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THE EVOLUTION OF THE RETURN RATES IN THE CASE OF ROMANIAN MERGED COMPANIES

Empirical study

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Mergers
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Return on Assets
Return on Equity

JEL Classification
G34, M40

Abstract

Nowadays, merger transactions are more and more popular, even at the level of Romania. Together with this trend, the need to identify whether these restructuring operations lead to the expected results becomes increasingly evident. This paper aims at analysing the financial performance of 87 Romanian companies from the trading sector, which participated in merger deals during the year 2011. It was considered that the three years' evolution of the return on equity (ROE) and the return on assets (ROA) rates could offer a complete image of the financial condition of the companies and the way these were influenced because of participating in the merger. These return rates were also compared with the medium levels recorded nationally for the same activity sector. It was found that in terms of both ROE and ROA the absorbing companies were negatively influenced, the medium-term financial performance being affectedbecause of the restructuring, their majority even failing to reach the average sectorial levels.

Introduction

Being highly debated, but yet controversial, the financial performance of the merger transactions continues to be a very interesting subject, to which researchers try to find an answer or at least to establish some conditions or golden rules that could ensure their success.

The mergers and acquisitions' Romanian market is quite new; only in recent years, these types of restructuring operations began to be considered as an alternative or a mean to overcome a difficult period in a business.

There are many ways of defining performance and there is no comprehensive and universal definition of this notion, each company being responsible for defining its goals and the ways to measure them, for internal and external users. The concept of performance is multiple and sometimes paradoxical. In the attempt to find a definition according to existing features, each day a business invents its own ways to compete in a harsh environment. There is a certainty: performance cannot be ascertained, it is built over time (Jianu, 2007).

Performance cannot exist unless it can be measured, i.e. if it can be described by a set of measures or indicators.

In order to assess the financial performance of merging companies, this paper is focused on the evolution of the return rates, specifically the Return on Equity (ROE) and the Return on Assets (ROA).

ROE and ROA in the context of mergers' performance

The post-merger performance measurement based on information provided by accounting, usually takes into consideration a time horizon. This involves comparing some results obtained before and after the merger. The rationale underlying these studies is that a business's strategic goal is to achieve a satisfactory return on capital, any benefit resulting from the takeover being, finally, reflected in the company's financial statements. (Tuch&O'Sullivan, 2007)

In accounting approaches, several indicators are used: profitability and cash flows (Healy, Palepu&Ruback, 1992), productivity (Bertrand &Zitouna, 2008), innovation indicators (Bertrand, 2009), the growth rate of sales or assets (Gugler, Mueller, Yurtoglu&Zulehner, 2003).

A wide range of indicators used to assess post-merger performance is included in the research conducted by Martynova and Renneboog (2006).

As respect to the Return on assets (ROA), this is widely used in empirical researches on mergers and acquisitions (Bertrand &Betschinger, 2011).

When studying the post-merger performance, Meeks and Meeks (1981) compared the profit with the sales, namely the return on equity (ROE) and the return on assets (ROA) and concluded that ROA is the most appropriate performance measurement in the context of mergers and acquisitions.

At the national level, ROA and ROE were used to analyse the post-merger and acquisition performance of banks, results showing that in the period of three years after the merger, both rates of return registered a decrease (Huian, 2012).

When analysing the performance of Romanian trading companies, Georgescu and Chiriac (2012) found that the financial performance measured with ROE was affected in the year the merger was completed.

Research methodology

In this paper, we considered interesting and appropriate the analysis of the financial and economic return rates since these are the most used nationally, providing more complex information than indicators in absolute size.

The financial profitability expressed by ROE reflects the degree of remuneration of the capital invested in an entity by the owners.

The importance of analysing this indicator is evidenced by the following considerations:

• ROE shows the degree of allocating funds to shareholders in the current activity, on one hand, and, on the other hand, the efficiency with which the company uses its capital;

• ROE also constitutes a measure of the entity's ability to pay dividends;

• allows to estimate earnings per unit of capital invested in shares, or the profit accruing to owners for their investment in the firm.

The analysis of ROEis interesting and useful both for external and internal users (P v loaia&P v loaia, 2006):

• For shareholders / investors, an increase in this ratio becomes stimulative for participating in the increase in capital. A favourable evolution of this rate will determine the shareholders or investors to continue to support the new entity either with contribution in the capital, or by opting out, for a limited periodfrom receiving dividends. (Bu e, 2005)

• For managers, an increase in ROE is also an objective or a target, because only this way they can keep their position and can continue to be supported by shareholders in future value creation.

• A comparison with the average rate from the same activity fields is relevant, in order to conduct the evaluation of the profitability of capital to shareholders.

The ROA expresses the efficiency of using the resources controlled by the entity in order to generate results.

The analysis of this rate envisages:

• An increase reflects the efficient management of resources controlled by the entity, with

implications for future growth in the company's value;

• Considerations relevant to the favourable or unfavourable value of this rate of return should be correlated with the medium levels existing in the industry or sector.

The sample on which this paper will concentrate comprises a total of 87 companies activating in the wholesale and retail sector, which attended as absorbent in mergers completed during the year 2011. All companies involved are located in Romania.

We chose this activity sector because, for the year under review, the highest number of mergers occurred in it. (Hromei, 2014)

We opted for determining these indicators for the year before completion of the merger, namely 2010, and for those who followed the restructuring, the latest available financial data being for the financial year ended at 31st of December 2013.

For the companies mentioned earlier, the Return on Equity (ROE) and the Return on Assets (ROA)were calculated for each year, and afterwards, their average growth rate for the three years was determined and analysed.

To ensure an even relevant image, we considered appropriate to compare the evolution of these ratios of the companies in the sample, with the average ones in the industry.

All financial data was collected from the database of the Ministry of Public Finance, while information about companies that merged were available through a subscription at the Romanian Official Gazette.

Results and interpretations

a) The Evolution of ROE for the Absorbent Companies

The first rate of return analysed was ROE, which highlights the extent to which, after the merger, the managers of the absorbing corporation succeeded to ensure the profitability of the capital that has been entrusted to them by the owners of shares in the resulting company.

The results obtained, shown in Figure 1, suggest that in term of the financial return, only about a third of the absorbing companies have improved this indicator due to the merger. In the other cases, respectively for 65.52% of the companies analysed, it was observed a decrease of ROE over the next three years following the merger.

Therefore, while shareholders' equity increased because of the merger, managers have failed to integrate the resources they had at disposition, nor to effectively manage the risk capital that has been entrusted to them.

At the national level, for the period analysed, it was found that in the wholesale and retail sector, the companies recorded increases from year to year of the financial return, with an average growth rate in three years of 6.71%, as seen in Table no.1.

Figure no.2 shows that, among the absorbent companies analysed, only 15 of them were able to record the same upward trend and exceeded this growth rate. The other 72, namely 82.76% of the total surveyed enterprises, have achieved a growth rate lower than the sectorial level, or even recorded a decrease in the return on equity(ROE) rate.

Therefore, regarding the financial profitability, it might be concluded that this indicator (ROE) was affected on the medium term due to involvement in a merger transactions, most of the absorbent companies registering a decline of the financial performance expressed in its base.

b) Evolution of ROA for the Absorbent Companies

The other rate this study focused on was the economic rate of return, i.e. the rate of return on total assets (ROA-Return on Assets), which highlights how effective was the asset's management of the company in order to generate profits.

The analysis of ROA for companies participating in the merger, presented in Figure no.3, showed that the medium-term economic profitability declined, 63 of the 87 companies analysed recorded on average a reduction of thisindicator.

Only in the case of 24 companies can be stated that the increase of total assets as a result of their takeover by merger, had a positive impact on the net earnings. Therefore, only about 28% of the cases succeeded a better use of resources, in order to obtain superior results or benefits than the ones obtained prior the merger.

It is possible that, following the merger, the acquiring companies have taken someassets, especially fixed ones, such as equipment, which were redundant or did not directly participated in the current activities of the company, and therefore didn't contributed to obtain benefits. However, these fixed assets might not have been fully depreciated, andadditional costs incurred with amortization or even with maintenance. Therefore, the takeover of assets as a result of absorption of other companies will not always produce benefits for the acquiring company. If the assets cannot contribute to the activity, they should be harnessed by sale, in order to avoid additional costsfor the entity.

If we take into account the evolution of the national ROA for companies operating in the same field with the analysed acquiring companies, it was found that, during the three years, the economic profitability recorded a minor trend, increasing on average with only 0.88%, as presented in Table no.2.

Although it can be considered a rather small average growth rate, of all the companies included

in the sample only 23 of them, representing 26.43%, were able to overcome the value obtained at the sectorial level, the other 64 companies registering a reduction of ROA or an increase in a lesser degree than the average growth rate.

Underperforming the industry in terms of the financial indicators analysed, could be an alarm signal, the more so as the time period analysed is relatively long; in three years the companies should have overcame the possible initial difficulties related to the integration process.

Therefore, it can be stated that, in terms of the two indicatorsanalysed, the performance of the absorbing companies is negatively influenced by participation in the merger, suggesting that there is a need of a better documentation, studies and detailed financial projections before deciding the involvement in such a restructuring operation. All of these studies, estimations and projections can be included in a due diligence process, an extremely useful and very important phase when negotiating a possible merger.

Conclusions

The results of the study conducted lead to the conclusion that, the financial performance of merged companies, expressed through the rates of return, has been significantly affected by the participation in a merger by absorption.

A medium decrease of ROE for the majority of the companies in the sample suggests that the strategy chosen by the management for the post-merger period was not adequately selected, so that it would lead to increase the company's value. It is well known that integrating two organizational cultures, two patrimonies and different working teams requires advanced managerial skills and experience. Both the old shareholders and the one who entered the companies because of the merger expect to identify an improvement in the financial results and a reward for their investment. Not being rewarded in the first three years for their investment, might determine shareholders to stop financing that business.

The same downtrend was recorded for the return on assets rate (ROA) in the majority of the companies, suggesting that the rapid and relatively inexpensive access to new assetsis not always a success factor. These assets retrieved by merger might be unproductive or might not be able to generate benefits and, besides, give rise to additional costs.

The comparison with the industry average is a further evidence for the negative impact the merger had on the financial performance of the companies, both ROE and ROA having an average evolution below the values recorded at the sectorial level.

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Tables and Figures

Table No. 1
Average ROE at the national level for companies in the trading sector

ROE	**2010**	**2011**	**2012**	**2013**	**Average increase/decrease rate**
Average sectorial ROE (%)	18,27	19.59	20.54	22.20	
Annual increase/decrease rate		*107.22*	*104.85*	*108.08*	*106.71*

Table No. 2
Average ROA at the national level for companies in the trading sector

ROA	**2010**	**2011**	**2012**	**2013**	**Average increase/decrease rate**
Average sectorial ROA (%)	4.66	4.65	4.60	4.78	
Annual increase/decrease rate		*99.79*	*99.07*	*103.84*	*100.88*

Figure No. 1

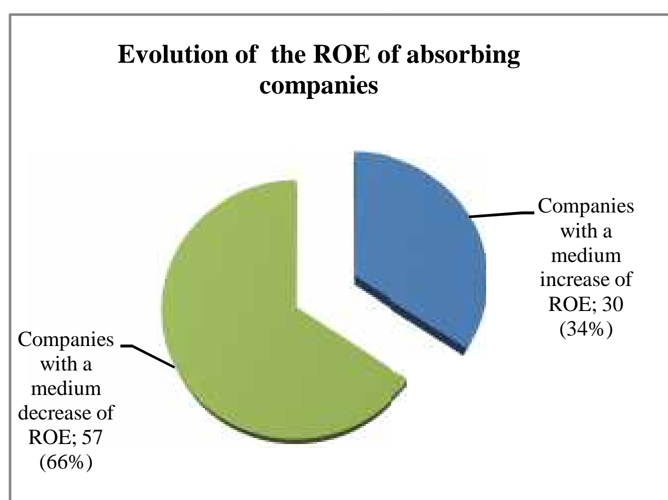

Figure No. 2

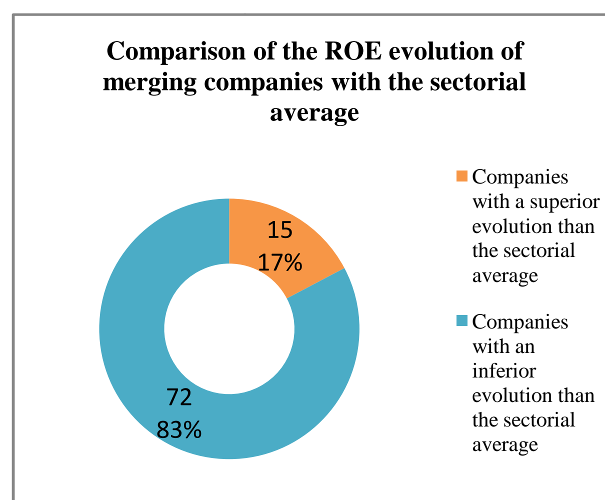

Figure No.3

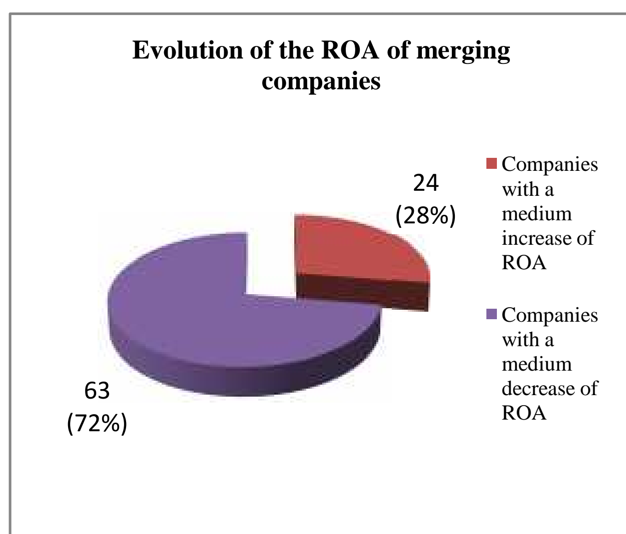

Figure No.4