Faculty of Economics and Business

CORPORATE'S MERGER AND ACQUSITION: A STUDY ON FREE CASH FLOW RETURNS AND STOCK PRICE REACTION

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CORPORATE'S MERGER AND ACQUSITION: A STUDY ON FREE CASH FLOW RETURNS AND STOCK PRICE REACTION

ELIZABETH KONG

This project is submitted in partial fulfillment of
the requirements for the degree of Bachelor of Finance with Honours

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Statement of Originality

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The work described in this Final year project, entitled
"Malaysia Corporate Merger and Acqusition: A Study on Free Cash Flow Hypothesis and Stock Price Reaction"
is to the best of the author's knowledge that of the author except
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ABSTARCT

CORPORATE'S MERGER AND ACQUSITION: A STUDY ON FREE CASH FLOW RETURNS AND STOCK PRICE REACTION

By

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The main objective of this research is to determine the effect of -pre and post mergers of firms in share price and their corporate performance in term of free cash flow. The samples of the research consist 28 firms selected from Malaysia listed companies which make M&A announcement in Bursa Malaysia. The sample period started from 2001 to 2010. The methodologies applied in this research are ordinary least square (OLS) and paired samples t-test. Based of the findings obtained, FCF hypothesis do not exist within the firm which make M&A announcement in Bursa Malaysia. FCF is positively significant impact on firm operating and stock market performance. Malaysia post M&A announcement firms do not show positive return toward stock performance.

ABSTRAK

KORPORATE PENGGABUNGAN DAN PENGAMBILALIHAN: KAJIAN KE ATAS PULANGAN ALIRAN TUNAI DAN STOK HARGA TINDAK BALAS

Oleh

Elizabeth Kong

Objektif utama kajian ini bertujuan untuk mengenal pasti kesan sebelum dan selepas penggabungan firma dalam harga saham dan pihak prestasi korporat aliran tunai. Sampel dalam kajian merupakan 28 buah syarikat Malaysia yang membuat penggabungan dan pengambilalihan pengumuman dipilih melalui Bursa Malaysia. Tempoh Tarikh sampel bermula dari tahun 2001 hingga tahun 2010. Kaedah yang diaplikasikan dalam kajian ini adalah regresi model dan berpasangan sampel t-ujian. Malaysia tidak mewujudkan aliran tunai hipotesis dalam firma yang membuat penggabungan dan pengambilalihan pengumuman di Bursa Malaysia. Aliran tunai bagi firma Malaysia munujukkan kasan positif ke atas operasi firma dan prestasi pasaran saham. M & A pengumuman firma tidak menunjukkan pulangan yang positif terhadap prestasi saham.

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INTRODUCTION

1.0 Introduction

Merges, acquisition, and takeover are the words mostly occur to subscribe when two or more firms come to combine into one entity for getting a greater chance in wealth gain. A mutual decision or ideal must be making by at least two firms to combine and become one entity. For example, when firm A combined with firm B then it will eventually a new large entity this process is called as merger. However, there is no statutory concept of a "merger" in Malaysia case (M&A Asian taxation guide report, 2010). As stated by M&A Asian taxation guide report, (2010) "the mode of merger in Malaysia involves either the acquisition of shares in an existing Malaysia company, or an acquisition of assets (and liabilities) of another entity". In Malaysia, Merges and acquisition (M&A) usually combined through acquisition of voting shares, business or assets in a firms and also by using a court-sanctioned scheme of arrangement under section 176 of the Companies Act 1965 (Loong, 2008). Firms with high free cash flow (cash-rich firms) are likely to acquire others firms and make large acquisition than normal population of firm. Some of the cash-rich firms like to invest in unprofitable project or use the excess cash flow involved in takeover activities instead of paying out the excess cash flow to their shareholder (Jensen, 1986). This is the way how the manager spend their excess cash flow by involving in acquire activities to make a larger firm size without knowing it is a profitable investment or unprofitable project. It is a risk to involve in M&A activity.

Firms which undergo mergers and acquisition (M&A) till now are still in an increasing trend. There are many reasons causing firms likely to undergo M&A activities which they believe that acquisition or take over will be a profitable investment that bring a lot of wealth gain after formed a new combined entity. The efficiency is improved after the M&A activities especially in operating and managerial efficiencies and reduces their production costs. Besides that, financial and tax benefits gain through the M&A also one of the reasons show the way to M&A activities. The profit that gain can be diversifying within the firm to avoid bankruptcy and tax reduction after associated with M&A. Some M&A may lead to market power effect. They believe that it is profitable to invest in M&A. There are difference merges waves occur during the 19^{th} and 20^{th} century, such as "mergers for monopoly and oligopoly". Therefore, M&A are boosted during this two century. In addition, the firms will engage in management greed, self-aggrandizement or hubris and obtaining a good buy are also motives for those potential acquirers have the idea or decision to take part in M&A activities. (Pautler, 2001).

This study evaluates the effects of corporate in Malaysia mergers comparing pre- and post- merger performance by measuring their free cash flow. It also addressed whether or not free cash flow increases during the pre-mergers and acquisitions (M&A) and post M&A period. M&A or take-over activities were aggressively transacted by corporations to expand their business so that the corporations have more opportunities to grow faster in the market and strengthening of a firm's financial position. M&A can add value to the combined corporate that has showed in past studies. Nevertheless, past studies showed that most of targets' shareholders were at the high level of wealth gain while the shareholders of acquiring firms were at zero, negative, or small positive returns upon the announcements of the business combinations. Acquirers lost even more in the long run performance. Conflicting results will show in merges and acquisition or combined entity especially the conflict between manager and shareholders.

The acquisition effect of cash-rich firms is examined for evidence of M&A-related free cash flow performance after M&A announcement at Bursa Malaysia listed announcement. Cash-rich firms are found to be more likely to begin acquisitions to increase their current acquisition spending, and engage in large entity. Free cash flow hypothesis Free cash flow theory used by Jensen (1988) implies that managers of firms with large free cash flows and unused borrowing power are more likely to undertake low-benefit or even value-destroying mergers. The theory predicts they will generate lower total gains for those firms that are likely to acquirer the other firms by using diversification programs. In the other hand, most of the acquirers will tend to have good impression on the takeover activities seem it will generate great wealth after acquire.

Free cash flows stated by Jensen (1987) are the discounted value of all the operating cash flows net of the needs of positive NPV projects. He argues that managers in firms with free cash flow engage in wasteful investment and positive relation is a manifestation of an agency problem. Richardson (2006) explains free cash flow is cash flow beyond what is necessary to maintain assets in place and to finance expected new investments. Free cash flow is in the region of a dozen theories to explain the takeovers and with some relevance in explaining the various forces motivating merger and acquisition activity (Roll, 1986). In addition to the accounting concept, free cash flows also represent idle cash flows at the discretion of management by Wang (2010).

Most of the research that involving in the free cash flow hypothesis will related with agency cost of free cash flow which agency cost is the cost arise from the inefficiency of a relationship between an agent and a principal. Conflict will occur when a firm's manager is not willing to pay out the excess free cash flow to shareholder or wish to maximize their personal power and wealth. Shareholders wish to increase their shareholder value.Stock returns surrounding announcement dates are focused by the free cash flow performance of M&A for most research to investigate the effect of free cash flow after M&A announcement. It is not surprisingly most of the result for all researchers have reported large positive average abnormal returns to targets and given the significant premiums typically involved in takeovers. Small abnormal returns are found in these same researchers for bidders over the announcement period.

1.1 Malaysia Capital Market Background

Bursa Malaysia acts as Malaysian capital market and providing efficient, secure and active trading market for all investors around the world that can enhance global competitiveness. Bursa Malaysia is a large exchange holding institution in Asia which follows Section 15 of the Capital Markets and Services Act 2007. Bursa Malaysia Securities Berhad, Bursa Malaysia Derivatives Berhad and Labuan International Financial Exchange Inc are belonging to Bursa Malaysia as wholly owned subsidiaries. Thousand of legally companies are listed in Bursa Malaysia that appears either Securities Berhad Main Market or ACE Market.

Singapore Stockbrokers' Association was recognized in 1930 which acts as the first securities institution in Malaysia. In the year 1937, Singapore Stockbrokers' Association was changed to Malayan Stockbrokers' Association. After a few tens years, there's appear a new named capital market institution with public trading of shares provided for investor in Malaysia, The Malayan Stock Exchange in 1960. Singapore and Kuala Lumpur have their own trading room in both places that linked by direct telephone lines.

The Stock Exchange of Malaysia was established in 1964. In 1965, the Stock Exchange of Malaysia has changed became the Stock Exchange of Malaysia and Singapore. In 1973 Malaysia without Singapore due to the cessation of the currency interchangeability between Malaysia and Singapore, it had been divided into the Kuala Lumpur Stock Exchange Berhad and the Stock Exchange of Singapore. The incorporation of the Kuala Lumpur Stock Exchange was established on December 14, 1976 to become a company limited by guarantee. In the same year, the operations of the Kuala Lumpur Stock Exchange Berhad have taken over by the Kuala Lumpur Stock Exchange.

The Kuala Lumpur Composite Index (KLCI) is well known as capitalization-weighted stock market index in Malaysian stock market. KLCI was set up in 1986 and act as an accurate performance indicator in Malaysia stock market and economy. KLCI has designated as the main Malaysia stock index. KLCI is used as a key benchmark for Bursa Malaysia. KLCI is a price index which is not accumulative and consists of 100 companies in the Main Board. Then it changed become FTSE Bursa Malaysia KLCI which was comprised the largest 30 companies listed on Malaysian Main Market.

Bursa Malaysia Berhad (former named Kuala Lumpur Stock Exchange) which set up on April 14,2004 was to develop their competitive position and to counter to global trends in the exchange sector with demutualization exercise. Bursa Malaysia was listed on the Main Board of Bursa Malaysia Securities Berhad on 18 March 2005.The ISO 9001:2000 Quality Management System and ISO 14001:2004 Environmental Management System standards that received on 5 October 2007 have brought the successes of Bursa Malaysia to accomplish the double achievements during the exchange.

September 2009, Bursa Malaysia Berhad with Chicago Mercantile Exchange (CME) institute a new trading platform with the objective to enhance accessibility to its derivatives offerings globally. 25% of the equity stake was hold by CME in Bursa Malaysia Derivatives Berhad, while the left over 75% interest was held by Bursa Malaysia Berhad.

1.2 Malaysia M&As' Rules and Regulations

There are rules and general requirements imposed on listed companies under the Bursa Listing Requirements. The rules administered by Bursa Malaysia are to ensure protection for investors and greater efficiency of the regulatory framework in conducting the business. The Securities Comission (SC) has a new Code on M&A of public listed companies in Malaysia. From the source of M&A Malaysia by Lim *et al.*, (n.d) in the acquisition of public companies mentioned, a M&A transaction appeal when a public or private company has their shareholder funds or paid up capital minimum RM10 million or above and a minimum RM20 million or above purchase is considered as a qualifying company in the provisions of the Malaysia Code on Takeovers and Mergers 1998 ,the Securities Commission Act and the bursa Listing Requirements.

According to Lim,Yeoh and Delamore (n.d), practice notes must be issued by the Securities commission and conduct in accordance with the provisions of the

Malaysian Code on Takeovers and Mergers are the mandatory takeover offer. Requirements for Malaysian Code on M&A are as follows:

a) the announcements, notices and documents to be provided to the shareholders of the listed company ;

b) the terms of the offer ;

c) the timing of the offer;

d) the form and content of the offer document ; and

e) the relevant obligations of various parties in relation to disclosure.

Securities Commision and Bursa Malaysia Securities Berhad are two main authorities to regulate the acquisition of a public company. The Malaysian Code on Takeovers and Mergers requires that a mandatory takeover offer be extended to the shareholders of the remaining voting shares of the company if: (1) an acquirer has obtained control in a company, for example the amount of shares acquired is more than 33% of the voting shares of the company or (2) a person that holds more than 33% but less than 50% of the voting shares of the company.

Dobbs et al,. (2006) claimed that announcement effects are useful to assess the impact of M&A on its own, as they excluded many of the other factors that drive share price movements beyond just the M&A announcement. But because the market's initial response to deals can be either wrong or affected by factors other than the value of the deal (such as bid speculation before the deal, signaling, and tax and market liquidity issues), announcement effects cannot be used to assess the value that any individual deal creates.

1.3 M&A Potential in Malaysia

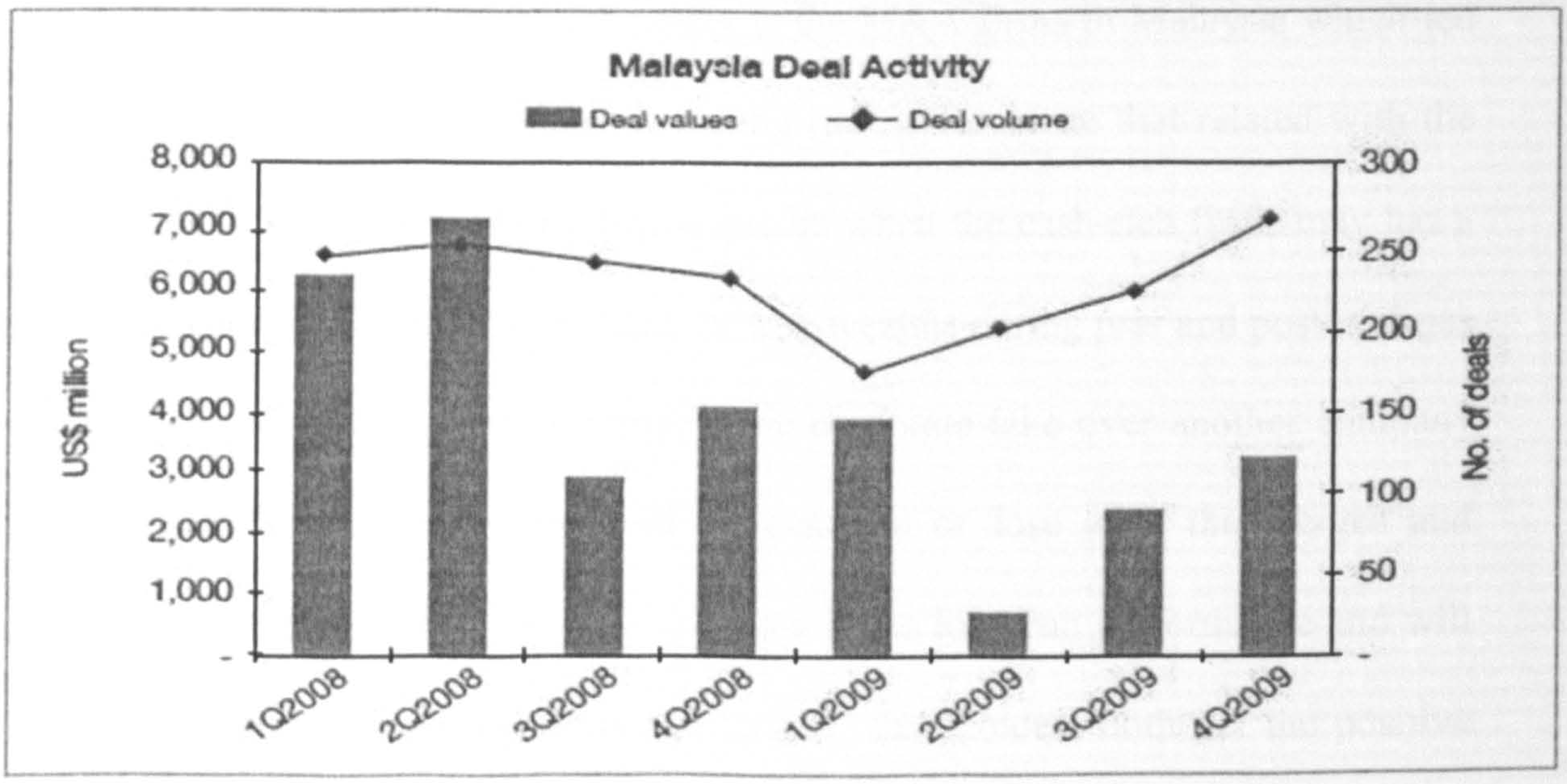
From the source of Bloomberg Businessweek news Dec 2010, M&A in Malaysia have reached almost tripled compared to last year of 2009 to $21.3 billion. It reached the maximum deal compare to past years. It also showed that Malaysia is in a boom and fastest growing market for mergers and acquisitions in the Asia-Pacific region as companies seize on record valuations and relaxed takeover rules to catch up with rivals in India and Singapore. Year 2010 is consider as the year of M&A for Malaysia.

M&A firms in Malaysia mostly merger or acquire the firms other than our countries. On the other hand, foreign countries also invest in our local firms through M&A. Local firms which the firms are listed companies in Bursa Malaysia online less undergoes M&A activities within Malaysia.

According to the United Nation's World Investment report, foreign direct investment (FDI) in Malaysia tumbled 81 percent to $1.4 billion in 2009.Our prime minister, Najib take some actions to prevent the decreasing of the M&A deals from foreign countries. Following the order from Malaysia Prime Minister Najib, they dropped a requirement for foreign country to invest in Malaysia that approves all acquisitions by overseas companies. Government is encouraging more and more overseas companies to invest in Malaysia making into a most deal in M&A to become Malaysia M&A year. This action has successes attracted 5.1 billion ringgit of foreign direct investment in the first quarter of 2010. The government forecasts economic growth of up to 7 percent in 2010, the fastest pace in a decade.

In year 2011, Malaysia seem has more M&A activities even though M&A growth slowed in developing countries like Malaysia but still the companies in our country are trying to get a better chance to increase their global footprints in the faster-growing emerging markets. Malaysia, as an emerging market, has seen its share of M&A deals. This trend is expected to continue as growth in developed countries will remain relatively stagnant in the near future thereby driving more M&A firms in Malaysia to form a larger enterprise to attract more oversea countries invest into Malaysia.

Below is the graft for the M&A deal activities in Malaysia:



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2009

M&A deal activity start from the year 2008 and year 2009 are showed above. It shows that there is a decreasing deal volume at first quarter of 2009 comparing with the year 2008. It starts also to increase dramatically after the first quarter of year 2009.From here, M&A in Malaysia is growing after the first quarter of year assessment 2009. The deal volume meet the highest point compare to last year 2008 reach above 250 numbers of deals which compare to last year that other deal volumes are below 250. In addition, the deal value also show increasing from the second quarter of 2009.It is shows that the M&A deal value in Malaysia s slightly increasing and getting better after that.

1.4 Problem Statement

The critical problem for this study is the M&A firms in Malaysia which led to performance of share price and their long run performance that related with the free cash flow. The practical problem is occurs when the cash-rich firms may has a difference value of free cash flow (gain or lose wealth) during pre- and post- merges and acquisitions of firm. For example, if the corporate take over another company how well is the free cash flow will be generate or lose after the merges and acquisition announcements are make and how is the long run performance and will the shareholders of acquiring firms and targets' shareholders both get the positive returns?