CHAPTER I

INTRODUCTION

1.1 Background

Every year companies aim to grow either organically or inorganically. A company can grow organically through expansion of their operation such as entering new geographic area, targeting new market segment, establishing new business, etc. Alternatively, the company can also grow its business through inorganic expansion by acquiring shares in other companies, merging with other companies, or joint venture. With reference to Foster (1986) in Helga and Salamun (2006), share acquisition refers to the acquisition of entire or majority of shares issued by targeted entities by using cash or other financial instruments. Ross et al (2008) stated that the other way to acquire another firm is to purchase the firm's voting stock with an exchange of cash, shares of stock, or other securities. According to Payamta (2003) and Setiawan (2004), acquisition will result in change of control from the acquired company to the acquiring company. According to Ross et al (2008), merger refers to the complete absorption of one firm by another where the acquiring firm retains its name and identity, and it acquires all of the assets and liabilities of the acquired firm. Prior to the inorganic expansion, management of the companies will typically perform comprehensive analysis including but not limited to identifying potential synergies that could be generated from the target company, estimating valuation of the target company, determining capital structure in the potential transaction, reviewing historical financial performance, planning post-transaction integration, etc. Based on Brigham and Houston, 2004, the primary motivations of merger or acquisition are synergies, potential tax benefit, assets with

price lower than replacement cost, diversification, residual value and manager's personal incentive. Based on Weston, Mitchell, and Mulherin (2004), the synergies could be achieved either through revenue or cost synergy. According to Gie (1992) in Payamta and Setiawan (2004), the key benefits of share acquisition include reducing competitions, survival from bankruptcy, complementary and larger pooling power. According to Jarillo (2003), a successful merger and acquisition must have a well-conceived strategy behind selection of target company, have a well-defined strategy of integrating the target and acquiring company, and consider drawbacks of paying too high premium. Theoretically, the acquiring companies could benefit from synergies (Larrson and Finkelstein (1999)), economic of scales (Pangarkar and Lim (2003)), greater monopoly (Sharma and Ho (2002)), etc., resulting in better consolidated financial performance post-acquisitions. Financial performance could be indicated among others, through profitability ratios, liquidity ratios, and solvency ratios. Profitability ratios measure the ability of a company to generate profits from revenue and assets. Profitability ratios include among others, gross margin, EBITDA margin, net profit margin, return on assets, return on equity. Liquidity ratios measure the ability of a company to meet short term obligations. Liquidity ratios include among others, current ratio and quick ratio. Solvency ratios measure the ability of a company to meet long-term obligations. Solvency ratios include among others, debt to asset ratio, debt to equity ratio, and debt service coverage ratio. This research will use EBITDA margin, net profit margin, return on asset, return on equity, debt to asset ratio, current ratio, and quick ratio as indicators to post-acquisition financial performance of the acquiring company.

According to Fang et al. (2004), mergers and acquisitions do not always result in better financial performance expected by the companies involved in the acquisition as the companies face obstacles to achieve benefits of the mergers and acquisitions. Factors that caused acquisitions do not result in better performance of the acquiring company post-acquisition are among others, inability to realize the expected synergies, more complex organization structure resulting in higher costs, and additional income from the acquisition does not sufficient to cover the cost of debt for acquisition.

This research focuses on observing and analyzing the financial performance of public listed companies in Indonesia Stock Exchange with business in non-financial sector ("Selected Acquiring Companies") and completed majority shares acquisitions in a period of 2014 to 2016 ("Acquisitions"). The basis underlying the selections of the Transactions are set out below:

1. This research excludes the extraordinary impacts of COVID-19 pandemic commencing in 2020 to 2022. As the research will observe and analyze the impact on financial performance up to 3 years upon acquisitions, the Transactions' completion date selected in this research will be:
   a. 2014 with post-acquisition performance to be observed from 2015 to 2017;
   b. 2015 with post-acquisition performance to be observed from 2016 to 2018; and
   c. 2016 with post-acquisition performance to be observed from 2017 to 2019.

2. This research excludes Companies with business in financial sector as financial metrics used in this research are substantially different from the metrics used for analyzing performance of companies in financial sector such as bank and multifinance. The following financial metrics are exclusively used to analyze performance of financial sector:
    a. net interest margin, which is net interest income a lender earns from loans or leases deducted by interest expenses (of saving accounts, time deposits, bank loans, notes, or bonds);
    b. loan to deposits or loan to assets, which is loans or leases a lender disburses as compared to the deposits or total assets of the lender, and is used to indicate the ability of the lender to cover withdrawals made by its customers;
    c. non-performing loan ("NPL") or non-performing asset ("NPA") ratio, which is calculated as NPL or NPA divided by outstanding loan disbursed by a lender; and
    d. capital adequacy ratio, which is a ratio comparing a lender's capital (tier-1 and 2 capital) to risk-weighted assets.
3. This research includes only acquiring companies that are listed in Indonesia Stock Exchange for the following reasons:
    a. the acquiring companies are typically the initiator of the acquisitions and the party expecting to generate synergies through the acquisitions; and

b. information of the listed companies is publicly available and can be more accurately presented as they are scrutinized by the equity analysts and investors.

1.2 Objective of the Research

The objective of this research is to

a. determine whether the post-acquisition financial performance of the Selected Acquiring Companies are better than the pre-acquisition financial performance; and
b. determine the factors in post-acquisition that produce better result compared to the performance in pre-acquisition.

1.3 Question of the Research

To observe the changes in pre and post-acquisition financial performance of the Selected Acquiring Companies, the following questions will be addressed in this research:

1. Does profitability of the Selected Acquiring Companies increase after the Acquisitions and what factors that drive the change in profitability post-acquisitions? EBITDA margin, net profit margin, return on asset, and return on equity will be observed in order to understand profitability trend of the Selected Acquiring Companies.
2. Does the financial leverage of the Selected Acquiring Companies increase after the Acquisitions? Debt to asset ratio over the observation period will be used to indicate the trend of financial leverage of the Selected Acquiring Companies and whether the trend in financial

leverage post-acquisition indicate consistent impact to the trend in profitability post-acquisition.

3. Does the liquidity of the Selected Acquiring Companies increase after the Acquisition? Current ratio and quick ratio will be observed in order to understand liquidity trend of the Selected Acquiring Companies.