Effect of Mergers and Acquisitions on the Financial Performance of Commercial Banks in Kenya

Ouma Duncan Otieno[1] Simon Linnet Kemunto[2]
1.PhD Student University of Nairobi School of Business Department of Finance and Accounting
2.MBA Graduate Kenyatta University School of Business Department of Finance and Accounting

Abstract
The study focuses on the effects of merger and acquisition on the financial performance of financial institutions in Kenya. The study adopts a descriptive study design using event study model to analyse the relationship existing between the accounting ratios (EPS, ROA and ROE) as measures of financial performance. The study finds that that merger and acquisition events results into either increase or decrease in the financial performance. The significance test finds that the p-value for EPS, ROA and ROE and were 0.587, 0.069 and 0.597 respectively, all greater than 0.05 signifying that the financial performance deviated significantly from the means recorded before the merger. The cumulative abnormal mean performance of EPS, ROA and ROE to 0.167, 5.274 and -1.823 respectively, hence the study concludes that merger and acquisition positively affect financial performance of commercial banks. The negative ROE is attributed to the single extreme negative performance recorded by ECB. The study recommends that managers to consider taking the corporate action to take advantage of the benefits of mergers and acquisitions.
Keywords: Mergers and Acquisition, Financial performance, Commercial Banks

INTRODUCTION

Mergers and acquisitions is a business strategy that has been invoked consistently by corporate organizations world over, with an intension to among other reasons gain their market share, gain and maintain competitive advantage, improve financial performance, minimize risk and to facilitate product diversifications (Maditinos, Theriou & Demetriades 2009). Merger is defined as the combination of two or more organizations into one larger organization in a process that is commonly voluntary and often results in a new organizational name (Moctar & Xiaofang, 2014). An acquisition, on the other hand, is the purchase of one organization by another in a process that can either be hostile or friendly and the acquirer maintains control over the acquired firm (Indhumathi, Selvam & Babu, 2011).

Mergers and Acquisitions (M&A) therefore, results into the change in ownership, business mix, asset mix and alliance with the view to maximize shareholders' value and improve firm performance (Pazarkis et al, 2006). Some of the benefits of mergers and acquisition are; rapid access to technology and products, an extended customer base, an enhanced market position and a stronger financial position. This not only provides an opportunity for sales of existing products to a larger group of customers, but also provides a greater base for future product sales. In addition, consolidated companies can own a greater share of market, which gives them a substantial competitive advantage. Mergers and acquisitions also benefit companies wanting to reposition themselves in the market. By adding capabilities to their product offerings, companies can rapidly expand their market coverage, modify their market position and enhance financial performance (Kithitu, Cheluget, Keraro, & Mokamba, 2012).

Financial performance relates to the overall financial health position of a firm over a given period of time, as measured by profitability in most organizations. The level of profitability in organizations is determined by the gross profit margin, and the earnings before interest and tax (EBIT) margin, which helps firms to assess the efficiency of the companies in the utilization of its assets to generate revenues (Pandey, 2008). Merger and or acquisition improve efficiency in the resource utilization of the consolidated resources to improve financial performance as a result of the increased capital and customer base as well as acquisition of new technology and competence.

Finance signalling theory asserts that capital markets react to information released into the market, based on the investor perception and expectations after receiving the information (Elton et al, 2009). This means that corporate decisions such as mergers and acquisition may signal either positive or negative future performance of the firms. Differential Efficiency theory indicates that mergers increase the efficiency of firms, especially when a firm with inefficient management team mergers with another with efficient systems. Equally, Financial Synergy theory asserts that upon mergers and acquisitions, the combinations of firms with different financial positions and investment opportunities may produce a financial synergy effect through capital adequacy that eventually achieves lower cost of capital as a result of the lower costs of internal financing versus external financing (Bose, 2014)

In Kenya, merger and acquisition is a strategy that has been widely used by firms to grow their asset value and increase their market share. According to CBK (2014), 20 financial institutions have been engaged in either a merger and or an acquisition since years 2000. The aim of this study is to try understanding whether such mergers impacted the financial performance of the firms in the post-merger period compared to the pre-merger period.

Several studies with mixed findings have been undertaken to look at the effects of mergers and acquisitions on the financial performance of firms. For instance, Kanahalli and Jayaram (2014) found no relationship between merger and acquisition and financial performance of firms in India, Pazarskis et al. (2006) found that financial performance as measured by profitability decreased after a merger and acquisition on firms in Greece, while studies by Mboroto (2013) and Marembo (2011) in Kenya, and Girma et al (2011) in the UK found that there was a positive relationship between mergers and their financial performance. This means that there is no consensus on the effect of merger and acquisition on financial performance. This study therefore intends to fill this gap to help corporate organizations both locally and internationally to have a general understanding of the direction of financial performance in firms upon a merger and or acquisition.

The main objective of this study is to investigate the effect of mergers and acquisitions on the financial performance of commercial banks in Kenya.

LITERATURE REVIEW

This study is anchored on three theories; finance signaling theory, financial synergy theory and differential efficiency theory.

Finance Signaling Theory

The theory is based on the premise that the higher the information asymmetry level, the higher the sensitivity of future returns. This point to the fact that, capital markets respond to information reaching it depending on the perception and expectations of the investors, upon receipt of the information (Elton et al, 2009). In this respect, corporate decisions such as mergers and acquisition may signal the direction of future performance of the resultant company. Therefore, this study looks at the direction of financial performance of firms upon a merger and or an acquisition.

Financial Synergy and Differential Efficiency Theory

Differential efficiency theory states that mergers increase the operational and managerial efficiency of firms, especially when a firm with inefficient management team mergers with another with efficient systems. Financial Synergy theory on the other hand asserts that upon mergers and acquisitions, the combinations of firms with different financial positions and investment opportunities may produce a financial synergy effect through capital adequacy that eventually achieves lower cost of capital as a result of the lower costs of internal financing versus external financing and improves asset quality (Bose, 2014). Tax saving is another consideration and the improved debt capacity may be greater than the sum of their individual capacities before the merger.

In reviewing related literature, a study by Marangu (2007) that focused on the effects of mergers and acquisition on financial performance of non-listed commercial banks in Kenya found significant changes in the post-merger results. The study targeted firms that merged between 1994 and 2001, and the analysis done based on profitability, total assets and shareholders' equity, return on assets, and analysing total liabilities. The study found a significant increase in profit margin, returns on assets, and return on shareholders' equity above the significance level of 0.05. The study concluded that mergers and or acquisition have significant positive effect on the performance for the non-listed banks.

Girma et al (2011) did a study on the impact of mergers and acquisitions on profitability and employee remuneration in UK manufacturing industry. The results showed that both profitability and wages increase after a merger or acquisition, and firms that merge within the same industry division experience larger increases in profitability and pay their workers higher wages than those engaged in unrelated acquisitions.

A similar study by Marembo (2011) investigated the impact of mergers and acquisition on the financial performance of commercial banks. Using a sample of 27 banks that had merged, the regression analysis established that the return on asset and return on equity of the significantly improved. The firms posted higher profits and became financially sound in the post-merger period as a result of the increase in the market share.

Akinbli and Kelilume (2013) also investigated the effects of mergers and acquisition on corporate growth and profitability of firms in Nigeria. The researchers found that while mergers and acquisitions can drive growth and profitability in some organizations, operating efficiency suffers at least in the short-term in the post-merger and acquisition corporate entity. The evidence also shows that mergers and acquisitions provided only a temporary solution to financial distress and no solution at all to operating indiscipline.

Finally, an empirical study by Abbas et al (2014) that looked at the financial performance of banks in Pakistan after Merger and Acquisition found no significant changes after mergers. The researchers studied financial data for 10 banks, by analysing the profitability and efficiency ratios, leverage ratios, and liquidity ratios to measure and compare the financial performance of the 10 firms during the pre and post-merger periods.

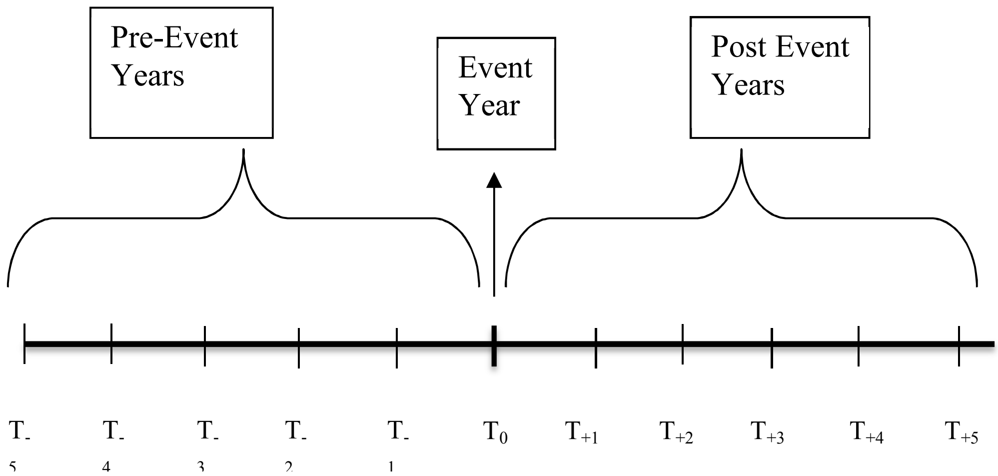
Results found no positive improvement in the financial performance of the banks in Pakistan after Merger and Acquisition.

In conclusion, the review of related literature points to the fact that there is no consensus on the direction the financial performance of firms take upon a merger and or an acquisition. For instance, studies by Marangu (2007), Girma et al (2011) and Marembo (2011) found that merger and acquisition have positive effect on the financial performance of firms, while studies by Akinbli and Kelilume (2013) and Abbas et al (2014) found no significant effect of the mergers and acquisition on firms.

RESEARCH METHODOLOGY

The research adopts a descriptive study design using event study model in order to determine the relationship between mergers and acquisitions and the financial performance and growth of financial institutions in Kenya. This design was preferred since the researcher intended to describe the behaviour of return on assets, return on equity and earnings per share of the firms that engaged in a merger or acquisition without manipulating their performance around the event period (Christensen, Johnson & Turner, 2011). Event model is a statistical method that assesses the impact of an event on the value of a firm (MacKinlay, 1997). This was done by analysing the financial performance of the sampled firms before and after the merger or acquisition in order to determine the natural behaviour of financial performance around the event period.

The event window was 5 years before the election date and 5 years after the merger or acquisition election day.



Analytical Model

This is done using the following steps;

Step one; involves determining the actual return (R_j) for each of the years under study. This is done by calculating financial performance (ROA, ROE, EPS) after the merger year, less financial performance before merger, divided by the financial performance (ROA, ROE,EPS) before the merger year (Elton et al, 2009). This is computed using the following model;

$$R_i = \frac{(P_1 - P_0 + D_1)}{P_0} \text{.................................Equation 1}$$

Where:

R_i = Financial performance on company i
P_1 = Financial return after merger date
P_0 = Financial return before merger date
D_1 = Any income received over the period

Step two; involve determining the abnormal financial returns (ROA, ROE, and EPS) for each of the years under study comprising 5 years before the merger and or acquisition and 5 years after the merger and or acquisition. Abnormal return in this case is the actual financial return less expected financial return. This step helps to determine any significant change in financial performance particularly on the EPS, ROA and ROE associated with the event (t_0).

To calculate the Abnormal Financial Performance (AR), the equation below was used;

ARit = Rit – Rmt...Equation 2

Where;

ARit = Abnormal financial performance on company i at time t;
Rit = Actual financial returns on company i at time t;
Rmt = Expected Returns.

Step three involves calculation of cumulative abnormal financial performance, done by adding all the abnormal returns for the event window (t_{-5} to t_{+5}).

DATA ANALYSIS, RESULTS AND DISCUSSION

The objective of the study was to investigate the effects of mergers and acquisition on the financial performance of financial institutions in Kenya. To meet this objective, data on the ROE, ROA and EPS of the companies that engaged in a merger and acquisition between the 2000 and 2014 were collected and analyzed to determine whether there was a difference in the financial performance as measured by ROA, ROE and EPS within the window period of 10 years. This section uses descriptive statistics to outline the movement of stock returns. The study analyzed the abnormal financial performance and cumulative abnormal financial performance attributed to the merger and acquisition events for all the financial institutions included in this study. This was done by analyzing the accounting ratios realized before the event, compared with the results after the event.

The results of the data analysis for each of the 9 commercial banks are summarized in table 4.1. The descriptive statistics indicate that the cumulative mean and cumulative standard deviation of ROA, ROE and EPS was higher in the post-merger period. This means that the financial performance of the commercial banks is higher after a merger.
below.

Table 4.1: Descriptive Statistics

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation	Variance
ROA Before Merger	45	-2.60	3.57	1.3149	1.51430	2.293
ROA After Merger	45	-4.60	5.93	1.8953	2.26601	5.135
ROE Before Merger	45	-7.95	33.02	12.4120	10.37459	107.632
ROE After Merger	45	-90.80	36.10	14.3478	27.17891	738.693
EPS Before Merger	35	-6.90	61.49	9.1149	18.86763	355.988
EPS After Merger	35	-20.06	88.25	11.4454	22.46003	504.453
Valid N (listwise)	35					

The significant difference between the mean abnormal return before merger and mean abnormal return after merger as tested by the t-statistic at 95% confidence level is an indication that merger impacts financial performance of commercial banks. The analysis of ROA show a significance level of 0.069 which is greater than a P-value of 0.05, ROE show significance level 0.597 and EPS with 0.587 significance level all greater than the P value of 0.05. This is represented in table 4.2

Table 4.2: Paired Sample Test

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	ROA Before Merger - ROA After Merger	-.58044	2.08608	.31097	-1.20717	.04628	-1.867	44	.069
Pair 2	ROE Before Merger - ROE After Merger	-1.93578	24.36350	3.63190	-9.25538	5.38383	-.533	44	.597
Pair 3	EPS Before Merger - EPS After Merger	-2.33057	25.12636	4.24713	-10.96178	6.30064	-.549	34	.587

Interpretation of Findings

The paired samples test found that the p-value for ROA, ROE and EPS are all greater than 0.05 signifying that the financial performance deviated significantly from the means before the merger. The table further indicates that EPS records mixed reaction after the merger with extreme increase recorded by I & M Bank and extreme reduction recorded by Prime Bank. Other than Equitorial Commercial bank which recorded a decrease in ROA and ROE, and KCB 2001 merger that recorded a negative in ROE, all the other nine banks reported increased ROA and increased ROE. The cumulative abnormal mean return (CAR) for all the banks involved in the study found ROA to be 5.274, EPS to be 0.167 to be thus concluding that merger and acquisition positively affect financial performance. However, the CAR for ROE found -1.823 as a result of the variability of the extreme negative performance of Equatorial Commercial bank.

Table 4.3: Results of Abnormal Returns

Institution	Pre- Merger			Post-Merger			CAAR		
	EPS	ROA	ROE	EPS	ROA	ROE	EPS	ROA	ROE
KCB 2001 Merger	0.83	0.96	1.621	-0.26	0.47	-0.882	-8.56	-0.49	-2.503
Southern Credit Banking Corp. Ltd	-3.37	0.84	1.5	5.40	0.98	6.91	8.77	0.14	5.41
National Bank	3.94	-2.16	2.54	-3.01	0.174	11.65	-6.95	2.334	9.11
KCB Ltd. 2010	3.59	3.07	28.06	4.68	5.4	30.09	1.09	2.33	2.03
I & M Bank	8.22	1.85	6.22	46.52	2.72	26.43	38.3	0.87	20.21
Prime Bank	52.59	1.66	15.43	19.26	2.85	25.4	-33.33	1.19	9.97
CBA	6.08	2.29	25.88	7.93	3.39	34.52	1.85	1.1	8.64
Equatorial Commercial Bank	-	1.29	30.89	-	-1.46	-28.42	-	-2.75	-59.31
CFC Stanbic Bank	-	2.08	20.46	-	2.63	25.08	-	0.55	4.62
CAR							0.167	5.274	-1.823

Source: Research Data

SUMMARY, CONCLUSION AND RECOMMENDATIONS

The significance test found that the p-value for ROA, ROE and EPS were 0.069, 0.597 and 0.587 respectively, all greater than 0.05 signifying that the financial performance deviated significantly from the means before the merger. In all the companies, financial performance as measured by EPS, ROA and ROE either reduced or increased after the merger event. Out of the nine banks engaged in the study, only Equatorial Commercial bank recorded a reduction on both ROA and ROE, and Kenya Commercial bank 2001 merger recorded a negative in ROE. All the remaining seven banks reported increased ROA and increased ROE. On the other hand, the analysis show mixed reaction of EPS after merger. This finding leads to the conclusion that the changes in financial performance were attributed to the merger or acquisition. The findings confirm the financial synergy theory that asserts that upon mergers and acquisitions, the combinations of firms with different financial positions and investment opportunities may produce a financial synergy and efficiency that eventually lowers cost of capital hence higher financial performance. The theory also affirms the differential efficiency theory that mergers increase the operational and managerial efficiency of firms leading to higher performance. The negative CAR recorded in ROE is attributed to the large variance in performance by Equatorial Commercial Bank. This study therefore, concludes that mergers and acquisitions generally results into increase in financial performance of commercial banks.

Recommendations for Policy

Management teams need to take advantage of the benefits of mergers and acquisitions to improve their asset value, liquidity, market share and competitiveness. However, due diligence should be done when choosing a firm to acquire or to merge with in order to minimise variability in performance similar to that of Equatorial Commercial bank. Shareholders should also be prepared for a reduced earnings per share.

Limitations of the Study

The study faced the limitation of having a bigger sample. This is because a number of commercial banks in Kenya either merged or engaged in an acquisition between 2013 and 2014 and based on the event period of 5 years after the merger event, such banks could not qualify to be included in the study. Another challenge was about difficulty in accessing the financial statements of some companies that do not make public their reports. This also limited the number of financial performance measures used in this study.

REFERENCES

Abbas, Q., Hunjra, A.I. Rauf I. A., Ijaz, M.S. & Zahid, M., (2014). Financial performance of banks in Pakistan after Merger and Acquisition. *Journal of Global Entrepreneurship Research* 2014, 4:13

Christensen, L. B., Johnson, B., & Turner, L. (2011).Research methods, design, and analysis (11th ed.). Boston: Allyn& Bacon.

Fan, Y., Li, M., Di, Z. (2006). Increasing Returns to Scale, Dynamics of Industrial Structure and Size Distribution of Firms. *Journal of Systems Science and Systems Engineering.*

Girma, S., Thompson, S., Wright, P. W. (2011). The impact of mergers and acquisitions on profitability and employee remuneration in UK manufacturing industry. *Discussion Paper*. No. 99/24

Indhumathi, G., Selvam, M. and Babu, M. (2011). The effect of Merger on Corporate Performance on Acquirer and Target Companies in India. The review of Financial and Accounting Studies, *Euro-journals Publishing*,

pp 14-40.
Kithitu, J., Cheluget, J., Keraro, V. and Mokamba, J. (2012). Role of Mergers and Acquisitions on the Performance of Commercial Banks in Kenya. *International Journal of Management & Business Studies*. pg 1- 17
Mboroto, S.N. (2013). The Effect of Mergers and Acquisitions on the Financial Performance of Petroleum Firms in Kenya. *Unpublished MBA project*. University of Nairobi.
MacKinlay, A. C., (1997). Event Studies in Economics and Finance. Journal of Economic Literature XXXV , 13-39.
Moctar, N. B., Xiaofang, C. (2014).The Impact of Mergers and Acquisition on the financial performance of West African Banks: A case study of some selected commercial banks. *International Journal of Education and Research Vol. 2 No. 1*. Pp 1-10
Mugenda, A. G. (2012). *Research Methods Dictionary.* Applied Research and Training services publishers. Nairobi Kenya
Muia, & Fidelis, P. (2012). *Determinants of growth of firms through mergers and acquisitions in Kenya.* An empirical study at the Nairobi Stock Exchange – Kenya. Unpublished MBA project. Maseno University, Kisumu Kenya.
Pandey (2008), *Financial Management*. Ninth Edition. Vik
Sekaran, U. (2003). *Research Methods for Business: A Skill building Approach. 4th Edition.* John Wiley & Sons publishers. India.
Shleiffer, A. and Summers, L. (1988). *Breach of trust in hostile takeovers*. In Auerbach (ed.) Corporate Take-overs: Causes and consequences. University of Chicago Press: London and Chicago.
Stahl, K. G., Mendenhall, E. M. & Weber, Y. (2005*). Merger and Acquisitions: Managing Culture and Human Resources.* Stanford University Press.
Stierwald, A. (2009). *Determinants of Firm Profitability – The Effect of Productivity and its persistence.* Melbourne Institute of Applied Economic and Social Research. The University of Melbourne.
Sudarsanam, S. (2003). Creating value from Mergers and acquisitions: The challenges, Harlow, Pearson Education Limited.
Thanatawee, Y. (2011). Life-Cycle Theory and Free Cash Flow Hypothesis: Evidence from Dividend Policy in Thailand. *International Journal of Financial Research*. Vol. 2, No. 2.
Tuch, C., & O'Sullivan, N. (2007). Impact of acquisitions on firm performance: A review of the evidence. *International Journal of Management Reviews*, Vol. 34(21) pp56-78.
Weston, J. F. and Copeland, E. T. (1989). *Managerial Finance.* 9th Edition, Fort Worth, TX: Dryden Press, USA.

APPENDIX I: Financial Performance (ROA,ROE &EPS) movement Before/After Merger

Figure 1: Movement of ROA, ROE & EPS for CBA Before and After Merger

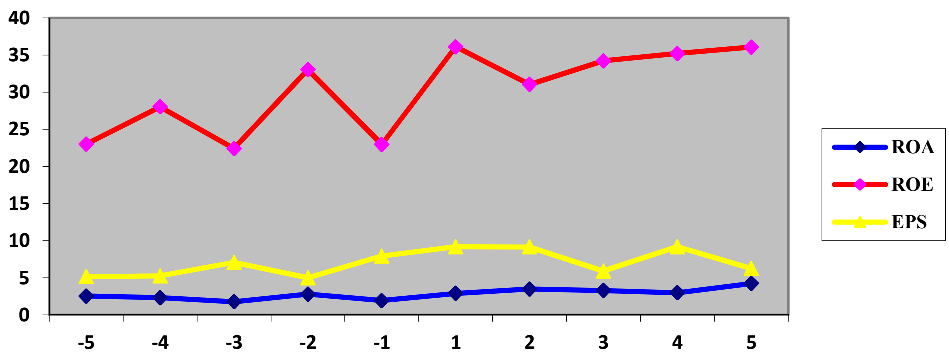


Figure 2: Movement of ROA, ROE & EPS of Prime Bank 2008 before and After Merger

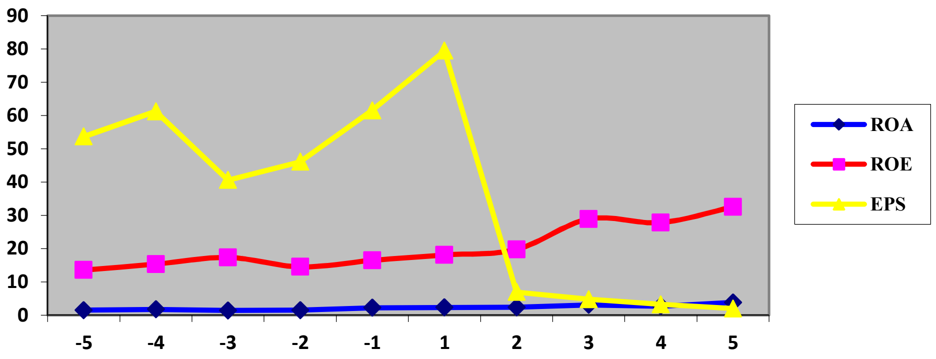


Figure 5: Movement of ROA, ROE & EPS KCB Before and After Merger 2010

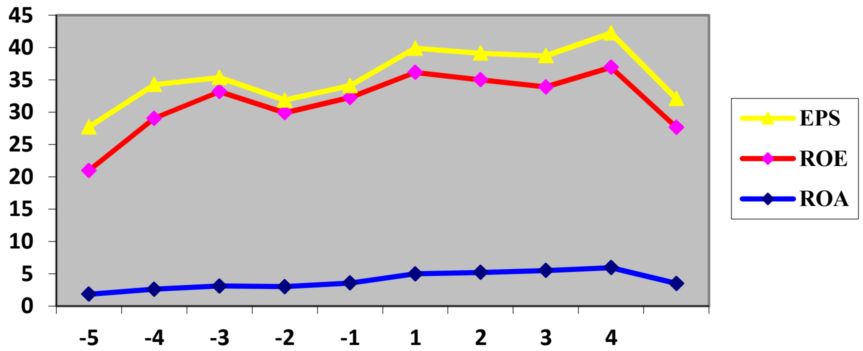


Figure 6: Movement of ROA, ROE & EPS for National Bank Before and After Merger

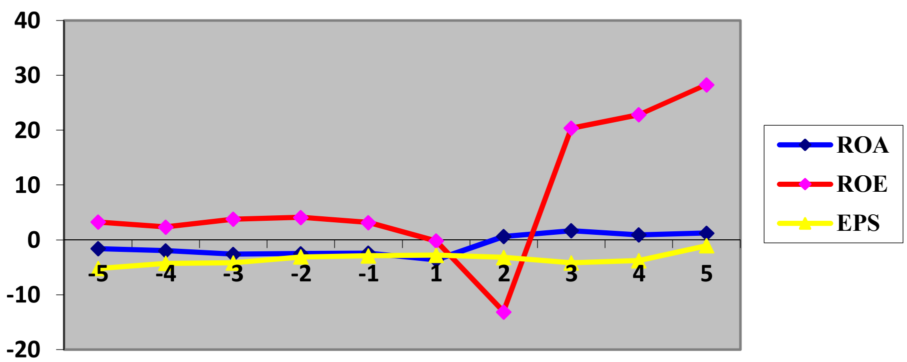
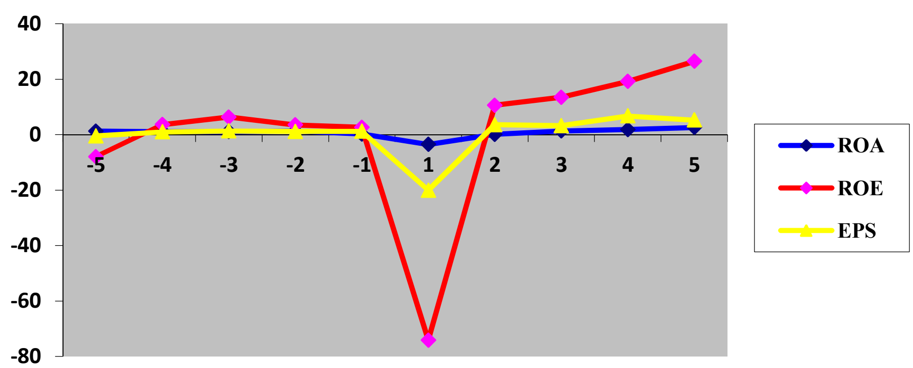


Figure 7: Movement of ROA, ROE & EPS for KCB 2001 Before and After Merger



Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol. 8, No. 14, 2017

Figure 8: Movement of ROA, ROE & EPS for I & M Bank Before and After Merger

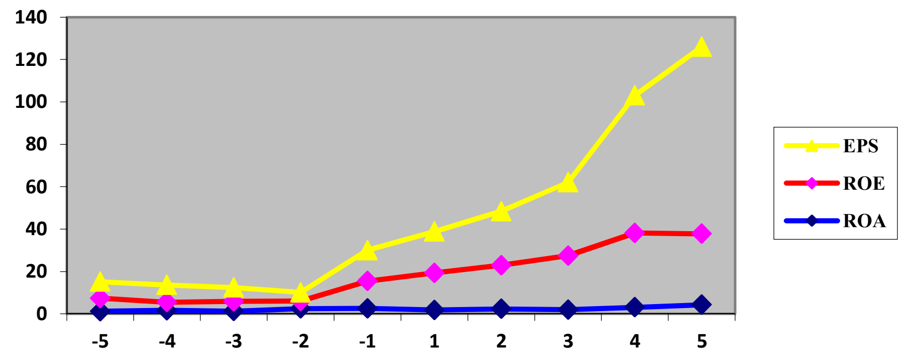
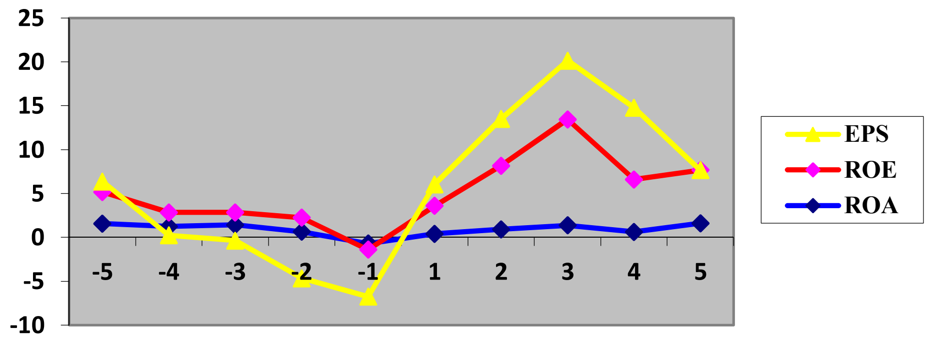


Figure 9: Movement of ROA, ROE & EPS for Southern Credit Banking Corp Before and After Merger



6

Figure 3: Movement of ROA & ROE for CFC Stanbic Before and After Merger

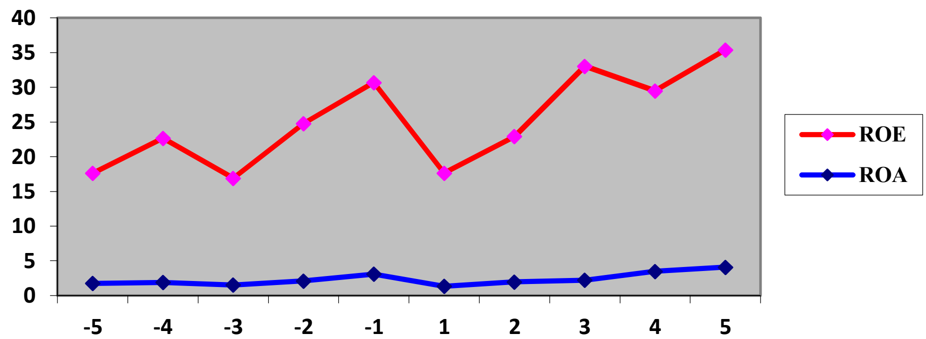


Figure 4: Movement of ROA & ROE for ECB Ltd Before and After Merger