MERGER AND ACQUISITION: THE SYNERGETIC EFFECT OF EQUITY OPERATIONAL - COST AND LOAN ON EARNINGS (CASE STUDY OF UNITED BANK OF AFRICA AND STANDARD TRUST BANK)

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Abstract

The study is on the effect of operational cost, equity and loan/ advances on the earning of the merged banks. The study compared the pre-merger and post-merger combined results of the merged banks. Since the basic low liquidity poor credit trading and high operational cost was the bane of merged banks before the 2005 forced combination fostered on the banks. The secondary data collected was analyzed using the SPSS version10, the t-statistic, correlation coefficient and basic linear regression models were used. It was discovered that equity and loan positively affect earning in both the pre and post merger period. Operational cost negatively effect the earning in the pre-merger period while it lowly affect earning in the post merger period. The synergetic effect of merger was found positive on the firms in the post-merger period. It was recommended that banks should reduce their operational cost in the post merger period to improve their earnings and concentrate more on their fundamental business.

Introduction

Strategic advantage remain pivotal to profitability and long term growth of the firm the larger the capital base of the firm the larger the market quota the mire economic of scale and low cost of the production the firm could enjoy. Merger and acquisitions is one of the basic methods of gaining these advantages. By way of firm combination (either a form of merger or acquisition) the combination can be horizontal or vertical combination. the capital base of a merged firm become robust the operational cost tend to drop and in the financial sector the credit trading become larger at lower cost .thus the study looked at the pre-merger and post-merger combined operational result of the bank. The effect of a robust equity base, reduced operational cost per operation and credit trading was regressed against the total earning before tax of the merged bank to measure the effect of the former on the latter. This will assist in measuring the synergetic advantage of merger and acquisition.

A merger is a combination of two or more companies to form a new company, while an acquisition is the purchase of one company by another with no new company being formed.

The phrase mergers and acquisitions refers to the aspect of corporate strategy, corporate finance and *management* dealing with the buying, selling and combining of different *companies* that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity.

An **acquisition**, also known as a **takeover** or a **buyout**, is the buying of one company (the 'target') by another. An acquisition may *be friendly or hostile*. In the former case, the companies cooperate in negotiations; in the latter case, the takeover target is unwilling to be bought or the target's *board* has no prior knowledge of the offer. Acquisition usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger or longer established company and keep its name for the combined entity. This is known as a ***reverse takeover***. Another type of acquisition is reverse merger, it is a deal that enables a private company to get publicly listed in a short time period. A **reverse merger** occurs when a private company that has strong prospects and is eager to raise finance buys a publicly listed company, usually one with no business and limited assets. The acquisition process is very complex, with many dimensions influencing its outcome.

- The buyer buys the shares, and therefore gains control of the company being purchased. Ownership control of the company in turn conveys effective control over the assets of the company, but since the company is acquired intact as a *going concern*, this form of transaction carries with it all of the liabilities accrued by that business over its past and all of the risks that company faces in its commercial environment.(**Investopedia ,2009)**
- The buyer buys the assets of the target company. The cash the target receives from the sell-off is paid back to its shareholders by dividend or through liquidation. This type of transaction leaves the target company as an empty shell, if the buyer buys out the entire assets. A buyer often structures the transaction as an asset purchase to select the assets that it wants and leave out the assets and liabilities that it does not. This can be particularly important where foreseeable liabilities may include future unquantifiable damage awards such as those that could arise from litigation over defective products, employee benefits or terminations, or environmental damage.

Categories of mergers

Mergers may be broadly classified in (i) Congeneric and (ii) Conglomerate.

Congeneric : is the merger of firms in same industries and taking place at the same level of economic activity- exploration, production or manufacturing wholesale distribution or retail distribution to the ultimate consumer.

Conglomerate: this is the merger of firms not in the same industries and between unrelated businesses.

(i) Congeneric mergers are of two types (a) Horizontal merger (b) Vertical merger (or take over)(eg: an ice cream maker in the United States merges with an ice cream maker in Nigeria)

Product-extension Merger – this merger of two or more firms selling different but related products in the same market (eg: a cone supplier merging with an ice cream maker).

Purchase Mergers - As the name suggests, this kind of merger occurs when one company purchases another. The purchase is made with cash or through the issue of some kind of debt instrument; the sale is taxable.

Acquisition of firms refers to purchase of one firm by another acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets are depreciated annually, reducing taxes payable by the acquiring company.

Consolidation Mergers - With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase me

Accretive Mergers are those in which an acquiring company's earnings per share (EPS) increase. An alternative way of calculating this is if a company with a high price to earnings ratio (P/E) acquires one with a low P/E.

Dilutive Mergers are the opposite of above, whereby a company's EPS decreases. The company will be one with a low P/E acquiring one with a high P/E.

Distinction Between Mergers and Acquisitions

Although they are often uttered in the same breath and used as though they were synonymous, the terms **merger** and **acquisition** mean slightly different things. [2]

When one company takes over another and clearly establishes itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.

In the pure sense of the term, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals". Both companies' stocks are surrendered and new company stock is issued in its place. For example, the merger of Glaxo Wellcome and SmithKline Beecham, both firms ceased to exist when they merged, and a new company, *GlaxoSmithKline*, was created.

In practice, however, actual mergers of equals don't happen very often. Usually, one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it is technically an acquisition. Being bought out often carries negative connotations, therefore, by describing the deal *euphemistically* as a merger, deal makers and top managers try to make the takeover more palatable. An example of this would be the takeover of standard trust bank (STB) and United Bank for Africa (UBA). Where UBA acquired STB and the name of the companies remain UBA and the logo remain that of the STB

A purchase deal will also be called a merger when both CEOs agree that joining together is in the best interest of both of their companies. But when the deal is unfriendly - that is, when the target company does not want to be purchased - it is always regarded as an acquisition.

Whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders. It is quite normal though for M&A deal communications to take place in a so called 'confidentiality bubble' whereby information flows are restricted due to confidentiality agreements (Harwood, 2005).

Business Valuation for Merger And Acquisition

Accurate business valuation is one of the most important aspects of M&A as valuations like these will have a major impact on the price that a business will be sold for. Most often this information is expressed in a *Letter of Opinion of Value* (LOV) when the business is being valuated for interest's sake. There are other, more detailed ways of expressing the value of a business. These reports generally get more detailed and expensive as the size of a company increases; however, this is not always the case as there are many complicated industries which require more attention of details, regardless of size. The five most common ways to valuate a business a

1) Asset Valuation,
   a) Historical earnings valuation,
   b) Future maintainable earnings valuation,
2) *Relative Valuation* (comparable company & comparable transactions),
3) *Discounted Cash Flow* (DCF) valuation

Professionals who valuate businesses generally do not use just one of these methods but a *combination* of some of them, as well as possibly others methods agreed on by the parties, in order to obtain a more accurate value. These values are determined for the most part by looking at a company's *balance sheet* and/or *income statement* and withdrawing the appropriate information. The information in the balance sheet or income statement is obtained by one of three accounting measures: a *Notice to Reader, a Review Engagement or an Audit.*

Financing Merger and Acquisition

Mergers are generally differentiated from acquisitions partly by the way in which they are financed and partly by the relative size of the companies. Various methods of financing a merger and acquisition exist they are :

Cash

Payment by cash; such transactions are usually termed acquisitions rather than mergers because the shareholders of the target company are removed from the picture and the target comes under the (indirect) control of the bidder's shareholders alone.

A cash deal would make more sense during a downward trend in the interest rates. Another advantage of using cash for an acquisition is that there tends to lesser chances of *EPS* dilution for the acquiring company. But a caveat in using cash is that it places constraints on the cash flow of the company. However, the financing capital may be borrowed from a bank, or raised by an issue of bonds. Alternatively, the acquirer's stock may be offered as consideration. Acquisitions financed through debt are known as leveraged buyouts if they take the target private, and the debt will often be moved down onto the *balance sheet* of the acquired company. The organization can also opt for issuing of fresh capital in the market to raise the funds. An acquisition can involve a combination of cash and debt or of cash and stock of the purchasing entity. *Factoring* can provide the extra to make a merger or sale work.

Advantages of Merger and Acquition

1. The dominant rationale used to explain mergers and acquisitions activity is that acquiring firms seek improved financial performance. The following are considered to be improved financial performance:
2. *Economy of Scale*: This refers to the fact that the combined company can often reduce its fixed costs by removing duplicate departments or operations, lowering the costs of the company relative to the same revenue stream, thus increasing profit margins.
3. Increased *revenue* or *market share*: This assumes that the buyer will be absorbing a major competitor and thus increase its market power (by capturing increased market share) to set prices.
4. *Cross-Selling:* For example, a *bank* buying a *stock broker* could then sell its banking products to the stock broker's customers, while the broker can sign up the bank's customers for brokerage accounts. Or, a manufacturer can acquire and sell complementary products.
5. ***Synergy:*** For example, managerial economies such as the increased opportunity of managerial specialization. Another example are purchasing economies due to increased order size and associated bulk-buying discounts.

6. ***Taxation***: A profitable company can buy a loss maker to use the target's loss as their advantage by reducing their tax liability. In the United States and many other countries, rules are in place to limit the ability of profitable companies to "shop" for loss making companies, limiting the tax motive of an acquiring company.
7. ***Geographical or other Diversification***: This is designed to smooth the earnings results of a company, which over the long term smooths the stock price of a company, giving conservative investors more confidence in investing in the company. However, this does not always deliver value to shareholders (see below).
8. ***Resource Transfer:*** resources are unevenly distributed across firms (Barney, 1991) and the interaction of target and acquiring firm resources can create value through either overcoming *information asymmetry* or by combining scarce resources.(King, et al 2008).
9. ***Vertical Integration:*** Vertical integration occurs when an upstream and downstream firm merges (or one acquires the other). There are several reasons for this to occur. One reason is to internalize an *externality* problem. A common example is of such an externality is double marginalization. Double marginalization occurs when both the upstream and downstream firms have monopoly power, each firm reduces output from the competitive level to the monopoly level, creating two deadweight losses. By merging the vertically integrated firm can collect one deadweight loss by setting the upstream firm's output to the competitive level. This increases profits and consumer surplus. A merger that creates a vertically integrated firm can be profitable. **(** Maddigan et al,1985)

However, on average and across the most commonly studied variables, acquiring firms' financial performance does not positively change as a function of their acquisition activity. (Dalton et al, 2004). Therefore, additional motives for merger and acquisition that may not add shareholder value include:

i. ***Diversification***: While this may hedge a company against a downturn in an individual industry it fails to deliver value, since it is possible for individual shareholders to achieve the same hedge by diversifying their portfolios at a much lower cost than those associated with a merger.

ii. ***Synergies***: Manager's confidence about expected synergies from merger and acquisition which results in purchase of the target company.

iii. ***Empire-building***: Managers have larger companies to manage and hence more power.

iv. ***Manager's Compensation***: In the past, certain executive management teams had their payout based on the total amount of profit of the company, instead of the profit per share, which would give the team a perverse incentive to buy companies to increase the total profit while decreasing the profit per share (which hurts the owners of the company, the shareholders); although some empirical studies show that compensation is linked to profitability rather than mere profits of the company.

Effects of Merger and Acquisition

A study published in the July/August 2008 issue of the Journal of Business Strategy suggests that mergers and acquisitions destroy leadership continuity in target companies' top management teams for at least a decade following a deal. The study found that target companies lose 21 percent of their executives each year for at least 10 years following an acquisition – more than double the turnover experienced in non-merged firms. (Newswise, 2008),

Problem of the Study

1) The stunted growth of the banks as result of low capitalization had reduced the effectiveness of the financial sector in Nigeria in term of net return to shareholders.

2) The nature and size of the banks in the Nigeria financial sector have precluded them from gaining the synergic advantage of low operational cost structure.

3) There is generally low earning structure in the Nigeria banks formation this is due to the low capital base of the commercial banks in Nigeria.

The above are the alibis of the banks in Nigeria before the consolidation of the banks, however, the fostered merger and acquisition was aimed at eliminating or reducing these problems

Hypothesis

H_{O}: The post merger earning is not positively affected by level of operational cost, loan and equity level.

H_1: The post merger earning is positively affected by the level of operational cost, loan and equity.

Model Specification

Earning = f (operational cost, loan, equity)

Earning = $a_o + a_1$Opcost + $a_2$loan + Eqty + e

Result and Interpretation

	Model	R	R^2	Adjusted R^2	Std Error of the Estimate	R^2 Change	F Change	df	Df^2	Sis F Change
Pre-merger		0.972	0.945	0.781	1298.5098	0.945	5.743	3	1	0.295
Post merger		0.991	0.982	0.972	2106.7497	0.982	3.472	3	5	0.000

a: Predicator (constant), Operatncost, loan & advance, equity
b: Dependent variable: total earning

	Regression	Dependent variable (y)	Independent variable	intercept	slope	Coefficient R^2	T. cal	t. tabulated 0.025	Durbin Watson
Pre-merger		Total earning	Operatn cost, loan & advance, equity	3302.686	0.757 0.0076 -0.140	0.972	3.187	0.510 2.404 -0.398	
Post merger		Total earning	Operatn cost, loan & advance, equity	057.869	0.139 0.0075 0.0517	0.982	2.365	1.660 3.133 10.223	5

Analysis and Interpretation

The hypothesis measures the post and pre-merger influence operational cost, loan and advance volume, and equity. The pre-merger correlation coefficient is 0.972. This suggests a high level of relationship between earning, equity, and operational cost. The coefficient of determination is equally 0.945 that is, 95% thus, it means that 95% change is earning in brought about by volume of equity, operational cost and loan and advances. A 0.972 correlation coefficient (R) is a high relationship according to Osuagwu (2006) that a 70% correlation coefficient is good enough in variable relationship. Generally a correlation coefficient of above 0.5 is good enough in measuring variable relationship.

Also in the post merger period the correlation coefficient (R) 0.991 while the coefficient of determination (R^2) is 98%. A high relationship is suggested by the R value while the deterministic factor of the variable is 98% meaning that a 98% change in earning is provoked by the volume of equity, operational cost and loan and advance. Comparing the post and pre-merger value of R the post merger value of R is 98% while the pre-merger value is 97%, 20% higher, the R^2 value is 95% pre-merger and 95% post merger suggesting a 3% increase. In order words the post merger R^2 influence is higher than the pre-merger R such that the influence of operational cost, loan and advance and equity is higher on total earning before tax in the post merger period thus in the pre-merger period.

The intercept of 5057.869 in the post merger period is higher than 3302.680 in the pre-merger period suggest a greater effect of the predictors or independent variable on the dependent variable (total earning). Also the slope in the post merger period are 0.139, 0.0075, 0.05 and pre-merger value are 0.757, 0.0758, -0.40 respectively for equity, loan and operational cost. It means that a unit change in equity in the post merger period provoked 13.9% change in earning while in the pre-merger is 75.7%

Also, a unit change in loan and advance produced 7.58% change in earning in the pre-merger and 7.51% in the post merger. It means loan and advance had more positive growth effect on earning in the pre-merger, thus, in the post merger period. Lastly a unit change is operational cost brought about 14% increase is earning, such unit the higher the operational cost the lower the earning and vice-versa. However, in the post merger period a unit change in operational cost provoke 5.17% increase in earning it means a lower non-operational expenses and higher non-operational increase. It means the back carry a higher and heavy operational cost in the post merger period.

Test of Hypothesis: Post and Pre-Merger

In the post merger period the critical value of t is 1.66, 3.133 and 10.223 for operation cost, loan/advance and equity respectively while the table value is 2.365 this means that while post merger equity value and loan/advance did significantly affect the earning the post merger value of operational cost did.

However, in the pre-merger period the critical value of t for equity, loan/advance and operation cost were 0.510, 2.404 and -0.398 respectively while the table value is 3.187 means that the value of equity, loan/advance and operational cost did not significantly affect the value of earning.

Conclusion

1. The post merger influence of equity, loan and advance and operational cost on earning is higher than pre-merger values.
2. The operational cost and earning are negatively skewed in the pre-merger but positively skewed in the post merger.
3. The bank carry the larger operational cost in the post merger than in the pre-merger and it significantly impact on earning.
4. Total earning those respond positively to change in equity, loan and advance and operational cost but other variables affect the growth of earning than the three acknowledged variables time.
5. The growth effect of equity and loan and advance on total earning of the bank is really marginal the earning a greatly positively skewed towards either variables.

Recommendation

1. The banks should reduce the operational cost in the post merger period to grow their earning because uncontrolled operational cost would erode their earning of other non-operational revenue sources dwindled.
2. The banks should do more of the fundamental business of the banks thus concentrate effort on the non-conventional business (non-operational revenue sources) any change in government policy will likely impact negatively on their corporate existence.

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