An Economıc Analysıs of Cross Border Acquısıtıons Effects on the Performance of Target Banks into the Serbıan Bankıng Sector

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Abstract

As one of the leaders of the Serbian transition process, banking sector was the most attractive industry for FDIs in Serbia. Most of the investments came directly from cross-border acquisitions of private and state-owned banks and reached value of approximately EUR 2bn of FDIs. Inflow of foreign capital, know-how and standards completely changed the structure of the banking sector, especially in terms of regulation, quality and structure of the products. Since the start of transition process in early 2001 over 20 cross-border acquisitions were successfully executed. So far, very limited academic research was performed on the analysis and evaluation of the performed transactions especially in the view of future market growth potential, attractiveness of the Serbian banking sector and possibility for further expansion of the banking sector via cross-border acquisition and increase of FDIs.

Jel Codes: F41, F42, G15, G18, G34

Key Words: Acquisitions, financial sector, motivation, operating performance

1. Motives for cross-border acquisitions

During the last ten to twenty years international banking sector has changed considerably.At first, acknowledge to the development and evolution of the financial sector and at second, acknowledge to the financial crisis and exposure to the global risks (Correa, 2008). In order to preserve its growth and to hedge and diversify from the risks most of the banks went global and abroad. According to Correa (2008), most of the leading players focused on banking sectors in developed countries, while the others went to emerging countries. Key drivers in the expansion strategies were resulted from liberalization of the financial sectors in most of the countries according to Levin (2005), stability of the banking sectors and countries risks according to Crystal et al (2001) and good opportunities for capital placements in emerging economies according to Giannetti and Ongena (2005).

According to Correa (2008), motivation for cross-border acquisitions vary from internal growth prospects factors to "followers" strategy. In line with this approach are theoretical studies like Miler and Parkhe (1998) and Esperanca and Gulamhussen (2001) who states that most of the cross-border acquisitions are mainly motivated by "follow the leader or main competitors" strategy. Others like Berger et al (2000) and Claessens and Van Horen (2007) argue that most of the transaction are motivated with the competitive advance in the target and overall regulative which stipulates investors to buy some assets and is related to FDIs. Same approach is in focus in the studies performed by Focarelli et al. (2002) and Hannan and Roades (1997) who states that regulatory incentives, better performance indicators and higher returns in the target country motivates investors to execute cross-border acquisitions. On the opposite side are the theories that states that cross-border acquisitions are mostly result of motive to increase a share price and shareholders wealth. According to the studies performed by Piloff and Santomero (1998) and Calomiris and Karceski (2000) key expectation of the investors is to increase the share price and returns, but not very often the chosen strategy do not executes in the wanted manner.

The result of these studies was that share price and expected returns did not changed considerable or even not changed at all after the acquisition of the target. Same result was brought by the study performed by Amihud et al. (2003) who analysed the link between reduction of risks and stock prices via cross-border acquisition which is geographically diversified. The result was that "the cumulative abnormal returns for the acquirers in these transactions are negative and significant" (Amihud et al., 2003). All of the above mentioned theories can be divided into two different types of motives: the cross- border acquisitions or mergers that creates the new value and others that are focused on keeping the status quo.

2. New values creation motives

Cross-border acquisitions bring new value to the bidder banks with decrease of operational costs and increase of the consolidated assets volume and available funds. According to Sushka and Bedeck (1998), acquisitions or mergers of domestic or abroad targets can downsize cost of operation with increase of economies of scale. Hughes et al (1998) thinks that key motives of the cross-border acquisitions, in mature markets, lies down in cost reduction and opportunity to diversify clients' base and to have much more competitive position at the market. Bigger banks have more financial funds and can offer much more products to the market. Houston and Ryngaert (1994) suggest that, according to their research, banks can offer better services to their clients with much lower costs using the strength of the merged entity.

On the other hand, Bagliano et al (2000) and Cornett et al (2006) think that acknowledgement to the cross- border acquisitions and mergers banks can increase their consolidated efficiency in the terms of costs and opportunities to acquire new clients at much better conditions. Banks mergers usually require implementation of new policy procedures and reduction of costs, and are generally focused on execution of decisions to increase efficiency and profitability. On the other hand, Berger (1999) and Calomiris (1999) thinks that along with reduction of costs and riding on the benefits from economies of scale, one of the important motives for cross-border acquisitions is increase of shareholders wealth and the value of the new assets.

According to them key decision in conducting the **acquisition** or a merger is to satisfy the shareholders and to protect their interests. Cross-border acquisitions bring new value to the bidder banks with decrease of operational costs and increase of the consolidated assets volume and available funds. According to Sushka and Bedeck (1998), acquisitions or mergers of domestic or abroad targets can downsize cost of operation with increase of economies of scale. Hughes et al (1998) thinks that key motives of the cross-border acquisitions, in mature markets, lies down in cost reduction and opportunity to diversify clients' base and to have much more competitive position at the market. Bigger banks have more financial funds and can offer much more products to the market.

Houston and Ryngaert (1994) suggest that, according to their research, banks can offer better services to their clients with much lower costs using the strength of the merged entity. On the other hand, Bagliano et al (2000) and Cornett et al (2006) think that thanks to the cross-border acquisitions and mergers banks can increase their consolidated efficiency in the terms of costs and opportunities to acquire new clients at much better conditions. Banks mergers usually require implementation of new policy procedures and reduction of costs, and are generally focused on execution of decisions to increase efficiency and profitability.

On the other hand, Berger (1999) and Calomiris (1999) thinks that along with reduction of costs and riding on the benefits from economies of scale, one of the important motives for cross-border acquisitions is the increase of shareholders wealth and the value of the new assets. According to them key decision in conducting the acquisition or a merger is to satisfy the shareholders and to protect their interests.

More financial benefits lie in motives to use the merged or acquired target for tax purposes and decrease of liabilities towards taxes (Avery et al, 1999). With acquisition of more profitable business more profits stays in the entity and is available for pursuing for business related products or services.

It is also usual that banks acquire other financial institutions to improve its client base, market share or new deposit base, according to the research from Kane (2000) and Lang (1999). Ackerman (2002) and Ramcharran (2001) believe that cross-border acquisition or a merger allows the bidder bank to expand its product and service portfolio and get more of clients. However, Berger et al (2001) noticed that most of the M&A deals in banking sector were strongly initiated by bidders motive to expand more geographically, to acquire new developed branch and ATMs network and to diversify its business risk.

Along with the above mentioned motives, according to Benston et al (1995), Spiegel (1996) and Bietel (2001) is an acquisition of a new technology and improvement of the current processes and procedures in the bidder bank. With acquisition and implementation of new acquired technology most of the previously mentioned motives, such as cost adjustment, acquisition of new clients and launching of new products, can be easily achieved.

3. Status quo motives

These studies and the theory researches are related to the cases were the motive of the cross-border acquisition or merger was not related to the increase of wealth or value of the bidder nor the target. Some of the authors, like Berger et al (1999), Focarelli and Pozzolo (2001) and Boot (1994), indicate that changes in the regulatory environment can additionally push the consolidation of the market and acquisition and mergers between the banks on the wider geographical playground. According to them, relaxation of the regulatory acts allows mush deeper cooperation between banks and their [potential mergers and acquisitions. The key reason for such relaxation is related to the decrease of the operational risks of the banking sectors and opportunity for product, client and allocation diversification by allowing the cross-border acquisitions and mergers (Mishkin, 1999; Smith, 1972).

According the regulatory perspective, as well as from the eyes of the market, there are some case were mergers or acquisitions are needed for saving the entire sector (Kane 2000). According to Penas (2001) and Kane (2000) one of the important situations is happened in the USA when the regulatory bodies were forced to merge and save the financial institutions, and banks which were closed to the bankruptcy but in the other hand very important for the banking sector. These "too big to fall" banks were merged and financed by the government due to very high risk to harm the whole banking sector. According to Penas (2001), these were very strong motives for most of the mergers that happened in the USA in 1990's.

On the other hand, according to Morck (1990) and Haynes (1990) managers of the bidder banks' represent key factors that push up the execution of mergers and acquisitions. Crucial reasons, according to them, lies in personal efforts of the managers to have much higher wages and bonuses of Ijie bigger merged entities.

According to Bjorvatn (2004) there is a direct connection between the potential acquisition or a merger and leading managers in terms of the expected managers' compensations, meaning that execution of the deal will increase the motivation of the manager to help in order to have personal benefits.

4. Performance of the target and acquirer banks before and after cross-border acquisition

Event study represents empirical approach and research on the M&A deals, their influence and impact on the value of the targets and bidders share price prior, at and after the execution of the deal (Kwan and Wilcox, 1999; Becher, 2000). Along with the expected increase of return and overall shareholders wealth, key expectation on cross-border acquisitions is related to the improvement of the target bank performance after the execution of cross-border transaction. According to Correa (2008) most of the improvements in cross-border acquisitions is in many cases very low or even negative in the first two years after the executed deal. Main reasons according to Correa (2008) lies in decrease of net interest margins, difference between borrowed and acquired capital, and an increase of overhead costs.

On the other hand, Frazer and Zhang (2009) argues that in the short run the only effect of the cross-border acquisition is related to the improvement of the target performance in the view of new management, new standards and policies. According to Healy, Palepu and Ruback (1992) measurement of the performance of the target bank can be only measured if we consider the performance of the target 3 years before and 3 years after the acquisition. In this way according to Frazer and Zhang (2009) we are capable to see the effects and to measure and compare them.

According to the study performed by Cornett, McNutt and Tehranian (2006) based on the measurement of the operating cash flow returns of the pre-acquisition and post-acquisition deals in US, find that after three or four years, operating performance of the merged or acquired bank improves steadily if it’s the case of large merger/acquisition because large banks produce higher return and gains. Same results were found by Frazer and Zhang (2009). He tested the same hypothesis and founded out that improvement in the performance of the target bank is related to the underperformance of the target before acquisition.

Increase of performance according to him lies in more efficient capitalization of labour and decrease of non-performing loans.

Frazer and Zhang (2009) analysed 83 M&A transactions in US in the period from 1980-2001 and realized that performance of the target banks in terms of earnings is significantly below the industry average in the period before acquisition while dramatically changed after several years after the acquisition.

5. Profitability of the target and acquirer banks before and after cross-border acquisition

Operating performance approach or OP approach represents the analysis of the financial indicators of the target and bidder bank prior and after the merger or acquisition (Houston et al, 2001). The approach is focused on the current and future financial statements before and after the consolidation and analysis of the important financial indicators of the consolidated financial entity (Altunbas, 1996).

Key motives for M&A activities are related to the increase of profitability and impact on share prices and profits of the acquirer and improvement and changes in the organization and increase of performance indicators of the target bank (Berger, 1999).

According to Correa (2008) most important profitability indicators for banking sector are return on assets (ROA) and return on equity (ROE). Numerous academic studies had researched and analysed the related profitability ratios. Some of them like the studies performed by Cornett and Tehranian (1992), Spindt and Tarhan (1992), Rhoades (1998) and, Frazer and Zhang (2009) suggest that ROA and ROE in the banking sector are directly correlated with the M&A activity.

Namely, they researched and analysed over a hundred cross-border transactions and mergers over the past twenty years and realized that profitability ratios were improved to the banks that were part of M&A transactions. According to these studies there is positive impact of M&A transaction on profitability of the target before and after the closing of the deal.

According the study performed by Frazer (2009), value of profitability ratios from pre-acquisition and post-acquisition period had positive improvement. In his study he found out that target banks show much lower profitability ratios than comparable banks in the pre-acquisition period and these differences according to the mentioned study are significant, between -0.22% to -2.60%.

However profitability ratios in the post-acquisition period of the same target banks shows similar or even higher values than comparable banks that were not involved in M&A transactions. On the opposite side we have research and studies performed by Berger and Humphrey (1992), Linder and Crane (1992), Pilloff (1996), Akhavein, Berger and Humphrey (1997) and Chamberlain (1998) whose work and analysis show that there was no. positive impact of cross-border acquisitions and M&A transactions to profitability ratios.

6. Concluding Remarks

Analysis of the reviewed academic studies and research suggest that there are opposite results in terms of pre-acquisition and post-acquisition profitability measurements of target banks. Different results and impacts of the M&A activities on the profitability ratios of the target banks according to Berger (1999) are mostly connected to problems with market power and problem with efficiency.

In line with the above mentioned we can conclude that strategic investors have different motives when deciding and conducting the cross-border acquisitions. Most of them are motivated with the expected high returns in particular markets, other are interested in increase of its shares on the stock exchange, while other are only following market leaders and key competitors. In the view of target performance, key findings of the related academic literature are underperformance of the target banks before the acquisition and problems with efficient use of capital and human resources, as well as high level of non-performing loans. Changes in the performance of the target banks in post-acquisition period, directly affects profitability ratios and overall returns. According to the respective academic studies, most of the target banks showed better profitability ratios in the period after the acquisition in relation to the other banks that do not been involved in M&A activities.

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