Post Merger Performance of Acquiring Firms: A Case Study on Indian Pharmaceutical Industry

Neha Duggal
Research Scholar, University School of Management, Kurukshetra University, India

Abstract

Mergers and Acquisitions (M&A) are considered as a significant tool for corporate restructuring and value creation in the present scenario. It enables the firms to expand their horizons, reducing the business risks, exploring new markets and geographical areas thereby increasing the profits and gaining through competitive advantage. The present research paper aims at studying the impact of mergers on the operating and financial performance of Indian pharmaceutical companies examining various financial ratios of the sample of companies listed on the BSE from the period 2000-2006. For the purpose of analysis paired sample t-test is conducted. The results suggested that there was positive impact (t+1 year window) of mergers on the profitability of the acquiring firms but this impact has not sustained in (t+3, t+5 yr period) post merger in terms of selected profitability variables. The results reported in the study points to the positive impact of merger announcement on the operating and financial performance in short run (+1 yr).

Keywords

Merger & Acquisitions, financial ratios, pharmaceutical industry

I. Introduction

Mergers and acquisitions have always been taken as the one of the most convenient and profitable strategy to survive in the competitive environment. The intent is to gain competitive advantage, capitalizing larger market share, creating profits through synergistic effect and economies of scale thereby bringing competencies and capabilities for a sustainable corporate performance. The rapid changing technologies, fast moving economies, the positive impact of globalization, accelerated revenues has triggered this activity manifold in recent times. M & A deals reached an all-time high in 2006 with a total value of $3.7 trillion [Dobbs, Goedhart and Suonio 2007]. At the beginning of twentieth century the drive for market share led to merger deals followed three decades later where the companies got connected through value chain, elements of raw material and production through distribution.

A. Mergers and Acquisitions in Indian Industry

Post economic liberalization in early 1990’s Indian economy has undergone a massive transformation. The economic reforms gave enabled the corporate to introduce various structural changes and restructuring activities mainly followed by merger and acquisition deals. The Indian companies have understood well the significance of environmental adoptions, technological innovations and competitive advantage.

A survey among Indian corporate managers across various industry sectors by Grant Thornton (2006) found that M&As are a significant form of business strategy. The three main objectives necessitating any M&A transaction, for corporate were found to be: (1) improving revenues and profitability, (2) faster growth in scale and quicker time to market, and (3) acquisition of new technology or competence. Fig 1 (a) shows various merger and acquisition deals announced from a period of 1999 to 2013 showing a significant increase in the activity upto 2007 where the highest amount of deal size and highest no. of deals have been attained. Although it doesn’t pace up the same beyond this year but still shows a continuous merger movement in Indian economy. The progress of mergers and acquisition activities spiked during the 2006-11 period coinciding the bullish phase of Indian economic activity- fig 1 (a)

Announced Mergers & Acquisitions:
India, 1999-2013
(source: www.imaa-institute.org)

B. Mergers and Acquisitions in Indian Pharmaceutical Industry

The Indian pharmaceutical companies have also reinvented their business model in the post liberalized era focusing more on contract manufacturing, generic formulations and the export led growth more so to the US market. Due to extreme competition from other Asian as well as European countries mainly Chinese and the eastern European countries, the Indian companies are facing hard time to survive in the foreign market. For foreign companies, Indian market has been a lucrative place to sell off their products considering the size and scale of Indian pharmaceutical industry. So Indian companies are facing a tough competition in the domestic market turf also which has made them realize the importance of working on adopting new and innovative technologies and advancement in terms of R & D activities. Developing the core competencies and innovation in the products can help the Indian firms to move upwards in the value chain. Indian companies opted for enhancing the capacities and adopted for technological advancements by conducting M & A activities. The reasons behind, are through competitive advantage created
by the synergistic effects when two entities combine. Such alliances led to increase in market share, economies of scale, new technologies, new products thereby leading to high revenues. 


According to (KPMG,2006) report Indian pharmaceutical companies are pursuing acquisitions with the following goals:

- Improve global competitiveness
- Move up the value chain
- Creation and entry to new markets
- Increase product portfolios
- Acquire assets (including research and contract manufacturing in order to boost their outsourcing capabilities) and new products
- Consolidate their market share
- Compensate for their continued sluggishness in their home market.

<table>
<thead>
<tr>
<th>Acquirer</th>
<th>Target</th>
<th>US$m</th>
<th>Deal type</th>
<th>Stake</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sun Pharmaceutical Industries Ltd.</td>
<td>Ranbaxy Laboratories Ltd</td>
<td>3200</td>
<td>Acquisition</td>
<td>100%</td>
</tr>
<tr>
<td>GlaxoSmithKline Pte. Ltd.</td>
<td>Glaxosmithkline Pharmaceutical Ltd.</td>
<td>1032</td>
<td>Increasing stake to 75%</td>
<td>24%</td>
</tr>
<tr>
<td>Meiji Seika Pharma</td>
<td>Medreich Ltd.</td>
<td>290</td>
<td>Acquisition</td>
<td>100%</td>
</tr>
<tr>
<td>Shire Aurobindo Pharma Ltd.</td>
<td>Shasun Pharmaceuticals</td>
<td>200</td>
<td>Merger</td>
<td>N.A.</td>
</tr>
<tr>
<td>Aurobindo Pharma Ltd.</td>
<td>Natol Inc</td>
<td>132</td>
<td>Acquisition</td>
<td>100%</td>
</tr>
</tbody>
</table>

Fig1 : Top M&A deals in Indian Pharma and Healthcare in 2014

(Source: Grant Thorton Annual Dealtracker Report, 2014)

According to a recent report, the M & A activities in the Indian pharmaceutical sector has shown an immense rise with a total value of US $ 5160 mn in the pharma and biotech sector. Sun pharma and Ranbaxy labs full stake acquisition of whooping US$ 3200 mn, constituting to be the major part of the total value of the deals in this sector followed by Glaxo Smithkline Pte. Ltd. with Glaxo Smithkline Pharmaceuticals Limited with a deal size of around US$ 1032 mn.

II. Review of Literature

Various studies have concluded and resulted an optimistic affect of mergers on corporate performance of the company. By adopting certain parameters of measuring the financial and operative improvements in the companies researches have concluded that mergers have favorable impact on corporate.

Kruze, Park and Suzuki (2003) studied the long term operating performance of mergers of Japanese companies with a sample of 56 mergers of manufacturing companies from the period 1969 to 1997. The cash flow performance in the five year period following mergers were studied . it found evidence of improvement in operating performance and also pre and post merger performance are highly correlated. It concluded that long term operating performance of control firms was positive but insignificant and high correlation existed between pre and post merger performance.

Vanitha. S and Selvam. M (2007) in their study “Financial Performance of Indian Manufacturing Companies During Pre and Post Merger” analyzed 17 companies as a sample out of 58 to study the impact of merger on the performance in Indian manufacturing sector from 2000-2002. For financial performance analysis ratio analysis, mean, standard deviation and “t” test was used. The found overall financial performance to be insignificant for 13 variables.

Pramod Mantravadi and Vidyadhar Reddy (2008) investigated a sample of 118 cases of mergers in their study, “Post merger Performance of acquiring firms from different industries in India” aimed to study the impact of Mergers on operating performance of acquiring corporates in different industries from a period of 1999 to 2003. The results showed minor variation in the operating performance following mergers where more impact of merger was noticed on the profitability of banking and finance industry, pharmaceutical, textile and electric equipment sector whereas significant decline was seen in chemical and Agri-Products sector.

Beena (2004) analyzed the pre and post merger performance of firms belonging to manufacturing industries with an investigation of sample of 115 acquiring firms between the period 1995-2000. For the purpose of analysis four sets of financial ratios were considered and it was tested using t –test. The study showed no improvement in the performance in comparison to the pre merger period for sample companies.

Ghosh and Jain (2000) analyzed whether the merging firms increase their financial leverage after merger. For this a sample of 239 mergers during 1978 to 1987 in the US taken. The result showed that mean financial leverage resulted in 17% increase as compared to pre merger financial leverage of combined firms. The study was conducted on comparing pre and post merger performance on the case to case basis. Likewise Healy, Palepu, and Ruback (1992) studied the post-acquisition performance for 50 largest U.S. Mergers took place in the time period of 1979 and 1984 by measuring cash flow performance the results showed that operating performance of merging firms improved significantly following acquisitions. On the other hand Ghosh (2001) investigated whether operating cash flow performance improves following corporate acquisitions, using a design that accounted for superior pre-acquisition performance, and found that merging firms did not show evidence of improvements in the operating performance following acquisitions.

Weston and Masingka (1971) studied the performance of conglomerate firms pre and post merger period. The results showed that earnings rates significantly underperformed those in the control sample group, but after 10 years, there were no significant differences observed in performance between the two groups. Surjit Kaur (2002) in her study compared the pre and post-takeover performance during 1997-2000 for a sample of 20 acquiring companies, with a set of eight financial ratios 3, during a 3-year period before and after merger. T-test was used for the purpose of analysis. The study concluded that both profitability and efficiency of targeted companies declined in post- takeover period. Similarly Pawaskar (2001) investigated the pre and post merger performance of 36 firms from 1992- 95 , using various financial ratios like profitability, growth, leverage and found that the acquiring firms performed better than industry average in terms of profitability. For analysis regression was conducted and it was observed that there was no increase in the post merger profits to main competitors of acquiring firms.

Danzon et al. (2007) studied that in large pharmaceutical and biotech firms mergers are motivated by excess capacity, provides for restructuring of asset base . also it was observed if smaller firms actively participate in mergers they would achieve more due to economies of scale as compare to larger firms.
III. Study Methodology

A. Objectives of the study
The present research paper aims at analyzing the impact of mergers on the performance of companies in the Indian pharmaceutical industry with the following objectives:
- To study the impact of merger announcement on the financial performance of the acquiring firms in the post merger period.
- To study the impact of merger announcement on the operating performance of the acquiring firms in the post merger period.

Further the study intends to investigate the sustainability of post merger performance in the +3 and +5 year window.

B. Research Hypothesis
To test the objectives stated above the following hypotheses were formulated:
- $H_{01}$ - There is no significant difference in the financial performance of Indian pharmaceutical companies post merger.
- $H_{02}$ - There is no significant difference in the operating performance of Indian pharmaceutical companies post merger.

C. Sample Selection
The present study takes into account the Mergers in pharmaceutical sector announced between January 2000 to December 2006 by the companies listed on Bombay stock exchange. Only stock to stock mergers were considered in the sample. Merger cases where 5 years post merger and 1 year pre merger data were not available have been excluded from the sample. All the companies merged in the same industry were included. Hence the sample size of study comes out to be 14 mergers in the recent study period.

IV. Data Collection and Analysis

A. Data Collection
Secondary sources have been used for data collection of various financial ratios for 1 year pre upto 5 years of merger of the sample companies. The data was obtained from Prowess database of Centre for Monitoring Indian Economy (CMIE) and website of the Bombay Stock Exchange (BSE). The announce dates and year of mergers of the sample firms was also verified from the BSE website.

B. Data Analysis
For the purpose of measuring the financial and operating performance of the merger following ratios have been considered to evaluate the impact of mergers.

<table>
<thead>
<tr>
<th>Financial performance Indicators</th>
<th>Liquidity and solvency indicators</th>
<th>Operating performance indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit margin</td>
<td>Current ratio</td>
<td>Inventory turnover ratio</td>
</tr>
<tr>
<td>PBIT Margin</td>
<td>Quick ratio</td>
<td>Debtor turnover ratio</td>
</tr>
<tr>
<td>Cash Profit Margin</td>
<td>Long term debt ratio</td>
<td>Investment turnover ratio</td>
</tr>
<tr>
<td>Net Profit Margin</td>
<td>Interest cover ratio</td>
<td>Assets turnover ratio</td>
</tr>
<tr>
<td>Return on capital employed</td>
<td>Total debts to owners fund ratio</td>
<td></td>
</tr>
<tr>
<td>Return on net worth</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on assets excluding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>revaluations</td>
<td></td>
<td></td>
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</tbody>
</table>

The year of announcement is taken as the base year and denoted as “0”. The year before the merger is denoted as ( -1 ) , post 1 year as (+1), post 3 years (+3) and post 5 years as (+5) respectively. To determine the impact on performance in the pre and post merger period, paired sample T test has been conducted at the confidence level of 0.05. The 1 year pre merger financial ratios are compared with post 1, 3 and 5 years financial ratios in subsequent pairs of (-1,+1), ( -1,+3) and (-1,+5) respectively.

V. Empirical Results

Table1 : Paired sample t-test of various financial ratios pre and post mergers

<table>
<thead>
<tr>
<th>Financial performance indicators</th>
<th>Mean values(pre and post mergers)</th>
<th>t-value(paired sample pre and post)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-1</td>
<td>+1</td>
</tr>
<tr>
<td>Operating profit margin</td>
<td>25.855 (19.778)</td>
<td>29.390 (13.938)</td>
</tr>
<tr>
<td>PBIT Margin</td>
<td>17.230 (7.131)</td>
<td>22.187 (8.565)</td>
</tr>
</tbody>
</table>
The aim behind studying this paper was to find out if there is any significant impact of mergers on the performance of the pharmaceutical firms. The results above show that post merger the PBIT (profit before interest and tax) shows an improvement in the succeeding year of merger which is depicted through mean values (17.230% to 22.187%) which is a significant increase indicated by t-statistics of -2.166 (p=0.049<0.05). whereas there is constant decline observed in the ratio post 3 and 5 years of merger respectively.
significantly proven through t-test value (p=0.052>0.05) which is marginally high at 0.05 level of significance whereas it proves to be significant at 0.10. The statistics indicates the performance to be insignificant post 3 and 5 years respectively. Negative impact of mergers are depicted through declined statistics of operating profit margin, return on net worth, return on assets excluding depreciation.

2. Liquidity ratios and solvency

The mean values of current ratio shows a marginal increase post 1 year of merger which is insignificant beyond this period it starts declining proving that there is no improvement in the ratio post merger. There is no improvement registered in the liquidity ratio parameter as well. Although the impact can be validated to be significant post 1 year given t-value=1.790 (p=0.097<0.10) at 10 % level of significance. There is no impact seen on other solvency and debt coverage ratios.

B. Operating performance indicators:

The results shows a significant improvement in the performance validated by the positive increase in the mean value (5.366% to 6.470%) of inventory turnover ratio post 1 year of merger depicted by the significant value of (p=0.006 < 0.05) with t-value=-3.313 obtained through calculations. Post this period result doesn’t remain the same. The results also supports that there is significant improvement seen in the investment turnover ratio after 1 year depicted through mean values (5.818% to 6.726%) with t-value of (-2.894) significant with (p=0.013<0.05) at 0.05 level of significance. There isn’t any improvement noticed in assets turnover and debtor turnover ratio in the post merger period.

VI. Conclusion

As the motive behind conducting the research is to study the impact of mergers on the performance of the firms. Also to find out if the impact is just for a short term which has not been sustained for long. Through the study it was observed that merger have significant impact on the performance as compared to pre merger period but the impact is evident more in the immediate year after merger. The findings revealed that profitability has improved as indicated by ratios like EBIT, Cash Profit margin and Net profit margin but the improvement in the performance is observed only up to 1 year of merger. As far as operating performance is concerned the short term positive impact can be observed but again it lasts upto 1 year only. Likewise the sustainability of post merger performance has conspicuously absent in this regard too in the post merger (+3,+5 year) period. This improvement has not sustained in post merger announcement (+3,+5 year) period. Therefore the results reported in the study points to the positive impact of merger announcement on the operating and financial performance in short run (+1 yr).

References