strengths:* The merged bank had a customer base of 4 million and a nation-wide distribution network of 462 branches and 963 ATMs.

¹ This section relies on information from:

- a. Opinion of the Business Regarding the Tender Offer to Securities Holders of DBS Thai Danu Bank Public Company Limited dated 7 June 2004, DBS Thai Danu Bank Public Company Ltd.
- b. Opinion of the Business Regarding the Tender Offer to Securities Holders of the Industrial Finance Corporation of Thailand dated 20 May 2004, Industrial Finance Corporation of Thailand.
- c. DBS Bank news release dated 8 March 2004.

- *The merged bank was well positioned to compete as a universal bank within the Financial Sector Master Plan, offering a full scale of financial services:* With services from all merged companies, there was strong potential that the new TMB bank would emerge as a strong and financially stable universal bank.
- *Substantial revenue enhancement and cost synergies:* The merger enabled the new bank to compete with the top-tier banks as it benefited from economies of scale and lower operating costs. Overall, the merged bank was expected to be able to expand its revenues through higher interest and fee incomes, the offering of new financial products, and reduction of operating costs from eliminating redundant units in their respective head offices and sharing IT expenses. Savings were also expected from replacing IFCT's high cost of funds with lower cost of funds from deposits, as IFCT was not allowed to take deposits from the public.
- *Partnership with DBS as strategic shareholder:* The merged bank would be supported by PBS under a Technical Service Agreement. Having DBS as a business partner ensured the transfer of expertise and management of modern banking to the new bank and enhance its competitive strengths for consumer finance, SMEs, and corporate clients.
- *Leverage of IFCT's established corporate and SME relationships:* The merger benefited from the IFCT's expertise in industrial finance and project finance, together with the clients, the large, medium, and small enterprises.
- *Enhance returns to shareholders:* The completion of the merger transaction was expected to result in increase in TMB's book value per share and an increase in earnings per share.

Amalgamation of National Petrochemical Public Co. Ltd and Thai Olefins Public Co. Ltd²

The National Petrochemical Public Company Limited (NPC) was in the business of manufacturing and sale of ethylene and propylene, and high density polyethylene (HDPE), with secondary businesses of production and sale of utilities (electricity, water, steam, and other utilities) and related services such as jetty and buffer tanks for liquid chemicals, oil, and gas products. The Thai Olefins Public Company Limited (TOC) was engaged in the business of manufacture and sale of olefins and other olefins products including pyrolysis gasoline, mixed C4, tail gas, cracker bottom, and hydrogen.

The petrochemical business is one of the core businesses that Public Company Limited (PTT), the major shareholder of these two companies, emphasized. It aimed to expand further in the future. PTT is an energy company operating a fully integrated oil and gas business, which encompasses gas-based petrochemical and total energy services. Before the merger, PIT managed its petrochemicals businesses through various subsidiaries and affiliates, such as olefins business through NPC and TOC, olefins derivative such as HDPE through investments in NPC, Bangkok Polyethylene Public Company Limited (BPE), and PIT Polyethylene Company Limited (PTTPE). Additionally, several subsidiaries and affiliates had also invested in other derivative petrochemical products.

An assessment of the shareholding structure before the merger revealed that the complex structure created internal competition amongst companies within the same PTT group, as well as limited cooperation in strategic planning, which might result in overlapping investments in similar businesses.

To solve the problem of the complicated structure of the petrochemicals business in the PTT group, PTT created a flagship company to operate further investments in the gas-based olefins and olefins derivatives businesses. The amalgamation of NPC and TOC resulted in a new entity, PTT Chemical Public

² Sources of information and date for this transaction are: Information Circular on the Amalgamation Between National Petrochemical Public Company Limited and Thai Olefins Public Company Limited presented to Shareholders of National Petrochemical Public Company Limited dated 12 July 2005.

Company Limited (PTTCH), which combines experience and expertise in olefins and derivatives businesses, making PTTCH as the appropriate choice to spearhead the petrochemical business in the olefins chain, including the operation of olefins downstream businesses of the PTT group.

Additionally, PTT has considered using PTTCHI to hold and manage its other subsidiaries in the olefins business in the long run, including PTTPE and BPE, as well as to make overseas investments. In the long run, PIT intends to hold less than 50% in PTTCH.

The expected benefits from amalgamation were as follows:

- *Provide clarity of business direction:* Based on PTT's strategic plan to use PTTCH as its gas-based olefins flagship and the operator of olefins derivatives businesses, the amalgamation would provide PTTCH with a clear direction for its expansion plans and business growth, with no duplication of efforts or competition in investments as has happened in the past. PTTCH would move in a coordinated direction to maximize shareholders' benefit.
- *Reduce business risks through improved scope and diversified operations:* After amalgamation, PTTCH was expected to become a more integrated petrochemical company with olefins production as well as a more diverse base of olefins derivatives production such as polyethylene (PE) and its derivative products, ethylene oxide (EO) and its derivative products, and ethylene glycol (EG). These diverse base of products would, in addition to adding value to the olefins business, help diversify PTTCH business risks, since each downstream petrochemical products' business cycle differs from the upstream petrochemical products' business cycle.
- *Increase production efficiency and reduce operating costs in the long run:* Joint strategic planning would enable resources to be utilized most efficiently. For example, optimizing allocation of limited supply of ethane and LPG from PTT to best suit the production configuration of each plant; the use of ethane tanks may be modified to improve production and decrease wastage; sharing of some common spare parts of the

plants; and modified use of by-products to create additional value. Moreover, human resources planning could be made more efficient through the pooling and optimum use of skills and knowledge of the existing employees. PTTCH could also institute certain policies, including limited new hiring, reorganization and exchange of employees in some departments, as well as the redeployment of personnel to upcoming future projects. Such measures were expected to reduce long-term operating costs and increase PTTCH's competitiveness in the international arena.

- *Stronger financial position:* The merged company would have a stronger financial position, with an asset size of approximately THB67.9 billion, and earnings before interest, tax and depreciation and amortization (EBITDA) of about THB15.0 billion. At the total liabilities to equity ratio of approximately 0.4 times, and the interest coverage ratio of approximately 28 times PTTCH would have sufficient ability to take on more debt to finance future investments.
- *Increase market capitalization:* PTTCH was expected to have a larger market capitalization and would rank 10th in the stock exchange in terms of market capitalization, with a market capitalization in excess of THB82 billion based on the closing share prices of NPC and TOC as of July 12, 2005. The enlarged market capitalization would increase the profile of PTTCH among both domestic and international investors.

Transaction Details

The merger was done by way of amalgamation in accordance with the Public Company Act BE. 2535 (PCL Act). Under the PCL Act, the transaction does not constitute a share sale or an asset sale by any of NPC and TOC or their shareholders; the amalgamation did not result in any capital gain, and, therefore, created no additional income tax liabilities for NPC, TOC, or their shareholders.

Existing shareholders of NPC were allocated PTTCH shares at the ratio of 1 NPC share per 1.569785330 PITCH share.

Existing shareholders of TOC were allocated PTTCH shares at the ratio of 1 TOC share per 0.784892665 PTTCH share.

After NPC sold all of the TOC shares it held before the amalgamation to PTT, the resulting shareholding structure in PTTCH was as follow:

Shareholder	Shareholding*
PTT Public Company Limited	44.83%
Siam Cement Public Company Limited	18.16%
HMC Polymers Company Limited	2.82%
Thai Petrochemical Industry Public Company Limited	2.02%
Oman Oil Company S.A.O.C.	1.74%
Bangkok Synthetics Company Limited	1.47%
Thai Plastic and Chemicals Public Company Limited	1.08%
Siam Styrene Monomer Company Limited	0.74%
Financial and other investors	27.14%

*Calculated from shareholding of NPC as of 23 June 2005 and shareholding of TOC as of 16 May 2005. PTTCH was registered on 7 December 2005.

Acquisition of EGV by Major Cineplex

Major Cineplex Group Public Company Limited is Thailand's largest cinema chain operator. Major Cineplex was founded by Vicha Poolvaraluck in 1996. The movie complexes offer a range of entertainment services, including movies, bowling, karaoke as well as restaurants and shops.

Entertainment Golden Villages (EGV) was established in 1993 by Vichai Poolvaraluck's Entertainment Theaters Networks as a joint venture with Hong Kong's Golden Harvest and Australia's Village Roadshow (which formed Golden Village). EGV was the first cineplex operator in Thailand. In 2000, Village Roadshow took over Golden Harvest's stake. In 2002, Vichai bought out Village Roadshow's 50% interest.

In 2004, Major Cineplex acquired EGV and EGV was delisted from the Stock Exchange of Thailand but its cinemas have continued to operate under the EGV banner.

Merger Rationales³

The following were cited as the reasons for the merger:

- *To strengthen the cinema business:* The merger would result in an enhanced client base and market share. This would enable Major Cineplex to be the operator of cinema business with the largest and the most comprehensive network in Thailand.
- *To increase flexibility of management:* Major Cineplex would have more management flexibility including the management of showtime and the showtime period of each movie for each branch in a manner that better responds to the demand of the target group. The effective management of showtime would contribute to improved operating results.
- *To enhance the efficiency of cost and expenditure management:* The merger would combine the strong points of running the business of both Major Cineplex and EGV, leading to enhanced efficiency in managing cost and expenditure by reducing overlap of work particularly in respect of marketing costs. Major Cineplex aimed to ensure efficient human resources management rather than adopt a policy of reducing manpower.

Transaction Details

Major Cineplex acquired all EGV shares by issuing 120 million new Major Cineplex shares to swap for EGV shares. The swap ratio comprised 2.27426 EGV shares for each new share of Major Cineplex and 11.44905 units of EGV warrants for one new Major Cineplex share.

³ Sources from: The Opinion of Tender Offer to EOV Securities Holders dated 13 September 2004, EGV Entertainment Public Company Limited.

Grammy's Takeover Attempt on Matichon

In September 2005, GMM Media Company Limited, a subsidiary of GMM Grammy Group, which is the largest entertainment conglomerate in Thailand, announced its intention to take over Matichon Public Company Limited (the publisher of five daily newspapers) and Post Publishing Public Co. Ltd (the publisher of the widely respected English newspaper *Bangkok Post*). GMM Media proceeded to acquire a 32.13% share in Matichon and 23.6% share in Post to become the major shareholder in both targets and then launched a tender offer for Matichon and Post.

GMM Media informed that its objective of the takeover was to expand Grammy's media empire to cover the publishing business. However, there were strong resistance from the public and the management of Matichon. There were also criticisms of the real motive of the acquisition, as it was known that the owner of Grammy, Paiboon Damrongchaitham, was a close friend of the then Prime Minister Thaksin Shinawatra. Some suspected that the investments were made on behalf of Thaksin with the intention of undermining media independence. Khanchai Boonpan, the founder of Matichon, beat back the hostile takeover by launching a counter offer for Matichon's shares.

In the end, forced by strong public opposition, GMM Media retreated from the bid to take over Matichon and reduced its stake to 20% by selling shares back to Khanchai at the same price that GMM Media bought for Matichon stocks. For Post, GMM Media became the second major shareholder with 23.26% shareholding, which was under the mandatory tender offer threshold.

CHAPTER 9

REASONS FOR THE RISING TREND OF M&A ACTIVITY AMONG SMEs IN JAPAN

Yoshihiro Yasumaru
Senior Director
Cross-Border M&A Team
Nihon M&A Center Inc.
Japan

In Japan the public has begun to recognize M&As (mergers and acquisitions) as a common corporate activity. As we shall discuss here, M&A activities have stepped more clearly into the public eye in recent years. We believe M&As are now regarded as essential to maintain old and develop new businesses.

Recently there has been a sudden change in the world economy. The old capitalism that had existed for 150 years since the 19th century by concentrating on capital, land, and manpower collapsed in favor of intellectual property and a globalized society and market that increasingly focus on *information* and *market intelligence*. This is the so-called New Capitalism. In such an era, Japanese companies are not only competing with Japanese companies in their home market but also with international companies in the global market. As a result, Japanese companies are suffering from differences in technological innovation, speed of response, management practices, and the structure of costs (wages, land price, and transportation) compared to worldwide companies. Southeast Asian countries and China, which have cheap labor costs and many talented employees, have emerged as competitors to Japanese firms. Moreover, Japan has been surpassed by the United States in the information technology industry. Japanese companies have been suffering in such tough conditions.

Under these circumstances, Japanese companies have been trying to extend their competitive power and rationalization using M&As in the past several years. As a result, Japanese large companies have carried out corporate reorganization and strategic integration. And some companies have jettisoned affiliated companies that were no longer considered vital to the company's operations.

On the other hand, in SMEs (small- and medium-size enterprises), the founders of companies are facing problems of successorship and growing concern about the future. To address these problems, SMEs are considering M&As as a possible approach.

We estimate that the number of completed M&A deals in Japan in 2007 was about 4,000, including deals never publicly disclosed. The available statistical data includes deals over relatively large projects whose value and details have been disclosed. Most of the statistics reflect cases involving listed companies and their affiliates, with the average value of a medium to large M&A transaction being around USD60–100 million. These statistics often do not include small M&A transactions. Some unlisted SMEs are profitable but struggling to find successors.

We speculate that of the 4,000 M&A deals, 70% of them involved S&M enterprises that had business succession problems. In Japan, 99% of all M&As are said to be friendly. Hostile M&As are believed to account for just 1% and most of them do not succeed. In Japan, in accordance with their articles of association, most SMEs require approval of the board of directors when they want to sell shares. Thus a hostile M&A is actually not an option for taking over a resisting SME.

The number of M&A deals of SMEs in Japan has recently been on the rise. The reason for the increase in the companies being sold is assumed to be a lack of successors within the SMEs and the concerns of their aging owners about the future. On the other hand, the reason the number of buyers has increased is due to the buyers' sense of market barriers. Buyers are also afraid of being in a critical situation in the future. So buyers see M&As as a way to expand their existing business or advance into different industries.

Regarding the background of rising M&As among SMEs in Japan, we can find both internal and external factors. For internal factors, Japanese people now have a better awareness and understanding of M&As because this is becoming more commonplace. Large Japanese newspapers such the Nikkei, Asahi, Yomiuri, Mainichi, and Sankei publish articles related to M&As virtually every day. The domestic market in Japan has matured because of a shrinking population so that to realize

continuous growth and expansion of market share, a diversification of strategies is required for the nation's companies to survive.

To compete with fast changes and the speeding up of the business environment, concentration and selection of core business are also required. Specialization in the existing core business and expansion into business that can bring synergies to the core business are considered a main strategy for M&As. Under the globalization and rapid progress of information technologies, shifting production and targeting overseas markets are also required. For instance, banks in Japan utilize M&As to accelerate collection of bad debts. Dissolution of cross-shareholding and a rise in foreign ownership have appeared. Due to these economic trends, M&As in Japan are increasing in significance across the face of commerce.

As one of the external factors, quite a few companies have started to consider M&As as a strategy to survive under intense competitive circumstances. The strategies to counter intensified competition and market maturity in a shrinking population, in other words, are an expansion of market share and/or diversification of sales networks.

Through the era of consolidation, quite a few companies have been compelled to consider consolidated management by utilizing M&As. Because of consolidated accounting and taxation systems in line with international accounting standards (IAS), reorganization of corporate groups and the sale of non-performing firms are being given increased attention. Furthermore, revision of corporate laws, bankruptcy laws, securities laws, and tax laws have become a trigger for company reorganization, such as the forming of holding companies or the divestiture of non-profitable segments, etc. Under the changing environment and speeding up of business cycles, companies require more specialization in their core business and expansion into new areas that bring synergies to their core business.

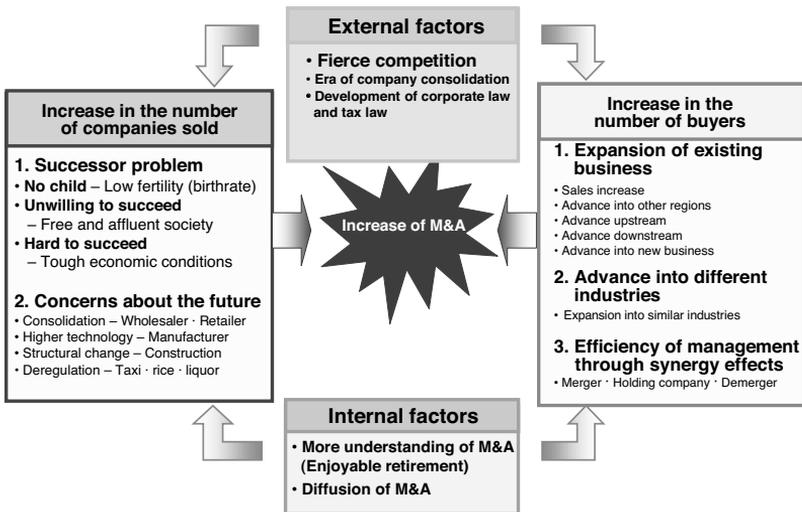
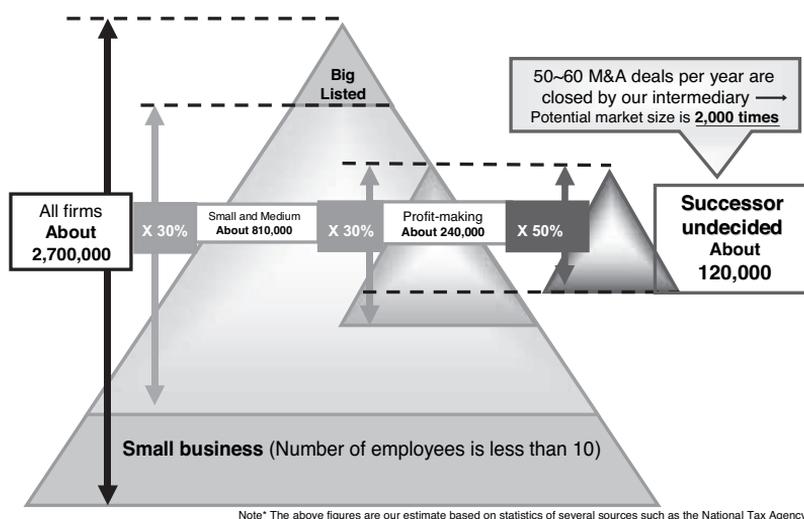


Figure 1. Background of Increase in the Number of M&A Deals

Japan has been facing some very real changes in the 21st century. Principal among these are likely to be the consequences of an aging population combined with a trend toward having fewer children. The birthrate in Japan in 2007 was just 1.25 children per woman. More than 25 million Japanese are over 65 years old but only 18 million are under the age of 15. This trend means there will be at least 20 million fewer Japanese by 2030, and it is assumed there will be 30% fewer by 2050 and 50% fewer by 2100. The fertility rate was just 1.39% in 2008. Meanwhile, the number of Japanese age 65 or over is growing by about a million persons annually. According to a report of the Small and Medium Enterprise Agency, approximately 70,000 Japanese companies were forced to liquidate in 2007 because they lacked a successor; consequently, roughly 300,000 jobs disappeared. The agency also reported that M&A is becoming regarded as one of the effective solutions for solving business succession problems. M&A contributes to the existence and development of companies. The Japanese government itself and local governments have stated that smooth business succession is desirable as far as employment is concerned. Thus, M&As have started attracting attention as a possible solution to the successor problem for SMEs.

In Japan the number of companies is presently about 2.7 million. Excluding bigger firms such as new IPO ventures and very small companies (of less than 10 employees), about 30% of the enterprises show promise of strength into the future, so it is estimated that the total number of these viable companies is 810,000. And among the 810,000, 30% are expected to be profit making while at least 50% of these have successor problems. So the total number of potential customers for M&A deals is estimated to be about 120,000 firms. It's a very big market.



Note* The above figures are our estimate based on statistics of several sources such as the National Tax Agency.

Figure 2. Potential Market Size of M&A

Between 1999–2001, a combination of the global technology bubble and revisions to the Japan Commercial Code and tax systems that paved the way for stock swaps and the establishment of holding companies triggered a record-breaking boom of M&A deals in Japan. M&As have also risen sharply since 2004 surpassing the boom of 1999–2001. The number and values of M&As in Japan have surged since 2004 and remained high through 2006–7. Toward 2008, the number of M&As will likely slow because of the influence of the worsened world economy.

Japan has seen two M&A booms. The first occurred from 1989–1990, when Japanese companies acquired mostly U.S. enterprises and real estate on the back of strong yen and high liquidity. However, with very few exceptions, these M&As failed to generate synergies or develop overseas business as expected. Then, the asset bubble burst and the number of M&As declined. Afterwards, mainly small- and medium-size unlisted distribution companies engaged in M&A activities.

The second boom began to build in 1999, fueled by revisions of the nation’s laws and tax regulations that paved the way for a surge in M&A activities. This boom initially centered on information and communications companies, with Japanese and foreign companies approaching each other. However, M&As between domestic companies gradually increased in the financial and distribution sectors, aiming for industry reorganization. After the end of the technology bubble, the number of M&As between information and communications companies declined, the total number of M&As flattened, and total value decreased. M&A activities have increased sharply since 2004, but we do not consider this to be a boom, because M&As have become a common method for industry consolidation.

If we look back at 1986–1991, this was the time of the “bubble economy” in Japan. The economy grew because everyone believed that the prices of property, especially land, would keep rising forever. Banks gave loans to individuals or enterprises relatively easily. At that time, almost 90% of companies in Japan used family succession for ownership, namely, the owner’s son, son-in-law, or other close relative. So the problem of a company’s succession was basically only one: how to lower the stock value of the firm in order to minimize the inheritance tax for a successor. However, business succession at SMEs to relatives accounts for 50% in Japan because of the reasons given below. Therefore, the issue of business succession is now not how to lower the company’s value but rather who will take over the business.

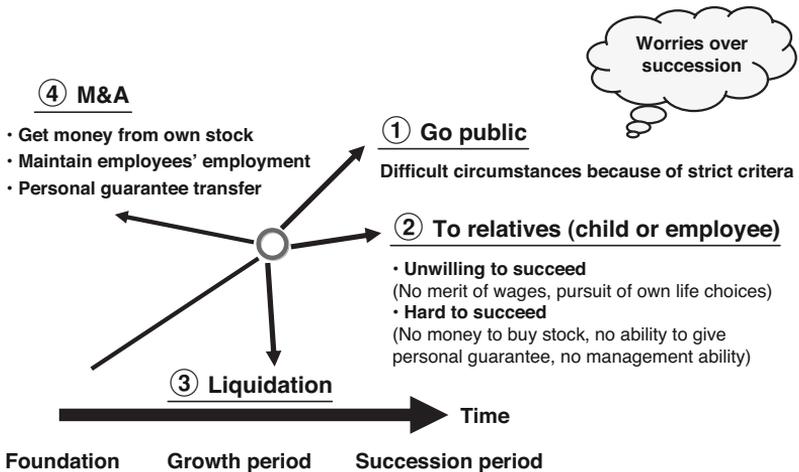


Figure 3. Exit from Company by Owners

If we consider a company's future, there are just four ends. The first is to go public. However, this is not so easy for SMEs to realize, because many strict criteria of internal control and observance of laws are required in order to take the company public. So just 4,000 among 2.7 million companies in Japan have actually gone public.

The second end is to pass control within the family. If a company owner has a potential successor such as a son or daughter, it is often better to let that person take over the business than to sell to an outsider. However, typically, the offspring do not want to take over the business from their parents these days. Instead, the children grow up to pursue their own personal lives, and see no merit to succeed in the family business. If they are talented and enthusiastic and work hard, they might get much money through their own efforts in a job they can select in an affluent society rather than taking over the family business. Or, they prefer to work in a large, vibrant city and do not want to go back to their quiet hometown after university graduation. In addition, under the difficult economic conditions these days, many offspring actually cannot easily take over the business because they lack the charisma of the original founder or have not developed sufficient skill to keep the

company profitable. So even family businesses several generations old may eventually face a succession dead end.

Other possibilities for ownership succession may be weak as well. In Japan, stock value is high if the company is adequately managed. As a result, mid-level or lower employees cannot afford to buy the company's stock. Furthermore, most employees hesitate to give personal guarantees to banks or mortgage their homes as collateral for a company's bank debts. Of course, managed buyout schemes might be adopted in some cases, but such cases are rare.

The third end is to simply liquidate the company. But when owners consider the well being of their employees, the long history of their customers, and the influence shutting down might have on the regional economy, they often do not want to liquidate.

The final option is M&A, for which there are mainly three benefits to the sellers. First, they can get money from selling the shares they hold (although unlisted stocks are not liquid and are basically difficult to convert to cash). Second, they can maintain the jobs of their staff. Third, personal guarantees for bank debt will be taken over by the buyers.

For the above reasons, the Japanese public and owners of SMEs have gradually come to recognize M&A as a common procedure and have treated it as an option for the retirement of owners. Thus, M&As have started drawing increasing attention as a possible solution for the successor problem of SMEs.

In recent years, around 75% of M&A activity in Japan has consisted of domestic deals but cross-border M&As of SMEs in Japan also have increased. Inbound (out-in) activity increased from 129 deals in 2006 to 308 in 2007. Thanks to deregulation, it is now much easier for foreign companies to take over Japanese companies than before. But it is still not easy for foreign companies to transact directly with Japanese companies, therefore, one solution is that they take over a Japanese company that has close connections with an M&A target company (or industry), then later begin M&A with the actual target company.

Of course, there are other reasons to take over a Japanese company such as for Japanese technology, brand strength, and so on. If there are succession problems for SMEs, they want to

hand over their business even to foreign companies. So out-in M&A has increased.

Among the 308 deals that included minority investment, about half were by U.S. investors, and approximately 10% came from the U.K. and China. Citigroup acquired Nikko Cordial Group through its wholly owned subsidiary in Japan. Citigroup made a successful takeover offer and collected over 61% of the voting stock of Nikko Cordial. Citigroup also offered a stock swap to the remaining individual shareholders of Nikko Cordial in January 2008. This was the first deal to use common stock issued by a foreign company following the amendment of Japan's Company Law in May 2007 that allowed foreign companies to use common stock as merger currency to acquire Japanese corporations in tax-deferred transactions.

Because the Japanese domestic market is mature, Japanese companies have to look for new markets in foreign countries such as the BRIC countries (Brazil, Russia, India, and China). For example, Toyota's sales in foreign markets account for 70% of the company's total sales volume.

Meanwhile, production has been moving offshore due to the high wages of workers in Japan. This is especially the case for labor-intensive industries. Outbound (in-out) deals totaled 366 in 2007, 55 less than the previous year. Among the 366 deals, 122 were in North America, 121 were in Asia, and 95 were in Europe. These deals were mainly for the purpose for expanding sales channels abroad instead of aiming to maintain cheap labor costs in low-wage Southeast Asian countries. This means that Japanese companies are increasingly regarding foreign countries as new markets.



Seller: Japanese-style hotel
Sales : About USD5,000,000
Place : Nara Prefecture
Reasons for selling: No successor



Buyer: Japanese real estate
Sales : About USD25,000,000
Place : Osaka Prefecture
Reasons for take over: Strategic

Figure 4. Successful Cases

Above is one recent successful case of a Japanese SME's M&A. The seller's business was a Japanese-style hotel in Nara Prefecture with annual sales of about USD5million. The image at left shows the seller and buyer exchanging the hotel shares certificate at delivery time.

The person on the far left is the seller, Mr. Ozaki. He was 68 years old and had been worried about his successor for several years. Through a regional bank, he asked a local bank to look for a successor company. The grandfather of Mr. Ozaki had started the business about 70 years ago as a small restaurant. Mr. Ozaki was the third generation to own and manage the hotel. He has three children, two sons and one daughter. His elder son became a doctor but was not willing to continue the business. The second son had studied the hotel trade for three years. Unfortunately, Mr. Ozaki thought his second son had insufficient capability to successfully manage the hotel. His daughter married a doctor and is enjoying a satisfying family life. For the above reasons, although the business continued doing well, he decided to consider M&A as the continuation and development of his company.

The main activity of the buyer, at right in the image, is real estate. Company sales at the time were about USD25,000,000 and they were beginning to consider doing an IPO. To hasten

the schedule of the IPO, they developed a strategy to take over Japanese-style hotels. The seller's hotel was very famous for its well managed employees, so guests enjoy their stay and come back repeatedly anticipating welcome hospitality and service that allows them to refresh themselves and relax. The buyer therefore hopes that employees of the firm's other hotels will be eager to study this style of hospitality and take it back to their own hotels. The buyer sees this as the main synergy arising from the acquisition.

At their first meeting, they were able to understand that both companies' culture and characteristics were close and that they would be able to respect each other. There was only one serious difficulty, Mr. Ozaki's wife, who was at first highly reluctant to sell. I, myself, spoke with her several times until midnight and was able to persuade her by giving a message from the bottom of my heart that M&A was their best solution. She finally accepted my suggestion and later told me thank you after completion of the M&A. It was a great moment as an advisor; we believe what M&A professionals need is not only to understand and make use of the theory and workings of capitalism but also to realize that decisions are made by individuals with human emotions, something that cannot be explained using cold reasoning or logic. Developing the ability and personality to understand a person's feelings is an essential part of providing professional M&A services.

In conclusion, the development and trends suggest that there will be no change in the outlook of steady growth of M&As among SMEs. The business succession problem, the global slow-down, and credit crunch loom large. Cross-border M&As also have become much more popular. The Japanese market is more open to outside investment and Japanese companies have to look for overseas markets because of the matured domestic market. For these reasons, Japan has to rely on M&As to survive as both sellers and buyers.

The true value of M&A is to combine the DNA of both sides with friendly forms to make a new corporate entity. We will continue contributing to the development of Japanese industry overall and endeavor to expand the Japanese M&A market.

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CHAPTER 10

OVERCOMING THE CHALLENGES AND ISSUES OF POST-MERGER INTEGRATION: PUTTING PMI IN THE DRIVER'S SEAT IN THE M&A PROCESS

Christopher Kummer

President

*Institute of Mergers, Acquisitions
and Alliances (IMAA)*

Switzerland

This chapter is based on my own knowledge and experience with merger and acquisition (M&A) strategies as well as pre- and post-merger situations, interviews with and presentations by senior executives and M&A professionals combined with studies, reports, and articles on the challenges and issues of post-merger integration (PMI). It does not try to cover all challenges and issues that might come up in PMI that would probably produce a very long laundry list of things that can go wrong. The aim of this contribution is rather to improve, challenge, and change the conventional view on the M&A process and PMI.

WHY M&A AND PMI IN THE ASIAN CONTEXT MATTER

There are three reasons why exploring PMI in an Asian context is important. M&A in Asia has played and will continue to play a vital role in business, especially cross-border deals.

- Overall M&A with Asian participation has greatly gained in significance over the past couple of years (see Figure 1). From 1995 to 2008, in total almost 100,000 deals with a known value of 3,941 billion USD have been announced. In 2008, 11,518 Asian transactions were announced. This is a slight decrease of 1.5% compared to 2007, but still another year of high activity in terms of numbers. This rather small decrease is even more astonishing given that worldwide the number of deals decreased much more, by 10%. The total value of Asian deals in 2008 declined 37% to 519 billion USD. This decline is almost in trend with developments

worldwide (down 40%). Although the number and value of transactions may decrease again this year, the long-term trend is clear and increasing: The number of Asian M&A since 1995 shows a compound annual growth rate (CAGR) of almost 10%. The value of deals will continue to fluctuate with stock markets. The year 2008 probably marks the end of just another M&A wave, but M&A however will remain cyclical and will continue to play a vital role in Asia. The next wave of M&A will come for sure.

- The number and value of cross-border M&A transactions have increased to levels never seen before (Figure 2). While in 1995 there were about 1,300 cross-border deals announced, in 2008 it was 3,600 (an increase of 280%). Over the same time period, the value of such deals has disproportionately increased from 46 to 238 billion USD (+517%).
- The importance of Asian M&A has increased its share in the number of worldwide transactions from 8.5% in 1995 to 17.7% in 2008 and in its value from 13.3% to 20.0% (Figure 3).
- M&As are said to be quite unsuccessful with a success rate of only about 25% to 50% at best (for a list of studies on the success and failure of M&As see Bruner, 1994). Post-merger integration (PMI) is often blamed as the major reason why M&A deals are less successful than they should be. For these reasons it makes perfect sense to explore how PMI in Asia can be improved.

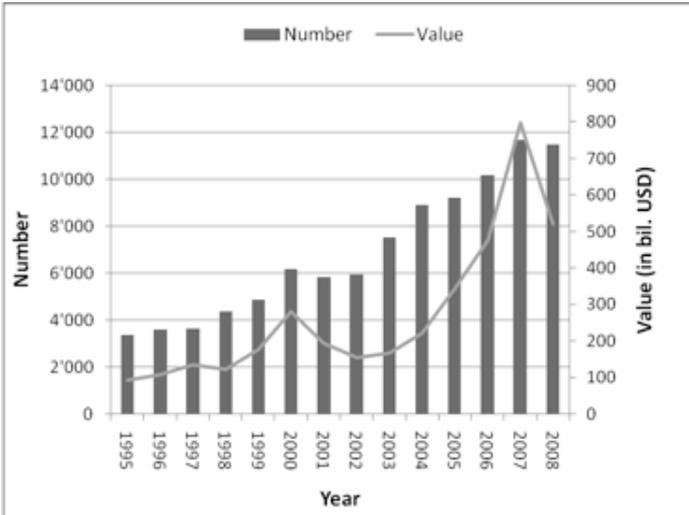


Figure 1. Number and Value of M&As with Asian Participation (1995–2008)

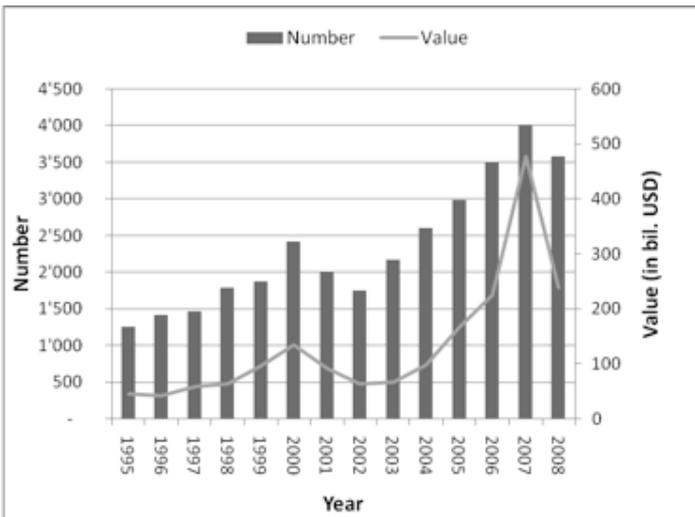


Figure 2. Cross-border M&As in Asia (1995–2008)

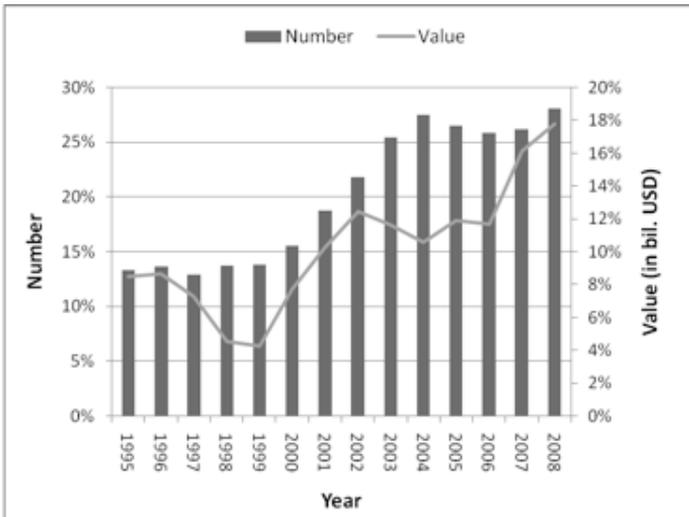


Figure 3. Share of Asian M&As in Worldwide Transactions (1995–2008)

THE M&A PROCESS SHOULD BE PMI ORIENTED

Many of the post-merger challenges are not unique to deals in Asia – they are quite universal all around the world. To drastically increase the chances that PMI will help make the M&A deal a success, I take a non-traditional, more holistic perspective: *PMI should be put in the driver's seat of the M&A process* – as an important step that goes along the complete M&A process from beginning to end (Figure 4). If you position PMI as a simple step after such tasks as strategy development, target search, due diligence, negotiations, and closing for a limited time period only, you tend to absolutely underestimate the contribution and the difference that PMI makes in making deals valuable! As an additional difference to the traditional process, I have also added a post-M&A review that should be mandatory to take place from time to time even during a transaction, but certainly at the completion of PMI. For the organization and people involved in deal making, it is essential to try to grasp the key lessons from single deals to improve transactions to achieve higher value creation the next time.

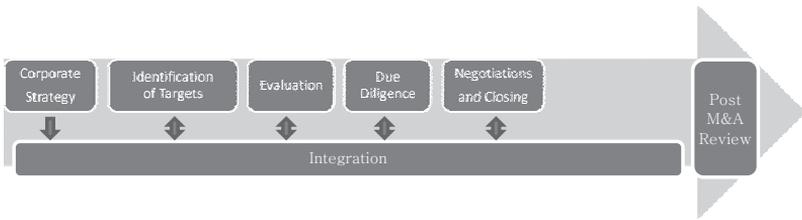


Figure 4. The Post-Merger Integration-oriented M&A Process

PMI Does Not Necessarily Mean Total Integration

Many employees (be it from the acquirer or from the target) that ultimately face PMI challenges are not frequently engaged in M&A. They often tend to think that integration means all things are made the same, i.e., to fully and totally integrate everything. This is certainly not the case; there are a variety of options of how to do a PMI. This choice of a PMI mode can actually vary from transaction to transaction and is also subject to cost/benefit considerations. There is basically a choice between five different PMI approaches:

- **Preservation or stand-alone:** Both companies are kept separate with almost no or only minimal changes. In many cases this PMI approach, which is rather the complete opposite of integration and taking it *ad absurdum*, is a very good choice in order not to destroy the value of a transaction.
- **Confederation:** Companies enjoy a relatively high level of autonomy, but a variety of interdependencies and some control.
- **Absorption:** One company is fully integrated into the other company or adopts its standards, processes, etc.
- **Best of both worlds or best of class:** Both companies create a combined entity taking over superior parts from both, or introducing best-of-class standards.
- **Transformation** whereby the integrated companies try to create something entirely new ranging from a giant leap in terms of geographic or product coverage to even a fundamental change in the business model, for example.

Strategy Making for Deals

Even the earliest step in the process that might ultimately lead to M&A deals to foster the company, namely the strategy making, will have an impact on the PMI approach. The strategy actually can clearly determine the kind of integration approach that the acquirer might want to follow. Especially small- and medium-size companies (SME) getting involved in M&A transactions often have not sufficiently considered and explored their strategic options and alternatives. SMEs should be aware that M&A after all is a large investment for which they should prepare themselves wisely. Interestingly enough there are also quite a number of large companies that have not sorted out these issues to a sufficient level and rush into M&A.

Let us shortly explore that fact that strategy does have an impact on PMI, for example, with one tool of strategy development: the Ansoff matrix (for a simplified model see Figure 5, for the original model see Ansoff, 1987). This tool is relatively old and simplistic, but quite easy to put to use and therefore might be quite handy in a first step to develop a company's strategy.

The Ansoff matrix explores the choices of a company in a framework of existing vs. new markets and existing vs. new products. Starting with the upper left segment in an existing market and existing product environment (market penetration), this relatively low risk strategy aims towards generating additional growth with selling existing products in existing markets in order to increase their market share and an increased product usage of existing customers. This can of course also be achieved by acquiring competitors, where the company will rather aim for solid consolidation and high synergy realization and therefore most likely will do best when choosing the absorption or best of both worlds approach of PMI. Taking a combination of existing and new like product development or market development (see upper right corner or lower left corner) where the company pursues a medium risk growth strategy to stimulate growth by either selling its existing products to new customers in new geographical markets or distribution channels or tries to introduce new products to existing clients or in its current markets, again something that can be achieved through acquisitions as well. In these two cases, a company might rather

go for the confederation approach for its PMI. When going for a more risky strategy of diversification (both new, lower right corner) then clearly a preservation might be more preferable.

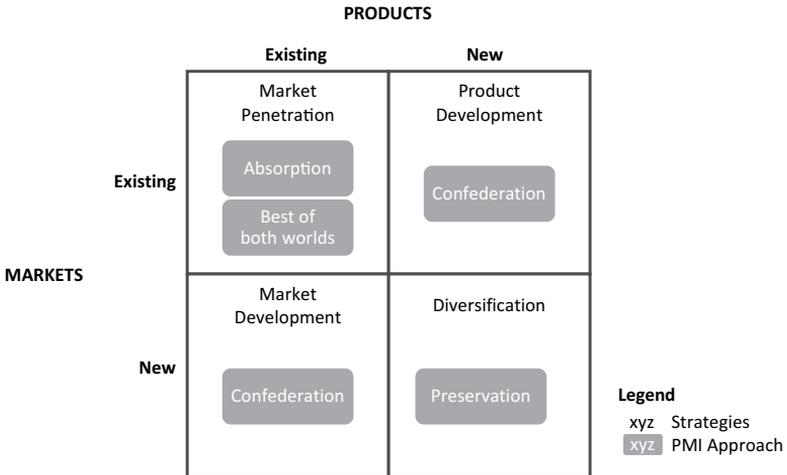


Figure 5. Strategy and PMI Example
 The Ansoff-Matrix and its relationship to PMI approaches

Strategy and PMI Realization

The realization of PMI is *not only project management*. One fundamental misperception of PMI projects is that they are simply about classic project management. While professional project management is one success factor for PMI, we should always keep in mind that the strategy that has led to a transaction is the far more important driver of such projects in order to succeed.

Another frequently underestimated challenge in PMI is to have the *management capabilities and employee and financial resources* available that it takes to make such PMI projects a success. In addition to implementing and delivering the actual integration, *business as usual* has to be continued and managed. During an integration, it is difficult not to be overly occupied with oneself, but to serve the customers as well. There might be even some extra worries to overcome in the usual operations as well, for example former customers might rather turn to and buy from competitors, because they know what to expect while your

own company is in unrest. In many transactions, *senior management* underestimates the amount of time and effort they have to put in to make the integration a success, because this is hard work and cannot be completely delegated. Although preparing and negotiating a transaction might have taken already a lot of time, the true and deciding moment comes with successful implementation of the integration where leadership has a lot to contribute.

M&A capabilities and resources are not only in large transactions an issue, but also in small transactions where often not *enough management attention* is given to the deal due to its small size and little impact on the overall performance of the company. From a management capability point of view, companies need to have enough in-house people that are experienced with the M&A situation and the complete M&A process in order not to entirely rely on external advisors, unless the company engages only in transactions from time to time. Of course the number of people that a company needs depends on the number of transactions it engages in per year. For an SME, having these resources available in experienced managers without sacrificing too much of the daily business efforts is an even bigger effort than for larger companies. Many large companies have created *their own dedicated resources* as focused professionals or even specialized departments and units that are responsible for M&A transactions (including contracting and coordinating advisors). Many of these people and departments however are very specialized on bits and pieces of the M&A process (e.g., deal making or integration) and are not able to cover the complete process from beginning to end which would increase the final success of transactions a lot. Therefore creating clear responsibilities for transactions from the very beginning to the very end (including PMI) have to be established. In addition, many key employees that get involved during deals and later in PMI are not well prepared and trained for their tasks. They tend to stick to the topics and issues for which they have expertise (e.g., finance, HR, IT, etc.) from an operational point of view, but they often struggle to translate this expertise into the deal situation and to link this with the overall strategic aims of the deal.

Although involving external advisors in PMI as additional resource and capacity to succeed in realizing the goals of the transaction and getting the project done is usually necessary and indispensable, companies must have enough *own organizational slack and capacity* for such projects. In order to do a meaningful PMI, people involved should be knowledgeable about the companies involved, if not to say insiders of them. Not only for having that organizational slack, it is also essential to worry about the employees of the acquired company.

Speed is always cited as another key ingredient for successful integrations. In many companies that are being sold, significant damage to *motivation* of employees has already been done during the sales process. From the company's point of view there is an immediate and high risk that involuntary fluctuation takes place. Quick and clear actions are necessary to restore motivation and trust in order to keep *key people* staying in the combined entity; otherwise value might be significantly reduced. The identification of key people that should be retained also can take place early on. This process should be guided again by the strategy: Why has this deal been done in the first place? What are its strategic and operational aims? These answers will help to answer the questions: Who are the people that have a significant impact on the future value of the company? Who are the people that possess critical capabilities, competencies and relationships for the future success of the business? Results of the process to identify key people could be a portfolio of employees (Figure 6).

This is why the preparation of integration as early as possible is essential. The later companies start to worry about PMI, the more pressure they have while developing plans, based on internally and externally available resources and a goal-oriented analysis during due diligence.

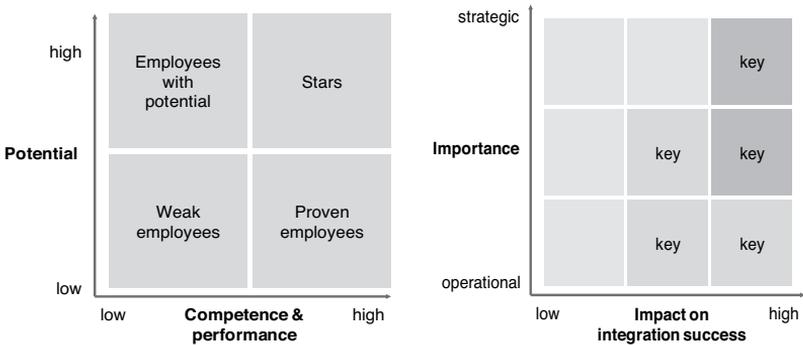


Figure 6. Examples of Frameworks for Identification of Key People (Kummer, 2008)

DUE DILIGENCE: FUTURE-ORIENTED REALITY CHECK WITH ACTIONABLE INSIGHTS FOR PMI

Unrealistic aims are another component of why PMI projects fail. Synergies and other advantages look fine on paper, but are often developed in a top-down manner without specifying exactly where the benefits come from or including a concrete bottom-up check. Therefore it might be beneficial to conduct a **reality check / review of all major aims** when preparing a deal. The right moment to do such a check might be during the due diligence.

Due diligence is a process whereby an acquirer studies his object of desire (i.e., the target company). It is a process/tool to gather more information and to assess the realistic values of a target company by evaluating its strengths, weaknesses, risks, synergies, and the overall fit within the acquirer’s strategy. The due diligence often is a lengthy process and far from being standardized. There are **quite a number of aspects and parts that a due diligence can cover**: financial, tax, commercial, operational, human resource, management, pension, information technology, legal, intellectual property, antitrust, compliance, and insurance/risk management due diligence. The due diligence can vary greatly with respect to factors such as duration and scope, and number and types of people (in-house and external advisors) involved. Although there are significant

differences in the due diligence among M&A transactions, each due diligence has the same purpose of assisting a buyer in determining whether or not to acquire a target, and if so, how much should be paid for the target. With the due diligence, an acquirer is able to evaluate the risks and maybe uncover hidden liabilities related to a company or transaction to determine whether to do a deal and how much to pay. Almost 20% of executives involved in M&A consider the due diligence to be critical for the success of a transaction (Chanmugam, et al, 2005). This is probably a complete underestimation of the results that you can get from a due diligence, if you conduct a thorough and PMI-oriented one. There are even companies that do not perform a due diligence at all; a study by PricewaterhouseCoopers finds this number to be as high as 30% (Schlöpfer/Baldinger, 2008). Doing deals without proper due diligence is not only risky, but also irresponsible and might suggest legal malfeasance that shareholders can pursue against management.

In reality, often a narrow due diligence limited to financial issues, e.g., hidden liabilities, accounting, tax, and pension issues, is carried out. While uncovering risks and liabilities (mostly from the past) that can easily make a difference in the millions of USD is an extremely relevant part of the due diligence, many future- and integration-oriented topics are insufficiently covered in many transactions. These future-oriented aspects can also amount to millions when calculated as their net present value. The insights resulting from a due diligence related to post-merger challenge should be: ***actionable knowledge which helps to successfully master PMI*** by being a sound foundation for concrete and detailed integration plans. Many integration plans are not ready when the transaction is finally closed or are ***very unspecific integration plans*** that cannot be implemented in due time.

CULTURAL ISSUES AS MAJOR CAUSE FOR PMI FAILURE

Contrary to conventional wisdom, I would like to close with cultural issues as a major cause for PMI failure and the low success rate of M&A in general. This is contrary to conventional wisdom, because the vast majority of studies and reports usually

blame cultural issues as a major ingredient for M&A disaster. Fully aware of these findings, in addition to putting that topic last but not least, I would like to start this section nevertheless with a big caveat. Of course there are a lot of cultural challenges that might affect the final outcome of a PMI. However, I am personally convinced that these issues are sometimes completely overstated. Culture is a good scapegoat and relatively easy to blame, because qualitative and soft issues are hard to disprove. This line of argumentation helps to distract attention from other major mistakes that have been done earlier in the M&A process, e.g., in strategy making.

Challenges in the cultural dimension can result from the several different spheres of culture at once (Figure 7). In many cases, it is *very obvious from the very beginning that cultural issues will be a major challenge* that needs to be overcome (for a case study on how to handle this from the very beginning see Pineda/Kummer, 2007). The first dimension of culture is geographical culture. This is the most obvious case of culture issues in deals, i.e., cross-border deals, where the acquirer or merging partners might experience differences due to different national cultures. But also in domestic deals a clash of cultures can originate from regional differences in culture. The next dimension is corporate culture that might cause conflicts when bringing companies together. These differences in corporate culture might make integration very slow and costly and could create an inefficient new organization. The next evident example is the combination of companies from two different industries with different industrial cultures such as banking and insurance (the concept of bancassurance which, by the way, has failed in most cases) or the diversification or forward integration toward distributors or clients. This difference in industrial cultures can even exist within the same industry, e.g., investment banking and private banking are totally different segments that are very likely to follow completely different philosophies. Last but not least, there are functional/professional cultures. For example, people from IT will get along with other people from IT more easily than from finance. This creates in a PMI situation additional obstacles, as the companies will have to tackle integration across all functions.

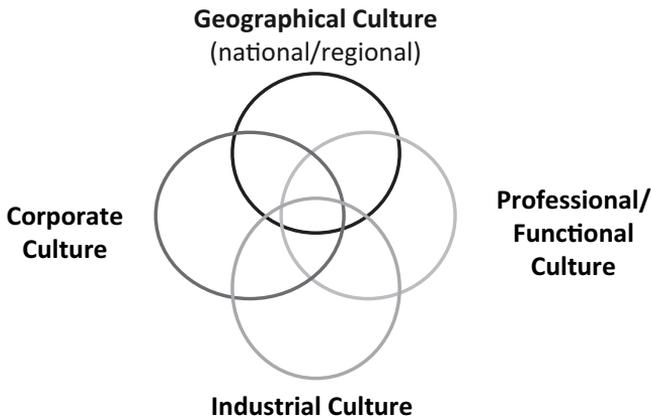


Figure 7: The Multiple Spheres of Culture in the Corporate Environment

The actual ***cultural integration approach is interlinked to the chosen PMI approach***. There are also different ways to handle cultural integration (for different approaches see for example also Cartwright/Cooper, 1993):

- ***Cultural preservation*** keeps the entities apart and maintains their cultures.
- ***Acculturation*** adapts the culture from one of the companies.
- ***Best of both worlds*** blends the best of cultures.
- ***New culture*** tries to create a completely new corporate culture.

As these challenges in cultures are most likely to exist in every transaction, ***cultural effects should be priced into the valuation*** of the combined entity and any expected synergies (or rather dis-synergies). Pricing these cultural issues into valuation certainly is very difficult, but possible to do. This can be done for example in the following ways to quantify them in terms of:

- The risk for the return on a transaction (a higher expectation on risk premium in valuation)
- The effect on operational productivity in the business plan (probably a drop)
- A budget to explore the cultural differences (investment during due diligence)

- A budget to invest during the actual PMI implementation (in terms of amount of time, people, workshops, etc.)

CONCLUSION

Post-merger integration (PMI) should be considered very early on in the M&A process – already the strategy development phase has implications on the integration, namely which PMI approach might work best. Basically each step during that process later on should be oriented toward PMI. Even if everything is done correctly up and to the integration, PMI will be the decisive instance to finally make a transaction a success or failure. The closer a company comes to an acquisition or merger, the more concrete and detailed PMI preparations should become. This is why the M&A process should be redesigned in a way that the actual PMI stream is a process which rather accompanies or drives all other activities.

PMI does not only require professional project management, but also the necessary ***management capabilities and resources***. Companies should arrange to have enough own resources available, especially generalists with the capability to handle the complete M&A process. Although external advisors certainly can be of assistance, a certain amount of slack in organizational capacity is mandatory.

The due diligence should be PMI oriented in the sense that it is broad rather than just narrowly focusing on financial aspects and helps to give a reality check of the aims of the transaction and to prepare specific integration plans and activities. These plans can finally quickly be implemented to keep employees motivated and retain key people.

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LIST OF CONTRIBUTORS

Viktoria Dalko, Instructor/Professor of Finance, Harvard University/City University of New York, USA.

Ping Ching Terence Fan, Assistant Professor, Singapore Management University, Lee Kong Chian School of Business, 50 Stamford Road, 5/F, Singapore 178899.

Moon-Kyum Kim, Professor, Department of Entrepreneurship and Small Business, Soongsil University, Sangdo 5 Dong 1-1, Dongjak-Ku, Seoul 156-743, Republic of Korea.

Fazilah Abdul Samad, Head of Department, Department of Finance and Banking, University of Malaya, Malaysia.

Ashutosh Kumar Sinha, Doctoral Student, Corporate Strategy & Business Policy Area, Indian Institute of Management Bangalore, Bannerghatta Road, Nagalore 560076, India.

Ganesh Chand, Director, Fiji Institute of Applied Studies, Lautoka, Fiji.

Shamshubaridah Ramlee, Faculty of Economics and Business, Universiti Kebangsaan Malaysia, 43600 UKM, Bangi, Selangor, Malaysia.

Rasidah Mohd Said, Faculty of Economics and Business, Universiti Kebangsaan, 43600 UKM, Bangi, Selangor, Malaysia.

Maria Victoria R. Castillo, Head, Service Excellence, Rizal Commercial Banking Corporation (RCBC), RCBC Plaza, 10th Floor, Tower 1, #6819 Ayala Avenue, Makati City 1200, Philippines.

Pravit Khaemasunun, Lecturer, Assumption University, 703 Taksin Road, Bookalo, Thonburi, Bangkok 10600, Thailand.

Pirinee Pringsulaka, Finance Manager and Head of Financial Planning and Project Acquisitions, Central Pattana Public Company Limited, 31st Floor, The Offices at Central World, 999/9 Rama 1 Road, Patumwan, Bangkok 10330, Thailand.

Yoshihiro Yasumaru, Senior Director, Cross-Border M&A Team, Nihon M&A Center Inc., 11F Breeze Tower, 2-4-9, Umeda, Kita-ku, Osaka, Japan.

Christopher B. Kummer, President, Institute of Mergers, Acquisitions and Alliances (IMAA/MANDA), Rotbuchstrasse 30, 8037, Zurich, Switzerland.