

**Merger: Valuation Process and  
Evaluation of Financial Performance  
in case of United Insurance Company  
and Shama Plc**

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January 2008**

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Professor.)**



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**Department of Accounting & Finance**

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Financial Performance in case of United  
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January 2008

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# Statement of Certification

This is to certify that Jemaneh Bayou has carried out his project work on the topic **“Merger: Valuation Process and Evaluation of Financial Performance in case of United Insurance Company and Shama Plc”** under my supervision. In my opinion, this work qualifies for submission in partial fulfillment of the requirements for the award of Degree of Masters of Science in Accounting and Finance.

Signature\_\_\_\_\_

Abebe Yitayew (Asst.Professor)

Project Advisor

## Statement of Declaration

I declare that this project work is my original work. It has not been submitted for any degree/Diploma in any University. I have undertaken it independently with the advice and suggestions of my advisor for the project, Ato Abebe Yitayew (Asst.Professor). In carrying out of the project work I have different sources and materials, which have been appropriately acknowledged.

Signature \_\_\_\_\_

Jemaneh Bayou

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Jemaneh Bayou  
January, 2008  
Addis Ababa  
Ethiopia

# Table of Contents

	<b>Page</b>
Statement of Certification .....	I
Statement of Declaration .....	IV
Acknowledgement.....	V
Table of Contents.....	VI
List of Tables .....	IX
List of Figures .....	X
List of Appendix.....	XI
Acronyms .....	XII
Abstract.....	XIII
CHAPTER ONE.....	1
1. INTRODUCTION.....	1
1.1 Background of the Study.....	1
1.2 Historical Background of the Companies .....	3
1.3. Statement of the Problem .....	5
1.4. The Objective of the Study.....	7
1.4.1 General Objective .....	7
1.4.2 Specific Objectives.....	7
1.5. Significance of the Study.....	8
1.6. Methodology.....	8
1.6.1 Data Collection .....	8
1.6.2 Data Analysis .....	9
1.7. Scope and Limitations.....	10
1.8. Organization of the Paper .....	10
CHAPTER TWO .....	12
2. LITERATURE REVIEW .....	12
2.1 Definition of Concepts.....	12

2.1.1 Mergers .....	12
2.1.2 Acquisitions.....	12
2.1.3 The Concept of Value .....	12
2.2 Valuation approaches.....	14
2.2.1 Discounted cash flow method <sup>5</sup> .....	15
2.2.2 Relative approaches.....	17
2.3 Pro-forma model <sup>6</sup> .....	19
2.4. Motives.....	21
2.4.1 Explicit Motives.....	21
2.4.2 Implicit Motives.....	22
2.4.3 Strategic Targeting of Mergers.....	24
2.4.4. Financial Targets.....	25
2.5. Benefits and Advantages of Mergers (Theories of Merger) .....	28
2.5.1. The Synergy Theory .....	28
2.5.2. The Market for Corporate Control Theory.....	30
2.5.3. Free Cash Flow Theory.....	31
2.6. Workings of Mergers .....	31
2.6.1 Merger Accounting.....	32
2.6.2 Tax Considerations .....	32
2.6.3 The Impact of Mergers.....	32
2.7. Valuation Process <sup>7</sup> .....	33
2.7.1 Analyzing the Business Environment <sup>8</sup> .....	34
2.7.2 Constructing a Model of Expected Financial Performance .....	36
2.7.3 Converting the Projected Financial Performance into Value.....	36
2.8. Method Evaluate the Performance of Mergers.....	37
2.9. Legal Frame Work Regarding Merger .....	37
CHAPTER THREE .....	40
3. DISCUSSION AND ANALYSIS .....	40
3.1. The Valuation Process of Shama Plc .....	40
3.1.1. Establishment of the Merged Company.....	40
3.1.2 Rationale for the Merger of the Three Companies.....	41

3.1.3	Process of the Merger of the Three Companies.....	42
3.1.4.	Analysis of the Financial Statements of the Three Companies.....	43
3.2.	The Valuation Process of United Insurance Company.....	49
3.2.1.	Establishment of the Merged Company.....	49
3.2.2	Rationale for Merger.....	49
3.2.3	The Process of Merger.....	51
3.2.4	Analysis of Financial Statements.....	54
3.3	Strategic and Financial Target of Merger.....	60
3.3.1	Strategic Target of Mergers.....	61
3.3.2	Financial Target of Mergers.....	62
3.3.3.	Impact of Mergers on Companies.....	63
3.4	Hypothesis Testing Using T-Test: Paired Two Samples for Mean.....	66
3.4.1.	Return on Capital Employed (ROCE).....	66
3.4.2.	Test of Economies of Scale.....	68
3.4.3.	Test of Operating Synergy.....	70
3.4.4.	Test of Financial Synergy.....	72
CHAPTER FOUR	.....	75
4.	CONCLUSIONS AND RECOMMENDATIONS.....	75
4.1	Conclusions.....	75
4.2	Recommendations.....	78
	BIBLIOGRAPHY.....	80
	APPENDIX.....	82

## List of Tables

	<b>Page</b>
<i>Table 3. 1 Ratio before and after merger of Shama Plc. (computed by the researcher)..</i>	46
<i>Table 3. 2 Ratio before and after merger of United Insurance .....</i>	57
<i>Table 3. 3 Summary of strategic target of mergers .....</i>	61
<i>Table 3. 4 Summary of financial target of mergers .....</i>	62
<i>Table 3. 5 Summary of impact of merger on companies.....</i>	64
<i>Table 3. 6 Analysis of what makes merger to be successful .....</i>	65
<i>Table 3. 7 Excel out put of T test for Return on capital employed. (Computed by the researcher).....</i>	68
<i>Table 3. 8 Excel out put of t test of economies of scale. (Computed by the researcher.) .....</i>	70
<i>Table 3. 9 Excel out put of t test of operating synergy. (Computed by the researcher.) .....</i>	72
<i>Table 3. 10 Excel out put of t test of operating synergy. (Computed by the researcher.) .....</i>	74

## List of Figures

	<b>Page</b>
<i>Figure 2. 1 Valuation models.....</i>	15
<i>Figure 2. 2 Steps Involved in an Acquisition Valuation Procedures for Analyzing Valuation of the Firm.....</i>	23
<i>Figure 2. 3 Financing Mergers .....</i>	26
<i>Figure 3. 1 Balance sheet trend of Shama Plc.....</i>	44
<i>Figure 3. 2 Income statement trends of Shama Plc.....</i>	45
<i>Figure 3. 3 Ratio analysis trends of Shama Plc .....</i>	47
<i>Figure 3. 5 Paid up capital, and premium &amp; earning per share before and after merger of United Insurance Company .....</i>	58
<i>Figure 3. 6 Ratios of United Insurance before and after merger .....</i>	59

## **List of Appendix**

Appendix 1. Financial statement analysis of Shama plc

Appendix 2. Financial Statements of United Insurance Company

Appendix 3. Questionnaire

Appendix 4. Interview schedule

Appendix 5. Result of the t-test

## Acronyms

M&A - Merger and Acquisitions

NBE - National Bank of Ethiopia

NOM - Net Operating Margin

OPM - Operating Profit Margin

ROA - Return on Asset

ROCE - Return on Capital Employed

ROE - Return on Equity

TRANCO - Trans African Commercial & Commission Agency Company

UNIC - United Insurance Share Company

## **Abstract**

*This paper entitled “Merger: Valuation process and Evaluation of Financial Performance” circulates around the key issues in merger valuation and financial performance of merged companies before and after merger.*

*The objective is to identify the rationales of merger, strategic and financial intents of mergers and evaluate the performance of merged companies before and after merger. The data used in the study was obtained through questionnaire and interview with the executives of merged companies. In addition, the deed of merger and financial statements are thoroughly investigated to understand the merger process and financial performance of the merged companies. The performance 5 years before merger and 5 years after merger are investigated using financial statement analysis. In order to substantiate the result t- test was used for hypothesis testing*

*The study finding indicates that the major merger motive is enhancing profitability. It is also found that the merger process is simply pooling the audited financial statements of companies going for merger.*

*The study analysis made both by financial statements analysis and the hypothesis testing made shows that performance of firms after merger has not increased as compared to the performance of firms before merger.*

# CHAPTER ONE

## 1. INTRODUCTION

### 1.1 Background of the Study

Merger is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long term profitability. Evidence on the success of Merger and acquisitions (M&A) however is mixed: 50-75% of all M&A deals are found to fail in their aim of adding value. Usually mergers occur in a consensual (occurring by mutual consent) setting where executives from the target company help those from the purchaser in a due diligence process to ensure that the deal is beneficial to both parties.

Historically, mergers have often failed to add significantly to the value of the acquiring firm's shares (King, et al., 2004). Corporate mergers may be aimed at reducing market competition, cutting costs (for example, laying off employees, operating at a more technologically efficient scale, etc.), reducing taxes, removing management, "empire building" by the acquiring managers, or other purposes which may or may not be consistent with public policy or public welfare. Thus they can be heavily regulated, for example, in the U.S. requiring approval by both the Federal Trade Commission and the Department of Justice.

Several studies have been done on the relationship between M&As and performance of the company, using a variety of financial measures (e.g. Profit, Stock price) and non-financial measures (e.g. firm's reputation) and time frame (e.g. pre-measurement and post measurement, initial market reaction etc.). These studies show that on average, M&As consistently benefit the

target's shareholders, but not the acquirer's shareholders. In fact, there are varying results with respect to the buying firm's performance. (Schweiger, pp4)

There are two types of empirical studies on M&A performance. One is "Event Studies", by comparing share prices before and after the merger. Even though there are numerous studies but there results are consistent. The target firm's shareholders benefit and the bidder firm's shareholders generally break even. The combined gain is mostly positive. Another type of empirical studies includes those which compare individual firm's profit few years before and after the merger. Results from these studies are more complex due to difference in methodology. For example, some studies concern absolute performance, while other concern relative performance. However a general conclusion is that most mergers reduce profitability.

In order to attain the required motive of the mergers many activities are performed from companies going for the merger. One of the major and critical activities is valuation of Target Company. There are many approaches in target company valuations: Discounted cash flow method and relative valuation models. Under the relative valuation method also there different approaches, Liquidation valuation, Replacement cost, P/E ratio, Book value approaches. This study examined the merger process, approach and the performance of merged companies in Ethiopia.

This study was conducted on two Ethiopian merged firms. The first one is United Insurance Company which is resulted from the merger of the earlier Lion Insurance and United Insurance .And the other one is Shama Plc. which is the result of three companies merger namely Book World plc, Tranco plc (Trans African Commercial and commission Agency Company) and Shama publishing plc. Both this two mergers was done in 2000. These companies are selected

for this study because, since the merges was made before 7 years, there is sufficient period to compare the performance of companies before and after merger.

## **1.2 Historical Background of the Companies**

### **Shama PLC**

Sham plc is the result of the merged company of there companies by vertically integrating Tranco, Shama Publishing and book world.

### **Shama Publishing Plc**

Shama Macmillan a joint venture between the shareholders of Shama Publishing and Macmillan Ltd was legally established on March 1999. Macmillan ltd. came to Ethiopia as an investor under investment laws of the country. The objective of Shama Macmillan was mainly to publish textbooks.

After operating for six months Macmillan decided to pull out due to the unfavourable situation of the book industry, and lack of copyright law. The liquidation took place in July 1999. Then Shama Publishing started its activity during July 1999 with the objective of publishing all types of books. (Unlike Shama Macmillan's objective of publishing text books only.)

### **Book world Plc**

Book world Plc was established in November 1997 with the objective of sales of books by opening retail bookshops. It purchased books from local book publishers and Shama Plc. Its objective was to have chain of retail outlets which sale different books. Now it has eight outlets

in Addis Ababa, which are located at the Sheraton, Hilton, ECA, Piazza, Haya-Hulet Matoria, Sar Bet, and Bole Road.

## **TRANCO Plc**

TRANCO Plc (the abbreviation word for Trans African Commercial & Commission Agency Company) was established in 1981. The objective of the Company was to import Magazines, periodicals & Books from abroad and distribute in the Country. It was established to be the leading information center in Ethiopia. It deals with International & Local sources to bring all written information in to the local market. It strives in a market where there is minimum interest for written materials.

It was the first and still one of only two or three companies that does this. During the previous regime it was prohibited to have access to international publications. Because of this, there were no companies' even shops that have access to these publications.

For the first time Ethiopia had access to world view in the form of different publications: Time, Newsweek, The Economist, Reader's Digest, National Geographic, Jeune Afrique, New Africa, Middle East, African Business, BBC-Focus on Africa, PC Magazine, Architectural digest, and other different English and French language Magazines & Newspapers.

It also distributes different local Newspapers, Magazines and books. Some of them are: the eye on Ethiopia, The African Economist, and Micro finance, Walia, different Books from Mega Distribution, ETTE, Addis Ababa University, OSSREA Publications, and institute of Ethiopian Studies.

It changed its name to Shama Plc after the merger of the three companies since the name has a social value to the surviving company as the name indicates the Amharic word for “Candle” with a parallel meaning of lighting knowledge.

### **United Insurance Company**

United Insurances sc. was established with initial capital of Birr 8,073,000. Its main objective was to transact all life and non-life insurance and reinsurance business. On the other hand, Lion Insurance Company was founded at a fully paid capital of Birr 4,700,000. The company's corporate objectives were, first to undertake in the operations of general insurance and reinsurance and in particular to engage in engineering, fire, liability, marine, motor, accident & Health, pecuniary, Fidelity, Money, bonds (performance, bid, etc) and workmen's compensation. Second, to engage in any other related activity pertaining to the accomplishment of its objectives.

On September 9, 2000 the two companies described above were merged with authorized capital of 28.95 Million Birr. After the merger Lion Insurance company was dissolved and its account's entered in to accounts of UNIC (the combined business)

### **1.3. Statement of the Problem**

Mergers and acquisitions are one of the popular topics in business today, since they characterize the new economy: pressure of global competition, development of technology and disappearance of country boundaries. These actions of companies are in order to get many competitive advantages. The success of a merger or acquisition lies in a lot of issues such as corporate strategy, valuation, risk, and integration...etc. A merger and acquisition can be negotiated for

months. But a core question is how much you will pay for this merger or acquisition? Is the price appropriate? Mergers and acquisitions can fail because of overprice, which results in destroyed shareholder value.

In country like Ethiopia in which there is no stock market that help to sets tock price of companies, determining the value of stock is not an easy task, and hence determining the value of target Company in merger will also be the same.

Theoretically it is assumed that Mergers and Amalgamations improve the performance of the company because of Synergy effect, increased market power, Operational economy, Financial Economy, Economy of Scales etc. But does it really improve the performance in short run as well as long run. Various studies have already been done on this matter. All these studies are related to European countries or US market. I have not come across with any of such study in Ethiopian context.

Several studies have been done on the relationship between M&As and performance of the company using a variety of financial measures (e.g. Profit, Stock price) and non-financial measures (e.g. firm's reputation) and time frame (e.g. pre-measurement and post measurement, initial market reaction etc.). These studies show that on average, M&As consistently benefit the target's shareholders, but not the acquirer's shareholders. In fact, there are varying results with respect to the buying firm's performance. (Schweiger, pp4)

Consequently Valuation has a decisive impact on the success of the merger and acquisitions because being over valuations means overstatement of the target company and it has a negative impact in the success of the merged and acquired company.

The other common phenomenon in merger and acquisitions is most merger and acquisitions are ultimately ended up by a failure. And there is a real question about does merger and acquisition adds value? There is no empirical study about the out come of merger and acquisition in Ethiopia. In order to understand the out comes of merger is it necessary to measure the operating and financial performance of merged companies before and after merger.

This study tired to assess the valuation process and approach; and analyze the financial performances of merged companies before and after the merger some merged companies in Ethiopia.

## **1.4. The Objective of the Study**

### **1.4.1 General Objective**

Theoretically it is assumed that Mergers and Amalgamations improve the performance of the company because of Synergy effect, increased market power, Operational economy, Financial Economy, Economy of Scales etc. But does it really improve the performance in short run as well as long run. Various studies have already been done on this matter. All these studies are related to European countries or US market. I have not come across with any of such study in Ethiopian context. So, the general objective of this study is to analyze the valuation process and performance of merged companies in two selected Ethiopian companies.

### **1.4.2 Specific Objectives**

- In order to assess the valuation process, and approach in mergers.
- To examine merger motives of companies.
- Examine the strategic target of mergers
- To identify financial target of mergers
- To investigate impact of mergers and reason of failure
- In order to assess the financial performance of merged companies before and after merger.

## **1.5. Significance of the Study**

The study is expected to have importance to many parties. Since the study revolves around one of the popular issues of current business scenario, the following are the expected significances

- It will provide some insight about the valuation process in merger of companies.
- It try to recommend appropriate valuation approach for merging companies
- It will identify benefit and short coming of companies merger
- It will contrast company's performance before and after merger.

By providing the above-mentioned information it will help the Business community at large and company directors in particular in making better decision in issues regarding merger.

## **1.6. Methodology**

### **1.6.1 Data Collection**

The data used to undertake this study were both primary and secondary. The secondary data are the financial statement of companies before and after merger, the necessary merger agreement and valuation documents (deed of merger.). In order to support the secondary data, additional information was obtained by primary data gathering tool through distributing questionnaire and conducting interview with selected officials of the merged companies.

### **1.6.2 Data Analysis**

The gathered information analyzed by descriptive and Analytical analysis methods. In addition in order to measure the operating and financial performance of merged companies' before and after merger various statistical tools was used to arrive in the required goal.

To test the impact of Mergers on performance, there are various alternative ways. Like “Event Studies”, where we compare stock prices of the firms a certain days before and after the mergers. Another way is “Regression Analysis”, where we can take after tax rate of return as dependant variable and Size of the firm, rate of increase in capital stock, R&D expenditures etc. as independent variables. Third way is ‘T-test: Paired two samples for mean’ which the researcher used in this paper.

In this study the researcher tested impact of mergers on the performance of the company in terms of four parameters. ROCE, Economies of scale, Operating Synergy and Financial Synergy. In addition to these four indicators financial ratios was computed in areas, which are believed to be necessary, and it will be compared with the industry average.

Finally the analyzed information was presented by using graphs, tables and diagrams that are appropriate to explain the fact.

## **1.7. Scope and Limitations**

In this study, the researcher only evaluated the valuation process and approach used. In the evaluation process, independent valuation of attributes such as politics, economic cycle, inflation that could affect the financial performance of companies was not considered. The other limiting factor is the number of companies of the study is only two. As a result of this it may not be possible to generalize for all Ethiopian case.

In addition to the few number of mergers made in Ethiopia most of them are not willing to provide the necessary data for this paper. For these two reasons theses two companies are selected for the study.

## **1.8. Organization of the Paper**

The presentation of this study takes the following form: The first chapter is introductory which consists of general background, statement of the research problem, objective of the study, significance of the study, scope of the study, research methodology, and research limitation. The second chapter provides the related summary of literature review on the merger process and

performance measurement of before and after merger. Chapter three is devoted to analysis of data and discussion based on data collected. Finally, chapter four concludes the study and provides relevant recommendation

## **CHAPTER TWO**

### **2. LITERATURE REVIEW**

#### **2.1 Definition of Concepts**

##### **2.1.1 Mergers**

A merger takes place when two or more firms combine to form a single enterprise, owned by a single set of stockholders to a single management staff. Mergers are classified according to how the merger takes place, the management's attitudes toward the merger and relationships between the merging parties. The two major means by which firms merge are the sales of assets or the sale or exchange of stock. Mergers may increase profitability by reducing costs, improving cooperation, removing ineffective management or eliminating competition.

##### **2.1.2 Acquisitions**

An acquisition is the purchase by one company of a substantial part of the assets or securities, normally for the purpose of restructuring the operations of the acquired entity. The purchase may be a division of the target firm or a substantial part of the target's voting shares. Bids are sometimes directed towards the acquiring firm's own shareholders, as in a minority buyout or in a leveraged buyout (LBO). For example, where a group of investors, typically involving the firm's own management, acquires all the outstanding voting shares.

##### **2.1.3 The Concept of Value**

In the most general sense, the terms mergers and acquisitions refer to the exchange of ownership control of a business enterprise. Company A and Company B may merge and form a new composite company; Company A may purchase or acquire Company B, or vice versa. In either situation, it is imperative that both companies should be valued either formally or informally.<sup>1</sup>

There are several perspectives of value as follows:

**Book Value** - The book value of a company is obtained from the balance sheet by taking the adjusted historical cost of the company's assets and subtracting the liabilities. Tangible book value is calculated in the same way as finding regular book value; intangible assets are possibly excluded in the calculation. The book value does not provide a true indication of a company's value, nor does it take into account the cash flow that can be generated by the company's assets.

**Liquidation Value** -- Liquidation value is another benchmark of the company's value. It is measure of the per share value that would be derived if the firm's assets were liquidated and all liabilities and preferred stock were paid. Liquidation value may be a more realistic measure than book value. If accurately computed, it may be a more accurate indicator of the true value of the firm's assets.

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<sup>1</sup> Link, Albert N. (1999) the Art and Science of Business Valuation, Westport, Conn. London: Quorum, pp. 2-3.

On the other side, the liquidation value does not measure the earning power of the firm's assets. These assets may have different values depending on the user. If the firm is using its assets very efficiently, the company's value may be well in excess of the liquidation value.<sup>2</sup>

**Fair market value:** - Fair market value is the price at which the property would change hands between a willing buyer and a willing seller when the seller is not under any compulsion to buy and the buyer is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.

A determination of fair market value will depend upon the circumstance in each case. No formula can be devised that is applicable to the multitude of different valuation issues arising in estate and gift tax cases. A sound valuation will be based on all relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.<sup>3</sup>

**Economic value:**-The economic value is the value of the expected earnings from using the item discounted at an appropriate rate to give a present-day value. The problem is not in defining the measure but in actually estimating future earnings, as this implies knowledge of what is going to happen.<sup>4</sup>

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<sup>2</sup> Gaughan, Patrick A. *Mergers and acquisitions* New York: HarperCollins, 1991, p. 576

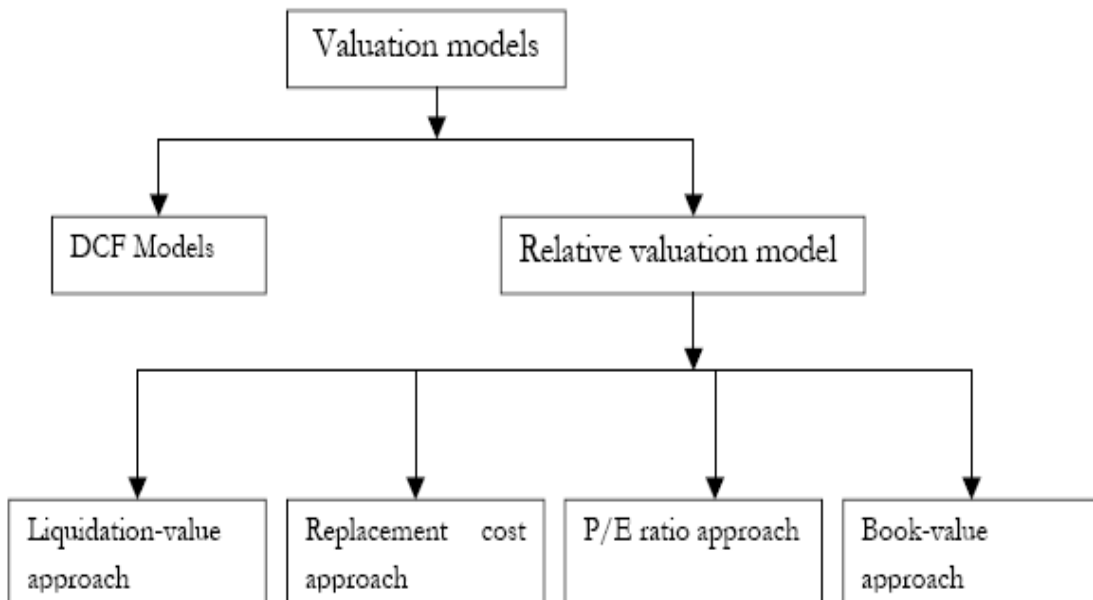
<sup>3</sup> Links, Albert N. (1999) *the Art and Science of Business Valuation*, Westport, Conn. London: Quorum, p. 18.

<sup>4</sup> Berry Aidan & Jarvis Robin (1997) *Accounting in a Business Context*, International Thomson Business Press. pp. 34.

## 2.2 Valuation approaches

There are a wide variety of models for evaluating a company. They are applied in the same context. Here I have classified these valuation methods into discounted cash flow (DCF) models and relative methods as follows :( see figure 2-1)

Figure 2. 1 Valuation models



### 2.2.1 Discounted cash flow method<sup>5</sup>

The theory for any financial investment evaluation is the capital budgeting approach that includes four concepts:

- ***Free cash flow***

The investor has put money into projects because he expects it to generate cash throughout the lifetime of his investment. We define these as cash flow to the investors. In the following analysis, the cash flow is defined as ‘free cash flow’. Free cash flow is a company’s true operating cash flow.

Free cash flow is generally not affected by the company’s financial structure. Free cash flow is defined to ensure consistency between the cash flow and the discount rate used to value the company.

- ***Time value of money***

One unit of currency is worth more today than it is tomorrow, since there is a cost of capital. This refers to opportunity cost. The sooner they are received, the less they are worth.

• ***Cost of capital***

❖ If the cash flow is not risk free, a risk premium will be concerned in the investment. The expected return on an asset should be positively related to its risk. The relationship between expected return on an individual security and Beta of the security could be described as capital-asset-price model (CAPM )

❖  $R = R_f + [E(R_m) - R_f] * (\text{beta})$

❖ Where R represents expected return on a security

$R_f$  represents risk free rate

$E(R_m) - R_f$  represents the difference between expected return on market and risk free rate

Beta represents the Beta of the security.

---

<sup>5</sup> Copeland Tom, Koller Tim, Murrin Jack (1990) Valuation: measuring and managing the value of companies, Published by John Wiley & Sons, Inc. p. 217.

• ***Weighted average cost of capital***

➤ The average cost of capital is a weighting of its cost of equity and its cost of debt

$$WACC = K_b * (1 - T) * (B/V) + K_s (S/V)$$

Where

$K_b$  = the pretax market expected yield to maturity on debt

$K_s$ =the market-determined opportunity cost of equity capital

T = the tax rate

B =the value of debt

S= the value of equity

V=the value of assets

When making a decision in mergers and acquisitions, the discounted cash flow (DCF) method can be used, assuming that the value of a company is equal to the sum of the present value of the various cash flow streams. The ultimate goal is to translate expectations about the company into financial performance and translate financial performance into values.

### 2.2.2 Relative approaches

Besides the DCF approach, there are five commonly used relative approaches that exist, liquidation value, replacement cost, price-to-earnings ratio, market-to-book ratio, and book value.

- ***The liquidation-value approach*** sets the continuing value equal to an estimate of the proceeds from the sales of the assets. Liquidation value is often far different from the value of the company as a going concern. In a growing, profitable industry, a company's liquidation value is probably far below the going-concern value. In a dying industry, liquidation value may exceed going-concern value.
- ***The replacement-cost approach*** sets the continuing value equal to the expected cost to replace the company's assets. This approach has a number of drawbacks. The most important ones are the following:

- Only tangible assets are replaceable. The company's 'organizational capital' can be valued only on the basis of the cash flow the company generates. The replacement cost of the company's tangible assets may greatly understate the value of the company.
- Not all the company's assets will ever be replaced. Consider a machine used only by this particular industry. The replacement cost of the asset may be so high that it is not economic to replace it. Yet, as long as it generates a positive cash flow, the asset is valuable to the ongoing business of the company. Here, the replacement cost may exceed the value of the business as an ongoing entity.

- ***The price-to-earnings (P/E) ratio approach*** assumes that the company will be worth some multiple of its future earnings in the continuing period. Of course, this will be true; the difficulty arises in trying to estimate an appropriate P/E ratio.

Suppose the current industry average P/E ratio is chosen. However, prospects at the end of the forecast period are likely to be very different from today's P/E ratio. Therefore, the drawbacks of price-to-earning (P/E) ratio are as follows:

- It is too affected by transitory events
- It hardly reflects future trends and historical fluctuation.
- It does not include enough financial information such as different leverages used by firms in the same industry.
- It hardly reflects risk differences even when restricted to the same industry's comparison.

- ***The market-to-book ratio approach*** assumes that the company will be worth some multiple of its book value, often the same as its current multiple or the multiples of comparable companies. This approach is conceptually similar to the P/E approach and therefore faces the same problems. In addition to the complexity of deriving an

appropriate multiple, the book value itself is distorted by inflation and the arbitrariness of some accounting assumptions.

- ***The book-value approach*** assumes that the continuing value equals the book value of the company. Often, the implicit assumption of this approach is that the company will earn a return on capital (measured in terms of book values) exactly equal to its cost of capital. Therefore, the book value should represent the discounted expected future cash flow. Unfortunately, book values are affected by inflation and the choice of accounting rules. Therefore, they do not provide reliable information for these assumptions.

## 2.3 Pro-forma model<sup>6</sup>

A pro forma is a model that predicts company's financial statements, its balance sheets, income statements and cash flow statements.

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<sup>6</sup> Benninga Simon (1997) Corporate Finance: A valuation approach, New York: McGraw-Hill pp. 109.

Basically, the pro forma is applied to integrate the financial statement into future developing perspectives. That means the accounting tools and techniques are used to ensure accurate financial prediction in the coming years.

A merger is a combination of two corporations in which only one corporation survives and the merged corporation goes out of subsistence. Alternatively, in merger two corporations combine and share their resources in order to accomplish mutual objectives and both companies bring their own shareholders, employees, customers and the community at large. Acquisition takes place when one firm is purchasing the assets or shares of another company.

Mergers are often categorized as *horizontal, vertical, or conglomerate*. A *horizontal merger* is one that takes place between two firms in the same line of business whereas *vertical merger* involves companies at different stages of production. The buyer expands backwards in the direction of the source of the raw material or forward in the direction of the customer. The last one, i.e., *conglomerate merger* involves companies in unrelated line of business. This distinction is very much necessary to make and understand the reasons for the mergers.

The scale and the pace at which merger activities are coming up are remarkable. The recent booms in merger and acquisitions suggest that the organizations are spending a significant amount of time and money either searching for firms to acquire or worrying about whether some other firm will acquire them. Also, mergers are regarded as one of the activities the purpose of business expansion or a measure of external growth in contrast to internal growths. The recent phenomenon booms in mergers and acquisitions would increase at a much faster rate in near future because the world markets are becoming more integrated because of open trade policies and hence more and more companies are adopting and forming strategic alliances in order to compete in the competitive world and to maintain their market shares.

Merger and acquisition decision is an investment decision. This is the most important decision, which influences both the acquiring firm and the target firm, which is to be acquired. An organization cannot make that crucial decision without incisive analysis by financial planners and corporate managers. The acquiring firm must correctly value the firm to be acquired and the

acquired firm must get the returns for the goodwill they have created over the years in the market. Growth through acquisition is occurring in an unprecedented number of companies today as strategic acquisitions replace the once-prevalent hostile takeovers by corporate raiders. In the current business environment, it is vital to understand how to blend strategic and financial concepts to evaluate potential acquisitions.

## 2.4. Motives

The findings from the theoretical material and the empirical investigation will be analyzed both horizontally and vertically according to the following: -

There are two types of motives involved in merger and acquisition and these are **Explicit** and **Implicit** motives.

### 2.4.1 Explicit Motives

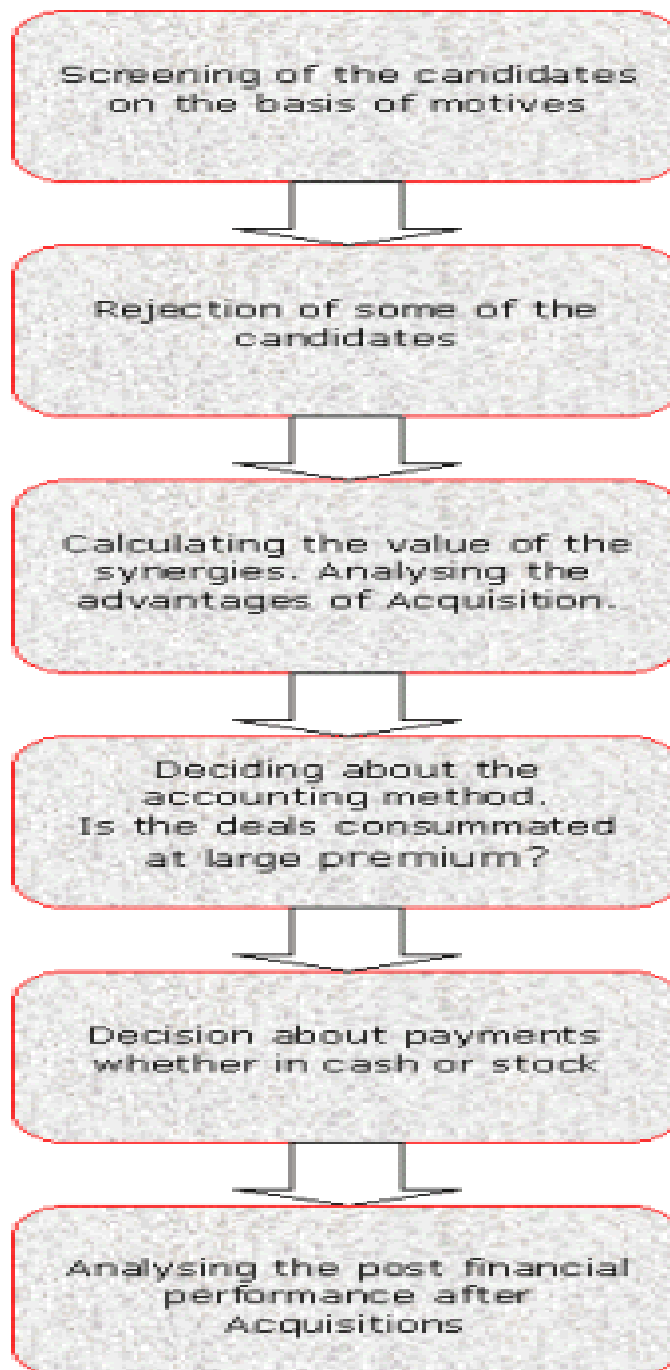
- **Synergy:** Synergy means that the merged firm will have a greater value than the sum of its parts as a result of enhanced revenues and the cost base.
- **Economies of Scale:** Economic of scale refer to the reduction in unit cost achieved by producing a large volume of a product. Horizontal mergers aim at achieving economies of scale. This phenomenon continues while the firm grows to its optimal size, after which a firm experiences diseconomies of scale.
- **Economies of Vertical Integration:** Economies of vertical integration are achieved in vertical mergers. It makes coordination of closely related operating activities easier.

- **Entry to New Markets and Industries:** A firm that wants to enter a new market but lacks the know-how can do so through the purchase of an existing player in that product or geographical market. This makes the two firms worth more together than separately.
- **Tax Advantages:** Past losses of an acquired subsidiary can be used to minimize present profits of the parent company and thus lower tax bills. Thus, firms have a reason to buy firms that have accumulated tax losses.
- **Diversification:** One of the reasons for conglomerate mergers is diversification of risk. There are two types of risks associated with businesses- systematic and unsystematic risk. Systematic variability cannot be removed by diversification and hence mergers are not able to eliminate this risk. Though, unsystematic risk can be spread through mergers.
- **Managerial Motives:** The management team of the acquiring firm tends to benefit from the merger activity. The four most important managerial motives for merger are empire building, status, power and remuneration.

#### 2.4.2 Implicit Motives

1. **Hubris:** It is like a maturity test for the owners and the company boards of directors when they see the opportunity to form a new business cycle.
2. **Excess of Money:** When a company has excess of money, the question of what to do with it eventually comes up and this leads towards merger and acquisition.

Figure 2. 2 Steps Involved in an Acquisition Valuation Procedures for Analyzing Valuation of the Firm



An acquisition valuation programme can be segregated into five distinct steps like:

Step 1: Establish a motive for the acquisition.

Step 2: Choose a target.

Step 3: Value the target with the acquisition motive built in.

Step 4: Choose the accounting method for the merger/acquisition - purchase or pooling.

Step 5: Decide on the mode of payment - cash or stock.

### **2.4.3 Strategic Targeting of Mergers**

According to the literature review (Papadakis, 2000), the driving force concerning the decision for buyout & merger, is the pursuit of scale economies, the pursuit of cooperation schemes, the increase of productivity and the reduction of the unit operation cost of the company.

As far as the long term time schedule, these motives concern:

- a) The formation- exploitation of scale economies leading to improved competitiveness of the company in field as well as in market levels.
- b) The improvement of its negotiatory position towards its suppliers, achieving thus a reduction of the operational cost and increase of profit margins.
- c) The activation in new markets for its products, covering a continuously growing area of consumer needs of an economy, with simultaneous decrease of its dependence from the trend of only one market.
- d) The long-term strengthening of a company through the decreased intensity of competition

- e) The acquirement of technological specialization (know-how) and other skills concerning marketing, logistics etc.
- f) The formation of cooperation schemes with strategic benefits.
- g) The formation of groups with manifold structure and strong capital base that can resist a potential hostile buyout.

#### **2.4.4. Financial Targets**

The financial motives for the implantation of Buyouts & Mergers are divided in short-term, middle term, and long-term (Georgiadis, 1989).

##### ***Short-term motives concern:***

- a) The raise of profits per share resulting in the raise of the share price and the capital gain for shareholders,
- b) The reduction of the index P/E so as to make the share price more attractive to buy,
- c) The cooperation schemes that are formed in liquidity issues through the buyout of a company with healthier financial structure,
- d) The tax benefits resulting either by the change of tax rate or by an increase of the reserve funds, or by a combination of the two factors.

##### ***Middle-term motives concern:***

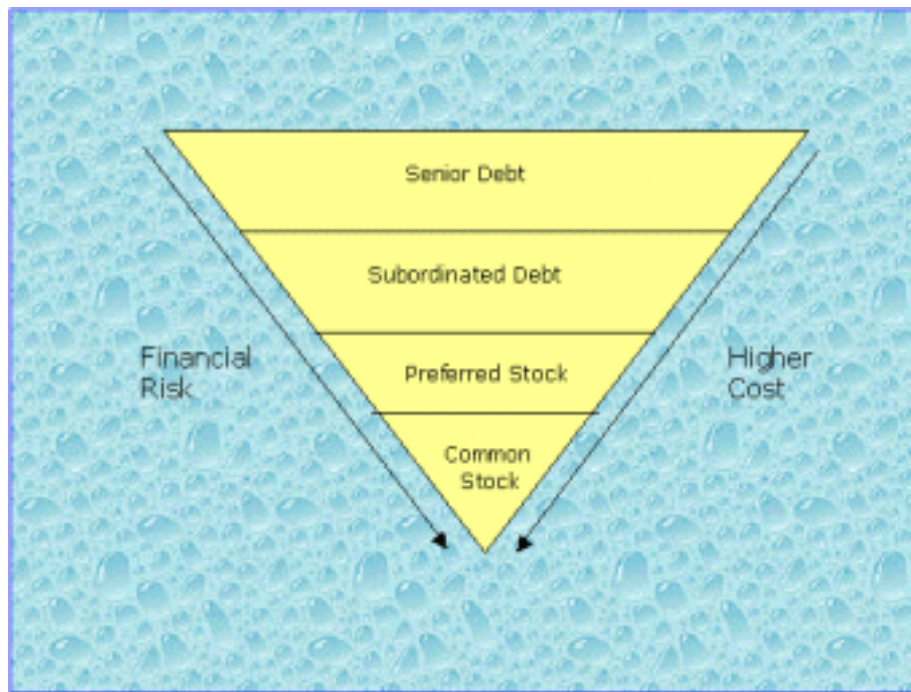
- a) The increase of the company's borrowing ability through the raised amounts of the balance sheet,
- b) The decrease of the total borrowing of the new business scheme with simultaneous improvement of the financial position of the company performing the buyout.

##### ***Long-term motives concern:***

- a) The formation of scale economies, and
- b) The reduction of its cost per unit of produced product.

- **Financing Mergers**

Figure 2. 3 *Financing Mergers*



The triangle in the figure provides a view of acquisition financing mechanism. As the options for financing the acquisition would increase, the layers in the triangle would also increase. But the basic question that arises or the consideration that comes is whether the transaction should be made in cash or stock as it has different effect on the various stakeholders of both the organizations the acquiring firm as well as the target firm. The influence of method of payment on post-merger financial performance is ambiguous. Post

merger performance maybe affected by the means of payment in the takeover. There are mainly two ways, in which mergers can be financed,

- Cash
- Stock

Using cash for payment helps the acquirer's shareholders to retain the same level of control over the company. Another obvious reason of financing mergers through cash is the simplicity and preciseness that gives a greater chance of success. Another advantage of using cash to the target's shareholders is that it is more certain in its value. Also, the recipients can spread their investments by purchasing a wide-ranging portfolio. There is also a disadvantage to target shareholders. They may be liable to pay capital gains tax. This is payable when a gain is realized.

- **Estimating Cost When the Merger is financed by Stock**

The cost depends on the value of the shares in the new company received by the shareholders of the selling company.

$$\text{Cost} = N * P \text{ of AB} - \text{PV of B}$$

Where,

N = the number of shares received by the sellers

P of AB = price per share of the merged firm

PV of B = present value of B (selling firm)

## 2.5. Benefits and Advantages of Mergers (Theories of Merger)

There are several theories explaining the possible sources of gains following corporate acquisitions. Three of the common theories are the synergy or efficiency theory, the market for corporate control theory and the free cash flow theory. All three theories predict enhanced operating performance through some sort of efficiency.

### 2.5.1. The Synergy Theory

A popular explanation for acquisition is improved efficiency: that somehow a combination of firms will result in improved operations and a better financial and operational profile. According to Chatterjee (1992), proponents of free markets have long maintained that acquisitions are value-increasing events. This improved performance is most often referred to as 'synergy'. Synergy occurs when two firms can be run more efficiently (i.e., with lower cost) and/or more effectively (i.e., with a more appropriate allocation of scarce resources, given environmental constraints) together than apart (Lubatkin, 1983). The common element is improved resource allocation, whereby an improvement in allocative efficiency is expected to

promote overall economic gains. As briefly explained below, synergies can be created through economies of scale, economies of scope and market power (Seth, 1990).

#### **(a) Economies of Scale**

The economies of scale argument posits that corporate combinations generate efficiencies through size. There are several potential sources of this efficiency. The new combined firm may have a much higher debt capacity and thus be able to borrow at a lower cost (Lewellen, 1971) through better access to capital markets (Levy and Sarnat, 1970). These economies may be exploited by both conglomerate and non-conglomerate acquisitions. A combined firm may also be able to achieve greater efficiency in transportation, production or management (Severiens, 1991). For instance, production linked economies may be achieved in the areas of purchasing or inventory management in the case of acquisitions involving firms using common raw materials or components. Consequently, these economies of scale should manifest in lower operating and financing expenses thereby improving operating performance.

#### **(b) Economies of Scope**

Economies of scope exist when managers are able to produce multiple products jointly at lower cost than if production were spread across multiple firms (Severiens, 1991). Most commonly, both partners in an acquisition bring some complementary skills to the combination such that value is created as a result of the acquisition (Seth, 1990). For instance, managers who acquire skills of firm A may find those skills very useful in lowering costs and increasing profits in firm B. Economies of scope may also arise from reuse of an input, such as sharing of production

know-how or other intangible assets by more than one product (Teece, 1980). Efficiencies from economies of scope are typical of nonconglomerate acquisitions and tend to improve operating performance through lower costs.

### **(c) Market Power**

Market power or pecuniary economies represent another source of synergies (Lubatkin, 1983). These economies are achieved by the firm's ability to dictate prices by exerting market power achieved primarily through size. Two types of pecuniary economies are monopoly and monopsony (Porter, 1980). The first refers to the ability of the firm to force buyers to accept higher prices. However, the existence of these economies has never been proven because of measurement problems (Shepherd, 1970). Regardless, market power supposedly enhances profit margins and therefore profitability of the new economic entity.

### **2.5.2. The Market for Corporate Control Theory**

There is an established recognition that corporate acquisitions provide a mechanism for more effective management of the acquiree's assets (Manne, 1965). The corporate control market is one in which several teams of management compete to acquire the right to manage the firm. Competition among these management teams ensures, at least theoretically, that the most efficient team manages the firm. The market therefore expects the new management to be more effective than the incumbent management. This increased effectiveness and efficiency should subsequently manifest in improved operating performance. Share price studies showing improved firm performance consistent with this view include Martin and McConnell (1991), studies reviewed

by Jensen and Ruback (1983), Jarrell et al. (1988) and Dodd (1989). Bugeja and Walter (1995) provide Australian evidence consistent with this school of thought.

### **2.5.3. Free Cash Flow Theory**

Jensen's (1986) theory of Free Cash Flow posits that managers have a tendency to invest 'free cash flow' in negative net present value projects, which is contrary to shareholders' wealth maximisation policy. According to Jensen (1986), this agency problem is particularly severe for firms with substantial free cash flow and limited growth potential, and where consideration for the acquisition is equity rather than debt or cash. Servaes (1991) found that more value is created when the consideration for the acquisition is cash or debt rather than equity. This is so because the acquisition event and the debt-load created in the process, limits management's freedom to use future cash flows, thereby reducing the possibility of misuse of free cash flows.<sup>6</sup> The increased fixed interest charges of debt also compel management to be more efficient. Thus, according to Jensen's (1986) free cash flow theory, post-acquisition performance should also improve relative to the pre-acquisition period particularly for non-equity purchased acquisitions.

## **2.6. Workings of Mergers**

### **2.6.1 Merger Accounting**

A merger can be either treated as a purchase or a pooling of interests. Under purchase method, assets of the acquired firm must be reported at the fair market value on the books of the acquiring firm. Under this method, *goodwill*, which is the excess of the purchase price over the sum of the fair market values of the individual assets acquired, is generated. Under the second method, *pooling of interests*, the assets of the merged firm are valued at the same level as they were carried out in acquired and acquiring firms.

### **2.6.2 Tax Considerations**

An acquisition can be taxable or tax-free. In a taxable acquisition, shareholders of the selling firm are treated for tax purposes as having sold their shares and are liable to pay tax on any capital gains or losses. In a tax-free acquisition, the selling shareholders are viewed as exchanged their old shares for similar ones, and they do not experience any capital gains or losses. The taxes paid by the merged firm also depend on the tax-status of the acquisition. There is no revaluation of assets in a tax-free acquisition, whereas, in a taxable acquisition, the assets are devalued and any increase or decrease is treated as a taxable gain or loss.

### **2.6.3 The Impact of Mergers**

Mergers have a universal impact, practically everyone from society, shareholders, employees, and directors to financial institutions. Society can benefit from the merger if it results in

producing goods at low costs due to economies of scale or improved management. The *acquiring shareholders* usually get poor returns and therefore very small average gains. However, *target shareholders* usually gain from mergers, as the acquirers have to pay a substantial premium over the pre-bid share price to convince target shareholders to sell. *Employees* may gain or lose from a merger activity. Mergers generate significant gains to the target firm's stockholders and buyers generally break even, there are positive benefits from mergers. The yardstick to measure a successful merger is the profit level. Profitability is the only overall significant identifier. (Arindam Suhasaria MBA, Leeds University Business School, Leeds, UK)

## 2.7. Valuation Process<sup>7</sup>

Business valuation is part art and part science. The term 'judgment' may be regarded as 'art'; the term 'systematic' may also be related to 'science'. There are many dimensions of the science in business valuation that are listed as follows:

- General accounting principles and the financial data of the business
- Facts associated with the historical growth of the business
- Extrapolation of financial data into future time periods
- Calculation of various valuation ratios and statistical formulae

There are also many dimensions of the art in business valuation as follows:

- Understanding the economically efficient life of productive assets
- Understanding the economically relevant industry in which the business is valued
- Understanding the appropriateness of one valuation method
- Understanding the limitations of financial information from comparable businesses
- Understanding the economic environment

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<sup>7</sup> Albert N.Link and Michael B.Boger; foreword by James H. Ogburn (1999) *The Art and Science of Business Valuation*. pp. 6-7

A business valuation is often dependent on valuator's knowledge, both accounting concepts and economic concepts. Accounting is a systematic way of documenting the business's financial activities, while economics is a systematic way of understanding the market environment in which the business's financial activities take place. Accounting methods are relatively more static in nature than economic methods; there are more systematic practices and principles that guide the application of accounting methods. There is rarely a situation where all aspects of a valuation are accounting related or all aspects are economics related.

### **2.7.1 Analyzing the Business Environment<sup>8</sup>**

The process of valuing a company begins with an analysis of its environment; the study of the firm's environment is typically called a 'top-down' process. The objective of the analysis of the firm's environment is to estimate the firm's sales in future years.

Three questions concerned are as follows:

- Are industry sales expected to rise or fall?
- Is the company's market share expected to expand or shrink?
- Are industry prices expected to increase or decrease?

The study of the company's environment begins with a study of the economy. Various industries tend to perform differently in different stages of the economic cycle. For instance, basic industries perform well when the economy gets out of a recession,

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<sup>8</sup> Simon Z. Benninga, Oded H. Sarig,(1997) corporate finance A valuation approach, The McGraw-Hill companies, Inc. pp. 134-135

cosmetic goods sell well in economic downturns and interest-sensitive industries such as banks and insurers do especially poorly when the economy enters a recession. Thus, to the extent that economic activity can be predicted, an understanding of the future course of the economy is useful information in analyzing industries and companies.

After analyzing the macroeconomic conditions, the industry in which the firm operates is analyzed. The objective of the analysis of the industry is to obtain sales projections for the company. Obviously, the industry analysis should incorporate the macroeconomic conditions. Beside the macro-conditions, the current and potential competition in the industry, the relative advantages and disadvantages of the major players have to be considered. Moreover, the relative industry that sells substitute products needs to be considered. These factors could be used to determine the growth in the industry's sales, changes in the company's market share and the growth in the company's sales.

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### **2.7.2 Constructing a Model of Expected Financial Performance**

After analyzing the corporate environment, the next step is to analyze the company's operating and financial prospects.

The marketing view of the company is converted into the sales projections and the sales projections are translated into financial performance, which are expressed in the form of pro-forma financial statement. Then proceed by converting the marketing view of the firm –the sales projections –into overall projections of financial performance. The way is to use various financial ratios according to its historical accounting statement. The projections of future financial performance should not be confined to an analysis of past relations. Firm and industry change should be incorporated into the projection of future financial performance.

### **2.7.3 Converting the Projected Financial Performance into Value**

After using the pro-forma accounting statement, the projected cash flow has been predicted. However, the firm does not cease to exist after the expected periods of cash flow. Therefore, the firm's ability to generate cash flows after the expected period has to be taken into account. This is done by a terminal value as the last cash flow. Discounting the FCFs at the WACC gives us the value of the firm as a whole-the value of the firms' assets. This value equals the sum of the values of all the securities that the firm has issued, such as debt, equity, preferred stock and convertible bonds. In financial terminology this is usually called the value of the firm.

## 2.8. Method Evaluate the Performance of Mergers

Studies that attempt to evaluate the profitability of corporations that have been the object of mergers or acquisitions can be categorized according to whether they take a financial or industrial organization approach.

The **financial approach** examines trends in the share prices of corporations involved in mergers or acquisitions and compares them with a reference group of corporations. Corporate performance is considered to have improved if the returns to shareholders are greater after the acquisition or merger. The results obtained using this approach, largely in the United States; show that corporate takeovers generally have favorable consequences for shareholders. Stock markets also seem to take a positive view of merger or acquisition announcements.

The **industrial organization approach** looks at certain financial or economic performance variables of corporations before and after they have been taken over. Trends in these variables compared with a reference group provide an indication of the net effect of the acquisition on profitability rates.

## 2.9. Legal Frame Work Regarding Merger

Article 549 of Commercial Code of Ethiopia states that two or more firms may amalgamate either by taking over or by formation of a new firm. Article No. 550 explains how the decision to amalgamate is practiced. It states that the decision to amalgamate, which shall be taken by each of the firm concerned special meetings of shareholders of different classes or meetings of

debenture holders shall approve the taking over or being taken over. The following three sub articles describe the deeds of amalgamation.

1. The terms of amalgamation shall be published in accordance with provisions of Article 224 of the code.
2. Notices of the amalgamation shall be published at the head office of the firm taking over or new firm resulting from amalgamation, as well as at the head offices of the firms ceasing to exist on amalgamation.
3. The claim and liabilities of the firm ceasing to exist shall pass to firm taking over on to the new firm.

Article 552 describes the rights of creditors under its three sub articles.

1. Creditors of the firm or firms taken over or the firms constituting new firms whose claims came into being before the publication of the deed of amalgamation in the official commercial Gazette (Addis Zemen & Ethiopian Herald) may object to the amalgamation within three months from date of such publication.
2. The court shall reject such objections where it is satisfied that all the creditors have been paid or that sums corresponding to their debts have been paid in to a special account in the State Bank of Ethiopia.
3. The court may reject such objection and order that deed of amalgamation shall be confirmed and that the firm taking over or the new firm resulting from the amalgamation shall pay the debts or provide adequate guarantees.

Article 553 defines the rights of debenture holder, which includes two sub articles.

1. Where amalgamation is not approved by a meeting of the debenture holders of the firm being taken over, the debtor firm shall redeem the debentures of holders who so require, not later than three months from the date of publication of the deed of amalgamation in the official commercial gazette.
2. These provisions shall apply to debenture holder of firms amalgamating on the creation of a new firm.

The above provisions are applied for any business combination in Ethiopia. However, the National Bank of Ethiopia- the governor of financial institutions in the country dictates Bank & Insurance companies, when merging, should follow the provisions made by National Bank of Ethiopia-Proclamation No. 80/1994 Articles 40.

## **CHAPTER THREE**

### **3. DISCUSSION AND ANALYSIS**

In this part of the paper detail discussion and analysis of the study finding are presented. The valuation process of the merged companies and their financial performances are obtained by questionnaire, making interview with the executive of the companies and by thoroughly analyzing their financial statements. The analysis is presented in the following sequence, first the valuation process of each companies followed by the evaluation of each companies and finally hypothesis testing.

#### **3.1. The Valuation Process of Shama Plc**

##### **3.1.1. Establishment of the Merged Company**

Shama plc is the result of the merger which is vertical integration of three companies. The companies forming the today's Shama plc are Shama publishing, Tranco and book world. It changed its name to Shama Plc after the merger of the three companies since the name has a social value to the surviving company as the name indicates the Amharic word for "Candle" with a parallel meaning of lighting knowledge.

### 3.1.2 Rationale for the Merger of the Three Companies

The interview result with the executive of Shama plc indicated that, the rationale and objective of the merger were initiated since there was unutilized resource in all of the three companies and to integrate vertically the companies to have strategic competitiveness and enhance shareholders return. The merger resulted in clearing over lapping activities, which require more resources. The nature of the company's business activities was more or less the same. So, the idea of merging the three independent companies has been implemented in order to utilize the resources effectively & efficiently. Further more it has the following rationales:

- Increasing Market Share
- Expected Cost saving synergy
- Enhance financial strength
- Sustainability of the type of business i.e., Book Industry
- Serve the public in a better way by reducing price of the books,
  - ✓ Less cost less Selling price
- Utilization of the slack variables
  - ✓ Shama Publishing – Excess capital & Fixed Assets
  - ✓ Book world - Retail space and competent marketing personnel
  - ✓ TRANCO – Highly qualified professional for management of book business, and
- Generate a higher return on investment

### **3.1.3 Process of the Merger of the Three Companies**

In the minutes of meetings of shareholder during January 2000, the shareholders of the three companies decided to merge. They assigned TRANCO Plc (as it has highly qualified Professionals for the Management of the Merger and consolidation of financial statements) to come up with detailed activities of the plans with the activities respective time schedules. The management of TRANCO Plc finalized the plan for the execution of the merger.

Then they started the legalization of the merger by requesting merger approval from Ministry of Trade & Industry. They submitted all the pertinent documents like the respective Audited financial statements of the three companies before the merger, Minutes of the meetings where the shareholders approved the merger and the necessity of the merger to sustain and add value to the book industry. After considering all the information the Ministry returned the Trading license of the two companies and approved for the license of the surviving company. (TRANCO Plc).

After they obtained the approval from the Ministry, they arranged for a meeting with the External Auditor of the three companies to finalize the dissolution of the two companies (Book world & Shama Publishing) and the continuation of TRANCO Plc. They decided to merge by the end of the financial year of 2000, which was June 30, 2000.

The Audit company was assigned to appraise the companies Assets and notify the share holders of the three companies on the status of the companies net assets verses the registered and paid up capital. Based on the appraisal of the fair market value of the three companies, the firm suggested that it is advisable to merge with the existing Book Value of the Accounts of the

companies and the shareholders of the liquidated companies can be the shareholders of the surviving company. It was discussed in the share holders meeting and they agreed to this suggestion, since the surviving and the liquidating companies have the same market value which was more or less the same as the book value of the companies. At that time the book industry didn't have good return on investment and all were dealing with the book industry.

### **3.1.4. Analysis of the Financial Statements of the Three Companies**

#### **3.1.4.1. Performance Analysis the First Year after the Merger:**

##### **A. Financial Statements (See Appendix I)**

The management informed the researcher to use the financial statements in percentage terms taking the merged account balances as 100%, since the statement constitutes some confidential information. Though it was in percentage terms, it helped the researcher in analyzing the operational performance of the surviving company.

The results of the conditions & operations of the company before and after the merger are analyzed and interviewed the management based on the results. The interpretation of the result is as follows:

- Fixed Assets increased by 7.48%, which shows the company continued spending on Non-Current assets. This was the result of opening a new shop. Current Assets have increased by 16.94% due to the fact that the company started purchasing merchandise inventory and sales on credit. Current Liability has increased by 28.49%, which was the result of

purchase on credit and advance collection for subscription of International magazines.

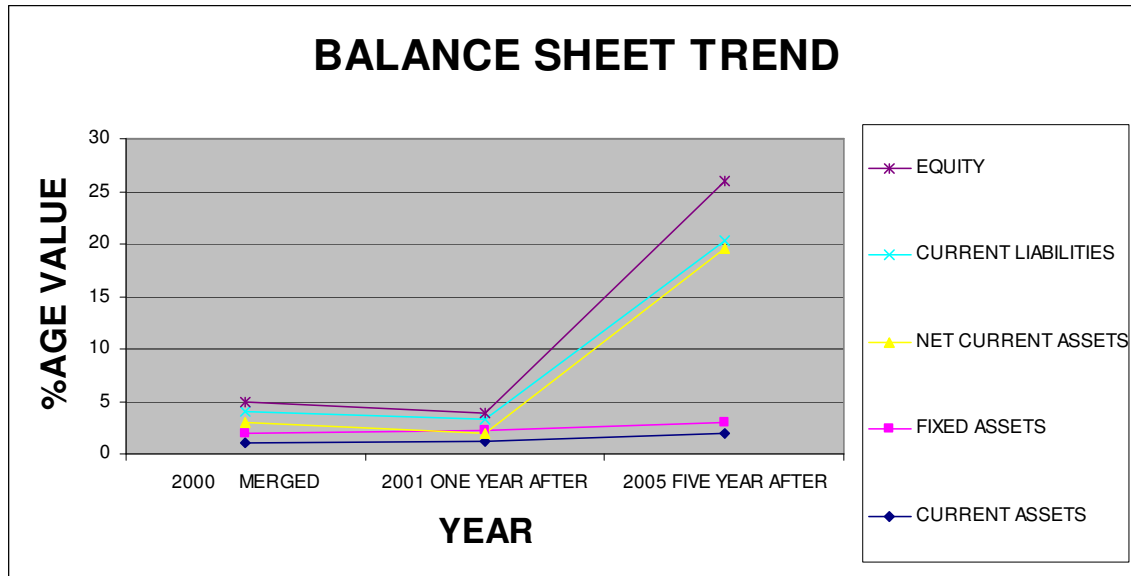


Figure 3. 1 Balance sheet trend of Shama Plc

⇒ Sales has decreased by 12.34%, which was the result of the company's strategy to attract the middle and lower class by discounting the sales prices of books from 20 to 70% while the CGS decreased by 16.98%. Though the decline in sales was 12%, the Gross profit on sales was 85%, which shows the installation of controlling direct costs. However, the company incurred a loss of 99.57% from that of the merged account, since it has increased its overhead cost by 62.10%.

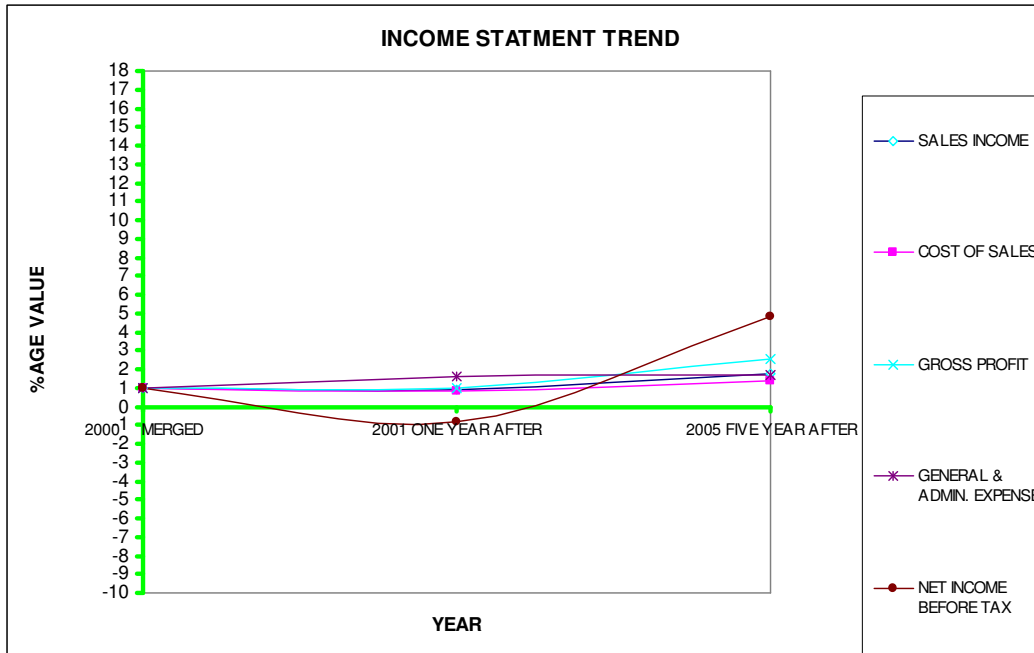


Figure 3. 2 *Income statement trends of Shama Plc.*

⇒ The over all performance of 2001 (after merger of the three companies in 2001) indicates that the company’s operational result has declined which forced the company to change its strategy of expansion by directly controlling the indirect costs. At this stage, the performance showed that there was no mechanism of internal control and working capital management to invest at profitable venture and control indirect expenses.

**B. Ratio Analysis**

The company’s Return on Equity, and return on Assets have been declining from 0.53 to (1.22) and from 0.11 to (0.71) respectively in the first year of the merger. The reason for this, as per the management of the company was the result of the rapid increase of the major Expenses, which doesn’t comply with the expanded activities and or sales.

Expenses like staff salary and Employment benefit, Rent, Telephone, Fax, Internet, repair and maintenance, custom clearing charges have been increasing above the expansion and sales increment of the company.

<b>Ratios</b>	<b>2000 Merger</b>	<b>2001, 1 year after merger</b>	<b>2005, 5years after merger</b>
<b>Return on Equity- NI/Equity</b>	<b>1</b>	<b>-1.22028</b>	<b>0.85968</b>
<b>Return on Assets - NI/Assets</b>	<b>1</b>	<b>-0.71348</b>	<b>2.694467</b>
<b>Fixed Assets Turnover – Sales/ FA</b>	<b>1</b>	<b>0.749595</b>	<b>0.944404</b>
<b>Debt to Asset Ratio - Liability/Assets</b>	<b>1</b>	<b>1.112411</b>	<b>0.422333</b>
<b>Debt to Equity Ratio - Liability / Equity</b>	<b>1</b>	<b>1.902592</b>	<b>0.134747</b>
<b>Working Capital Ratio - CA/CL</b>	<b>1</b>	<b>-0.23645</b>	<b>22.0677</b>

*Table 3. 1 Ratio before and after merger of Shama Plc. (computed by the researcher)*

As it can be seen from the table above and the figure below except working capital ratio the other ratios are decreased after merger or increased in small amount. .this indicate that the companies performance as per return on equity ,asset turnover and other ratio measure after merger does not show any significant increase as compared to before merger.

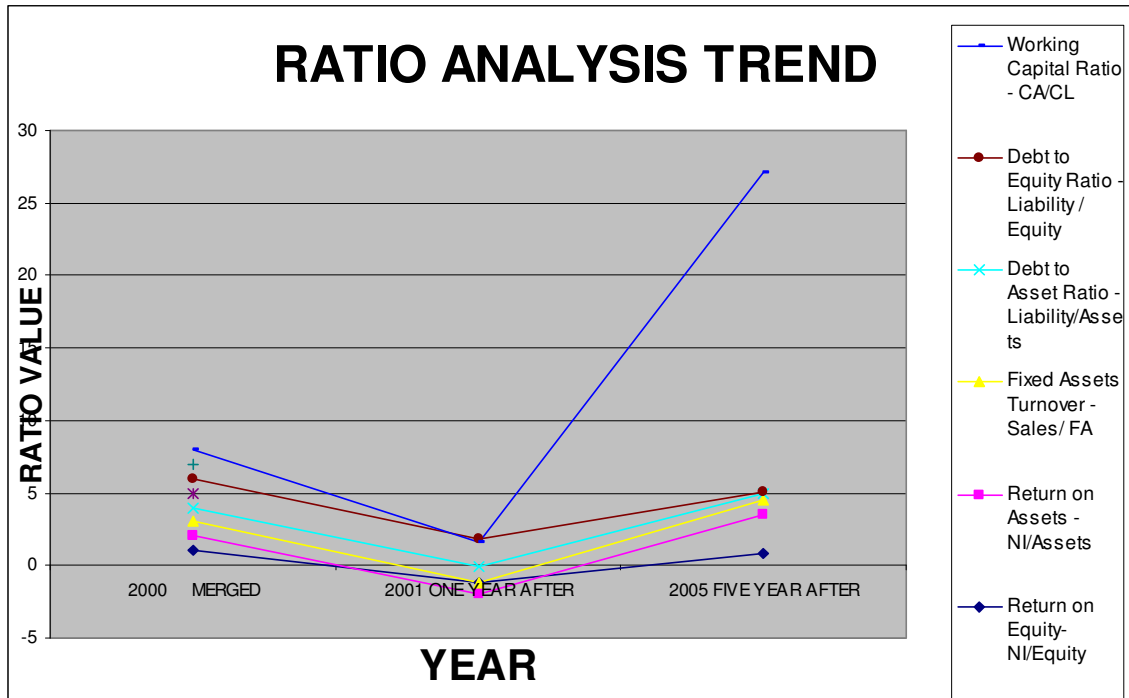


Figure 3. 3 Ratio analysis trends of Shama Plc

The second point for the decline of returns is that the company is working with a unique business venture for which the returns are minimal. This venture leads the company in to a higher profit in the long-term situation If:

- There will be reading improvement and development with in the society.
- The living standard of the society increases.
- The company gets written information at a cheaper price (Invoice, Freight & Customs).
- The government decreases tax for printed materials.
- The company, in cooperation with the community, prepares awareness creation mechanism about the importance of education as well as written information.

The unfavorable result was also due to the fact that the company started standardizing departments to the acceptable level, which require the above-mentioned expenses. The

management designed a strategy, which involves all the departments so as to meet the company's objectives.

#### **3.1.4.2 Performance Evaluation after Five Years of the Merger (2005)**

After five years of its operation the company achieved its objective of attaining a targeted sales turnover. This was due to the fact it has tackled all the strategic problems it faced during the first year of the merger. As the management recognized the drawbacks of its business it focused on the issues related to its long-term objective.

It branded its book business and started supplying books at reasonably cheaper prices, which addressed the major customers i.e., The Middle Class & Low Class. Its motto being promoting knowledge, it also addressed the existing problems of 2001, and designed the following objectives:

- Work towards improving the reading culture of the society by organizing reading events.
- Work closely with the staff so as to create conducive professional environment.
- Focus on decreasing of sales price- Quality books at a reasonable price.

After analyzing the financial statement of 5 years after merger the following facts are identified. (See Appendix I).

The total assets increased by 78% from that of 2000(Merged account). The capital and reserve showed an increasing trend due to the profitability of the business.

The trend of the sales income showed an increase in the sales turnover due to the increase in purchase of books at cheaper prices and the decrease in the sales price of the books. This in turn

resulted in generating a profit of 379%.but even though the asset and profit are increased but in terms of ratios except working capital ratio the others are decrease. Return on equity, fixed asset turn over ratio, debt to equity and debt to total asset ratios are decreasing. Thus it is possible to conclude that the company does not increase performance after merger.

## **3.2. The Valuation Process of United Insurance Company**

### **3.2.1. Establishment of the Merged Company**

United Insurances sc. was established with initial capital of Birr 8,073,000. Its main objective was to transact all life and non-life insurance and reinsurance business. On the other hand, Lion Insurance Company was founded at a fully paid capital of Birr 4,700,000. The company's corporate objectives were, first to undertake in the operations of general insurance and reinsurance and in particular to engage in engineering, fire, liability, marine, motor, accident & Health, pecuniary, Fidelity, Money, bonds (performance, bid, etc) and workmen's compensation. Second, to engage in any other related activity pertaining to the accomplishment of its objectives.

On September 9, 2000 the two companies described above were merged with authorized capital of 28.95 Million Birr. After the merger Lion Insurance company was dissolved and its account's entered in to accounts of UNIC (the combined business)

### **3.2.2 Rationale for Merger**

The following are the main reasons for the merger of the two companies as it is able to be analyzed by looking in to the deed of merger and interview with the managing director of the merged company.

1. Financial Distress: Lion insurance being the youngest and smallest insurance firm (in capital base) at the time was unable to stay competent in the market. As per the feasibility study (project study) of the company, it expected to collect premium amounting 10 million in the first year but actually it ended up with only around 5 million. This led management of the company to financial distress and ultimately conflict with the board. Finally they ended up choosing to merge with other company rather than go bankrupt.
2. Increasing market share: all private insurance companies entered into the market after Ethiopian insurance company has been established long. At the time, the market was monopolized by Ethiopian insurance company and the market share of other companies was lesser. United insurance company being an average company and lion insurance company being the youngest and smallest insurance company at the time opted to increase their market share through merger.
3. Synergy: is the force that allows for enhanced cost efficiencies of the new business. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from Economies of scale, acquiring new technology, and improved market reach and industry visibility. The merger of the two allows pooling of capital and expertise together. This accumulation of resources is expected to benefit the emerging company in many ways. The idea of **the whole is greater than the sum of its parts** was one of the motivating factors for merger- To create a better and financially strong company.

4. Providing more secure career for policy holders: Policy holders rely on insurances for any loss that they might face. But the insurance only cannot be a security for the policy holder. The policy holder is secure if the insurer company is able to pay the losses faced by the insured. Since the merger of the two increases the capital base and the capacity to collect more premium, policy holders will be more secure, especially when it comes to customers of Lion insurance company.
5. To enhance financial strength: a more stable and financially strong company was formed after the amalgamation of the two.
6. To improve the merger entity's ability to retain the business at hand and to diversify more
7. To reduce the price focused competition prevailing in the market.
8. To be advantageous from the pooling of experiences & have competent management and
9. To establish mutual benefit of horizontal merger to shareholders of the company

### **3.2.3 The Process of Merger**

The initial step taken was the agreement made by the shareholders of both companies to merge. Then they established the merger committee which is intended to execute the merger procedures. The merger committee was composed of the peoples elected from both the combine and the combiner and included one external auditor. Both companies approved (accepted) the committee to proceed with the merger.

The committee, then, started the procedure of merger by requesting merger approval in principle from the supervisory body the National Bank of Ethiopia. As the major stakeholder of financial institution in the nation, the National bank of Ethiopia supervises and consults the activity of financial institutions including the acts of merger between Lion Insurances, and united insurance S.C.

The approval of the supervising body NBE is one of the prerequisites in order to undertake the merging process. To have this approval, both companies submitted in their initial application the minutes of the agreement for merger in their respective extra ordinary meetings where two-third (2/3) of shareholders approved the merger. In addition, the detail background information of both companies that justifies the merger was also included. This background information was intended to provide the supervisory body with the relevant information for decision whether to approve or not. Furthermore, the information included the potential benefits synergy values to be gained from the merger by both companies and their reasons that initiate the merger.

After considering all these information, the supervisory body; NBE issued the approval in principle. Then the committee started the technical procedures of the merger. To decide the cut off date the committee together with the board of directors and shareholders of both companies had repeatedly revised the original date of agreement of cut off date which was on December 31, 2000. Eventually, it was decided to be held on September 9, 2000.

The major issue during the merger process was the case of Goodwill. According to the officials of NBE, UNIC added an estimated goodwill of about 10 million and inflated its capital. By the time the national bank raised two important questions:

- 1) Is it possible for an existing company to assume goodwill? Since united insurance company remains and is regarded as the taking over firm, good will cannot be recognized for the company. If there is one that assumes goodwill, it should be Lion insurance company.
- 2) Do insurance companies at the time have any goodwill? Due to high competition, enormous amount of un-collectible accounts (trade debts), and the unfavorable business environment for insurance companies at the time, some insurance companies were estimated to have a market value below their book value .finally, none of them assumed goodwill and the merger was finalized.

But since lion insurance was in its weakest form at the time of merger, the share values of lion were estimated below the share values of UNIC. The par value of the new company was Br. 1,000 each. Under the agreement value of the former united share holders to be valued at 1500 and the share price of lion to be 1000. In essence the former lion insurance will have one additional share for every share but the amount is to be paid from profit after merger for ten years 5% each year. Until 2007 about six 5% deductions are made.

### **Economic Impacts of The merger**

- 1) **Strong and competent company was created:** as a result of the merger, the capital base of the newly created UNIC increased, implying a financially strong company. This allows to retain existing clients of both merged companies and to attract some more clients from other firms, becoming more competent and reliable. Since adequate funds are available, claims can be paid and hence policy holders are more secure.
  
- 2) **Reduced capital flight:** Since most Ethiopian companies do not have strong capital base, they rely more on re-insurance. Accordingly, in a pre specified ratio the premium will be divided between the Ethiopian company and the re-insurer. Henceforth, if there is a loss subject to claim, the claim will be the liability of the re-insurer and the Ethiopian company. This part payment of premium to other worldwide reinsures is technically referred as **capital flight**. As the two companies merge, the capital base increases and as a result the merged company can shoulder more claims and reliance on reinsurance will decrease to some extent.
  
- 3) **Foreign currency saving:** premiums to re-insurers are paid in foreign currency. Hence, as the capital base of the merged company increases, premium payment to re-insurers decreases to some extent and thereby foreign currencies are saved

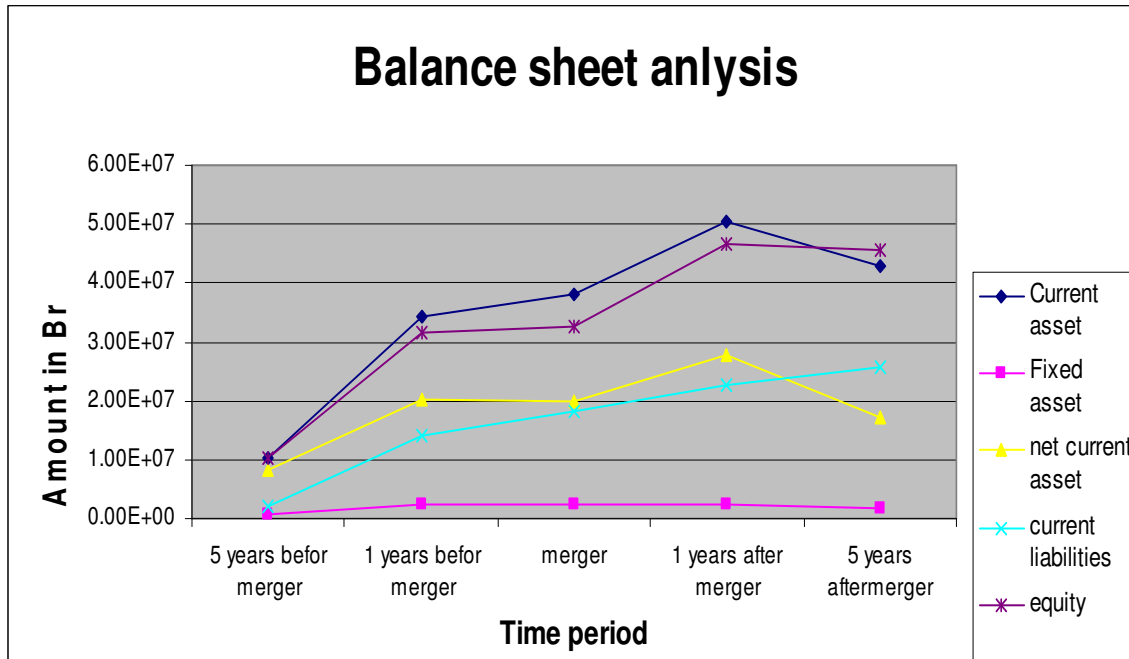
### **3.2.4 Analysis of Financial Statements**

#### **3.2.4.1 Performance Analysis One Year after Merger**

Most mergers are not expected to have short term impact on performance like 1 year after. In order to analyze this fact the financial performance of UNIC is analyzed by using trend analysis and ratio analysis.

#### **A. Financial statement (Appendix II)**

The financial performance analysis that is obtained by analyzing the standard financial statements of the merged insurance company indicate from the outset of the merger the performance has not promising .this fact is as the result of the portend that is exhibited in the income statement and balance sheet items. For instance general and administrative expense has been increased by 20% one year after merger while profit has increasing only by 5% .The Company directors justified this fact by raising the issue that merger by it self has cost and when companies merge the number of branches and employees increase and as a result the operating expense will increase. But when we look in the balance sheet of the merged companies since two companies are merged one can see increase in all assets, liabilities and equity , nevertheless this increase does not helped the company to increase its operating performance.



**B. Ratio Analysis** *Figure 3.4 Balance sheet trend of United Insurance*

Return on Equity	<b>0.1829</b>	<b>1.5897</b>	<b>1.0000</b>	<b>0.9098</b>	<b>-0.1633</b>
Return on Assets	<b>0.2359</b>	<b>1.7138</b>	<b>1.0000</b>	<b>0.9503</b>	<b>-0.1623</b>
Fixed Assets Turnover	<b>0.4168</b>	<b>1.2894</b>	<b>1.0000</b>	<b>1.3523</b>	<b>1.2507</b>
Debt to Equity ratio	<b>0.5033</b>	<b>0.9138</b>	<b>1.0000</b>	<b>0.8580</b>	<b>1.0263</b>
Debt to Asset Ratio	<b>3.7589</b>	<b>1.0106</b>	<b>1.0000</b>	<b>1.0963</b>	<b>0.9614</b>
Working Capital Ratio	<b>2.3029</b>	<b>1.1672</b>	<b>1.0000</b>	<b>1.0555</b>	<b>0.7906</b>
Profitability Ratio	<b>1.6383</b>	<b>0.8279</b>	<b>1.0000</b>	<b>0.9794</b>	<b>-0.2848</b>

In this study ratios are also used to evaluate the financial of the merged company before and after merger. In this study the ratios used are return on equity, return on asset, fixed asset turn over, debt to equity, working capital and profitability. In analyzing ratio analysis the ratio of the

Ratios	5 years before	1 year before	Merger	1 year after	5 years after
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merged year are considered to be 100% and the ratios and proportionately evaluated before and after merger. As it is possible to understand from the table below the ratios one year after merger are decreased as compared to one year before merger. This fact indicates that the company does not show any improvement in performance one year after merger. The directors of the company accepted this fact and replied this is due to lack of coordination and during the year the entire industry was not performing well it was not for United Insurance only.

*Table 3. 2 Ratio before and after merger of United Insurance (Computer by the researcher.)*

#### **3.2.4.2 Performance Analysis Five Years after Merger**

To analyze the performance of united insurance company before and merger the financial statements of the company five years before and five years after are analyzed through trend analysis and ratio analysis. The trend analysis is made by making the year of merger as 100% and prorate forward and back ward for five years in the income statement and balance sheet items.

The analysis of the financial statements 5 years after merger indicates the company is not in the way of increasing performance after merger .this is due to the fact that the profit of the company is decreasing after the year of merger. In addition to profitability the earning per share of the company also is decreasing.

In contrary to the decrease in performance of the company the paid up capital of the year and premium of the company are increased in significant rate .As per the managing director of the company this is as a result of the due focus given by company to enhance paid up capital and premium, since both are the critical item to sustain in the business.

Even if premium was increased in 2003 and 2004 premium was decreased as it can be seen in the figure 3.5. The managing director explained this fact as purposeful decision made the company because some of the premiums were collected from ISUZU cars which were having higher claims. Because of this the company forced to refund some of the premiums.

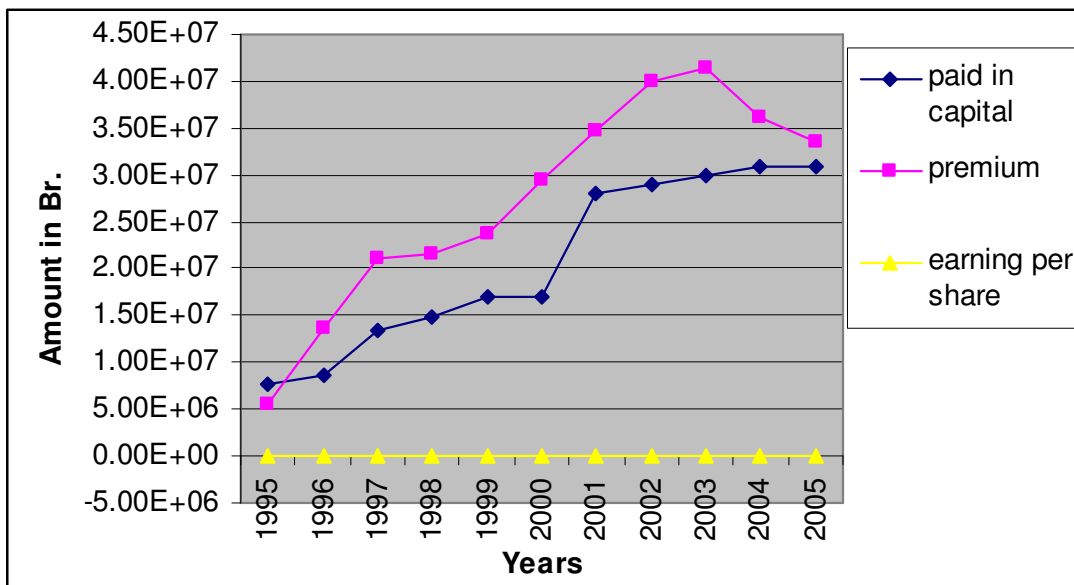


Figure 3. 5 Paid up capital, and premium & earning per share before and after merger of United Insurance Company

The ratio analyses of united insurance company before and after five years are presented in the figure below (Figure 3.6).As it can be observed from the figure most of the ratios are declining. For instance profitability, return on asset and return on equity ratios are declined more twice (200%) before they were five years before the merger. The solvency position of the company that is the currents ratio of the company also indicate declining trend before and after merger.

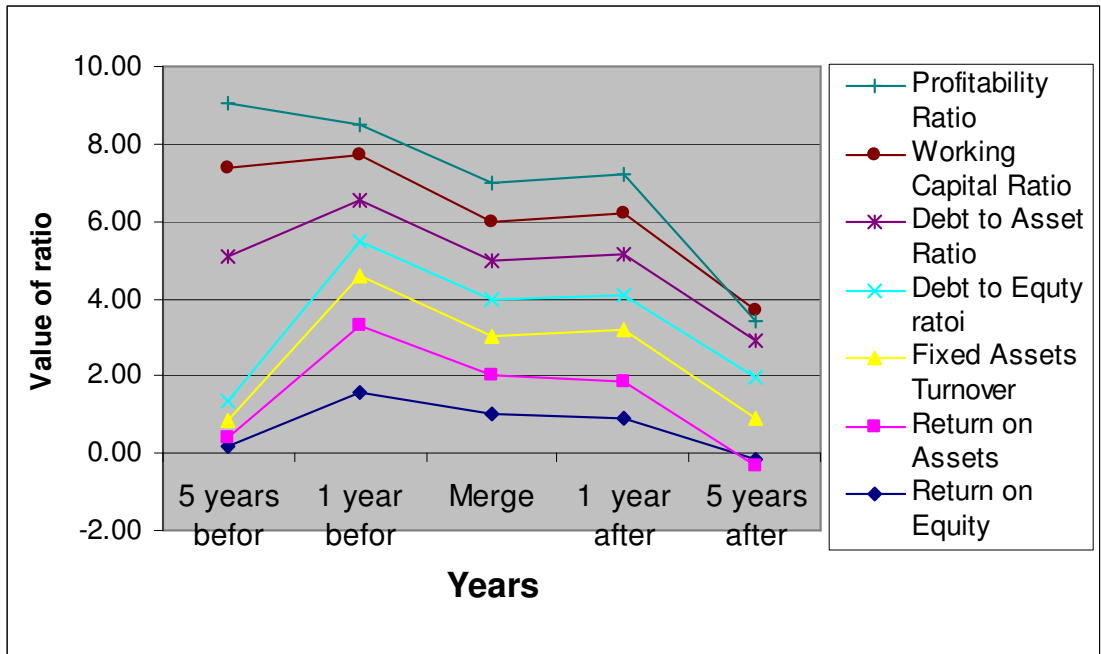


Figure 3. 6 Ratios of United Insurance before and after merger

To sum up the financial statements and ratio analyses of United Insurance indicates the performance of the company after merger has not increased before merger. The result obtained is communicated with managing director of the company at the time of the interview made with them. The managing director believe the fact that performance has not increased before merger but argued that even though merger was not their the performance result remains the same . For this argument three concrete justifications are given.

First, there was unfavorable tend in performance of the insurance industry. This is to indicate that the insurance industry is exhibiting the lowest growth from the financial institutions. United,

as part of the industry, shares the result of the unfavorable condition. Even when it compared to the insurance industry the performance of United insurance is remarkable. Even though it is not part of the study, the company exhibited the highest profit after tax among private insurance companies.

Second, there were some decisions that was made by national bank of Ethiopia, the supervisory body, the adversely affect the performance of the company. One of the significant rules made uncollected premium provisioning. This rule made in 2004 is retroactively applicable. Based on this rule insurance companies are obligated to deposit up to 75% of the uncollected premium if the premium is uncollected for more than 365 day. This rule tied most of the operating capital of the companies which adversely affect the performance of the company.

Third, the dispute between the Insurance and national bank of Ethiopia during 2004. As per the company reported about 4 million profits after tax but the national bank of Ethiopia ordered them to revise the statement and to have 1 million losses. This also affected the company to report loss and adversely affected the after merger performance of the company.

### **3.3 Strategic and Financial Target of Merger**

In this study one of the objectives is to investigate the strategic and financial target of merger. To get the required information a questionnaire was prepared that helped the researcher to get the necessary information. The research questionnaires were mainly filled by executives of the financial administration department of the mother company (the one which performed the merger) in a percentage of 75%.

### 3.3.1 Strategic Target of Mergers

According to the literature review (Papadakos, 2000), the driving force concerning the decision for merger, is the pursuit of scale economies, the pursuit of cooperation schemes, the increase of productivity and the reduction of the unit operation cost of the company. The research results agree with the literature data as shown in Table 3.3.

STRATEGIC FACTOR	Percentage					
	Don't know/ don't reply	Minimum	Little	Enough	Very	Very much
Important technology is present	13.3%	33.3%	6.7%	20.0%	20.0%	6.7%
Specialized knowledge is present	20.0%	33.3%	13.3%	6.7%	26.7%	0%
Service ability is available	20.0%	6.7%	13.3%	13.3%	20%	26.7%
Service cooperation schemes are present	13.3%	33.3%	13.3%	13.3%	6.7%	20.0%
Power of negotiation is boosted	13.3%	33.3%	13.3%	33.3%	13.3%	13.3%
Intervention in new markets	6.7%	6.7%	13.3%	13.3%	0%	6.7%
Minimization of business risk	20.0%	46.7%	13.3%	26.7%	6.7%	6.7%
Nullification of competition	13.3%	13.3%	33.3%	6.7%	13.3%	0%
Same market-targets	13.3%	20.0%	13.3%	6.7%	33.3%	20%

Table 3. 3 Summary of strategic target of mergers (computer by the researcher from primary data)

### 3.3.2 Financial Target of Mergers

#### *Analysis of the financial targets of Mergers*

The most important financial target of the research sample Mergers -on long-term timeline was the improvement of profitability of the mother company.

FINANCIAL TARGETS	Percentage					
	Don't know/ don't reply	Minimum	Little	Enough	A lot	Very much
Improvement of profitability due the acquisition of modern service technology	26.7%	26.7%	13.3%	33.3%	0%	0%
Formation of scale economies in the rendering service.	13.3%	20.0%	6.7%	13.3%	20.0%	26.7%
Decrease per unit cost	20.0%	6.7%	6.7%	20.0%	26.7%	20.0%
Cost reduction due to the increased number of transactions	20.0%	13.3%	20.0%	26.7%	13%	6.7%
Utilization of tax regulations	6.7%	33.3%	13.3%	20.0%	13.3%	13.3%
Exploitation of the bought out company's real estate	6.7%	20.0%	20.0%	26.7%	6.7%	20.0%
Exploitation of the surplus value (Book value / Market value) of the target company	40%	20.0%	26.7%	6.7%	6.7%	0%
Secession of the sector of activity	93.3%	0%	0%	0%	0%	6.7%

*Table 3. 4 Summary of financial target of mergers (computer by the researcher from primary data)*

### 3.3.3. Impact of Mergers on Companies

The factors that were examined through the questionnaire were related to:

- A. the organizational structure of the bought out company (number of employed persons, communication relations between departments),
- B. the organization systems of the bought out company (budget & control, MIS, Logistics),
- C. Marketing issues (structure of sales department, products image),
- D. Human resources issues (skills, cooperation spirit, role played by the labor unions, position taken towards the change) and, how these factors unfavorably affected the business matching of involved companies. Each one of the above mentioned factors is separately analyzed in Table 3.5.

Impact of mergers on companies						
	Don't know/ don't reply	Minimum	Little	Enough	A lot	Very much
1. In what way the number of persons employed affected the implementation of the Merger?		40.0%	33.3%	13.3%	13.3%	
2. In what way the communication between departments affected the implementation of the Merger?		20.0%	40.0%	26.7%	6.7%	
3. In what way the Budget & Control Systems affected the implementation of the Merger?		46.7%	33.3%		6.7%	
4. In what way the Information Systems affected the		33.3%	33.3%			

<b>implementation of the Merger?</b>						
<b>5. In what way Logistics affected the implementation of the Merger?</b>		<b>20.0%</b>	<b>40.0%</b>	<b>13.3%</b>	<b>6.7%</b>	
<b>6. In what way the structure of marketing departments affected the implementation of the Merger?</b>		<b>33.3%</b>	<b>33.3%</b>	<b>13.3%</b>		
<b>7. In what way the image of the service and the way clients see them affected the implementation of the Merger?</b>		<b>40.0%</b>	<b>26.7%</b>	<b>13.3%</b>		
<b>8. In what way the skills and experience of human resources of the bought out company affected the implementation of the Merger?</b>		<b>26.7%</b>	<b>13.3%</b>	<b>26.7%</b>	<b>6.7%</b>	
<b>9. In what way the cooperation spirit, affected the implementation of the Merger?</b>		<b>40.0%</b>	<b>20.0%</b>	<b>20.0%</b>		
<b>10. The position and role played by Labor Unions during the implementation of the Merger.</b>		<b>53.3%</b>	<b>20.0%</b>	<b>6.7%</b>		<b>6.7%</b>
<b>11. Attitudes and views towards Change during the implementation of the Merger</b>		<b>53.3%</b>	<b>33.3%</b>			

*Table 3. 5 Summary of impact of merger on companies (computer by the researcher from primary data)*

In addition, the company executives were asked in the questionnaire to give their personal definition in relation to what makes a Merger successful as well as to argument on the successful or failed Merger they experienced in their company. The research results are summarized in table

3.6. As it can be seen from the table below the main factor for the success of mergers is the achievement of merger target by management.

<b>What makes a Merger successful</b>	<b>Grades (Minimum=1, Little=2, Enough=3, A lot=4, Maximum=5)</b>	<b>Participation percentage % in the sample</b>
<b>1: The positive reaction of the investors.(commitment of share holders)</b>	<b>3.00</b>	<b>100%</b>
<b>2: The achievement of the Merger targets by the management</b>	<b>4.20</b>	<b>100%</b>
<b>3: The raise of the company's Book Value</b>	<b>3.73</b>	<b>100%</b>

*Table 3. 6 Analysis of what makes merger to be successful(computer by the researcher from primary data)*

The interviewed executives identified the following factors to be the main possible causes for the mergers to fail. The disincentives or the reasons that Buyouts & Mergers fail, are summarized in the following facts:

- a) there is not strategic planning and proper investment reasoning,
- b) there are unrealistic anticipations,
- c) the merger cost is extremely high,
- d) there are conflicting company philosophies (different culture),
- e) the two enterprising entities fail to merge fast,
- f) shareholders' contradictory interests,

- ☑ g) external environment (state interventions and institutional framework),
- ☑ h) the general economic conjuncture (macroeconomic conditions).

### 3.4 Hypothesis Testing Using T-Test: Paired Two Samples for Mean

To substantiate the result obtained by using ratio analysis hypothesis was tested for the two firms by using T test.

The two hypotheses are:

*Null hypothesis Ho:* There are no significant differences in post-merger and pre merger operating performance for firms.

*Alternative hypothesis H1:* Operating performance in the post-merger period is greater than operating performance in the pre- merger period.

To test the impact of Mergers on performance, there are various alternative ways. Like “Event Studies”, where we compare stock prices of the firms a certain days before and after the mergers. Another way is “Regression Analysis”, where we can take after tax rate of return as dependant variable and Size of the firm, rate of increase in capital stock, R&D expenditures etc. as independent variables. Third way is ‘T-test: Paired two samples for mean’ which the researcher going to use in this paper.

In this paper the researcher tests impact of mergers on the performance of the company in terms of four parameters. ROCE, Economies of scale, Operating Synergy and Financial Synergy. The T test used is, T test: Paired two samples for means’.

#### 3.4.1. Return on Capital Employed (ROCE)

Here the test is the overall impact of the mergers on the performance of the Acquirer Company (or amalgamated Company). For, ROCE, the researcher take PBIT (Profit before Interest and Tax) minus Tax. And to calculate pre merge ROCE, weighted Average is used. First calculated weighted average ROCE for each year are calculated and then simple average of 5 years weighted Average ROCE is determined. Similarly, weighted Average ROCE for post merger is determined. Thus, two series of ROCE; one for Pre-merger and one for Post-merger are obtained.

When the t-test' is run on this series the following results are obtained as indicated in the table below (table 3.7).

t-Test: Paired Two Sample for Means	Return on Capital employed	
	Variable 1	Variable 2

<b>Mean</b>	<b>0.16723051</b>	<b>0.079388369</b>
<b>Variance</b>	<b>0.008893647</b>	<b>0.007392086</b>
<b>Observations</b>	<b>5</b>	<b>5</b>
<b>Pearson Correlation</b>	<b>-0.288022484</b>	
<b>Hypothesized Mean Difference</b>	<b>0</b>	
<b>Df</b>	<b>4</b>	
<b>t Stat</b>	<b>1.356842585</b>	
<b>P(T&lt;=t) one-tail</b>	<b>0.123175709</b>	
<b>t Critical one-tail</b>	<b>2.131846782</b>	
<b>P(T&lt;=t) two-tail</b>	<b>0.246351418</b>	
<b>t Critical two-tail</b>	<b>2.776445105</b>	

*Table 3. 7 Excel out put of T test for Return on capital employed. (Computed by the researcher)*

Mean (pre) is 0.16723051 against the Mean (Post) 0.079388369. While variance are 0.00889(pre) and 0.00739 (post). The obtained statistic t-value is 1.3568 against the critical t-value of 2.7764. That shows that we can accept null hypothesis at 5% confidence level. In other words mergers did not improve the performance of the companies under study.

### **3.4.2. Test of Economies of Scale**

Economy of scale refers to the cost reduction due to large number of units produced. Because there are various fixed cost involved in the operation and per unit cost component of such cost reduces when a firm produces more units. This economy of scale also arises because merger increases the size of the firm, so now firm become enable to get better terms and conditions on

purchases. For all these reasons, ‘cost of production per unit’ is taken as a measure of economies of scale. But, since the companies under the study are not manufacturers the researcher forced to selected ‘total cost of service per birr sale’ as a measure.

When the t-test on the series is run (Average cost of service/ sale for the companies pre-merger and post-merger) the following results are obtained as shown in the table 3.8.

<b>Total cost/ sales</b>		
<b>t-Test: Paired Two Sample for Means</b>		
	<i>Variable 1</i>	<i>Variable 2</i>
<b>Mean</b>	<b>0.460795</b>	<b>0.234684</b>
<b>Variance</b>	<b>0.035678</b>	<b>0.313376</b>
<b>Observations</b>	<b>5</b>	<b>5</b>
<b>Pearson Correlation</b>	<b>0.190789</b>	
<b>Hypothesized Mean Difference</b>	<b>0</b>	

<b>Df</b>	<b>4</b>	
<b>t Stat</b>	<b>0.909986</b>	
<b>P(T&lt;=t) one-tail</b>	<b>0.207152</b>	
<b>t Critical one-tail</b>	<b>2.131847</b>	
<b>P(T&lt;=t) two-tail</b>	<b>0.414304</b>	
<b>t Critical two-tail</b>	<b>2.776445</b>	

*Table 3. 8 Excel out put of t test of economies of scale. (Computed by the researcher.)*

The t-statistic obtained is 0.909986 against the critical value of t 2.776445 at 5% confidence level. That shows that companies under study did not achieved economies of scale after merger.

### **3.4.3. Test of Operating Synergy**

It is assumed that merger improves the performance of the company, because it helps to avoid the duplication of tasks like duplicating Advertisement Expenses, Duplicating sales and Distribution expenses etc. This should results in decreasing operating expenses and increasing operating profit. To test this aspect Operating Profit Margin is selected as a criterion and take weighted average of each year and simple average of these weighted. Average OPM to calculate pre and post OPM figures.

When I run the 't-test' on this series, I obtained t-statistic 1.362414 against the table value 2.776445 at 5% confidence level. That proved that mergers do not even contribute in the operating synergy, for the sample under consideration.

<b>Operating Profit Margin</b>		
<b>t-Test: Paired Two Sample for Means</b>		
	<i>Variable 1</i>	<i>Variable 2</i>
<b>Mean</b>	<b>0.109331</b>	<b>0.051727</b>
<b>Variance</b>	<b>0.003266</b>	<b>0.003171</b>
<b>Observations</b>	<b>5</b>	<b>5</b>
<b>Pearson Correlation</b>	<b>-0.38865</b>	
<b>Hypothesized Mean Difference</b>	<b>0</b>	

<b>Df</b>	<b>4</b>	
<b>t Stats</b>	<b>1.362414</b>	
<b>P(T&lt;=t) one-tail</b>	<b>0.122367</b>	
<b>t Critical one-tail</b>	<b>2.131847</b>	
<b>P(T&lt;=t) two-tail</b>	<b>0.244735</b>	
<b>t Critical two-tail</b>	<b>2.776445</b>	

*Table 3. 9 Excel out put of t test of operating synergy. (Computed by the researcher.)*

### **3.4.4. Test of Financial Synergy**

Theoretically it is also assumed that mergers provide the financial synergy. According to Lewellen (1971), Higgins and Schall (1975), Galai and Masulis (1976) and Kim and McConnell (1977)- Mergers increases the debt capacity of the firm, especially in case of diversified mergers, where cash flows of the two companies are not positively correlated. This decreases lender's risk and as a result cost of capital decreases. Financial synergy can also be obtained by reducing Interest or taking benefits of Tax shield and depreciation.

To test the financial synergy, Net Profit Margin is selected as a criteria and calculated Pre and Post Net Profit Margin in the same way I calculated OPM.

When I run t-test on this series, our results were totally opposite to the theoretical assumption. I obtained t-statistic 2.039699 against the critical t-value 2.776445 at 5% confidence level. That proved that mergers even do not contribute in achieving financial synergy.

<b>Net operating margin</b>		
<b>t-Test: Paired Two Sample for Means</b>		
	<i>Variable 1</i>	<i>Variable 2</i>
<b>Mean</b>	<b>0.364486</b>	<b>0.199542</b>
<b>Variance</b>	<b>0.006992</b>	<b>0.018258</b>
<b>Observations</b>	<b>5</b>	<b>5</b>
<b>Pearson Correlation</b>	<b>-0.32955</b>	
<b>Hypothesized Mean Difference</b>	<b>0</b>	
<b>Df</b>	<b>4</b>	
<b>t Stat</b>	<b>2.039699</b>	
<b>P(T&lt;=t) one-tail</b>	<b>0.055491</b>	
<b>t Critical one-tail</b>	<b>2.131847</b>	
<b>P(T&lt;=t) two-tail</b>	<b>0.110982</b>	

<b>t Critical two-tail</b>	<b>2.776445</b>	
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*Table 3. 10 Excel out put of t test of operating synergy. (Computed by the researcher.)*

Generally the result obtained by analyzing the financial performance of merged companies before and after merger using trend and ratio analysis is perfectly supported by the t test indicating the performance does not increased after merger.

## CHAPTER FOUR

### 4. CONCLUSIONS AND RECOMMENDATIONS

#### 4.1 Conclusions

In this part of the study major findings based the analysis made in chapter three a summarized as conclusions.

In the merger process of Shama plc, the merger is initiated because there was idle resource in the companies going for merger. The process is made by pooling the auditing financial statements of the merging companies. This merger was is also vertical integration of firms in book publishing, importing and distributing industry.

It can be noted that the company's combination was effected in the manner of statutory consolidation. However, since there is no cash payment at the time of combination and only a fusion of the three companies, rather than take over occurs, we can conclude that the method of financial reporting for consolidation is pooling of interest method at which time it was practical.

It can also be noted form the analysis of the study the strategic intent of companies in merger is the driving force concerning the decision for merger, is the pursuit of scale economies, the pursuit of cooperation schemes, and the increase of productivity and the reduction of the unit operation cost of the company. The most important financial target of the research sample Mergers -on long-term timeline was the improvement of profitability of the mother company.

The factors that were examined and found to be the impact of merger in the following areas

- ◆ . the organizational structure of the bought out company (number of employed persons, communication relations between departments),
- ◆ . the organization systems of the bought out company (budget & control, MIS, Logistics),
- ◆ . Marketing issues (structure of sales department, products image),
- ◆ Human resources issues (skills, cooperation spirit, role played by the labor unions, position taken towards the change) and, how these factors unfavorably affected the business matching of involved companies.

As per the interviewed official of the merged companies to have successful merger their must be achievement of managements objectives. In addition it requires also commitments by investors and critical valuation of Target Company.

The disincentives or the reasons that & Mergers fail, are summarized in the following facts:

- ◆ there is not strategic planning and proper investment reasoning,
- ◆ there are unrealistic anticipations,
- ◆ the buyout cost is extremely high,
- ◆ there are conflicting company philosophies (different culture),
- ◆ the two enterprising entities fail to merge fast,
- ◆ shareholders' contradictory interests,
- ◆ external environment (state interventions and institutional framework),
- ◆ The general economic conjuncture (macroeconomic conditions).

The financial statements of the merged companies 5 years before and 5 years after merger has been analyzed using trend analysis and ratio analysis. It can be understood from the result performances before merger has not increased. But it is difficult to conclude that it is because of the merger, since the company directors raise so many exogenous factors for decline of performance.

This study proves that Merges have failed to contribute positively in the performance of the company, especially for the sample under consideration. It neither provides Economies of scale nor synergy effect. When overall impact (i.e. ROCE), is calculated mergers were failed to provide any positive contribution here also. In fact, these results are not surprising. They are in line with what was expected on the basis of literature survey. But still here the researcher would like to add one thing. There are numerous motives that motivate a company to enter in to merger activities. Some times these motives are qualitative and cannot be interpreted in to quantitative figures. Again, a merger may be effective or successful to deliver the immediate objective but may be failed to deliver all the theoretically defined benefits. So, it will be fallacious to assume, on the basis of this study, that overall mergers do not contribute any thing to the companies and it is a useless exercise.

## 4.2 Recommendations

In this part of the study from the conclusion made in earlier chapter possible recommendation which are feasible and applicable are forwarded.

1. The problems for a smooth implementation of Mergers are not only institutional, financial or operational. Factors such as, man, culture, company philosophy and potential internal weaknesses that are part of each company's micro-world, can be determinant in the final outcome of the Merger. The involved parts do not only deal with the financial aspect of the Merger, but also with the social cost of each Merger that is usually interpreted in issues concerning the management of excessive personnel resulting in the loss of work places (Schliefer & Vishny, 1989). So companies should give due focus for non financial aspect in addition to the qualitative before going the merger deal.
2. Valuation of Target Company has an impact in the performance of merged companies and also on the wealth of share holders. So there must be companies should use better approach than simply pooling of the financial statements.
3. With regard to the valuation of the fixed assets of the merger, the management of the companies decided to merge so as to utilize slack variables since they have idle fixed assets and working capital. However, at the time of consolidation, the committee considered the book value of the asset is equal to the current fair value of the assets, which seems impractical. Because the current fair values of fixed assets like computers,

vehicles, etc... could not be actually equal to their respective book values. As per the researcher, it would be advisable if the fair value the assets were appraised with in the prevailing market price of the assets at the time of the merger.

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APPENDIX

# Appendix

## Appendix I financial statement analysis of Shama plc

SHAMA PLC				
FINACIAL ANALYSIS				
FOR THE YEAR 2001				
	%AGE	%AGE	%AGE	%AGE
BALANCE SHEET	CHANGE	CHANGE	CHANGE	CHANGE
FIXED ASSETS( NET)	6.45	0.12	7.34	56.28%
DEPRECIATION				109.19%
DEFFERED EXPENDITURE				
FIXED ASSETS	11.61	(0.03)		7.48%
CURRENT ASSETS				
STOCK IN HAND	4.18	0.71	7.85	18.52%
DEBTORS & PREPAYMENTS(NET)	-0.44	1.45	0.36	62.06%
CASH IN HAND	55.54	(0.56)	24.02	5.57%
CASH AT BANK	5.69	1.29	14.29	-69.89%
	0.64	0.92	2.15	
CURRENT ASSETS				16.94%
CREDITORS & ACCRUALS	86.65	1.27	197.85	57.54%
SUPPLIERS	4.80	0.27	6.35	-31.71%
PROVISION FOR PROFIT TAX	0.30	(0.96)	(0.95)	-237.20%
BANK OVER DRAFT				0.00%
CURRENT LIABILITIES	4.38	0.52	7.18	28.49%
NET CURRENT ASSETS	-1.65	(1.11)	(0.93)	-130.38%
TOTAL ASSETS	0.94	0.75	2.39	15.51%
CAPITAL	0.00	-	-	-0.14%
MEMBERS ACCOUNT	-1.21	(1.75)	(0.84)	-452.04%
LEGAL RESERVE	0.00	-	-	0.00%
PROFIT / LOSS OF THE YEAR	-1.06	(15.02)	(0.15)	-99.59%
TOTAL EQUITY	-1.08	(7.96)	(0.41)	-32.46%

SHAMA PLC				
FINACIAL ANALYSIS				
FOR THE YEAR 2001				
	%AGE	%AGE		
INCOME STATEMENT	CHANGE	CHANGE		
SALES				
BOOKS	9.00	0.44	13.40	-19.98%
COMPACT DISK	0.08	0.02	0.10	-1.22%
PHARMACEUTICALS & PERSONAL CARE	10.15	0.42	14.80	95.92%
TOBACCO & ACCESSORIES, SWEETS	2.91	1.30	7.97	18.05%
STATIONARY & POST CARDS	2.27	0.83	4.99	18.30%
SOUVENIRS & GIFT ITEMS	0.54	(1.00)	(1.00)	-100.00%
MAGAZINES	1.18	0.39	2.04	-24.66%
NEWSPAPERS	-0.47	(1.00)	(1.00)	
MACHINERY	0.00	(0.91)	-	
ART WORK				
TOTAL INCOME	2.45	0.43	3.94	-12.34%
COST OF SALES				
TOURISTIC BOOKS	101.70	0.31	133.65	-29.86%
COMPACT DISK	0.25	0.08	0.34	-25.11%
PHARMACEUTICALS & PERSONAL CARE	40.04	0.22	49.26	43.05%
TOBACCO & ACCESSORIES	3.66	(0.16)	2.91	50.04%
STATIONARY & POST CARDS	3.07	0.71	5.98	10.95%
SOUVENIRS & GIFT ITEMS	-0.54	(1.00)	(1.00)	-100.00%
MAGAZINES	1.39	(0.02)	1.34	-51.33%
NEWSPAPERS	-0.44	(1.00)	(1.00)	-100.00%
MACHINERIES	0.00	(0.81)	-	-100.00%
ART WORKS				
TOTAL COST OF SALES	2.92	0.11	3.36	-16.98%
GROSSS PROFIT	1.02	2.30	5.68	-2.49%
	0.00	-		253.61%

OTHER INCOME			(0.99)	
COMMISSION INCOME	0.00	0.09	-	-37.74%
TOTAL GROSS PROFIT	-0.41	2.09	0.82	99.15%
GENERAL & ADMINISTRATIVE EXPENSE				
SALARIES & ALLOWANCES	2.01	0.16	2.48	39.99%
BOARD ALLOWANCE	-1.00	-	(1.00)	#DIV/0!
RENT	2.94	0.16	3.55	34.64%
POSTAGE & TELEPHONE	21.99	0.28	28.37	36.02%
CAR RUNNING	0.36	0.34	0.82	1.02%
REPAIR & MAINTENANCE	0.92	(0.02)	0.88	216.65%
STATIONARY & PRINTING	2.12	0.66	4.18	101.31%
ELECTRICITY & WATER	2.17	0.12	2.55	73.22%
ENTERTAINMENT	4.33	(0.63)	1.00	177.55%
ADVERTISEMENT & SPONSORSHIP	9.03	1.34	22.49	185.42%
COMMISSION	6.91	0.05	7.27	-38.42%
TRADING LICENCE	2.08	(0.05)	1.94	247.24%
AUDIT FEE	0.74	-	0.74	-4.53%
DEPRECIATION	2.98	0.41	4.62	26.77%
BAD DEBT EXPENSE	-1.00	-	(1.00)	#DIV/0!
SUNDRIES	1.21	(0.89)	(0.77)	-61.30%
INSURANCE	0.00	0.15	-	107.02%
BANK CHARGE	0.00	(0.46)	-	65.11%
EMPLOYEE BENEFITS	0.00	0.45	-	-41.54%
TRAVEL & PERDIEM	0.00	2.36	-	191.08%
TENDER & BID BOND	0.00	(1.00)	-	
TAXI FARE	0.00	0.76	-	31.50%
AMORTIZATION		-	-	-50.00%
DONATION				14.65%
GENERAL EDITING				
PROFESSIONAL FEE				690.70%
ISBN -BAR CODING SERVICE	0.73			

SOFTWARE		(1.00)	(1.00)	
TOTAL EXPENSES	2.26	0.29	3.20	62.10%
	4.80			
NET INCOME BEFORE TAX	-1.51	(2.63)	(0.16)	-182.41%
PROVISION FOR PROFIT TAX	-1.00	-	(0.18)	-100.00%
	-1.80	(2.06)	(0.15)	-257.84%
LEGAL RESERVE				
	-1.80	(2.06)	(0.15)	-257.84%
BALANCE BROUGHT FORWARD	-30.33	(1.08)	1.34	275.46%
PRIOR YEARS ADJUSTMENT	-			
BALANCE CARRIED FORWARD	-1.06	(14.39)	(0.19)	-99.57%

## Appendix 2. Financial Statements of United Insurance Company

Profit and loss account							
		1995	1996	1997	1998	1999	2000
UNDERWRITING SUPPLIES		729,261.00	2,714,358.00	6,144,668.00	8,532,747.00	9,596,613.00	6,974,462.00
INTERST INCOME		306,884.00	829,602.00	1,105,148.00	1,059,756.00	921,103.00	899,218.00
OTHER INCOME-MISCELLANEOUS		-	601.00	2,255.00	2,528.00	9,267.00	7,828.00
<b>TOTAL INCOME</b>		1,036,145.00	3,544,561.00	7,252,071.00	9,595,031.00	10,526,983.00	7,881,508.00
EXPENSES							
SALARIES AND EMPLOYEE BENEFITS		184,181.00	582,004.00	571,088.00	598,391.00	683,191.00	653,765.00
DIRECTORS EMOLUMENTS		103,000.00	162,000.00	162,000.00	336,800.00	340,548.00	239,343.00
DEPRECIATION AND AMORTISATION		138,136.00	295,001.00	386,655.00	500,742.00	691,786.00	845,384.00
PROVISION FOR DOUBTFUL DEBTS					297,297.00	323,927.00	85,993.00
AUDIT FEES					24,750.00	29,232.00	29,232.00
FINANCIAL EXPENSES		403.00	22,234.00	118,685.00	18,362.00	22,375.00	26,267.00
GENERAL AND ADMINISTRATIVE EXPENSES		365,415.00	782,725.00	929,889.00	1,441,550.00	1,970,805.00	1,793,166.00
<b>TOTAL EXPENSES</b>		791,135.00	1,843,964.00	2,168,317.00	3,217,892.00	4,061,864.00	3,673,150.00
PROFIT BEFORE TAX		245,010.00	1,700,597.00	5,083,754.00	6,377,139.00	6,465,119.00	4,208,358.00
PROVISION FOR TAX		(98,004.00)	(595,209.00)	(1,779,314.00)	(2,354,428.00)	(2,377,948.00)	(1,511,777.00)
PROFIT AFTER TAX		147,006.00	1,105,388.00	3,304,440.00	4,022,711.00	4,087,171.00	2,696,581.00
TRANSFER TO LEGAL RESERVE		(14,700.60)	(110,538.80)	(330,444.00)	(402,271.10)	(408,717.10)	(269,658.10)
NET PROFIT FOR THE YEAR		132,305.40	994,849.20	2,973,996.00	3,620,439.90	3,678,453.90	2,426,922.90
BALANCE BROUGHT FORWARD		-	132,305.40	58,843.00	406,901.00	207,382.90	3,897,345.80
TRANSFER TO DIVIDEND PAYABLE						-	(3,894,749.00)
						11,509.00	
PRIOR YEAR ADJUSTMENT		-	(52,986.00)	15,249.00	(68,392.00)	3,897,345.80	2,596.80
UNAPPROPRIATED SURPLUS		-	1,074,168.60	3,048,088.00	3,958,948.90		
PROFIT APPROPRIATED		-	1,015,325.00	2,641,187.00			
PROFIT BEFORE APPROPRIATIONS							2,429,519.70
PROPOSED DIVIDENDS					(3,751,566.00)	-	-
BALANCE CARRIED FORWARD		132,305.40	58,843.00	406,901.00	207,382.90	3,897,345.80	2,429,519.70

**PROFIT AND LOSS ACCOUNT  
FOR THE YEAR ENDED 30 JUNE**

			2001	2002	2003	2004	2005
NON LIFE							
<b>INCOME</b>							
UNDERWRITING			9,856,017	9,974,872	10,001,945	3,219,333	3,873,356
INTERST INCOME			1,149,309	1,052,364	890,714	772,545	739,650
DIVIDEND INCOME			900,393	355,176	454,804	623,670	2,472,969
OTHER INCOME-MISCELLANEOUS			38,883	9,496	33,393	67,155	152,016
<b>TOTAL INCOME</b>			<b>11,944,602</b>	<b>11,391,908</b>	<b>11,380,856</b>	<b>4,682,703</b>	<b>7,237,991</b>
<b>EXPENSES</b>							
EMPLOYEES' SALARIES AND BENEFITS			1,337,526	1,374,126	1,437,669	1,353,963	1,425,559
DIRECTORS' EMOLUMENT			304,863	50,400	50,400	37,800	37,800
DEPRECIATION AND AMORTIZATION			975,546	1,071,947	459,554	507,291	485,104
PROVISION FOR DOUBTDUL DEBTS			1,226,558	1,014,265	881,280	2,952,645	3,214,107
AUDIT FEES			71,065	32,200	35,420	24,150	24,150
FINANCIAL EXPENSES			24,792	45,618	38,001	20,887	38,037
GENERAL AND ADMINISTRATIVE EXPENSES			2,859,288	2,605,422	2,747,039	3,368,895	2,973,824
<b>TOTAL EXPENSES</b>			<b>6,799,638</b>	<b>6,193,978</b>	<b>5,649,363</b>	<b>8,265,631</b>	<b>8,198,581</b>
<b>NET PROFIT BEFORE TAX</b>			<b>5,144,964</b>	<b>5,197,930</b>	<b>5,731,493</b>	<b>(3,582,928)</b>	<b>(960,590)</b>
CONSOLIDATED PROFIT AND LOSS ACCOUNT AND APPROPRIATION OF PROFIT							
NET PROFIT BEFORE TAX-NON LIFE			5,144,964	5,197,930	5,731,493	(3,582,928)	(960,590)
PROFIT FROM LIFE BUSINESS			306,837	257,254	382,594		
			<b>5,451,801</b>	<b>5,455,184</b>	<b>6,114,087</b>	<b>(3,582,928)</b>	<b>(960,590)</b>
PROVISION FOR TAX			(1,998,344)	(2,128,203)	(1,682,764)		
<b>NET PROFIT AFTER TAX</b>			<b>3,453,457</b>	<b>3,326,981</b>	<b>4,431,323</b>	<b>(3,582,928)</b>	<b>(960,590)</b>
TRANSFER TO LEGAL RESERVE			(345,346)	(332,698)	(443,132)		
			<b>3,108,111</b>	<b>2,994,283</b>	<b>3,988,191</b>	<b>(3,582,928)</b>	<b>(960,590)</b>
BALANCE BROUGHT FORWARD			2,433,016	2,925,486	3,125,269	4,614,616	(2,926,605)
TRANSFER TO DIVIDEND PAYABLE			(2,378,850)	(2,794,500)	(2,895,300)	(4,142,944)	
			<b>54,166</b>	<b>130,986</b>	<b>229,969</b>	<b>471,672</b>	<b>(2,926,605)</b>
PRIOR YEAR ADJUSTMENT			13,209		396,456	184,651	(664,433)
<b>PROFIT BEFORE APPROPRIATIONS</b>			<b>3,175,486</b>	<b>3,125,269</b>	<b>4,614,616</b>	<b>(2,926,605)</b>	<b>(4,551,628)</b>
APPROPRATIONS							
PROPOSED DIVIDENDS							
ACQUISITION OF OWN SHARES			(250,000)				
<b>BALANCE CARRIED TO BALANCE SHEET</b>			<b>2,925,486</b>	<b>3,125,269</b>	<b>4,614,616</b>	<b>(2,926,605)</b>	<b>(4,551,628)</b>

			1996	1997	1998	1999	2000
<b>BALANCE SHEET</b>							
<b>ASSET EMPLOYED</b>							
<b>CURRENT ASSETS</b>							
CASH AND BANK BALANCES			347,697	1,522,648	1,315,820	3,840,594	4,113,025
BANK DEPOSIT AT INTERSET			6,452,584	11,703,420	20,527,941	13,699,790	14,369,435
TREASURY BILL							
DEBTORS			3,452,760	3,107,245	7,510,588	14,405,302	15,644,358
DUE FROM REINSURERS						31,312	-
PROFIT TAX RECOVERABLE							
			<b>10,253,041</b>	<b>16,333,313</b>	<b>29,354,349</b>	<b>31,976,998</b>	<b>34,126,818</b>
<b>CURRENT LIABILITIES</b>							
OUTSTANDING CLAIMS			660,511	2,869,592	4,570,290	7,120,599	7,238,517
DUE TO REINSURERS			886,836	67,015	1,101,819	1,311,035	1,234,861
PROVISION FOR TAX (RECOVERABLE)/PAYABLE			98,004	555,960	1,788,437	2,313,510	2,377,948
OTHER CREDITORS, ACCRUALS & PROVISIONS			473,206	2,850,599	4,251,671	6,601,825	3,062,134
			<b>2,118,557</b>	<b>6,343,166</b>	<b>11,712,217</b>	<b>17,346,969</b>	<b>13,913,460</b>
NET CURRENT ASSETS			8,134,484	9,990,147	17,642,132	14,630,029	20,213,358
DEFERRED CHARGES			375,772	253,050	279,622	614,189	482,007
INVESTMENTS			-	1233000	1,333,000	5,160,000	6,047,000
FIXED ASSETS			714,228	1,034,252	1,155,216	2,115,875	2,345,796
STATUTORY DEPOSITS			1,194,450	1,194,450	2,024,102	2,245,207	2,535,654
<b>TOTAL ASSETS LESS CURRENT LAIBILITIES</b>			<b>10,418,934</b>	<b>13,704,899</b>	<b>22,434,072</b>	<b>24,765,300</b>	<b>31,623,815</b>
<b>FINANCED BY</b>							
<b>TECHNICAL PROVISIONS</b>							
UNEARNED PREMIUMS			2,191,886	3,948,096	6,393,891	7,137,074	8,241,551
OTHER TECHNICAL PROVISIONS			417,470	1,000,708	1,563,739	1,103,867	530,215
LIFE FUND			-	-	-	270,389	520,692
PROFITABILITY BONUS FOR LIFE POLICY HOLDERS							
			<b>2,609,356</b>	<b>4,948,804</b>	<b>7,957,630</b>	<b>8,511,330</b>	<b>9,292,458</b>
<b>SHAREHOLDERS' FUNDS</b>							
PAID UP SHARE CAPITAL			7,662,572	8,542,000	13,494,017	14,968,050	16,904,357
SHARE PREMIUM			-	35,900	188,875	232,375	274,775
LEGAL RESERVE			14,701	119,352	451,490	846,162	1,254,879
PROFIT & LOSS ACCOUNT			132,305	58,843	406,901	207,383	3,897,346
			<b>7,809,578</b>	<b>8,756,095</b>	<b>14,541,283</b>	<b>16,253,970</b>	<b>22,331,357</b>
LIFE OPERATIONS-CURRENT ACCOUNT					(64,841)	-	-
<b>TOTAL TECHNICAL PROVISIONS &amp; SHAREHOLDERS'</b>			<b>10,418,934</b>	<b>13,704,899</b>	<b>22,434,072</b>	<b>24,765,300</b>	<b>31,623,815</b>

			2001	2002	2003	2004	2005	2006
<b>BALANCE SHEET</b>								
<b>ASSET EMPLOYED</b>								
<b>CURRENT ASSETS</b>								
CASH AND BANK BALANCES			2,260,769	6,034,907	4,358,194	6,918,194	5,264,589	6,123,446
BANK DEPOSIT AT INTERSET			18,725,693	22,030,348	19,111,953	22,226,902	19,672,810	22,658,463
TREASURY BILL					986,100	-	-	
DEBTORS			16,950,225	22,033,440	27,022,241	27,587,366	19,802,706	13,049,236
DUE FROM REINSURERS			50,351	169,651	144,396	649,525	300,637	331,921
PROFIT TAX RECOVERABLE								527,009
			<b>37,987,038</b>	<b>50,268,346</b>	<b>51,622,884</b>	<b>57,381,987</b>	<b>45,040,742</b>	<b>42,690,075</b>
<b>CURRENT LIABILITIES</b>								
OUTSTANDING CLAIMS			11,850,645	12,812,217	18,373,487	23,160,774	18,160,630	17,553,081
DUE TO REINSURERS			1,357,047	2,601,253	1,051,981	139,244	2,148,654	2,637,702
PROVISION FOR TAX (RECOVERABLE)/PAYABLE			1,511,777	1,997,816	1,976,781	1,073,085	(65,074)	-
OTHER CREDITORS, ACCRUALS & PROVISIONS			3,356,577	5,252,028	4,994,099	5,216,543	4,848,810	5,502,637
			<b>18,076,046</b>	<b>22,663,314</b>	<b>26,396,348</b>	<b>29,589,646</b>	<b>25,093,020</b>	<b>25,693,420</b>
NET CURRENT ASSETS			19,910,992	27,605,032	25,226,536	27,792,341	19,947,722	16,996,655
DEFERRED CHARGES			251,263	442,229	241,082	193,101	230,802	113,264
INVESTMENTS			7737588	11814355	17,815,513	18,804,721	21,870,436	22323737
FIXED ASSETS			2,264,550	2,537,874	1,983,671	1,738,302	1,771,390	1,662,791
STATUTORY DEPOSITS			2,559,684	4,191,750	4,342,950	4,492,950	4,642,950	4,642,950
TOTAL ASSETS LESS CURRENT LAIBILITIES			<b>32,724,077</b>	<b>46,591,240</b>	<b>49,609,752</b>	<b>53,021,415</b>	<b>48,463,300</b>	<b>45,739,397</b>
<b>FINANCED BY</b>								
<b>TECHNICAL PROVISIONS</b>								
UNEARNED PREMIUMS			10,276,654	11,897,988	13,008,542	12,846,132	11,017,448	9,598,445
OTHER TECHNICAL PROVISIONS			336,462	375,369	508,547	505,608	3,465,702	1,762,332
LIFE FUND			817,567	1,114,126	1,724,690	2,320,832	3,152,712	5,227,254
PROFITABILITY BONUS FOR LIFE POLICY HOLDERS					44,136	48,475	47,775	47,075
			<b>11,430,683</b>	<b>13,387,483</b>	<b>15,285,915</b>	<b>15,721,047</b>	<b>17,683,637</b>	<b>16,635,106</b>
<b>SHAREHOLDERS' FUNDS</b>								
PAID UP SHARE CAPITAL			17,064,561	27,945,000	28,953,000	29,953,000	30,953,000	30,953,000
SHARE PREMIUM			274,775	420,400	2,245,568	2,732,752	2,753,268	2,702,919
LEGAL RESERVE			1,524,538	1,919,871	3,125,269	4,614,616	-	-
PROFIT & LOSS ACCOUNT			2,429,520	2,925,486	-	-	(2,926,607)	(4,551,628)
			<b>21,293,394</b>	<b>33,210,757</b>	<b>34,323,837</b>	<b>37,300,368</b>	<b>30,779,661</b>	<b>29,104,291</b>
LIFE OPERATIONS-CURRENT ACCOUNT			-	-	-	-	-	-
TOTAL TECHNICAL PROVISIONS & SHAREHOLDERS'			<b>32,724,077</b>	<b>46,598,240</b>	<b>49,609,752</b>	<b>53,021,415</b>	<b>48,463,298</b>	<b>45,739,397</b>

### Appendix 3. Questionnaire

**Addis Ababa University**  
**Faculty of business and economics**  
**School of Post graduate**  
**Department of Accounting & finance**

This questionnaire is prepared in order to get the necessary information about strategic and financial target of mergers. The information obtained is used will be used only for academic purpose. The researcher would like to thank in advance for the time you devoted in filling this questionnaire.

#### **1. Strategic target of mergers.**

STRATEGIC FACTOR	Percentage					
	Don't know/ don't reply	Minimum	Little	Enough	Very	Very much
Important technology is present						
Specialized knowledge is present						
Service ability is available						
Service cooperation schemes are present						
Power of negotiation is boosted						
Intervention in new markets						
Minimization of business risk						
Nullification of competition						
Same market-targets						

**4. Financial target of mergers.**

<b>FINANCIAL TARGETS</b>	<b>Don't know/ don't reply</b>	<b>Minimum</b>	<b>Little</b>	<b>Enough</b>	<b>A lot</b>	<b>Very much</b>
Improvement of profitability due the acquisition of modern production technology						
Formation of scale economies in the distribution of products						
Decrease per unit						
Suppliers' cost reduction due to the increased number of transactions						
Utilization of tax regulations						
Exploitation of the bought out company's real estate						
Exploitation of the surplus value (Book value / Market value) of the target company						
Secession of the sector of activity						

**5. Impact of merger on companies.**

<b>Impact of mergers on companies</b>						
	<b>Don't know/ don't reply</b>	<b>minimum</b>	<b>Little</b>	<b>Enough</b>	<b>A lot</b>	<b>Very much</b>
1. In what way the number of persons employed affected the implementation of the Merger?						
2. In what way the communication between departments affected the implementation of the Merger?						
3. In what way the Budget & Control Systems affected the implementation of the Merger?						
4. In what way the Information Systems affected the implementation of the Merger?						
5. In what way Logistics affected the implementation of the Merger?						
6. In what way the structure of marketing departments affected the implementation of the Merger?						
7. In what way the image of the service and the way clients see them affected the implementation of the Merger?						
8. In what way the skills and experience of human resources of the bought out company affected the implementation of the Merger?						
9. In what way the cooperation spirit, affected the implementation of the Merger?						
10. The position and role played by Labor Unions during the implementation of the Merger.						
11. Attitudes and views						

towards Change during the implementation of the Merger						
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#### 4. What makes a Merger Successful?

<b>What makes a Merger successful</b>	<b>Grades (Minimum=1, Little=2, Enough=3, A lot=4, Maximum=5)</b>	<b>Participation percentage % in the sample</b>
1: The positive reaction of the investors.(commitment of share holders)		
2: The achievement of the Merger targets by the management		
3: the raise of the company's Book Value		

#### 5. What do you think in the main reason for merger failure?

- € there is not strategic planning and proper investment reasoning,
- € there are unrealistic anticipations,
- € the buyout cost is extremely high,
- € there are conflicting company philosophies (different culture),
- € the two enterprising entities fail to merge fast,
- € shareholders' contradictory interests,
- € Other specify. \_\_\_\_\_

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## **Appendix 4**

### **Interview schedule**

*Interviews were conducted with the chief executive officers of the merged company (United Insurance & Shama Plc) about the following issues.*

- *The rationale of the merger*
- *The valuation process of Target Company*
- *Valuation approached used*
- *Strategic intent of the merger*
- *The financial intent of the merger*
- *Parties' involved in the merger and their role*
- *The financial performance of the company after and before merger*
- *The advantage obtained after merger*
- *The difficulty they during the merger*
- *Reason for the failure of most mergers*
- *Impact of merger*

**Appendix 5**  
**T-test results**

<b>1. Return on capital employed</b>	Years	before	
		merger	after merger
	1	0.0235	0.128601
	2	0.124086796	0.116996
	3	0.226608616	0.109962
	4	0.2575	0.115314
	5	0.204438301	-0.07393

t-Test: Paired Two Sample for Means	<b>Return on Capital employed</b>	
	<i>Variable 1</i>	<i>Variable 2</i>
Mean	0.16723051	0.079388369
Variance	0.008893647	0.007392086
Observations	5	5
Pearson Correlation	-0.288022484	
Hypothesized Mean Difference	0	
Df	4	
T Stat	1.356842585	
P(T<=t) one-tail	0.123175709	
T Critical one-tail	2.131846782	
P(T<=t) two-tail	0.246351418	
T Critical two-tail	2.776445105	

<b>2. Total cost/sale</b>	Years	before merger	after merger
	1	0.763536957	0.466047
	2	0.52022352	0.4564
	3	0.2990	0.4789
	4	0.335370673	0.5372
	5	0.385852623	-0.76514

<b>Total cost/sales</b>		
t-Test: Paired Two Sample for Means		
	<i>Variable 1</i>	<i>Variable 2</i>
Mean	0.460795	0.234684
Variance	0.035678	0.313376
Observations	5	5
Pearson Correlation	0.190789	
Hypothesized Mean Difference	0	
Df	4	
t Stat	0.909986	
P(T<=t) one-tail	0.207152	
t Critical one-tail	2.131847	
P(T<=t) two-tail	0.414304	

t Critical two-tail	2.776445	
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	Years	before merger	After merger
<b>3. operating margin</b>	1	0.019542188	0.082841
	2	0.084825992	0.078721
	3	0.148881596	0.071773
	4	0.151431855	0.074011
	5	0.141974218	-0.04871

<b>Operating margin</b>		
t-Test: Paired Two Sample for Means		
	<i>Variable 1</i>	<i>Variable 2</i>
Mean	0.109331	0.051727
Variance	0.003266	0.003171
Observations	5	5
Pearson Correlation	-0.38865	
Hypothesized Mean Difference	0	
Df	4	
t Stats	1.362414	
P(T<=t) one-tail	0.122367	
t Critical one-tail	2.131847	

P(T<=t) two-tail	0.244735	
t Critical two-tail	2.776445	

<b>4.Net profit margin</b>	Years	before merger	after merger
	1	0.34562	0.23443
	2	0.43567	0.34435
	3	0.33456	0.21112
	4	0.24985	0.23122
	5	0.45673	-0.02341

<b>Net operating margin</b>		
t-Test: Paired Two Sample for Means		
	<i>Variable 1</i>	<i>Variable 2</i>
Mean	0.364486	0.199542
Variance	0.006992	0.018258
Observations	5	5
Pearson Correlation	-0.32955	
Hypothesized Mean Difference	0	
Df	4	
t Stat	2.039699	
P(T<=t) one-tail	0.055491	

t Critical one-tail	2.131847	
P(T<=t) two-tail	0.110982	
t Critical two-tail	2.776445	