REASONS FOR FAILURE IN MERGERS AND ACQUISITIONS

By

NAPO MAFIHLO
202516083

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Supervisor: Mr Henry Mkhize

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TO WHOM IT MAY CONCERN

RE: CONFIDENTIALITY CLAUSE

Not Applicable

Sincerely

Napo Mafihlo

DECLARATION

This research has not been previously accepted for any degree and is not being currently submitted in candidature for any degree.

Signed..

Date.... 07th June 2006 ....

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ABSTRACT

Embraced in this study, is the content and structural approach on how corporate mergers and acquisitions should be planned and executed to facilitate post-acquisition synergies and improvement in customer service levels.

The project covers Saambou bank post-acquisition business failure after take-over by First Rand Group, in a horizontal integration process that did not diversify or restructure product or service offerings between the two banks. There being no positive impact on post-acquisition market share and competition sustainability by the two banks, it implied that, the post-acquisition strategy did not adequately address the business risk factors that ultimately impaired the expected synergies of a take-over bid.

Lack of proper post-acquisition business plan resulted in corporate failures pertaining to ineffective competitive strategies, non optimization of market and service levels, compounded by poor corporate governance resulting in the bank's internal control procedures and processes failing. Furthermore, poor customer service levels and transgression of the Bank's Usury Act regulations, rendered the organization more uncompetitive.

The over-reliance on few large corporate customer deposits added a huge element of financial risk that marginalized Saambou bank's going concern prospects. Hence, upon experiencing few large corporate deposit withdrawals, for instance by Investec, resulting in the bank undergoing liquidity problems that resulted in it being placed under curatorship.

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Chapter 1: Introduction and Problem Statement

1.1 Background to the study

Mergers and acquisitions (M&A) have been used as a tool for facilitating corporate external expansions through the control of shares and assets in another company, or by consolidating resources and operations to gain full and effective control of the market, undertake joint strategic opportunities and hedging against business risk (Thayser 2002). The acquiring company performs a capital budgeting analysis to ensure that it will earn the required rate of return, and beyond that, special considerations for legal, tax, accounting and financial issues are brought into perspective when determining value that will be added.

Thayser (2001) argues that, in the past, before South Africa was transformed politically and economically, the economy was in the control of few private sector companies and institutions that were in control of the majority of the market capitalization of the Johannesburg Stock Exchange (JSE) Securities Exchange of South Africa, with Anglo American Corporation in control of the Forty percent market capitalization of the JSE. In the event of political transformation and post 1994 inception of democratic rule, the unbundling of big conglomerates was undertaken in order to marginalize their huge level of stake holding in the JSE and accord other companies and the newly emerging Black Economic Empowerment (BEE) companies some participation in the stock market. This was evidenced through the unbundling of large consortiums.

The acquisition by Black Economic Empowerment (BEE) consortiums of entities within the Anglo American group, such as Johnnic and the Johannesburg Consolidated Investments (JCI) in the wake, led to black emerging business participation in the country's economy by awarding them stakes in big conglomerates via the M&A process, and giving companies access to public capital.

In the event of this string of emerging acquisitions, during the past few years, BEE control of the JSE rose to eight percent control of market capitalization with the trend continuing to increase despite failure to grow and winding up of some of the BEE companies in the JSE, examples being, the downsizing and failure of companies such as JCI, Nail and shut down of Molope (Services and Facilities) Group.

M&As are an integral part of South African corporate life, and it is therefore relevant for us to analyze the reasons for failure in M&A's, and how to set the terms for a successful merger or acquisition. Also, as part of due diligence, how these terms get wrongly applied or misjudged in the event of a business deal coming to failure.

In summary, mergers and acquisitions are primarily aimed at facilitating corporate expansions, allow for market dominance and business risk diversification (Brews, 1987). M&As are motivated by the desire to acquire more opportunities that the acquiring company does not posses in full or in part through direct or indirect participation in the acquired business. Failure attributable to any of the opportunities driving the business acquisition decision, can result in an investment becoming non-viable and failing to realize expected synergies for maximizing post-acquisition returns (Correia *et al.*, 1993).

Reasons for mergers and acquisitions, according to Correia *et al.*, (1993:666), are the following:
Operating economies, managerial skills, tax considerations – assessed losses, use of excess liquidity, diversification, lower Financing costs, replacement costs and technology integration. Some of these factors are explained in this research context where deemed relevant to the content of this research.

1.2 Motivation for Research

The need to contribute some analytical thinking and critical judgement towards the study on maximization of corporate returns through diversification of investment risk, to enable the spread of risk between diversified business interests has been the key motivator for this study on M&As.

According to Affleck-Graves *et al.*, (1988), the problem associated with failure to achieve the above-mentioned motivation is mainly attributed to companies looking forward to investing surplus capital without adequately evaluating the potential financial and technical viability of future business activities that lie ahead of their target companies.

Most organizations invest without having under-gone sufficient due diligence in order to gain full know-how of the business they wish to embark on. According to Thayser (2003:103), an insufficient coverage is dangerous, as acquirers do wipe more value of the market capitalization through failures in due diligence.

Lack of proper feeding of due diligence into the business plans, has seen the collapse of most businesses after the M&A process. For novice acquirers, a due diligence is just an information gathering process, they usually do not begin to formulate strategy and build a valuation model until the process is complete, and hence fail to link their due diligence closely to business planning.

1.3 Purpose of study

The purpose of this study is to establish reasons linked to post-acquisition failure in M&A deals, to establish how these failures develop, and to find best possible means and outcome of planning and structuring an optimum due-diligence approach, prior to negotiating a deal with other parties to the transaction. The purpose above has been conveyed in a checklist of guidelines and procedures for an optimum due diligence approach, available from http://www.woodbridgegrp.com/corporate_revitalization.html.

The research is aimed at establishing a formal approach and checklist of events that should be covered in performing a due diligence exercise, an example used in this research case study is that of a post-acquisition failure of Saambou bank, after being acquired by First Rand Group. It highlights the lack of attention on key areas that would have been vital in setting a viable post-acquisition business strategy that would enhance the expected synergies that motivated the acquisition, hence leading to post acquisition failure of the bank.

The study also explores the nature of investment risks associated with M&As. These risks can render less synergies in a deal, from the point of pre-acquisition, where value of the target entity is being negotiated, and on post-acquisition business performance where the expected synergistic benefits are not being realised (Barr and van den Honert, 1988).

1.4 Limitations

The limiting factors on this study are due to the fact that the research exercise was based on an entity that no longer exists, and for which part of the information necessary for executing this project is still perceived confidential and not being made available for public consumption, namely the Curator's liquidation report by Mr John Louw, of Audit firm KPMG. Hence, no contact, or information could be availed for this purpose by the former employees of the liquidated bank cited in the case study below.

Saambou bank, being the first banking group to be forced to close down due to customer reactions in connection with negative sentiments concerning its governance, and on the basis of liquidity problems inherent from extreme cash withdrawals by depositors, resulted in the study having no comparative terms of reference.

1.5 Significance of study

The relevance of this study is pertinent in the investment banking sector, and to corporate investment managers looking forward to making key strategic corporate investment decisions. Factors outlined below, are elaborated further in this study, for the purpose of assisting readers about an optimal approach to be followed when embarking and concluding on a M&A deal.

Answers must be obtained to the following questions when evaluating a deal for acquisition (Affleck-Graves *et al.*, 1988).

- How to evaluate the inherent risks within the target company for acquisition?
- What makes the target company render synergies in an acquisition?
- How to evaluate and deliver synergies as part of the post acquisition business plan?

1.6 Research Questions

This study attempts to answer the following questions:

- What are the main reasons motivating M&A deals in the corporate investment environment?
- What are the expected post-acquisition synergies, inherent from a deal?
- What are the critical factors often over-looked when evaluating a transaction?
- How do target companies fail with regard to re-alignment of their systems and controls for proper governance and competitiveness, subsequent to a deal?

1.7 Objectives of the study

The purpose of this exercise is to determine the reason why companies invest their resources on others, the types and impact of risk associated with that, and how risk should be identified and managed prior and after concluding a M&A deal. In order to achieve the purpose of this study, the following objectives are set for this study:

- To determine reasons leading to M&A, and to what extent these reasons can be compatible to the acquiring company's type of business and objectives.
- To determine how risk should be evaluated as part of the due-diligence exercise.
- To determine how business valuation of the acquired or merging companies should be quantified based on inherent risks and perceived synergies.
- To determine how strategies to the above objectives can be measured and managed in the post-acquisition business plan.

1.8 Structure of the study

The study has been outlined and structured in the following manner:

Chapter 1 - Introduction

Embraces the context of the study, statement of goals, the scope and significance as well as limitations, which are all outlined above. These factors elaborate on the purpose and objectives of this study, which are embraced in the above-mentioned research questions.

Chapter 2 - Review of related Literature

Theory of the study, which incorporates the general principles underlying a M&A deal, synergies encompassed in a M&A deal, reference is made to examples outlined in the Capital Alliance Group of Companies Review of Operations, which is fully outlined in Appendix 2.

Chapter 3 - Research Methodology

Outlines the approach used in gathering information for this study, tools used to gather information and methods used to analyze it. Qualitative means of obtaining information were used, which amongst others, include, considerations outlined by Lincoln and Guba (1985), as follows:

- Literature review
- Data collection
- Data population
- Data analysis

Chapter 4 – Case Study

Case study is on Saambou bank's business history, which outlines the outcome from its governance processes and business procedures, which determined the quality of its service levels and effectiveness of its service delivery. The Saambou bank example best is most suitable for the purpose of this study as it outlines some causes that can lead to post-acquisition failures in M&A deals.

Chapter 5 – Evaluation of the case

Critical evaluation of the case study results, using the Porters five forces, analysis of strengths, weaknesses, opportunities and threats (SWOT) that faced the business, as well as the political, economic, social and technological (PEST) factors.

The above approach results in the analysis of the case a study, obtained through literature reviews and data population.

Chapter 6 – Recommendations and Conclusion

Analytical review and conclusions drawn from the entire analysis of text and readings generated in this study, and of the case example cited to explain the purpose of this research. The underlying factors and conclusions are structured to critically contribute to organizational decisions for corporate investment and planning in future M&A deals.

The following chapter embraces general theory to explain the reasons motivating business acquisitions and mergers for corporate maximization of wealth, through exploitation of industry opportunities by means of risk diversification through vertical and horizontal business integrations.

Chapter 2: Literature Review

2.1 Background factors to the problem

While a lot of acquisitions and mergers have taken place in South Africa, there has been an assortment of outcomes following these deals (Thayser, 2002).

Hence, for those that failed to achieve the objective, there is a need to establish causes for failure in order to devise a checklist of procedures and rules that must be followed when evaluating the business prior to deciding whether to buy or merge, in valuing the deal and integration strategies that can enhance synergies.

Reasons leading to synergies in a merger and acquisition deal can be overstated with the intent to come up with an attractive value for the deal, or to render a good impression to facilitate the deal to go ahead without an adequate feasibility study on the achievement of cited reasons for merger or acquisition. The overstating or non-consideration of all reasons that should be considered for evaluation as part of due diligence has led to failure of merged and acquired enterprises (Dodd, 1980).

The projected outcome of all reasons leading to a M&A determine the outcome of value for the deal. As argued by Kitching (1967), in a valuation exercise, a set of financial ratios based on future cash flow projections for post acquisition results will form a basis for decision making on whether to merge or acquire, and also the weighing and benchmarking of these ratios to industry averages and opportunity cost of forgone alternatives will contribute to the decision on whether to buy, and determine value for negotiations. Therefore, it is evident that misleading due diligence performance leading to inaccurate cash flow forecasts can result in wrong investment decisions, that can lead to failure in achieving expected post merger results and returns (Rappaport, 1979).

Companies merge or acquire each other to take advantage of each other's existing resources and ensure their maximum capacity utilization.

Instead of a company developing its own resource or asset base, it can opt to merge or take over another entity in order to make full use of existing resources and render economies of scale benefits (Affleck-Graves *et al.,* 1988).

Kitching (2001) argues that, in some cases, companies may opt to merge in order to make use of benefits of large scale economies, only to find that the realization of such benefits is made unrealistic as a result of the market circumstances in a case of a matured or saturated market, with constant or declining market shares and not facilitating this purpose in the event of a merger or acquisition being entered into. A good example is the delayed investment and reluctance by big strategic players in the world fixed line telecommunications to invest in the South African Second Network Operator due to the phasing out of the fixed line telecomm market and its market dominance by Telkom.

Large firms are chasing managerial skills. Conversely, from a different perspective, a large firm may decide that it needs the managerial skills found in a smaller firm. This was the purported reason why Nedbank acquired Finansbank, (Correia *at al.*, 1993). A large conglomerate may acquire a small one in the interest of acquiring skills and knowledge inherent in it, and not for the purpose of facilitating business expansion as such. The outcome will still be perceived as a failure if the acquired business is winded up following the acquisition.

In some cases, mergers and acquisitions are embarked upon for sole purposes of tax considerations. Where the acquiring company can set out good economic reasons for the merger, the set-off of future income of the target company against the assessed loss of the merger partner will be allowed.

However, if the Receiver of Revenue can establish that the change in shareholding has been effected solely or mainly for the purpose of utilizing any assessed loss in order to avoid taxes, the Receiver will disallow the set-off of future income against pre-merger assessed losses and this will eliminate any expected benefits that encouraged the M&A decision and change the outcome of post-merger forecasted financial performance to the detriment (Mandelker, 1974).

Use of excess liquidity by companies is another cause for acquisitions. On the other hand, a company may take over another firm in order to obtain the benefits of its strong liquid asset base, which may result in surplus funds for increased level of returns in the event of tight monetary recession (Correia *et al.*, 1993).

Diversification is often cited as a reason for M&A, as cited by Barr and van den Honert, (1988). A company in a particular business field may decide to enter into an unrelated business area. In so doing, it obtains the benefits of diversification if there is no perfect positive correlation between the returns of the two sectors, thereby reducing the variability of its returns. Portfolio risk in some cases render the level of risks above the expected returns, and can result in the investment not being financial viable.

The gearing effect of the post M&A deal can lead to the failure of companies due to the inherent high financial risk and poor management of liquidity. For example, the merged company may result in improved credit rating than before, when companies were operating as separate entities. The merged company may decide to make full use of its improved credit rating on capital projects with feasibility of earning positive returns.

Some companies opt for the acquisition of another company if the market value placed on its acquisition is substantially below that of the replacement cost of the required assets. This is mainly a short-term view of cash savings, whilst the long-term view is focused on realizing the value of inherent synergies from operating activities of the merged or acquired business (Bhana, 1983).

Mergers and acquisitions are sometimes decided on firms wanting to take an opportunity on full use of technological resources and skills of another or target entity. Technology changes rapidly, and new advanced technology outperforms the old version.

Different technologies can differentiate quality of products and services and immediately divert consumer focus and perception on the product. Firms decide to merge on grounds of using the technological expertise and resources of target company. In the event of technology advancing in the short-term, the expected benefits out of this technology base collapse and the investment for the merger becomes worthless as more costly capital will be required for re-investment to make the new business remain competitive.

As argued by Bhana (1983), setting the merger or acquisition price is an exercise based on the probability of returns, with assumptions made turning out to be acceptable by all parties to the value negotiations. Based on this uncertainty, there is a possibility that the price can be overstated, and based on the overstated cost of investment, future returns may fall below the expected level of returns marginalized by the over pricing of the deal. If the valuation of the deal is prudent, proper decision can be made and best investment alternatives taken.

The publication cited in the website http://www.woodbridgegrp.com/business valuations.htm, states that business valuation is subjective and unique to the circumstances of each business. A potential buyer will place little credibility in a value arrived at by an owner's accountant. A properly prepared valuation report by an independent valuation expert is the best tool you can use to obtain the maximum selling price. The agreed price will be dependent on the negotiations and bargaining terms of the negotiating parties to the agreement.

The merger or acquisition is intended to result in synergistic benefits, which implies that the sum of forecasted post-M&A returns is more than the sum of pre-M&A returns of the two companies combined (Brews, 1987).

As pointed out by van den Honert *et al.*, (1989), in light of the above, monetary outcome of projected figures could be misleading. For example, the post merger or acquisition returns in total can exceed sum of returns prior to the deal, but only to find that, due to the capital structure inherent in business after the deal, the merger or acquisition financed through the issue of share capital has a high cost of capital associated with it, thereby, also diluting the post-M&A earnings per share (EPS).

While financing through debt could be cheaper but increase the financial risk, and distorting the credit ratings of the new business by reducing interest cover ratio and increasing gearing ratio. The best optimal structural finance deal that will optimize the weighted average cost of capital and facilitate improvement in returns as part of the deal to unlock synergies must be established and implemented (van den Honert *et al.*, 1989).

There are dazzling varieties of reasons leading to M&A. Their projected evaluated outcomes through the due diligence exercise have a direct impact in the valuation exercise of the two companies in the event of a merger, or the target company in the event of an acquisition. In case of failure to accurately project the outcome of these reasons, or the post implementation strategy not being effective and efficient to ensure accomplishment of expected results, failure of the merger or acquisition is probable under such circumstances.

2.2 Assumptions

Below, are the assumed key reasons for failure of M&A, according to Kitching (2001), poor business judgement pertaining to anticipated synergies can lead to the overpayment of target company. In addition to this pre-M&A misjudgments, failure to M&A can also be attributable to the wrong planning of M&A post-integration processes, as argued by Owens and Scott (1990), rather than failure owing to business operations.

Another reason that M&As fail is due to insufficient attention paid in order to make the deal work after the transaction has been concluded. Often, the deal is negotiated at senior executive level, where the focus is mostly strategic, and then the implementation is left to the immediate lower level of management. What often transpires is that, this lower level of management may not share the same vision with that of senior executive level which drew the post integration business plan, and as a result they may end up not being in tune the critical steps that need to be taken to unlock the anticipated value.

One classical example in South Africa was the demise of the small bank, Saambou bank in 2002. This model prompted the long expected consolidation in the financial sector. Disappearing from the scene were historic stalwarts BoE, Saambou and PSG Investment Bank. Much of the activity in the financial sector was prompted by the failure of smaller banks such as Saambou, Unifer and BoE. The implication is that, size and intent to grow and dominate the industry sector are some of the reasons leading to M&A. If these reasons are not diligently handled, or market forces do not permit survival of smaller players, this can result in failure in M&A. The South African small bank model discussed above is a classical example. It is argued that the run on deposits experienced by a number of small banks, led to their liquidation (Thayser, 2002).

The key motive behind M&As is expansion of the existing market base and creation of wealth through acquisition of smaller role players who can add to this benefit. However, lack of proper post acquisition strategies could see the acquisition purpose not being realized.

For example, in the past, the reason for South African larger banks to acquire smaller banks was to take opportunity to grab the imminent arrival of the Community Reinvestment Bill. This bill was arranged through the Government for small banks to provide larger amount of housing finance to lower income household. With large banks move to indirectly participate in this market opportunity, the acquisition for smaller banks by the large banks was then intensified (Thayser, 2001).

Banks make a profit by undertaking a calculated financial risk, where depositors money (secured liabilities) is used to raise banks assets (not fully secured). If post acquisition strategies do not adequately focus on proper management inherent financial risk, external environmental factors, including market perceptions about the business can lead to business failure.

Using the financial services sector as an example of risk assessment, Mueller (1977) argues that, banks going concern prospects are dependent on certain liquidity thresholds being attained. Without minimum liquidity thresholds, a bank's continuity is much under threat. Hence, to attain the required liquid capital mix, the bank's assets are to a great extent funded by risk free liabilities, thereby, increasing the inherent business financial.

Since, the banking sector comprises of high competition, brand image and customer loyalty is the key to business continuity. Hence, smaller banks experienced problems in South Africa as a result of their marginal reputation and lack of brand image on their service offerings. In the foregoing, M&As by larger banking groups was adopted to enhance the survival of smaller banks through the image and customer confidence brought in by acquiring banks, and for market growth out of synergies brought in by bigger acquiring or merging banks.

Lack of a commercially viable post-acquisition strategy, can render expected synergies worthless. Due to intense competition in the banking sector, service offerings to the public should be streamlined to motivate customers to stay with the bank. Service offering incentives, coupled with strategic focus on marketing and promotions are key strategies for competitiveness (Mueller, 1977).

The cost of delivering the marketing strategy and rendering services much more convenient to the public must be matched with returns achievable from high risk asset base of the institution, as cited by Mandelker (1974). In other words, deposits and other risk-free investments with the bank must be at certain capacity level to ensure economies of scale returns to recover all costs necessary to give the institution a going concern and warrant expected returns to investors, whilst at the same time, the results must portray good image to the public for the sake of giving it confidence for trading its stock/shares favourably in the stock market, and to encourage new depositors (Graves, Flach and Jacobson, 1988).

The demise that faced most of South African small banks that were acquired by larger banks, was dependent on their poor post-acquisition strategies that did not adequately focus on post acquisition events and how best to optimize them. One relevant example, is on the acquisition of Saambou bank by First Rand Group, for which the motive for the acquisition was on the synergistic benefits inherent from the Community Reinvestment Bill arranged through the Government for small banks to provide larger amount of housing finance to poor and lower income household groups (Thayser, 2002).

In a financial institution like Saambou bank, where acquisition by First Rand Group was driven by an opportunity from one service offering, amongst other service offerings, can pose a risk significant to render the whole deal to failure. In other words, a sensitivity analysis comparing the varying risk levels inherent in the relationship and timing of the bank's assets and liabilities was overlooked, and hence resulting in poor match of liquidity in the bank's balance sheet (Mandelker, 1974).

Commercial Bank's are highly geared institutions. The timing of assets and liabilities in their balance sheets is not consistent. In most cases, their capital structure comprises of insignificant equity funding, and mainly of long and short-term money market loans. The latter includes investors' deposits, which are withdrawn at call. These are high-risk liabilities with full obligation to honour withdrawals and cost of capital. Whilst, on the other hand, the assets funded by this capital base are exposed to risk, subject to payment default by borrowers.

According to an interview with Dave Thayser, partner at Ernst & Young Corporate Finance, he says the deal may look great on paper (deal looking impressive due to an existing opportunity to expand, ignoring other unforeseeable risk factors – due to lack of adequate sensitivity analysis to cover all possible risks). The ultimate success of the deal is dependent upon a successful integration process. The key to successful integration is developing an effective strategic integration plan, and the first step in developing this plan is through evaluation of possible business alternatives that will constitute the post-acquisition plan.

The main goal motivating M&As is on securing market growth, and drive towards inheriting the synergies rendered by the economies of scale from integrated operations. As earlier mentioned, core benefits resulting in synergies are focused on, securing market expansion and dominance, procure competitors management skills and expertise, diversification of business risk through investment portfolio acquisitions, spare capacity utilization for cost effectiveness and enhanced efficiency, tax benefits and avoidance, through combined assessed losses at acquisition, and technology integration and development (Correia, *et. al.*, 1993).

The benefits mentioned above, serve as reasons for acquisition cited by Life Assurance companies under Capital Alliance in Appendix 2, which are focused at streamlining and optimizing operations to achieve improvement in service delivery, through more efficient and cost effective approach to operations, whilst still maintaining best customer service by fulfilling and complying with changing customer needs and market preferences ahead of its competitors.

The MSN Web Page Home Results on Capital Alliance acquisition of Life Assurance companies explain the expected synergies from a merger and acquisition, as outlined below.

With reference to Appendix 2, it is noted that, the following synergies are expected out of a M&A deal, which were realized by Capital Alliance under review of its operations.

Improvement in Customer Service Levels, as service level turnaround times were optimized, due to enhanced efficiencies and cost savings from integrated projects. As per Table 1,and Graph 1.

Demonstrated by the reduced number of work flow in queues between January 2001 and January 2003 after acquisitions and integration of Fedlife projects into Capital Alliance operations.

Efficiencies from integration of acquired projects were also experienced from improvement in Call Centre statistics, mainly the response time for calls, reduction in number of abandoned calls, and less average talk time, coupled by re-enforcement of the culture of cost effectiveness. As per Table 2, and Graph 2.

The completion of various integration of projects (merged projects) resulted in overall reduction of costs and increased volume of policies administered and reduction in administration average cost per unit of policy.

Another factor that creates a host of unforeseen complications at point of M&A deal, which results in the deal losing its potential value perceived from the due diligence point of view, is the lack of identification of all embedded value factors for the new business, which undermines the expected synergies inherent from the deal (Jensen, 1984).

Lack of post acquisition strategy on addressing the embedded value factors which can be overlooked at acquisition point, can lead to poor governance being experienced moving way forward. The lack of focus in planning for systems integration like financial and operating software/ERP systems resulted in control weaknesses which led to many post-M&A failures.

According to Devine (2002), Michael Porter, a strategy guru at Harvard Business School, puts his finger on the unique nature of M&As when he declares :

"There is a tremendous allure to M&As. It's the big play, the dramatic gesture. With the stroke of a pen, you can add billions to size, get a front page story and create excitement in the market. M&A can disrupt business performance, often damage profits over the short term, distract the management and, ultimately, add little or nothing to the book value of the acquired or new business".

For example, as per research conducted by Anderson on media and communications sector, respondents cited people-based problems contributing to failure, such as the length of time taken by management to adapt, failure to integrate new technology because of "not invented here" mentality, poor cultural integration and the failure to retain key people. Respondents on this survey highlighted the following as reasons for post acquisition problems, the lack of an executive champion, an unclear strategy, poor executive alignment and a failure to involve major stakeholders.

Hence, lack of an optimal business plan and post acquisition strategy on integrating systems and controls for corporate governance, and in ensuring optimal use of underlying resources to promote business efficiency and effectiveness can render the target company's customer service ratings to decline (Van den Honert *et al.*, (1988).

To validate the above theoretical review on M&As, and to support the research motivation, the following chapter sets the criteria for the method and approach to obtain qualitative information for investigation and analysis of the gathered data for the purpose of this study.

Chapter 3: Research Methodology

3.1 Introduction

This study is of a descriptive qualitative nature, with a case study analysis pertaining to in depth description of organizational behaviours influencing M&A activity, and known reasons for failures thereon.

A descriptive study attempts to describe or define a subject, often by creating a profile of a group of problems, people, or events as encapsulated in a case study situation in chapter four below (Cooper and Schindler 2003).

The purpose of this research was to establish reasons that lead to corporate post-acquisition failures as a result of poor planning around the due diligence process following a decision to invest or merge businesses for the purpose of managing operational and investment risks.

3.2 Research Methods

The proposed research incorporated a range of methodologies, similar to the approach adopted by Krairit (2001).

3.2.1 Research Methodology 1: Literature Review

Reference was made to M&A annual review of activity publications edited by David Thayser, Partner at Ernst & Young accounting and auditing firm, and intensive search through websites on Saambou bank's history, as well as reference on other publication journals and texts on M&A activity.

3.2.2 Research Methodology 2: Interviews

In order to validate the assumptions inherent from the evaluation of the case study example, interviews were conducted with selected individuals to acquire generic knowledge on M&A activity, and to make use of their experience and ideas generated from the interviews in the analysis and evaluation of the case study below. The interviews were open-ended and assumed a conversational manner, but followed a set of questions based on the list in Appendix 1.

Interviews in particular, were held with David Thayser of Ernst & Young, and Harry Kelan, Senior Manager- Corporate Investments and Acquisitons – of Investment Bank, Hong Kong Shanghai Banking Corporation (HSBC). This interviews were generic on the topic, with examples used pertaining to the organization used in the case study example.

3.2.3 Research Methodology 3: Data Collection

Appendix 2, relates to some of the inherent synergies expected out of a M&A subsequent to a deal. Reference was made to capital Alliance review of M&A operations. This was used for re-alignment and comparison to findings out of the Saambou bank's case study research, in order to facilitate data analysis and conclusive guidelines to aid future users of this exercise when entering into transaction deals of similar nature.

Sources of data collection:

- Reference to websites on M&A activities relating to Saambou bank, and on other business corporates for information re-alignment and guidelines on way forward for future deals.
- Textual reference on M&A activity
- *Focused interviews with relevant parties in the corporate investment sector*

3.2.4 Research Methodology 4: Data Population

The inherent difficulty in populating this exercise is that, at the time of conducting the research, the entity was placed on liquidation, and the scope of the research further limited by the fact that the KPMG's curator's report, Mr John Louw, is not yet made public.

The intention of this exercise, was not to evaluate the investment risk specific to one entity, but to set a framework and reference guidelines in optimizing investment decisions to be made in future acquisitions within the financial sector. A case study reference on Saambou bank in chapter four outlines the operational and financial risk factors inherent in an acquisition, and the population and analysis thereof used for evaluating in case study evaluation in chapter five.

Critical information regarding the negotiations that were put forward when striking the deal between Saambou bank and First Rand, and the information on the bank's curator ship were not made public or made available on the bank's website.

3.2.5 Research Methodology 5: Data Analysis

The analysis progressed in three phases, first the introduction, which outlined the generic purposes from a micro to macro economic perspective of entering into M&As, the literature review for outlining facts and reasons why M&A exist, and finally the case study approach which outlined specific facts around Saambou bank's acquisition failure.

Information gathering for this exercise is through a case study analysis of Saambou bank's acquisition by First Rand Limited, to provide an in-depth description of factors involved in organizational approach in handling strategic corporate investment decisions, as outlined later in the case study.

Tools used for analysis of the case study, and for compilation of recommendations moving forward for the benefit of users of this study, were based on the following techniques, Porters five forces, SWOT analysis, and PEST analysis.

Lastly, elite interviews were conducted from industry experts as an attempt to establish their interpretation of the key issues, and the impact of their assessment of M&A activity in relation to corporate investment synergies. The data was documented using standard interview questions outlined in appendix1, and the researcher then tried to prioritize and rank some of the key issues of concerns raised, as well as illicit common views emerging from the various phases of analysis.

The above-mentioned methodologies were made applicable for obtaining relevant data, investigating and analyzing the case study data used in this exercise.

Chapter 4: Case Study

4.1 Introduction

The case study covers pre and post-acquisition activities leading to organisational failures in corporate governance for the Saambou bank, following its acquisition by First Rand Limited.

The case below analyses corporate investment risk factors leading to post-acquisition failures, key risk elements embraced in the case study include the following:

- Financial risk inherent from the Balance sheet capital structure
- No product/service diversity
- No effect in the market – no economies of scale to raise market competitiveness
- No post acquisition systems and processes re-engineering to enhance internal control efficiencies

The above-mentioned risks can therefore be interpreted in the case below which was referred to the Tribunal by the Competition Board during the process of the business acquisition, as published on website http://www.fnb.co.za/saambou/fnb/relationship.htm

4.2 Case – Tribunal Hearing

First Rand Bank holdings Ltd vs. Saambou Bank Ltd

This transaction, which involves firms, which are both in the banking industry, will be effected by way of scheme of arrangement ('the scheme") that was proposed by First Rand Bank. In terms of this scheme First Rand Bank will acquire the entire issued share capital and certain claims of Saambou Bank from Saambou Holdings. In terms of the scheme, certain assets will remain vested in and under the control of Saambou Bank. On completion of the transaction First Rand will control the deposits valued at R12, 751 billion and the mortage book, valued at R4, 878 billion.

The Commission found that this merger is not likely to prevent or substantially lessen competition and recommended to the Tribunal that the transaction be approved without conditions for the following reasons:

Although the market shares for the parties will be above 15%, they are not likely to raise competition concerns, as there are other big financial institutions, which are competing with the merging firms. These big financial institutions are likely to discipline price should the merged entity attempt to increase their prices above competitive level. In addition, this transaction does not raise significant public interest concerns.

4.3 Tribunal Hearing Judgement and Outcome

The outcome of the above case implies that the acquisition by First Rand did not take the financial risk implications into account. The Balance Sheet structure of Saambou comprised more of secured debt, and less long and short -term investment assets.

4.4 Inherent Corporate Financial Risk

The timing of assets and liabilities lacked proper balancing, and compounded further by the huge gearing level inherent in Saambou capital structure.

Due to high gearing, the main source of funding for investment assets (loans) was more from customer deposits, which were payable at call, whilst investment assets were unsecured and recoverable at differing time frames, and hence increasing the liquidity risk and incidental shortfalls on cash flow due to timing imbalance between assets and liabilities (esp on working capital).

4.5 Due Diligence Risk Factors (not adequately addressed in the acquisition deal)

Also, the acquisition did not enhance any growth in product lines or service offerings, and had no value add on existing revenue streams for the two banking sectors, apart from the fact that it was motivated by the government's market offer of low income subsidized housing schemes for civil servants to Saambou bank. This opportunity, however got overwritten by the mismanagement of the capital structure and timing of cash flows inherent from Saambou's Balance Sheet.

The above, implies that, due to the Tribunal's statement when deciding the above case, lack of competitive force from the acquisition rendered no economies of scale benefits as the trading volumes in Saambou remained at original levels even after the acquisition, before incidentally dropping with the eventual collapse of the business from loss of customer confidence following post acquisition downfalls on systems and processes.

Hence, no added benefits in terms of reduction in average cost levels and no improvement in operating profit margins. Hence, the Tribunal citing the fact that, due to lack of competitiveness evident from the acquisition, the acquisition will have no force to control the deregulated pricing in the market, as other big institutions which will not be affected by the acquisition will have the ability to step in and correct the pricing in a much competitive way.

Lack of economies, and no proper investment and post strategy viability test before deciding on the acquisition, have rendered the above deficiencies and mismanagement problems in this acquisition.

Below, is the case study detailing the culture and operational activities that were inherent in Saambou Bank pre and post acquisition by First Rand, and the implications thereof for inherent operational and financial risks that ought to have been addressed in the post acquisition strategy to alleviate the weaknesses that led to post acquisition corporate failure.

It is thereby proven by this case that, First Rand motive for the acquisition was to create more market and wider customer and diversity of customer service range, without considering in their post acquisition plan the strategies to make full use of synergies available as part of the operational plan moving forward.

4.6 Case Study Content

HOW SAAMBOU BANK OVERCHARGED BONDHOLDERS AND FIRSTRAND CONTINUES WITH THE RIP OFF.

The content of the extract outlined below, was published from the following website, http:// www.bankgate.co.za/How FNB continues to rip off Saambou bank bondholders.htm

When First Rand obtained the mortgage book of Saambou, they were informed by the Registrar of the Usury Act to rectify all mortgage bonds where the illegal advance interest calculation was applied. However, the bank never adjusted the overstated balances of Saambou bondholders and is currently still levying interest on the inflated balances and is presently recovering millions of rands from prejudice Saambou bondholders in unearned interest. This is a contravention of section 5(1) & 5(1)(c) of the Usury Act, which is a criminal offence. Hence, inefficiencies of this kind become public knowledge especially in the case of public companies, mainly because their audit report get publicized, and findings like this resulted in Saambou loosing its grip as a result of poor corporate image in the perspective of its customers and the public in general.

This issue of corporate inefficiencies, got spread to the market, and as a result the response was a sharp drop in the Saambou stocks in the JSE, sending bad investor, customer and public perceptions which led to secondary market selling of bank shares and customer deposit withdrawal which left the bank illiquid, and causing its demise.

Saambou Bank ignored a 1990 warning from the Reserve Bank that interest may not be calculated in advance without the necessary adjustment of interest payable in respect of payments received, but continued with this unlawful practice until September 1999.

It is estimated that the amount overcharged by the bank could be as high as R5-billion, an amount Treasury has to pay after the Reserve Bank agreed to provide liquidity support i.e. the taxpayers will foot the bill.

This is how SAAMBOU defaulted:-

Saambou Bank calculated interest in advance for the following month, on the outstanding balance one day preceding payment date, which was the first day of every month. The Usury Act determines that interest should be calculated at the end of the period i.e. payment date. Furthermore, whenever any payment was received during the month, Saambou Bank did not make any credit interest adjustment in respect of the payment received.

The above, resulting in over-statement of the Balance sheet value of business or its net assets, due to unearned interest revenues forming part of the business net worth. Hence, from a due diligence and valuation stage preceding the take over of the bank by First Rand, it implies the probability that First Rand overpaid for Saambou on the basis of over-stated working capital assets, and wrong valuation resulting in overpayment in the cost of investment, which understated future returns on investment for the acquired business. This implies one reason for post acquisition failure, when returns were marginal when benchmarked to market returns.

On 30 May 2000, the Commercial Crime Unit tasked forensic auditor, Gregory Johnson to investigate the mortgage bond of Saambou for contraventions of the Usury Act. The bond was registered in December 1990 for an amount of R 123 000 and repayable over a term of 20 years.

In his affidavit submitted to the Commercial Crime Unit dated 12 September 2000, Johnson explained the effect between calculating interest in advance and interest in arrears as follows:-

"Where interest is calculated in arrears, the loan will be repaid within nineteen and a half years. Where interest is calculated in advance [the method Saambou used], the loan will never be repaid. In fact, after 20 years, the balance increases from the initial amount to R 133 960.00"

The law:

As far back as 1978, the Appeal Court ruled in the matter, viz Ex Parte Minister of Justice 1978 (2) SA 572 (A) in support of Section 4 of the Usury Act which determines that if a borrower or credit receiver or lessee fails to pay any amount due upon the date when such amount is payable, the moneylender shall thereupon be entitled to recover

an additional amount of finance charges for the period of default at the interest rate that applied at the time of default.
Furthermore, it was an internal policy of Saambou Bank to increase interest unilaterally to maximise profitability, which is a contravention of Section 5(1)(c) of the Act that determines that the agreed rate must apply.

Hence, public knowledge on the overstatement of financial results was badly perceived by the investors in the secondary market, and from that point, the market reacted and pushed the share price down, sending a bad signal to depositers, who reacted by withdrawing funds at amuch faster pace than collections from mortgage bond payers, thereby resulting in liquidity and cash flow problems.

The debiting of administration costs without complying to the limit set by the Usury Act, while the only administration cost that is permitted by the Usury Act is the R 5,00 monthly fee, implied poor corporate governance.

Curatorship:

On 9 February 2002, Saambou Bank was placed under curatorship after an alleged "run" on the bank prior to the collapse, in the course of which investors, mainly Investec, withdrew R 1 billion from Saambou. But nobody saw any long queues at Saambou branches - so the "run" was large corporate investors, who had access to inside information.

Who pulled the plug on Saambou, resulting in its post acquisition Failure?

Everyone trust's their bankers and the powers that (supposively) regulate them. Perhaps the most glaring remains the one about the alleged "run" on the bank prior to the collapse, in the course of which investors supposedly withdrew R 1 bn from Saambou. But nobody saw long queues at Saambou branches – so the "run" was large corporate investors, who had access to inside information and the fingers are pointing to Investec.

Just what was Investec's involvement in the Saambou debacle and the subsequent dismemberment of the Bank? Much of the information is contained, apparently, in the still-secret KPMG report that the Reserve Bank resolutely refuses to release because the information may endanger SA's financial welfare and economy, implying that the stock market index movements are not entirely based on efficient market hypothesis, as there are indications on insider trading influencing movement of shares and to some extent impairing company images and their going concern sustainability. The reason given by the Reserve Bank for its refusal to release the report immediately has raised concerns that the regulatory shortcomings highlighted in the report could extend beyond Saambou (as per above on efficient market hypothesis of running the stock market). The question that needs to be asked is what " regulatory shortcomings" could endanger the S.A. economy and banking industry.

Bank failures

In approximately April 2001, Investec acquired Fedsure's 41 % stake in Saambou Holdings (Saambou Bank was Holding's wholly owned subsidiary). It made clear at an early stage that an investment into Saambou didn't really fit its portfolio strategy. Investec entered into a tender process for the stake and indicated that it was looking for something of the order of R 2 bn but when no offers of sufficient value were forthcoming, Investec abandoned the process.

Investec was concerned about the overcharges on the Saambou mortgage and personal loans, and during July 2001 arrange a meeting with the financial consultant Emerald van Zyl who exploited the wrongdoings of Saambou Bank. (An issue which was ignored by the First Rand Group in its due diligence post acquisition strategy for Saambou bank, and hence resulted in post acquisition synergies not been realized, and the investment being worthless).

During this meeting in Cape Town, Investec made no bones that they were concerned about the Usury Act violations by Saambou Bank. They were informed that the amount could be as high as R 4 bn on the mortgage loans. This amount could even be higher on the personal loan book of Saambou Bank. The matter which overstated the Saambou business valuation at acquisition point, and resulting in over-payment by First Rand for an investment which did not render long term benefits as a result of mal-administrative functions (noted by Investec in July 2001 in the abandoned investment process as cited above) which were not rectified by the post acquisition strategy.

In August that year, Investec appointed four of it's senior people (David Lawrence, Glyn Burger, David Nurek, and Bradley Tapnack) to Saambou Holdings' board. Six months later, on 9 February 2001, Saambou Bank was put under curatorship.

Shortly before the collapse of Saambou, an article was published in the Sunday Argus on 28 January 2002 under the title "*Angry bank client claim home loan rip off*". The article quoted Saambou Bank Chief Executive Johan Myburgh saying that "the bank's method of calculating interest is not, and never has been, contrary to the Usury Act". Sunday Argus referred to a letter in their possession from the Registrar of the Usury Act, Ms Lana van Zyl that she agreed that when interest was calculated in advance, credit interest had to be given to the client if any payment was made later that month.

On Monday morning, Saambou tried to get a copy of the Registrar's letter from Van Zyl. They were informed that the letters of Ms Tanya Smuts and Lana van Zyl will be attached in an affidavit for a court application to stop the sale in execution of one of his clients properties. The documentation was served on Saambou's attorneys, De Klerk & Van Gend on Monday, 4 February 2002.

Heavy sales of Saambou shares started the next day. The result was the alleged run on Saambou Bank. After all, if institutions had lost confidence, what else should depositors think? So who was leading the selling? The evidence points to Investec. From the perspective of the bank's depositors, who reacted by withdrawing their deposits as a result of indirect signals that were prevailing in the JSE secondary market, resulted in the direct cash outflow impact on the bank rendering it illiquid and with no going concern prospects.

Once the curator (John Louw of KPMG, the accounting firm that is also Investec's auditor) took office, he established a deal forum, intended to superintend the sale of Saambou's assets. Extraordinarily, senior Investec executives were members of the forum. The conflicts of interest that arise are so encompassing as to be mind-blowing.

Later, Louw told the Reserve Bank that the Saambou group's structure was very complex and that some of its businesses may not have operated within their legal entities. Specific assets, identified by Investec, may have been transferred to entities that were subsidiaries of Saambou Holdings, not of Saambou Bank.

As an example, nearly three weeks after the installation of a curatorship, a compulsorily convertible loan of R816m was converted into shares in Saambou Bank and Investec and Primevest sanctioned this. This enabled the continued settlement of interest due from Saambou Bank on promissory notes it had issued. It is suggested that what then happened is that these notes were tendered to the Reserve Bank, which bought them at face value. The sum was about R400m.

And that's where, or so it seems, Investec's involvement ended. It is almost as though someone drew a line under the matter and firmly concluded that was that.

One of the great mysteries at the time of Saambou's curatorship was the deal constructed by Investec ostensibly to "save" Saambou and presented to the Reserve Bank. Its structure was well formulated, and more convincing than what was finally adopted when FNB stepped in.

Rejection of proposed Investec plan to rescue Saambou bank

What is known is that it was accepted and supported by the Reserve Bank, but was vigorously opposed by the National Treasury. After it was given the Reserve Bank's imprimatur, deputy governor Gill Marcus called finance director-general Maria Ramos. What happened during that conversation isn't known but one result was that Finance Minister Trevor Manuel and governor Tito Mboweni had what is described as a "huge fight' about it.

Let's add a rider: the Financial Services Board has passed a Saambou internal audit report on insider trading to the Scorpions. One cannot think why. That report exonerates MD Johan Myburgh and executive director Charles Edwards from any misdeeds. All one can conclude is that this is another smoke and mirrors device intended to divert attention from those massive institutional sales. As observed at the time, Myburgh was being universally excoriated and on the basis of the information available at the time, anyone prosecuting this case in a court has two chances: nil and zero.

The conclusion to all this is inescapable: Investec had a major say in the construct of the bank's curatorship and the process of dismembering it. To what extent it received preferential treatment is, presumably, hidden in the pages of that secret KPMG report.

Mr. T.J. Louw was appointed as curator in terms of section 69 of the Banks Act and all efforts by the curator to sell Saambou as a going concern failed, (No party was prepared to buy the bank at an overstated value embraced in its Balance Sheet, as overpaying for the deal could result in less favourable returns, which signal another point of failed acquisition). *In* September 2002, FirstRand Bank Holdings obtained the mortgage book of Saambou Bank Limited through a Scheme of Arrangements proposed by First Rand between Saambou Bank Limited, then under curatorship, and it's creditors (other than Saambou's creditors and funding creditors). The meeting for scheme creditors was held in Johannesburg at 9h00 on 5 August 2002 - but no bondholders attended the meeting.

Scheme of arrangements to refund bondholders for overcharging on bond interest

On 20 August 2002 the Scheme of Arrangement was sanctioned by the High Court (Transvaal Provincial Division). The order was registered with the Registrar of Companies on 30 August 2002, and all of a sudden bondholders became scheme creditors and had to submit their claims to the curator within 60 days i.e. by not later than 30 October 2002.

Who's footing the bill:

After the collapse of Saambou Bank, the Government and the Reserve Bank agreed to provide liquidity support - so the taxpayers are to stand in for all the illegal fees that

FirstRand are currently recovering from prejudiced clients, which at this time could be approximately R 5 billion.

Below, is a statement from the web gate Saambou website, indicating the sub-standard approach between stakeholders at the point of structuring of the acquisition deal between First Rand and Saambou bank.

The unresolved differences and unknown factors between the stakeholders at acquisition point, unfolded more diversity of interests and unresolved inefficiencies not covered in the post-acquisition strategy of the business after acquisition, and these pulled the plug for business failure.

In the foregoing, all efforts by the curator to sell Saambou bank as a going concern failed. In September 2002, First Rand Bank Holdings Limited obtained Saambou Bank Limited through a scheme of arrangements proposed by First Rand between Saambou Bank Limited, then under curatorship, and its creditors other than Saambou's depositors and funding creditors. The meeting for scheme creditors was held in Johannesburg at 09h00 on the 5th August 2002, but no bondholders attended the meeting.

Below, are the reasons that led to the curator's failure to sell the business as a going concern:

None of the more than 60 000 Saambou bondholders were officially informed of the meeting. Emerald van Zyl, financial consultant from Cape Town, who represented more than 200 Saambou bondholders, only learnt of the meeting five days before the time – but the documentation he needed to represent his clients was deliberately delayed, and only handed over to Gologix Couriers by the curator for delivery on Friday afternoon, 2 August 2002 at 13h00. The documentation was only delivered to him per courier in Cape Town at 11h00 on Monday - two hours after the meeting had started in Johannesburg.

Arrangement approved:- The Scheme of Arrangement was sanctioned by the High Court (Transvaal Provincial Division) in terms of the order granted on 20 August 2002. The order was registered with the Registrar of Companies on 30 August 2002. All claims

by scheme creditors, as defined in the arrangement, had to be submitted to the curator within 60 days i.e. by not later than 30 October 2002.
accusations:-

Louw and the Reserve Bank were widely accused in the media, for assisting fraud cover-up in an effort to avoid claims due to bondholders, possibly worth millions of rands.

Herman le Roux, an ex-deputy director in the Department of Trade and Industry, who was responsible for administrating the Usury Act, describes the scheme of arrangement in the magazine, Noseweek as: "the biggest cover-up in the history of SA banking"
questions that Louw refuses to answer:-

Could a bondholder with a debit balance on 9 Feb 2002 with an overpayment on his bond be classified as a scheme creditor?

How many bondholders attended the meeting of scheme creditors on 5 August 2002

- In which of two categories defined as scheme creditors did they vote?
- If bondholders as a class were not represented, nor voted at the scheme meeting, would they be bound by the scheme of arrangements?
- Why is the receiver, after more than three years, still adjudicating mortgage claims, on matters that the Appeal Court adjudicated viz Ex Parte Minister of Justice 1978(2) SA 572(A) as far back as 1978?

Financial consultant, Emerald van Zyl, who acts on behalf of approximately 200 Saambou bondholders and assisted 140 homeowners in stopping the sale in execution of their properties after legal action by Saambou, could not obtain any answers to the abovementioned questions from the receiver John Louw.
Below is the letter dated 24 September 2003 to the receiver, Mr. John Louw.

The letter from the financial consultant of the stated 200 bondholders, conveyed the following inherent weaknesses in the structured acquisition deal and on curatorship process of the bank.

The acquisition by First rand bank of the inaccurate mortgage book of Saambou, due to unaccounted advanced interest payments on debtors, and the over-statement of the debtors book due to non-reflected Balance Sheet liabilities from advanced payment by bondholders.

The continued operational inefficiency assumed by First Rand Group post acquisition.

Mortgage book not taken over by First rand at a fair value at acquisition, due to inherent misstated value from Saambou's Balance Sheet. Most unfortunately above all, not queried and qualified in Saambou's audit reports, and thereby misleading users of Saambou's financial statements at due diligence and business acquisition point.

The curatorship and liquidation process not complying with the Companies Act requirements which stipulate that, for dissolution of any legal entity, a special resolution should be obtainable from all its creditors (which was not the case with Saambou).

Below, are cited questions which were raised against the Saambou bank's curator for non-compliance with the Companies Act requirements and PFMA requirements essential for compliance within dissolution of entities of similar nature, which were not complied with in the case of Saambou bank's curatorship. As per website publication on January 2004 on http:// www.bankgate.co.za/ How FNB continues to rip off Saambou bank bondholders.htm.

Mortgage-Bonds:

- How many bondholders attended the Scheme of Arrangement meeting held on 5 August 2002?

- If any, in which of the two categories of scheme creditors as defined in the Scheme of Arrangements, did they vote?

- Were all bondholders informed in writing of the meeting of scheme creditors on 5 August 2002? If not, why not?

- In your letter dated 13 March 2003 to Mr. Curt von Keyserlingk, Editor, Sake Rapport, you are on record as having written the following :

"Only creditors who were creditors at the time of the holding of the scheme meeting [on 5 August 2002] were notified. Late claims are catered for in the scheme of arrangements".

When you were appointed as curator by the minister of finance, Mr. Trevor Manuel, on 9 February 2002, you became aware of more than twenty bondholders who at that time had submitted claims in respect of overpayments. If they were by definition "scheme creditors" why did the names of these bondholders not appear on the list of known scheme creditors that was submitted to Court and why were they not informed of the scheme meeting on 5 August 2002?

- You are on record as having said that the Usury Act is "badly worded and open for interpretation". In my letter dated 1 August 2003, I drew your attention to the contraventions of the directives as contained in the Usury Act related to Saambou Bank's mortgage bonds. These contraventions had been supported by the Appeal Court, viz, Ex Parte Minister of Justice 1978 (2) SA572(A).

Further, I refer you to an extract from paragraph 3.2 on page 62 of the book titled "Basic Principles of Consumer Credit Law" by Prof. N.J. Grove [BA LLB LLM (UP) LLD (RAU)], Professor in the Department of Private Law, University of Pretoria and L. Jacobs [BCOM (Acc) (UTC) BLC LLB (UP] Senior Lecturer in the Department of Mercantile and Labour Law, University of Pretoria, in which the following relevant questions are answered:-

Until which date should finance charges be calculated?

In Ex Parte Minister of Justice, the court decided that the period for the calculation of finance charges terminates on the date stipulated for payment.

On which amount should finance charges be calculated?

The court held in Ex Parte Minister of Justice that finance charges are to be calculated on the balance of the principle debt *owing from time to time".*

In a letter dated 29 August 2003 you advised all clients who had submitted claims for refunds of overpayments on their mortgage, that you were, after almost one year, still in the process of adjudicating these claims. In the light of the Appeal Court's aforementioned judgment in 1978, and the fact that you are after one year still adjudicating mortgage claims, would you also be prepared to say that the judgment could be regarded as "badly worded and open for interpretation".

Personal loans

In a letter dated 15 March 2002 the Registrar of the Usury Act, Ms. Lana van Zyl informed you that administration fees of R 1 140,00 were illegally debited and "should be written back as the act does not make provision for administration costs to be levied on any money lending transaction other than housing".

"We are aware that overcharges took place. Saambou bank should have changed their method, but they did not. We would assist clients with their claims against the curator and would, if necessary, open a special auxiliary line".

Furthermore, if there were no overpayments by clients on the personal loan book, could you please explain why you sold the loan book for one third of the price ?

In response, the Registrar of the Usury Act, conveyed that, In the aforementioned letter, I addressed the personal loans of three clients namely J.Greeff, H. Briesies and E.J. Carstens, and you would have noticed that on all three of these accounts the maximum interest rates permitted by the Usury Act, were exceeded.

In a letter dated 22 September 2001 the Registrar of the Usury Act, Ms. Lana van Zyl, informed Mr. Myburgh, that Saambou Bank contravened section 2(1)(a) of the Usury Act on the account of Mr. Greeff, by charging a higher interest rate on his non exempted loan as permitted by the Usury Act. I attach this letter as annexure "D".

Further to Van Zyl's letter to the curator of Saambou bank, the following question was raised to the curator:

If you were aware that Saambou Bank exceeded the maximum rates as permitted by the Usury Act on personal loans, could you please explain why you informed the media that Saambou Bank did not overcharge their clients?
I await your response and would appreciate acknowledge of receipt of this letter.

The letter of the receiver dated 3 October 2003 in reply to Van Zyl's letter.

Before forming your opinion here is some more information:

A legal opinion by Adv M Welz concluded: "It is my opinion that the clients (bondholders) are not included in the scheme of arrangement between the offeror and the two voting classes of scheme creditors, and are therefore not bound by the terms of the arrangement".

The fearless and indefatigable magazine, Noseweek, reported in the Oct – Nov 2002 edition, as follows:

Tthere was no-one present at that meeting of creditors to represent the interest of the mortgage bondholders. Van Zyl says that he first learnt of the meeting five days before it took place – but the documents he needed to represent his clients were only delivered to him per courier in Cape Town two hours after the meeting had begun in Johannesburg.

Stated below, are some operational inefficiencies which First Rand failed to combat in its post acquisition strategy, mainly because of their main interest for the acquisition was to diversify its interest in the low income subsidy housing market, than address the functional inefficiencies to streamline future operations.

These inefficiencies were outlined in the letter by the Receiver of Revenue to the curator of Saambou bank, Mr Johan Louw

Contents of the Letter

I refer to a letter written on your behalf by Ms. Renet van Wyk dated 13 August 2003 in response to my letter dated 1 August 2003.

I refer to paragraph three of the aforementioned letter where you deny allegations that yourself, First National Bank and the Reserve Bank are covering up the overcharges on mortgage and personal loans to prevent the refunding of hundreds of millions of rands by National Treasury to prejudiced clients.
With reference particularly to your accusation in respect of libellous (lasterlike) statements, I wish to inform you that the following correspondence has been published on the website www.bankgate.co.za:

Is the receiver of Saambou Bank, Mr. John Louw, covering up the overcharges on mortgage and personal loan accounts? - form your own opinion".
Saambou synergies driving the acquisition process by First Rand Group

4.7 Motivation

One of the motivating factors for the First Rand acquisition of Saambou were the positive financial results reported prior to the deal been announced. Based on the favourable returns, and market opportunities in the subsidized government low income housing loan schemes, First Rand projected synergies out of that deal by overlooking inherent credit and operational risks pre and post acquisition.

Below, is the financial performance used for due diligence purposes and for determining the value at acquisition, which ultimately did not focus on the sustainability of the underlying performance when basing value at acquisition.

As referenced in, Jan. 2004. http:// www.bankgate.co.za/ financial services.htm.
Saambou bank fits its niche more comfortably. The restructuring of the niche financial service provider Saambou has paid off handsomely for the group with headline earnings rocketing by over 40% in the year to March 01.

And at Friday's board meeting to approve the results, the company will ask shareholders' approval later this month to privately place 9.3 million non-issued shares at R15.60 to raise R145 million to, "establish new alliances".

An emphasis on cost reduction and an increase in non-interest income enabled Saambou bank to increase total income by 16.3% to R378.3 million from R325.4 million in the previous year, while expenditure rose by only 5.6% to R245.9 million (R232.8 million). This left net operating income 43% higher at R132.4 million (R92.6 million).

The overall restructuring and cost-cutting efforts, which were accounted for financially in the past year, will be completed at the end of this calendar year but were already evident in the second half. The 5.6% increase in operating costs compares with the 17% increase at the halfway stage.

An added bonus has been an exceptional item of R58.2 million added to the income statement, largely from the sale of the company's interest in Rentsure Holdings for R49.8 million.

Added to the income statement, this pushed attributable profits up by 112.3% to R101.9 million, from R48 million and included a substantial increase in the taxation charge to R51.1-million from R18.8 million. Bank Chief Executive, Johan Myburgh points out, however, that R30.5 million of this represents a once-off Vat charge on an insurance premium. Total earnings, therefore, increased to 80.5c a share against 37.9c a share.

The group says the bank is now managing its credit risks on an insurance basis in conjunction with an international reinsurer, which will allow improved ability to absorb bad debts.

A final dividend of 7.5c a share has been declared, taking the total for the year to 11c (7.9c). A capitalisation issue in lieu of the dividend will be offered. It is expected that Fedsure, with a stake of 47% in Saambou, and Metropolitan will opt for the capitalisation issue.

A much stronger balance sheet shows total net assets increasing to R10 billion from R7.7 billion, while the net asset value has risen to 306.2c a share against 222.9c a share.

4.8 Economic and Political factors in today's mergers and acquisition deals

The main drivers for mergers were management buy-outs as a result of large companies divesting their non-core business, failing firms, black economic empowerment initiatives, in particular in the mining and petroleum industries, and financial services restructuring.

Of the total number of cases finalised, twenty three were viewed favourably on public interest grounds,(See Above case on : First Rand v Saambou acquisition that was referred to arbitration by the Competition Board - First Rand Saambou deal was declared not to be in the public interest, due to the deal not bringing any diversity to financial institutions service offerings, with no positive impact on tariffs as other big banks we found to be in a position to intervene on prices if the deal could result in price changes, as well as projected post-acquisition market share not expected to change between the two banks) that is, they positively affected black economic empowerment and small and medium enterprises. The greatest impact was in mining, followed by manufacturing and retail, whereas other sectors contributed less than 10% each in this regard. The 27% black economic empowerment component of merger activity attributable to mining, compares favourably when viewed against overall merger activity, where mining comprised 9% of all mergers notified with the Commission. Wholesale activities contributed 9% in terms of black economic empowerment and small and medium enterprise development, and only 5% of total merger activity. The figures for other sectors, however, leave much room for improvement in terms of black economic empowerment and small and medium enterprise participation.

Mergers using Special Purpose Vehicle entities have increased from 17 in 2001/02 to 21 in 2002/03. This is possibly linked to the desire by large companies to unbundle and create new firms with which to enter new markets or for sale when representing non-core assets.

There has been little merger activity involving BEE and SME. This can be attributed, inter alia, to the difficulties these entities face in raising finance for buying other interests. Twenty two BEE cases were notified during 2002/03 and 11 cases during 2001/2.

4.9 Motivating factors behind Financial Services deals

There has been an increase in merger activity in the financial services sector - from 12% to 13.8%. This increase is indicative of the restructuring of the financial services sector following the demise of Saambou and BOE during the financial year.

Like any other merger, a banking transaction is notified to the Commission if it meets the merger thresholds (First Rand v Saambou activity did not satisfy the threshold as it was perceived not to be in the public interest, with no economies of scale and no benefits of post merger restructuring of service operations arising out of the merger/acquisition, and hence the outcome of the demise in Saambou). Once the Commission receives a banking transaction, a notice is sent to the Minister of Finance. As a result of an amendment to the Competition Act, the Minister of Finance now has the authority to revoke the jurisdiction of the Competition Authorities where systemic risk is a primary consideration (public interest). The Minister of Finance revoked the jurisdiction of the Act in six cases, see footnote 1.

Chapter 5: Evaluation of the Case

5.1 Introduction

The above case study is being analyzed to portray the objective of the study, and to emphasise and validate the problem embraced by the title of this research.

The analysis below, is based on environmental and business behavioural factors around Porters five forces, SWOT and PEST analysis, leading to conclusions drawn thereof upon the facts of the case.

5.2 Michael Porters Five Market Forces

	Market Force	**Comment**
1	**Threat of new entrants**	The threat of new entrants in the banking and financial institution sector is not of great significance, and most businesses in this sector do not consider it a crucial risk factor to have a strategy on it as part of their strategic planning. Even though, there are no restrictions in awarding of licences to the new entrants, whilst exit barriers are low, this appears to be one of the most attractive segment (Arbee and Naidu, 2001). However, competition is still a factor to be taken note of, and focus on competitive strategies is imminent in the banking sector. Because, competition and growth is more focused on being a large player in the market, mergers and acquisitions for oligopolistic and market dominance reasons are a tool used in overcoming competition. Hence, the threat in this particular industry is on potential mergers and acquisitions that can lead to

		big role players who will undermine competitors as a result of large scale economies, and efficiency outcome of utilizing the acquired company's managerial skills for the benefit of the group. The above reasons were not of major substance in driving the deal for Saambou acquisition by First Rand Group, implying that the acquisition strategy did not cover all necessary areas of expected synergies.
2	**Threat of substitute products**	The main threat here for Saambou was that of similar product lines offered by competitors with more efficiency in service delivery, leading to more customer satisfaction at zero rate of queries. The key revenue streams for the bank was on interest earnings from customer deposits (withdrawal thereof led to business failure) and on mortgage loans (not fully recoverable due to a certain degree of defaulting customers). The main threat here for Saambou was on poor service delivery to customers, were competitors took advantage and ceased the market in terms of cash flows that were diverted from Saambou to competitors by shaky depositors uncertain about the bank's future.
3	**Threat of segment rivalry**	The banking segnment rivalry for First Rand acquisition of Saambou was rife, as there were other large role players in the market i.e. Standard Bank, ABSA and other acquired smaller banks by these large ones all coming up with the same service offerings at more cost efficiency and more customer satisfaction levels. The post acquisition results of Saambou did not portray any synergistic returns on investnment, whilst the customer satisfaction index (Customer satisfaction

		ratings) did not show any improvement compared to pre-acquisition period, as is the case on the example above under Chapter 2 portraying synergies of Capital Alliance acquisition of Fedlife, where service level statistics reflect improvement in service delivery to clients as opposed to pre-acquisition ratings. This implies that segment rivalry was intense for Saambou and first Rand Group, as deemed by the Competition Commission during the Tribunal case between First Rand and Saambou, which decided that the acquisition will have no great impact on competition as it will lead to no market growth, and will not have the power to regulate pricing against competitors. (See Tribunal case above by the Competition Commission).
4	**Threat of buyers (bondholders) growing bargaining power**	According to Arbee and Naidu (2001), a segment is unattractive if the buyers posses a strong or growing bargaining power. Buyers have the potential of forcing the price adjustments if they have a bargaining power of choosing where to procure services in an open market situation. Hence, with banks, the market is more open and unrestricted, resulting in rates/price war on service offerings compared to those of competitors. Also, poor customer service, like was the case with Saambou bondholders who were overcharged interest on mortgage loans, with the public knowledge of this sending wrong sentiments in the market and leading to the bank's demise. Mortgage loans are also not fully secured assets in terms of value, which are balanced against secured customer borrowings, and this poses a financial risk in the bank's balance sheet from the buyers perspective,

		which can lead to cash flow problems for any financial institution, including what happened with Saambou.
5	**Threat of suppliers (depositors) growing bargaining power**	According to Arbee and Naidu (2001), a segment is unattractive if the suppliers posses a strong or growing bargaining power. A supplier being a party the business falls into obligation for future payment with. Hence, in banking this is mainly classified as depositors of funds, who borrow funds to the institution. In the case of banks, the nature of that industry and its form of short to medium term capitalization render suppliers with more bargaining power, resulting in extreme competitive pressure, which results in incentives such as offering the public services at competitive rates, which in other industry can be classified as a pricing war. Hence, to proof this point beyond doubt, anything that results in poor service delivery or sends negative signals to the public can result in capital outflow from panicking depositors in a form of withdrawals and on speculative grounds, thereby leading to business failure, as it was the case with Saambou Bank. Hence, Saambou bank's demise was the result of strong bargaining power of suppliers/depositors in response of negative sentiments about the bank as perceived in the market.

Having discussed the outcome of Porters Five forces competitive strategies and inherent features thereof associated with Saambou bank, it becomes evident from the stand point of Saambou that, the acquisition by First Rand Limited did not accord the bank a competitive edge and value add from the pre-acquisition strategies that were in existence before take over. The bank's relationship and interaction with the outside world was neither strengthened nor made more effective by post-acquisition strategies from the First Rand group.

In addition, from the case above, the business approach for Saambou can be analyzed in terms of internal processes efficiencies/deficiencies and outcome of its relationship with the external environment. This can be expressed by analyzing the strengths, weaknesses, opportunities and threats which were facing the business as perceived from the above case study and theory statement citing Saambou operations. Below is the SWOT analysis of the Saambou case.

5.3 SWOT Analysis

Strengths	• The availability of differentiated service offerings to its customer base at competitive rates with flexibility of moving borrowed funds between money market investment accounts and the capital market, i.e Tradek Banking Products, re Saambou Share Manager website. The movement of funds was facilitated by the bank through secured loan funding to enable borrowers to speculate and maximize their returns from borrowed bank funds. • Diversification of service offerings, by incorporating trust property business within its business segments, and boosting pre-acquisition returns to motivate the First Rand acquisition.

	The original definition of 'financial institution' prior to amendment in 1997, did not contain the qualification that the bank or mutual bank must deal with trust property as a regular feature of its business. I agree with counsel for the first (second and fourth) respondents that the legislature realised in 1997 that the application of the legislation was potentially wider than intended and then gave effect to its true intention.
Weaknesses	• Poor Corporate Governance that led the business to its failure in cases where the bank contravened the Financial services Usury Act, i.e. by over-charging customers on interest, as a result of calculating finance charges on balances not yet due for settlement at a particular cut off point. • Weak internal control systems and processes inherent from the implementation of a computer software system (*i.e.* Twenty 20, Canadian Fincentric system) that is unique to the South African banking operations, with no relative benchmarks perculiar to South African banking operations, and with no outstanding Service Provider support in south Africa. • The imbalanced financial risk from the capital structure of the bank. Customer short-deposits which constitutes a liability obligation for the business were worth R 12.751 billion, far outweighing the mortgage book which amounted to R4.878 billion, hence leaving working capital (excl cash equivalents) in a deficit position, or in a negative short-term gearing position.

	• The acquisition by First Rand did not render synergies, as it was unlikely to increase the market share of the two banks after acquisition. (see: Competition Board Tribunal case above) • Lack of adequate skills and experienced know-how amongst the bank's management. See extract below from Saambou website about their problematic software technology (Twenty 20, which was rescued by Standard Chartered Bank) "Thank God we were so naive about what was needed to run a bank," begins Christo Davel, CEO of Saambou. Considering that he launched a bank in 18 months, found himself less than seven months later at the wrong end of a curatorship that wasn't his fault, kept the bank all dressed up with nowhere to go for another 18 months, and has had to rebuild the bank almost from scratch in the past year, this admission by the bank's CEO is stunning.
Opportunities	• Government subsidized low income housing scheme loan benefits that were directed to be offered through Saambou by government. (The *main motivator for the acquisition, which* impaired the due diligence for analysis of risks and facts surrounding the acquisition for streamlining of post-acquisition strategy).
Threats	• The acquisition had no potential for business growth within Saambou, hence competition was

	not mitigated and the price war remained intact as before the acquisition.

To further gain thorough knowledge about the business, in this case how Saambou's relationship with the outside world sufficed, and how mismanagement of the external environmental factors led to poor governance, which resulted in corporate failure. Also, in business, the discussion on strategy for business continuity centers around proper planning and decision making around four areas, i.e. Political, Economic, Social and Political (PEST) factors.

Any poor planning and bad corporate governance on PEST, jeopardizes the long term continuity of business, as per reading from Effective Strategic Leadership by John Adair.

To further analyse the above case study for Saambou, a PEST analysis on the above case factors clarifies management and First Rand Group's/FNB lack of strategic focus and vision on PEST factors for long term continuity of the bank post acquisition.

5.4 PEST Analysis

Political	• The political transformation in South Africa led to several merger and acquisition deals in an effort to facilitate corporate expansion, and for larger conglomerates attempt to achieve business opportunities accorded to small Black Economic Empowerment (BEE) sectors. The transformation led to the acquisition of smaller banks i.e. Saambou, BoE and Unibank by larger banking conglomerates in an effort to expand and for indirect participation on state accorded business opportunities to these smaller

	banks with BEE attributes. (This was a motivation for FNB acquisition of Saambou) • Bank Regulatory clauses that were transgressed by Saambou, including the wrong calculation of interest on mortgage bonds which resulted in the bank landing in debt against its customers, in transgression of the Banks Usury Act, which resulted in poor corporate image to clients and public.
Economic	• Mergers and acquisitions are intended to facilitate industrial and economic growth by giving sound economic structures of business at micro level of the economy, which translates into improved efficiencies and capacity building at both corporate and national level. • Mergers and acquisitions render maximum utilization of economic resources within firms, and results in economies of scale benefits which make companies become more cost efficient, and more competitive in service delivery pricing. (Re: Theory statement on Capital Alliance – Review of Operations above) • Hence, reason for failure of

	Saambou bank, due to its acquisition by First Rand group not fulfilling the above factors – (Re: judgement in the Saambou & First Rand Group case refered to arbitration by the Competition Commission – the judgement stated that, *the acquisition does not* indicate future growth in market share between the two banks, and will not have any impact on rendering low prices/rates as there were no foreseen economies of scale, and bigger banks could afford to intervene in pricing.
Social	• Saambou was used as a vehicle by Government to deliver its social aspirations of providing low income housing subsidies to facilitate housing loans for government employees. Being the key motivator to the acquisition by First Rand Limited.
Technological	• Banking sector by nature does not posses much in terms of technological network and assets, except for computer network facilities for rendering services with clients and outside world through LAN and WAN network facilities. Hence, technology is in a form of Information Technology (IT) infrastructure, and also in the form

	of software tools that renders service delivery to clients i.e. Fincentric/Twenty 20 canadian software installed by Saambou. • With Saambou, the above resulted in software Technology failure following the implementation of Twenty 20 software, which upon its poor implementation, operational inefficiencies were experienced by the bank resulting in customer service deficiencies, bad publicity and eventual depositors run out on the bank, causing shortfall on liquidity and downfall of the bank. Lack of adequate post implementation follow up budget, and unavailability of system back up support in RSA due to the system being a unique Canadian banking software not popular in RSA, implies that, bad business decisions affecting future outcome of operations were made when selecting operating software, by overlooking inherent risks from a software operating perspective, that resulted in operating inefficiencies.

5.5 Further Analysis of the Case

While the internal process of evaluating the target company leads to the decision to acquire or merge with the company, an extra evaluation to the normal criteria of assessing the strategic fit, revenue forecasts, and product architecture, there are a number of subjective integration related criteria such as cultural fit, management style, human resources issues and employee morale that must be included at this stage of the evaluation.

Many companies make the mistake of assigning these other factors a lower priority when making the ultimate decision to pursue the target company. Countless examples of failed mergers and acquisitions prove that when critical personnel and organizational issues driving the merger/acquisition process are overlooked in the due diligence process, the overwhelming odds are that even the most promising transactions will fail.

Chasing a merger or acquisition should be based on fundamental synergies that will add value in real sense, (reason proved not to be taken into consideration by the First Rand Saambou acquisition strategy, as evidenced by the Pre-acquisition case referred to the Tribunal by the Competition Commission – See case study above in Chapter 3). Most mergers & acquisitions are based on setting a strategy for growth with no underlying synergies. For example, perhaps because of chasing size for size's sake without no additional capacity in utilization of existing assets or in distribution channels (no economies of scale benefits), or as a result of following a diversification strategy which stayed too far from the buyer's core competencies.

First and foremost, the acquisition should be in alignment with management's overall business strategy and should provide the best fit within the entire corporate plan.

Lack of proper due diligence is another problem common to failed mergers and acquisitions. Due diligence should play a major role in reducing the risk being taken on by making an acquisition or merger.

These days part of the value of a company can be found on its intangible assets, and due diligence process will help in assessing the fair values attributable to these assets, as book values may no longer bear relevance, and whether the target company really has title to these assets.

Evaluation of other quantifiable and non-quantifiable risk areas is covered in the due diligence process on matters such as risks on imminent bankruptcy I.e. consistency and alignment of software tools and processes was overlooked in the Saambou acquisition by First Rand), significant off-balance sheet liabilities, employee retention issues and regulatory issues (contravention of the Banks Usury Act which was prevalent before acquisition, was not addressed in the post acquisition strategy as this continued even after acquisition). The anticipated outcome of these events is filtered through the valuation process for negotiation and bargaining by both parties, to avoid future failure of the acquisition based on wrong valuation assumptions not rendering expected levels of future returns.

A merger or acquisition should be undertaken as part of delivering corporate goals that are embodied in the strategic plan of an organization. To comply with the value enhancement embodied in the corporate strategies in delivering the plan, due diligence should be used to evaluate acquisition prospects that will suit the value expectations as laid out in the business plan, even before embarking on a transaction. This will allow management to expediently eliminate from consideration companies that do not fit the acquirer's goals.

Part of the valuation problem emanates from the overly optimistic culture of individuals when attributing value to underlying synergies. This is often because the source for synergies has not been thought through correctly. Merging with a company in the same industry for growth in market share and for economies of scale is a valid reason, (reason unfulfilled in the title and case study example inherent in this project). But attention may not be paid to the accounts that may be lost as a result of the merger, and or the Regulator's and Competition Board's intervention to keep competition alive by protecting other licenced entrepreneurs by regulating tariffs to a level where competitive pricing cannot be exercised to lure customers from competitors (First Rand acquisition of Saambou was declared not conducive to effecting competitive pricing, as the foreseen result was no growth in market share between the two banks, with no inherent economies of scale benefits) , but only resulting in increased margins without real economies of scale emanating from the merger.

In light of the above, it can be seen that the objective for market share growth can be impeded by tariffs and regulatory issues, (for which the Saambou acquisition as indicated in this project, did not have such impact that could lead to the Banks Regulator intervention, or price war between banks in the same industry), and if these strategic reasons and outcomes cannot be analyzed in a way that produces numbers that make valuation sense and in identify any value add to the transaction if any, then probably the deal will be based on wrong reasons, and the company should consider not to embark on the deal at all, or otherwise the same company can later be announced selling the stake it recently acquired or undergoing the process of restructuring and rationalization shortly after the deal.

Saambou Service levels

As per on-line publication dated Oct, 2003. http://www.bankgate.co.za/Saambou service levels.htm, the bank inherited bad publicity through its service levels to customers. Service delivery was below acceptable standards, with bad news pertaining to poor service delivery being made public and damaging the bank's image, and resulting in its loss of value to investors in the capital markets.

Also, non compliance with the banking industry's governing rules and regulations (i.e. contravention with the banks Usury Act) led to loss of confidence by the market and the investors, and ultimately leading to erosion of capital, liquidity and market and customer confidence for the bank.

Hence, the above factors occurred even post acquisition period of Saambou by First Rand Group, to highlight the fact that, the acquisition was mainly market driven to facilitate First Rands indirect participation in the Government granted low income housing schemes market segment, of which Saambou was granted the opportunity of financing and delivering.

The post acquisition strategy for First Rand group did not cover overall elements of governing the acquired bank, and no overall review of policies and business processes was undertaken, and improved to ensure better service delivery, efficiency and effectiveness of operations amid the bank's failure post acquisition by the First Rand Group. Hence, the following statement from the Saambou website justifies the above reasons on Saambou's bad service levels.

The Road to Destruction

In the early 1990's, Mr. Johan Myburgh, a member of the Afrikaner Broederbond was appointed Chief Executive of Saambou Bank. For years, he was one of South Africa's most respected Bankers. In 2000, he was honoured as Pretoria's man of the year. Year after year, everyone listened to Myburgh's entertaining presentation at "Profit Announcements" and enjoyed the refreshments provided.

However, he achieved his goals to the detriment of his clients and staff.

In 1995, Saambou Bank paid admission of guilt for charging illegal administration fees on clients' personal loan accounts. In the media, Saambou admitted that all of their 90 000 client accounts were recalculated and corrected. It was later revealed that a mere 264 clients were refunded.

The Commercial branch of the Police is currently investigating *seven* different contraventions of the Usury Act against Saambou on personal and home loan accounts.

During the past 2 years, Emerald van Zyl had assisted 135 Saambou bondholders in stopping the sale in execution of their properties following action taken by Saambou against so-called "defaulting bank clients".

However, after recalculation of the accounts, it was discovered that the clients had been incorrectly debited, and were not in arrears at all.

In one matter, Saambou summonsed a client for R 46 000 which it alleged was outstanding on his bond, but recalculations proved otherwise - the client had overpaid Saambou by R 54 000.

Saambou's share prices plummeted as bad news and rumours grew, Saambou faced losses on its home and personal loan book because of Usury Act violations.

Directors began selling shares - massive interest free loans to the value of more than R 200 million (now worthless) were made to staff to entice them to buy Saambou shares, and one wonders how many more examples of blatant corporate deception will come to light before the Officers of this company are punished.

They have robbed Peter to pay Paul on investments, and we will be going into more detail about this very soon.

This is how Saambou Bank contravened the directives of the the Usury Act:-

Mortgage Loans: -

- Interest in advance - no credit interest for payments.
- Increasing interest rate when the account is in arrears
- Illegal administration costs and other diversifications
- Increasing homeowners insurance when account is in arrears.

Personal Loans: -

- Interest - Exceeding the Usury Act ceiling on non-exempted loans.
- Unlawful administration fees
- Unlawful interest charges on single premium life insurance for longer than 12 months.
- Credit life Insurance covering a period of more than one year
- Failure to provide proof that the amount charged was paid over on behalf of the client to the life assurer.
- Interest above Usury Act limits on loans where the sum advance, plus the insurance premium exceeds R 10 000.

Hence, the absence of a standardized operating and financial system within the First Rand Group due to Saambou being acquired only for the sole purpose of taking over the Government subsidized low income housing schemes, led to a lack of focus and strategy of maintaining uniformity of approach to operations and processes within the group. This can be evidenced by the above stated contraventions to the directives of the Usury Act.

Processes for maintaining efficiency and effectiveness of operations were not given attention at the stage of signing the deal, the due diligence exercise was not comprehensive to cover these issues. Hence, lack of standardized processes of operation due to different control systems being applicable within the banking group resulted in non-uniformity of operations within the business units, and those that were non-core to the scope of the First Rand business ended up in failure.

The above can be evidenced by Saambou's conversion from a banking on line system called 20Twenty to Fincentric. The latter was not applicable to core banking operations of the First Rand group, and also new system with less back up support service in South Africa, thereby adding to the post acquisition operational risk of the merger and acquisition deal.

According to Correia *et al.*, (1993), another reason for mergers and acquisitions is the resultant economies of scale for cost optimization, particularly for horizontal mergers and acquisitions.

In the case of Saambou bank, the acquisition led to the bank's lendings (especially in the low income housing segment) exceeding borrowings by the bank, and the timing of borrowings not balanced with that of recoveries of monies from lendings, and hence resulting in liquidity problems from the imbalanced timing of cash flows and imbalanced inherent risks from the recoveries and settlement of cash flows.

The reason for the bank's failure was on liquidity, which was not given attention as part of due diligence strategy for Saambou's post acquisition business plan.

The above factor can be explained further below,

5.5.1 Lack of product diversification

Saambou was operating in a risk oriented environment, stirred by the nature of Saambou's business of borrowing money and lending it out again, the funds became part of and commingled with Saambou's assets, whose recovery was not secured, whilst the deposit with bank were secured. From the inherent level of business risk in this regard, the short term nature of the business comprised of foreseeable liquidity risk, which required to have been balanced off by diversifying risk through the restructuring of service offerings to embrace medium to long term investments to secure funds for a further period, to avoid instant deposit withdrawals in few days that led to the cash flow problem that dissolved the bank.

Post acquisition lack of risk diversification, through a broadened product mix that can sustain cash flows over a longer timeframe resulted in failure of the business, since the bulk of liabilities/obligations were of short-term nature, and that constituting core part of the business financing.

See an extract below from the website on practice Management – Bank Failures

Practice Management - Bank failures

Were s 78(2A) investments 'trust property' separate from Saambou's assets?

On investing the moneys with Saambou, the incorporated practices entered into separate relationships as clients of Saambou (the debtor) by investing moneys as creditors on behalf of their clients. The letters of the applicants stating that moneys had to be available immediately for transfers of immovable properties merely meant that they could not be placed in a medium-term or long-term
investment. They had to be invested 'on call'.

Customer deposit (banks liabilities) are secured funds, which translate into unsecured bank's assets resulting in risk of failure. Deposits/liabilities are deemed similar to funds held on trust on behalf of third parties.

I am of the opinion that the position of the money deposited in an attorney's trust account and the relationship between the bank, the attorney and the attorney's clients is still the same as prior to 23 November 2001 (when the FI Act commenced) and as stated in the following cases:

If the judgment is correct, by implication it has the result that one can argue that most deposits by clients with 'financial institutions' will be 'trust property'. Commercially speaking, I cannot think of any 'financial institution' which will receive money into an interest-bearing account without any opportunity to 'make money' with such money to derive a profit there-from to enable it to pay the interest and make a profit for shareholders.

From the list of cited cases by the Competition Commission of South Africa in deciding whether the First Rand Group acquisition of Saambou bank will have any competition implications conducive or not conducive to the national economic framework for approval or disapproval of a merger or acquisition, the case for First rand/Saambou acquisition was recommended to the Tribunal by the Competition Commission, and referring to the case study in chapter Three below were the motivational facts and assumptions by the Tribunal in passing judgement the case, and the outcome of the tribunal thereof in terms of the impact of the acquisition and lack of inherent synergies thereof.

Hence, from the facts of the case, inherent liquidity risks can be established, for which the acquirer did not give much attention when laying out the post-acquisition strategy of running the business, and ultimately resulting in problems of liquidity, and mismanagement of systems and processes, which led to the post acquisition failure of the bank.

5.5.2 Motivation for the Saambou acquisition

Below, are real motivating factors which set the criteria for mergers and acquisitions. The main force behind the deal between Saambou and First Rand, which was to allow FNB's indirect participation in the growing mortgage bond loan business accorded to Saambou by the Government low income housing subsidy scheme, did not realize the expected synergies, as it was evident from the beginning that, this will not render growth in market share between the two banks, and will not have competitive effect and benefit in pricing to the end customer – See pre-acquisition case refereed to the Tribunal by the Competition Board.

All the highlighted criteria below which sets the trend for successful mergers and acquisitions were not embraced or achieved in the First Rand Saambou deal.

Mergers and acquisitions are an important part of South African corporate life, and it is therefore relevant for us to analyze the reasons for business amalgamations both at a micro and macro level and how to set the terms for a successful deal.

Mergers and acquisitions involve the supply and rotation of resources and if successfully carried out they stimulate economic activity.

The idea starts at a micro or corporate level, whereby the whole reason for embarking on a merger/acquisition is to facilitate external business expansion for maximization of shareholders returns via synergies inherent in a merger or acquisition deal. While, at macro level the whole idea and intention is to attract foreign investment and privatization of state owned enterprises, as is the case now in South Africa.

5.6 Reasons for mergers and acquisitions

5.6.1 Micro purpose

Business expansion is essential in the South African economy for the purpose of sustaining and increasing economic growth and employment levels.

Properly conducted due diligence results in efficient and effective planning and integration process of business amalgamations, at precise values and expectations of post amalgamation results. Proper due diligence allows the setting of a successful integration strategy and strategy for going forward with the business post amalgamation business plan. Also, due diligence to a larger extent eliminates the risk of uncertainty in setting the plan for managing the business after the transaction has been concluded. With due diligence, the chances for risk exposure and business failure are exposed and strategies set forthright on how to curb them, and at what price can the transaction take place amid known present circumstances and future results that are made probable.

Hence at corporate level, synergistic benefits for maximizing corporate returns for investors and creation of employment in the economy are key objectives that must be supported with proper conduct and approach on how to make mergers & acquisitions become successful.

5.6.2 Macro level

In South Africa there is a drive to bring foreign investment through the privatization of state owned enterprises. In compliance with the World Bank and IMF's policy for Structural Adjustment Program, which advocates that developing countries must hand over their state owned assets to private hands for more efficient management of resources and inflow of foreign capital to repay their foreign and national debts and for investment in social activities.

Through mergers and acquisitions, inflow of foreign capital is made possible through the merger of state enterprises with foreign investors who inject capital to become partners in a merger or joint venture agreements with local investors. An example would be the foreign investment to be generated out of the foreign bids for second fixed network operator in South Africa.

With mergers and acquisitions, some companies gain international listing i.e. Telkom shares traded in London Stock Exchange, give companies exposure to foreign capital to facilitate the financing of projects for expansion.

The favourable impact is that of improvement in the Balance of Payments through cash inflow in the capital account of the Balance of Payments and underpinning of the value of the Rand by the likely inflow of foreign currency reserves.

Hence mergers and acquisitions play an integral role in streamlining the economy both at micro and macro level, therefore proper due diligence process for mergers & acquisitions to avoid their failure remains important at corporate and national level.

5.7 Value of Project

Value of this project is determinable from the suggestions and recommendations that came out of the research exercise, and to what extent will its findings and recommendations add value or provide new insight knowledge to the practitioners in this field of mergers and acquisitions.

The research was aimed at providing more information and optimal approach in the conduct of due diligence and business valuations issues that facilitate the acquisition transaction, and guidelines in formulation of best strategies for integration and post amalgamation running of the business, with risks known, analyzed and policies set to overcome such during due diligence.

Acquisition strategy weaknesses and recommended guidelines on the above will contribute value to the field experts and potential candidates in this field, and research results will be of relevance to the Corporate Finance divisions of the Investment Banking Groups, for their advisory role to their clients and financing of clients for mergers and acquisition deal purposes.

Checklist of items for reference to future transactions

- How best to conduct due diligence
- Checklist of due diligence procedures and guidelines to avoid possible risks and in formulating the most effective business strategy for integration and post amalgamation operations.
- Best options and means of ensuring accuracy in merger/acquisition valuation deal.
- Evaluation criteria leading to decision making on whether, and on how to invest in an acquisition deal.
- How to base post transaction expectations and possible means of measurement against actual results.

Assurance on all of the above will imply that, there is a clear course of action on how to embark on a deal and that value can be quantified and risk minimized in the process of a merger or acquisition.

5.8 Interview Results

This section presents the results of the interviews, and is structured in accordance with the key research questions as set out in Appendix 1, following elite interviews that were conducted with David Thayser, partner for Corporate Finance at Ernst & Yong, and Harry Kelan, Executive Manager for Investment and Corporate Acquisitions for HSBC.

Question 1:

Describe the key elements motivating M&A activity in industry?

Response:

The general view from the respondents is that the M&A activity is driven from a corporate objective of maximizing shareholders wealth by mitigating business risks from diversification of investments, to take market opportunities through direct and indirect participation in various of market opportunities, sustain market share dominance, and opportunity to acquire skills from different sectors of industry, as well as for integration of resources through business combinations.

Question 2:

What are the risks involved in corporate M&A deals?

Sub questions

a) What are the financial risks associated with poor planning for deciding on a deal for acquisition and mergers?
b) From a post acquisition perspective, what are the critical common operating risk factors leading to failure in M&A deals?
c) What risks were associated with the Saambou First Rand acquisition deal?

Response:

In terms of the respondents perceptions about issues pertaining to risks, the prevailing overall view was that, risks are drawn from a broader perspective of the business, which involves the financial risks associated with the capital restructuring of the Group's balance sheet after M&A transaction, which results in amendments in gearing and working capital structures as a result of the deal, also, from an operational perspective, the value in use for determining future financial performance upon which valuation is based, can be impaired by risks of operational nature which involves risks from wide range of factors like marketing, legal and regulatory issues which may not suit the business moving forward into the future, human resources mismanagement and others.

The whole aim of due diligence is to focus on the above wide range of issues, analyse them and suggest strategies for incorporation into the post-integration business plan, which also must be used to decide on value for the acquisition.

The respondents view about the risks associated with Saambou acquisition were that, the acquisition was driven by market factors to acquire opportunities that were availed to smaller banks by the government to financing of lower income housing schemes, which larger banking groups were not introduced to. However, the interest was on market expansion, and overlooking the inherent governance problems and capital structure inefficiencies within Saambou, of which were not assigned strategies in the post acquisition business plan by the First Rand Limited.

Hence, the bank was forced into curatorship upon the inherent inefficiencies being exposed to public, and with few large corporate clients withdrawing their deposits, this attracted negative market sentiments resulting in other depositors withdrawals and within little time leaving the bank illiquid, due to its inherent non-optimal capital structure.

<u>Question 3:</u>

What are the essential elements required to develop an effective strategic plan to cover post-acquisition business operations?

Response:

The respondents view was that, the objective/s that motivated the M&A deal should be adequately addressed in the strategic plan following the acquisition. There should be strategic initiatives covering the main objective/s for the acquisition, these should be tested for feasibility and be measurable against the plans. Budgets and financial projections for such strategies should be evaluated against the deal, prior to making an acquisition, in order to ensure that the acquisition price covers all factors to the business plan.

Question 4:

What lessons can be learned in a deal whereby the acquisition has failed to deliver the expected synergies, such as the Saambou deal?

Response:

There are various lessons to be learned, amongst them, is that, companies do not acquire others for the sake of utilizing their surplus cash resources to acquire market opportunities under which their investment decisions were not properly evaluated, and post-acquisition business plans not detailed to address key inherent operational inefficiencies.

Due diligence should not be taken for granted, but must be followed strictly to address all levels of operations of both strategic and operational nature, with quantification of the financial impact of such operations, including development of post integration strategies for their management.

Chapter 6: Recommendations and Conclusion

6.1 Summary of major results

This research was basically intended at sensitizing corporate bodies about the investment risks inherent from embarking on a merger and acquisition deal. The inherent facts from the above case, have been interpreted and evaluated using Porter's Five Market Forces model, SWOT and PEST analysis.

The main weaknesses exposed from Saambou bank, which the acquirer, First Rand Group failed to manage, as a result of its lack of post-acquisition strategy which did not embrace post –acquisition synergies from the deal are as follows:

- Poor governance procedures, including the non-compliance to the Bank's Usury Act procedures for charging interest on customer accounts. This to a larger extent tainted the bank's image and customer service reputation.

- Risk management was a key factor that led to the bank's failure. The inherent liquidity risk from imbalanced numbers in the level of customer deposits to borrowings given by the bank, resulted in the one major customer (Investec) deposit withdrawal of R1bn as a result of negative sentiments drawn by the market from inherent management inefficiencies, leading to the rest of the customers withdrawing their deposits to render the bank illiquid.

- The reason for the acquisition, which was driven from First Rand Group's perspective of taking advantage of the market opportunity of government's low income subsidy housing scheme loaned to employees via Saambou bank, was not properly risk managed to justify viable returns.

M&A involve a process that must be followed consequentially to ensure that no stones are left unturned in evaluating a deal, as omission of some evaluation factors could render the transaction fruitless, as the companies could transact on wrong or incomplete elements of the deal, which do not portray the true value of the deal in its present value context, and value moving forward inherent in the post acquisition strategies.

Important motivators for M&A, which must be aimed at being achieved by the post acquisition strategy to make the transaction a future success, are as follows, as per Correia *et al.*, (1993:666).

- Increase future returns through economies of scale
- Bring product and service diversity to embark or dominate new and existing market segments (increase market share)
- Optimize competition, cost structure and enhance quality and efficiency – (via increased operating volumes and capacity, and by acquiring target company reputable management skills)
- Tax considerations including taking account of assessed tax losses of the target company with potential returns to avoid exposure to Corporate tax on current profits of the acquiring entity.

The first three reasons which influence corporate acquisitions, appears not to have been given enough attention on the post-acquisition strategy for First Rand acquisition of Saambou bank, as in overall it implies that the status quo was the case even after acquisition. There appears to have been no or not significant post –acquisition change management process within the acquired bank to drive new strategy.

Hence, the above factors, if read in conjunction with the facts inherent in the above Saambou bank's case, its evaluation and theory study above, will give useful insight information to companies intending to embark on M&A deals, and to Investment Bankers undertaking an advisory role in M&A deals to their clients, on what elements to look for in planning for an M&A, and in drawing up a post-M&A strategy for embracing synergies for the new business.

6.2 Recommendations (Process and approach)

This covers, amongst other factors, things that must be considered by potential buyers before signing off on an M&A deal,

- Compliance to Regulatory issues that must be covered in a deal, including regulatory aspects of the Bank's Usury Act and the Public Finance Management Act (PFMA).

- Planning for risk management processes. As part of due diligence process, current and potential risks should be identified, and risk management policies embedded in the post acquisition strategy. An example, was the imbalanced timing of liabilities (deposits of short-term nature) used to finance assets (of medium to long-term nature), which resulted in problems of liquidity when customers withdrew savings. Hence, there was a need to plan for the restructuring of the Balance Sheet, as part of the post acquisition strategy for Saambou bank.

- With reference to a summary of Sahakian's due diligence checklist, from Woodbridge Group - M&A specialists who are leading middle market investment banking firm, the key factors to note and cover within the due diligence exercise are as follows, the identification of risk factors pertinent to the business, strategies to manage risk as part of the post acquisition business plan, build in the cost of managing risk in future business as part of the valuation exercise for the acquired or merged entity, and the strategy implementation plan thereof.

6.3 Conclusion

Based on the limitations inherent from the project, the following conclusions can be drawn:

Overlooking the inherent inefficiencies of the target company, resulted in First Rand Limited continuing to overcharge customers for interest, which amounted to a transgression of governance procedures prescribed by the Bank's Usury Act.

Lack of efficient and effective management skills of the acquired bank, which ultimately led to systems and control inefficiencies, i.e. below, a statement made by Saambou CEO to this effect.
"Thank God we were so naive about what was needed to run a bank," begins Christo Davel, CEO of Saambou.

Considering that he launched a bank in 18 months, found himself less than seven months later at the wrong end of a curatorship that wasn't his fault, kept the bank all dressed up with nowhere to go for another 18 months, and has had to rebuild the bank almost from scratch in the past year, this admission by the bank's CEO is stunning.
Also, operating inefficiencies inherent from the bad implementation of a Canadian operating software system called Twenty 20, which was not well implemented, had no post implementation follow up budget to address implementation problems, and with no adequate Service Provider back up support in South Africa.
Financial risk of the bank's capital base residing on a few large corporate depositors, which in the case of withdrawing their funds, the business effectively becomes illiquid, and subject to curatorship. I.e. R1bn withdrawal of Investec deposit from saambou, called the shots for the bank's curatorship.

6.4 Summary

Due to the fact that most corporate expansions are facilitated through mergers and acquisitions, more than is the case internal expansion for investment on capital projects, it becomes evident that the South African economy is more reliant on mergers and acquisitions for enhancing more economic activity at corporate level and in ensuring that employment levels are retained or increased, also rendering more state revenues by way of taxes from the increased returns based on inherent synergies from successful outcome of mergers and acquisitions.

While at macro level, this helps attract foreign investment and capital needed for economic growth in this country.

In the foregoing, it is therefore evident that successful outcome of mergers and acquisitions can lead to industrial and economic growth.

This research study is therefore intended to formulate logical steps and approach for optimizing due diligence in order to facilitate prudent investment decisions and successful implementation of strategies for realization and achievement of intended synergies.

APPENDICES

Appendix 1 – Interview Questionnaire

Question 1:

Describe the key elements motivating M&A activity in industry?

Question 2:

What are the risks involved in corporate M&A deals?

Sub questions

d) What are the financial risks associated with poor planning for deciding on a deal for acquisition and mergers?
e) From a post acquisition perspective, what are the critical common operating risk factors leading to failure in M&A deals?
f) What risks were associated with the Saambou First Rand acquisition deal?

Question 3:

What are the essential elements required to develop an effective strategic plan to cover post-acquisition business operations?

Question 4:

What lessons can be learned in a deal whereby the acquisition has failed to deliver the expected synergies?

Appendix 2 - Capital Alliance – Review of Operations

The relevant text referred to in the Literature review, provides an emphasis to inherent synergies common in acquisitions, mergers and integration of business activity. This is portrayed inherent synergies in Capital Alliance review of Operations, referred to in the Appendix below. Accessed on the website for http//www.msn.search/Capital Alliance/Review of Operations.htm.

OVERVIEW

During the period under review, the group focused on the following areas:

- Integrating the Fedlife policy data onto the Capital Alliance Life operational platform;
- The concluding acquisitions of life insurance companies. This was achieved with the acquisition of Saambou Life, effective 1 November 2002 (after all regulatory approvals were obtained):
- Increasing the base of policies administered, achieved with the reinsurance and administration of the IEB pensions annuity book, effective 30 September 2002;
- The managing of expenses, persistency, mortality, morbidity and investment returns (which are the main embedded value drivers) in order to maximise the operating profits in the year and the present value of future profits on the in force business;
- Providing distribution partners with products that demonstrate attractive value propositions and grow the group's policy base by means of new business (merger); and
- Continued improvement in new business activities undertaken on the Capital Alliance brand, being group risk business written by the Corporate Risk Solutions division and individual life business written by the Capital Alliance Life Commercial division.

The above activities are considered critical in achieving the group's stated objectives of:

- Enhancing customer service;

- Reinforcing the culture of cost effectiveness (derived through economies of scale benefits that motivate merger and acquisition deals); and

- Growing embedded value, through optimization of risks inherent from variables outside the key objectives driving a merger and acquisition deal i.e. post acquisition strategy and Group policy formulation on prevention and minimization of mortality rates to avoid increased level of claims, optimize future cash flows, and to enhance future new business returns to outperform historical returns in obtaining M&A synergies.

Lack of post-acquisition strategic focus on securing values inherent from the new business led to the post acquisition downfall of Saambou bank. First Rand's lack of focus in coming up with a competitive strategy to secure customer deposits from future competitive withdrawals, and lack of focus in building customer confidence and reputable brand name for the bank in all its service streams resulted in portrayal of non-confidence on the bank by customers, and sudden continual stream of deposit withdrawals which left the bank illiquid.

As a consequence of the reinsurance transactions concluded during the 2002 and 2003 financial years and the acquisition of Saambou Life, the group's activities are now primarily life insurance related and hence this review focuses on its life insurance activities.

Also, no proper restructuring and reorganization of activities was done subsequent to the Saambou acquisition. Implying that, there was no rightsizing and streamlining of services to allow the new business to focus only on risk controlled and value add activities across all service range. Hence, risk based service offerings which had no post acquisition strategic approach, led to the overall failure of the bank, despite inherent business opportunities like low income government driven housing loans offered by the bank.

The Capital Alliance group has a number of other investments, mainly the 30,83% interest in Nova Group Holdings Limited, a company active in both life and non-life cell captive insurance and an effective 39% interest in Prefsure Life Limited ("Prefsure Life"), an Australian life insurance company. Both of these investments performed well in the year and are on track to deliver the shareholder return objectives set at the time of the original investment.

CAPITAL ALLIANCE LIFE

Capital Alliance Life had a good year, characterised by:

- the completion of the Fedlife integration projects onto the Capital Alliance Life operations engine ahead of time and within budget
- the acquisition of Saambou Life and subsequent integration of the policy book onto the Capital Alliance Life operational platform;
- the conclusion of the IEB annuity reinsurance transaction and subsequent integration of the annuities in payment onto the Capital Alliance Life operational platform;
- further enhancement of client service levels;
- achievement of planned renewal cost savings;
- a substantial increase in the embedded value of new business;
- good persistency in respect of the in force business and retention of new business written;
- a relatively good investment result in a weak investment period; and meaningful progress in the transformation of the company in terms of the group's empowerment strategy.

A) Service levels

The conclusion of the integration projects listed above gave rise to substantial cost savings, which in turn led to increased profits in the year and enhanced the value of business. They also allowed the group to offer enhanced service to clients. Service level turnaround times were shortened in order to deal with queries more quickly and more efficiently. Table 1.1 below indicates the improvement in both Service Level Agreements ("SLA's") and achievement of SLA's for Fedlife clients:

Table 1: Improvement in Service levels

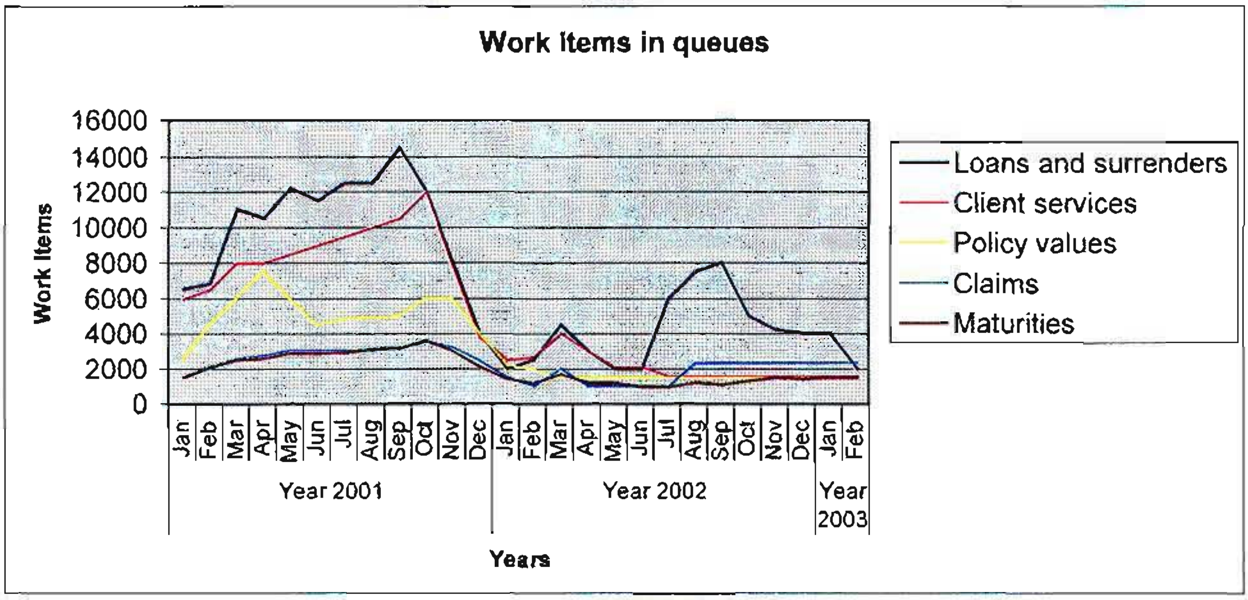
	Service level	Achievement	Service level	Achievement	Service level	Achievement
	August	August	May	May	May	May
Item	2001	2001	2002	2002	2003	2003
		%		%		%
Scanning	Current	0	Current	100	Current	100
Refunds	5 days	5	5 days	100	1 day	98
Premium queries	5 days	5	5 days	100	2 days	95
Premium reconciliations	30 days	40	5 days	100	2 days	95
Complex alterations	10 days	80	5 days	100	1 day	96
Other alterations	10 days	70	5 days	100	1 day	98
Death claims	50 days	80	5 days	100	2 days	100
Surrenders	20 days	80	5 days	100	1 day	98
Loans	20 days	80	5 days	100	1 day	100
Value calculations	20 days	80	5 days	100	2 days	99

Please note the following:

- The information for August 2001 is prior to the reinsurance and administration agreement i.e. indicates SLA's provided by Fedlife to clients;
- The information for May 2002 indicates the improvements brought about by the group prior to the integration; and
- The information for May 2003 is after the conversion of the Fedlife data onto the Capital Alliance Life operations engine.

The improvement in service levels is also evident when looking at the number of outstanding work items in queues over the period January 2001 to January 2003 as reflected in Graph 1 below (note that the increase in client service items in June 2002 was due to pre-conversion clean ups):

Graph 1: Work items in queues



The group was invited to enter the "Call Centre of the year" competition run for banks, insurers and other financial services companies and was pleased to be placed 5th against a very competitive field. The improvement in service delivered by the call centre is shown in Table 2 below:

Table 2: Improvement Call Centre statistics

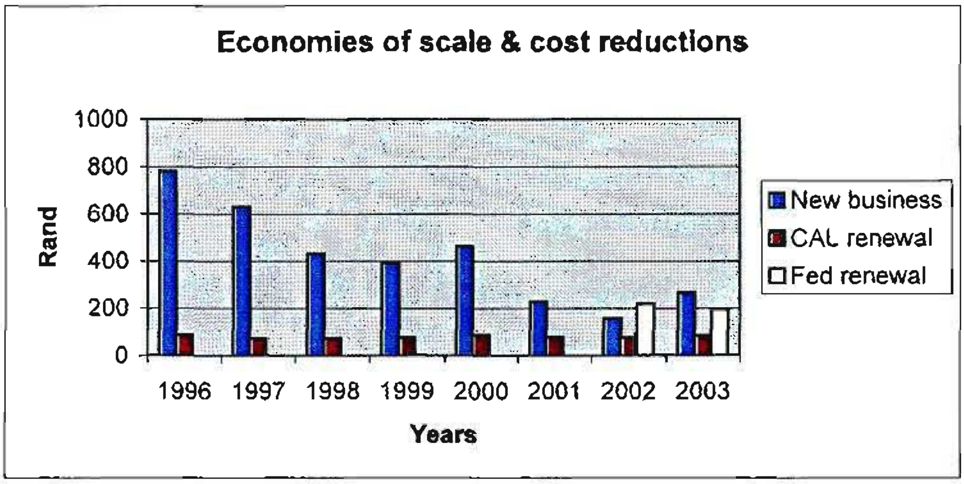
Item	August 2001	May 2002	May 2003
Service level (80% answered in 45 seconds)	60%	77%	93%
Average queue time	180 seconds	37 seconds	25 seconds
Incoming calls	6 200	4 561	2 896
Abandoned calls	15%	6,5%	3,4%
Average talk time	240 seconds	173 seconds	143 seconds
Number of agents	66	50	37

In order to further improve service delivered to policyholders a new range of maturity extension products was launched. These products offer clients with maturing funds, who do not require immediate use of these funds, a secure, tax efficient and low cost vehicle in which to house their matured policies until they require the funds. This product range has been branded the "Future Select Capitaliser" and has achieved a good level of acceptance in the short period since launch.

B) Optimization of Expense management

As a consequence of the completion of the various integration projects, which reduced overall costs and increased the volume of policies administered, the group managed further reductions in per policy costs for Fedlife. The per policy costs for Capital Alliance Life increased in line with the valuation assumptions, as can be seen from Graph 2 below:

Graph 2. Economies of scale and cost reductions



Please note the following:

- Figures are given in nominal amounts per year i.e. comparatives are not adjusted to compensate for inflation. In real terms unit costs have reduced in most periods and;
- The Capital Alliance Life renewal costs over the year were affected by the termination of a block of 50 000 policies. Had this termination not occurred the cost per policy would have remained constant in nominal terms from 2002 to 2003.

The group remains on track to achieve further cost savings during the course of the 2004 financial year.

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