

AN EVALUATION OF POST-MERGER PERFORMANCE OF ACQUIRING
FIRMS

A CASE OF COMMERCIAL BANKS IN KENYA

BY

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D61/70758/2008

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE
REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS
ADMINISTRATION, UNIVERSITY OF NAIROBI

NOVEMBER 2012

DECLARATION

This research project is my original work and has not been submitted to any other University for academic award.

Sign.....

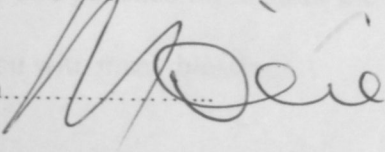
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ACKNOWLEDGEMENTS

First and foremost, I give thanks to the Almighty God who has brought me this far. You have given me intelligence, understanding and good health. May you be glorified always.

I acknowledge the effort and assistance given to me by my beloved husband and the cooperation of my lovely children whom with their little understanding gave me piece of mind to prepare and carry out the study.

Special thanks to my lovely dad, mum and siblings who have given me support and encouragement to read and gain more knowledge.

My sincere gratitude to my supervisor, Mr. Mirie Mwangi, for his invaluable guidance, time, assistance and patience throughout the study. May the Great Lord keep you in good health and shower you with many blessings.

To all my friends, colleagues, relatives and many others who in one way or another assisted me to go through my study, I say thank you and may you be blessed abundantly.

DEDICATION

This project is dedicated to my loving and caring husband, my daughter and son for their love, support and patience throughout the project period.

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Mergers and acquisitions have been very common incidents since the turn of the 20th century. These are used as tools for business expansion and restructuring. Through mergers the acquiring company gets an expanded client base and the acquired company gets additional lifeline in the form of capital invested by the purchasing company (James, 2002).

In today's global environment where business is becoming more and more complex, companies may have to grow to survive; and one of the best ways to grow is by merging with another company or acquiring other companies (Banerjee, 2007).

Thus, there is needed to look at the after effects of mergers and acquisitions by comparing their financial performance before merging with their post merger periods to evaluate whether their merger motive(s) have been met.

1.1.1 Concept of Mergers and Acquisitions

Mergers and acquisitions are explained as modes of establishing inter-organizational linkages whereby companies buy a part of or a controlling interest in another company (Harrison, 2002). A merger is the unification of two or more organizations into a single unit whilst an acquisition involves the purchase of one organization by another so that the

buyer assumes control (Brouthers et al., 1998). An acquisition is a takeover which refers to the transfer of control of a firm from one group of shareholders to another (James, 2002).

From theories and definition put forward by various authors, mergers and acquisitions can be seen as a means of accessing growth through two ways; firstly, developing the strengths that organization currently possesses and secondly, acquiring the strong points or competitive edge enjoyed by another organization. This notion is supported by Salles (2002), "mergers & acquisitions are a means of reinforcing existing capabilities and for accessing a new set of valuable capabilities, which are difficult to imitate not widely available and integrated in an indivisible part of another firm". This view on mergers and acquisitions' is similar to that put forward by Kang and Johansson (2000), as the two authors refer to strategy as a process that enables the organization achieve its goals in much shorter time once it harnesses the strengths of the firm with which it engages in the strategic partnership. Therefore, for the entire mergers and acquisitions process to be a success, there must be a transfer of the capabilities and knowledge for cost effective synergies to become a reality.

Specific goals that were sort through mergers and acquisitions's include; achieving synergies, economies of scale, cost savings increased products and rationalization of distribution channels. There were certain objectives and reasons for mergers and acquisitions that propelled the increase in mergers and acquisitions (Hensmans et al., 2001). These included; desire to increase the size of the organization to ensure it reaped the benefits of enhanced economies of scale, business combination also lead to risk

diversification, particularly where the two companies had different income streams, Increasing the company's market competitiveness; thus, being in a position to stave off competition, the strategy also was used as a means of avoiding taxation, as a means of achieving the organizations' growth objectives by expanding their existing markets or by entering in new markets, businesses with good potential were poorly managed and the assets underutilized, thus resulting in a low return being achieved as a result such a business were likely to attract a takeover bid from a more successful company.

Successful mergers depended very much on the swift implementation of a carefully thought out post-merger policy, often only after a careful period of courtship (Very and Schweiger, 2001).

1.1.2 Concept of Performance

Performance is the ability to sustain income, stability and growth. Financial performance is one of many different mathematical measures used to evaluate how well a company is using its resources to make profit. This measures the overall financial health over a given period of time and can be used to compare similar firms across the same industry or compare industries.

There are various measures of financial health of a company. Financial performance may be measured by use of accounting ratios extracted from relationships between various components of the financial statements and may be compared with different periods or other companies in the same industry or other industries to provide meaningful information. The most common measures of financial performance of banks are

profitability, efficiency, capital adequacy and leverage ratios. Measures of financial performance are not exhaustive, and many have not been included in this study.

1.1.3 Mergers, Acquisitions and Financial Performance

Mergers are undertaken if it is believed two or more companies which are merging will be greater together than sum of its parts. Specific motives for mergers are strategic and for financial reasons which may include; Tax advantages; increased liquidity for owners; gaining access to funds if the acquired company has high financial leverage and with no access or have limited additional external financing sources; for growth of the company; for diversification due to increased competition; synergistic benefits derived from the larger merged company resulting to economies of scale and cross selling.

Mergers, acquisitions and take-over's are undoubtedly a sign of our times. The airwaves are flooded with talk about mergers, take-overs and acquisitions. It has become a game of the hunters and the hunted. Mega-groups are sprouting up tentacles engulfing everything in sight. This jungle warfare has not spared the velvet-lined halls of the luxury brands – Daimler-Benz or the Swiss watch manufactures.

Global mergers and acquisitions activity has been rapidly increasing as organisations seek growth for varied strategic reasons. In 2000 the global value of deals was over US\$2,000 billion. In East Africa, mergers and acquisitions activity is increasing, partially driven by global transactions such as Smithkline Beecham acquiring Glaxo Wellcome as well as international considerations such as Citibank's acquisition of ABN Amro.

Mergers and acquisitions have raised important issues both for business decisions and for public policy formulation. Mergers and acquisitions can be critical to the healthy expansion of business firms as they evolve through successive stages of growth and development. Successful entry into new product market and new geographical markets by a firm may require mergers and acquisitions at some stage of the firm's development. Successful competition in internal markets may depend on capabilities obtained in a timely and efficient manner through mergers and acquisitions.

As competition intensifies in the local and international markets there will be opportunities for leading organisations to undertake rapid growth and create more defensible strategic positions through mergers and acquisitions rather than organic growth. There is an increasing need for consolidation within many industries for example the banking industry in the East African region is filled with many players forcing banks to merge or acquire other banks in order to survive. For example, Investment and Mortgages Bank's recent acquisition of Biashara Bank or internationally, Citibank's acquisition of ABN Amro. Other international acquisitions having an effect in the region include British American Tobacco's acquisition of Rothmans and Del Monte's acquisition by Ciro.

The role of mergers and acquisitions had evolved as a strategy tool for companies. In the current rapidly changing environment and in the era of systemic innovation, where technology is embedded in people and processes, well-planned mergers and acquisitions are recognized as critical to a global company's success or even survival.

1.1.4 Mergers in Kenyan Context

The Restrictive Trade Practises, Monopolies and Price Control Act (Cap 504 of Laws of Kenya) is the legislative statute that regulates mergers and acquisitions in Kenya. The Act defines a merger as two or more independent business concerns dealing in the same or similar goods/ services combining to form one business concern. Mergers and takeovers in Kenya must be consummated with the prior approval of the Minister. The criteria for determining whether mergers and takeovers are prejudicial to the public interest or not are set out in Section 30 (a), (b) and (c) of the Act. Criteria used include productivity, competitiveness and employment creation potential and /or the enhancement of capital intensive, as opposed to labour intensive technology (Republic of Kenya, 1990)

As at 31st December 2011, the banking sector comprised of the Central Bank of Kenya, as the regulatory authority, 44 banking institutions (43 commercial banks and 1 mortgage finance company), 4 representative offices of foreign banks, 6 Deposit-Taking Microfinance Institutions, 118 Forex Bureaus and 2 Credit Reference Bureaus. For the purposes of this study, we will focus on the commercial banking institutions in Kenya.

Merger activities have not been very prominent in the Kenyan scene. However there are a number of mergers of commercial banks dating back in 1989 where 9 financial institutions merged together to form Consolidated Bank of Kenya Ltd.

Recent mergers include, the acquisition of First American Bank by Commercial Bank of Africa in 2005 which enabled Commercial Bank of Africa to obtain the stock of

corporate customers held by First American Bank and gain an interest in United Bank of Tanzania Limited, a commercial bank operating in Tanzania.

Other recent mergers are CFC/Stanbic Bank mergers in 2008, East African Building Society and ECOBANK in 2008, Equatorial Commercial Bank and Southern Credit Bank in 2010 and City Finance Bank Ltd and Jamii Bora Kenya Ltd to the form Jamii Bora Bank Ltd in the same year.

In 2008, the then Finance Minister Mr. Amos Kimunya proposed to raise the minimum core capital for banks to 1 billion shillings from 250 million shillings, giving 2012 as the deadline for all banks to comply. Two lenders, Equatorial Commercial Bank and Southern Credit Bank have already completed a merger recently, citing the need to enlarge their branch network and balance sheet.

1.2 Statement of the Problem

Mergers and acquisitions became a strategy of choice for organizations attempting to maintain a competitive advantage (Wullaerts, 2002). Goals for this increasingly popular strategy converge around themes including growth, diversification, and achieving economies of scale. A number of scholars argued that mergers and acquisitions of companies were common and important response to globalization and the changing market environment (Zollo, 2003). All forms of mergers and acquisition were expected to create value from some kind of synergy; however the available statistics have shown that the strategies behind the mergers and acquisitions were not successfully implemented. Mergers and acquisitions were used as growth strategies for companies that wished to

increase their market share and revenues. Mergers and acquisitions served as one way of deposing inefficient management (Hill and Jones, 2001).

Rhoades (1993) talked about the impact of merger in banking industry on efficiency and profitability considering both the domestic and cross border mergers. This article discussed the cost and profit efficiency analysis of 33 bank-to-bank merger which shows that the most of the domestic mergers improves the cost efficiency and little improvement of profit efficiency here as little improvement in the profit efficiency and no improvement in the cost of efficiency in the cross border mergers.

Despite the increasing popularity of mergers and acquisitions, it was reported that, more than two-thirds of large merger deals failed to create value for shareholders in the medium term. They mainly resulted in value destruction as indicated by Weston et al, (2004).

In summary, the post merger performance is also somehow controversial. Dodd (1980) and Asquith (1983) reported negative bidder returns from the day of takeover announcement to the outcome announcement, while Malatesta (1983) identified a negative return of 13.7% of the combined firm in the 12 months after the completion of the merger. Kaplan and Weisbach (1992) found that 44% of target companies purchased are eventually divested, and they classify about one third to one half of the divestitures as unsuccessful. On the other hand, Frank et al. (1991) and Healy et al. (1992) found positive developments in the merged firms. Rau and Vermaelen (1998) attribute long-term bidder underperformance to the poor post-acquisition performance of low book-to-

market “glamour” firms. There is lack of consistency in many studies hence more room to carry out research in the area. Data will be drawn from larger time frame which is not taken care of in previous studies.

As evidenced by the foregoing paragraphs, the impact of mergers and acquisitions on the performance of the acquiring firm remains, at best, “inconclusive” and, at worst, systematically detrimental” (Dickerson et al., 1997). Mergers fail to create value, it is suggested – with somewhere between 60 and 80% classified as ‘failures’ (Puranam and Singh, 1999) – and a number of value destroying theories have been put forward in explanation.

Locally, various researchers have researched on the field of mergers and acquisitions; Kiplagat (2006), Nyagah (2007), Wangui (2007), Muthiani (2008), Ndura (2010) and Owuor (2011) have all not been able to establish whether merger activity improve the profitability of firms in Kenya. To the best of the researcher’s knowledge, no study has conclusively established the impact that mergers and acquisitions have on the financial performance of the commercial banks in Kenya. Ndungu,(2011) researched on the effects of mergers and acquisitions on the financial performance of commercial banks in Kenya. His sample consisted of 16 commercial banks that had merged between the period 1999-2005. He used ANOVA method to test the hypothesis by analyzing capital adequacy, long term solvency and profitability ratios. He concluded that there was improved financial performance after merger. However, in his study, he did not take into account the market strengths of banks under study in terms of their capital base and asset mix. Thus, the study evaluated the post merger performance of acquiring firms with reference

to commercial banks in Kenya in an attempt to fill the existing gap that has been left by the previous studies. It is seen that, most of the works have been done on trends, policies & their framework, human aspect, which is needed to be investigated, whereas profitability and financial analysis of the mergers have not been given due importance. The present study would go to investigate the detail of Merger and Acquisitions with greater focus on the Kenyan banking sector in post liberalization regime. The study also discussed the pre and the post merger performance of banks. An attempt is made to predict the future of the ongoing Merger and Acquisitions on the basis of financial performance and focusing on Kenya banking sector. Thus, the study focused on answering the question “Do mergers have any positive effect on the performance of acquiring firms?”

1.3 Objectives of the Study

The objective of this study was to evaluate the post merger performance of acquiring firms with reference to commercial banks in Kenya.

1.4 Significance of the Study

This study is important in informing the stakeholders of commercial banks as well as other institutions who consider mergers and acquisitions as a corporate restructuring tool allowing them to make sound decisions based on facts. The study will offer valuable contributions from both a theoretical and practical standpoint. From a theoretical standpoint, it will contribute to the general understanding of how mergers and acquisitions affect firm profitability; more specifically, it will provide one of the few

detailed examinations on how commercial banks that have undergone through mergers and acquisitions affects in their profitability.

The study will help to sensitize Central bank as a regulator and the Government of Kenya on the effects of mergers and acquisitions on a firm's performance. The government will find this study useful in identifying the various advances in mergers and acquisitions used in the institutions in Kenya and the effects on profitability.

Policy makers will benefit from the issues and insights raised in the study that are important in developing the frameworks where formation of such organizations will enhance to influence their profitability.

Capital Markets authority, as the body mandated to promote, regulate and facilitate the development of Capital Markets in Kenya would find this study quite helpful. Development of the capital markets in the country would most certainly be affected by restructuring decisions by commercial banks and other firms in other industries. The findings from this study can therefore be used by the capital markets authority to either promote or discourage mergers, as the case may be.

The study will add to the existing body of knowledge on the concepts of mergers and acquisitions and on firm performance to benefit academicians and aid further research on the concept. It forms a fundamental base upon which further research into the field based as it act as both reading and secondary source material in such cases.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter summarizes the information from other researchers who had carried out their research in the same field of study. The specific areas covered here were mergers and acquisitions theoretical review, empirical review, conceptualization and operationalization.

2.2 Theoretical Review

Trautwein (1990) provides a critical review of the predominant theories of takeover/merger motives within financial economics and strategic management, with the purpose of providing a practical guide to merger prescription. Trautwein identifies seven theories of merger motive: efficiency theory, monopoly theory, valuation theory, empire-building theory, process theory, raider theory and disturbance theory. Trautwein argues that the major distinction, at a general level, between the various theories is whether the merger is viewed as a rational choice based on expected favourable consequences as opposed to being an outcome of a cognitive decision process or an external economic disturbance. The theories that model merger causes as a rational choice are then further divided into two categories, those that argue that the major benefits of merger accrue to bidder shareholders and those that see management as behaving in their own self-interest.

According to Trautwein, the differences between the theories that consider bidder shareholder as the main beneficiary of mergers are caused by different views as to the source of that wealth. The most widely accepted theory, efficiency theory, proposes that it is mainly bidder shareholders and indirectly target shareholders and management who benefit from the wealth created by the generation of synergies from the two firms.

2.2.1 Efficiency Theory

This concept held that acquisitions were executed to achieve synergies. Three types of synergies are identified. First, financial synergy aimed achieving a lower cost of capital through lowering the systematic risk of the acquirer. Second, operational synergy targeted achieving operational excellence from a combined firm's operations. Third, managerial synergy was used to enhance a target's competitive position by transferring management expertise from the bidder to the target firm. The view of financial synergy has been attacked by saying that there is no evidence for a lower systematic risk or an advantage of internal capital market. It was determined that operational and managerial synergies are rarely motivations for acquisitions. Trautwein (1990) concluded that the efficiency theory performance is unfavorable.

2.2.2 Monopoly Theory

This theory viewed that acquisitions were executed to achieve market power. The implications of this type of acquisition are that conglomerates use cross-subsidized products, to limit competition in more than one market simultaneously, and to deter the potential entrance of competitors into its market. These three advantages of the monopoly

theory supported the idea of a collusive synergy (Trautwein 1990) concluded that the monopoly theory's overall performance is even worse than that of the efficiency theory.

2.2.3 Valuation Theory

This philosophy viewed acquisitions as being executed by managers who have superior information than the stock market about their exact target's unrealized potential value. The assumption here is that the acquirer possesses valuable and unique information to enhance the value of a combined firm through purchasing an undervalued target or deriving benefits from combining the target's business with its own. The leveraged buyout can be categorized into this theory. (Trautwein 1990) mentioned that one of the most common criticisms about this valuation theory is that it is impossible to acquire accurate and tangible information about the acquisition results, and further stated that "the concept of private information as a basis for mergers warrants further consideration, since it shows why the problematic assumption of capital market efficiency can be avoided"

2.2.4 Empire-Building Theory

This theory holds that managers maximize their personal goals, rather than their shareholders' value maximization through acquisitions. This theory stems from (Berle & Means's 1933) early study on the relationship between ownership and corporate governance structure. Trautwein (1990) concluded that "the empire-building theory has to be given the most credit of the theories investigated up to this point".

2.2.5 Process Theory

This approach indicated that strategic decisions are described as outcomes of processes governed by bounded rational theory. Roll (1986) found that the managers' behavior was overoptimistic in the acquisition decision process. Jemison & Sitkin (1986) proposed a systematic acquisition process perspective. Gaddis (1987) found that political and structural matters affect the acquisition process and outcome, whereas Sales & Mirvis (1984) argued that cultural distances between two companies have enormous impacts on acquisition and the post-acquisition integration process.

2.2.6 Raider Theory

Holderness & Sheehan (1985) portrayed the term, "raider," as meaning a person who causes wealth transfers from the shareholders of a target firm. Wealth transfer refers to the huge compensation after a successful acquisition transaction. This theory therefore suggests that the acquirer sets off to make huge benefits at the expense of the target firm. The primary problem with this assertion is its illogical hypothesis of wealth transfer. Against this background, the empirical evidence shows that the presence of a well known raider in a takeover bid results in greater benefits to both target and acquiring shareholders than bids by non-raiders (Holderness & Sheehan 1985, Casey, Dodd and Dolan 1987).

2.2.7 Disturbance Theory

This approach holds that the motives of acquisitions occurred as a result of economic disturbances. Economic disturbances cause changes in individuals' expectation and

increase the general degree of uncertainty. Thus, they alter the array of individual expectations. Trautwein (1990) commented that this theory is no longer examined.

2.3 Profitability and Firm's Future Value

Profitability which has been defined as the capacity to make a profit or as a quality or state of being profitable is the matter at hand. Profitability is one of the most important indicators for measuring the success of a business. Maintained profitability leads to continued strengthening of the net worth and value to shareholders/owners of the organisation.

2.3.1 Capital Size

The capital size of a commercial bank can be seen in two ways. Narrowly, it can be seen as the amount contributed by the owners of the institution (paid-up share capital) that gives them the right to enjoy all the future earnings of the bank. More comprehensively, it can be seen as the amount of owners' funds available to support a bank's business (Athanasoglou *et al.*, 2005). The later definition includes reserves, and is also termed total shareholders' funds (Anyanwaokoro, 1996). Thus, the capital size is widely used to analyze the status of its financial strength (Bobáková, 2003).

According to Central Bank of Kenya (2005), capital adequacy is measured by the ratio of total capital to total risk weighted asset ratio which shows the amount of capital the institution holds relative to the risk profile of its assets.

Positive correlation between returns and capital has been demonstrated by Furlong and Keeley (1989), Keeley and Furlong (1990), Berger (1994), Berger (1995), Naceur (2003) and Kwan and Eisenbeis (2005). Investigating the determinants of Tunisian banks' performances during the period 1980-1995, Naceur and Goaied (2001) indicated that the best performing banks are those who have struggled to improve labour and capital productivity and those who have been able to reinforce their equity. Bourke (1989) and Naceur (2003) agree that well-capitalized banks face lower need to external funding and lower bankruptcy and funding costs; and this advantage translates into better profitability. Therefore, researchers widely posit that the more capital a financial institution has, the more resistant it will be to failure (Uche, 1998: 30).

2.3.2 Size of Deposit Liabilities

Empirical evidence from Naceur and Goaied (2001) indicate that the best performing financial institutions are those who have maintained a high level of deposit accounts relative to their assets. Increasing the ratio of total deposits to total assets means increasing the funds available to use by the institution in different profitable ways such as investments and lending activities. In turn, this should increase the bank's returns on assets *ceteris paribus* (Allen and Rai, 1996 and Holden and El-Bannany, 2006).

2.3.3 Size and Composition of Credit Portfolio

The profit function of a bank includes the size and composition of its credit portfolio (Bashir, 2000 and Fries *et al.*, 2002). Ordinarily, loans generate revenue through interest and increase bank profits (Rhoades and Rutz, 1982); hence, a large credit portfolio ought

to imply improved profitability. However, since substandard credits are a source of heavy financial losses to a bank and have actually been held responsible for numerous bank failures (Olajide, 2006), it follows that a large credit portfolio could also result in reduced bank profitability if it mainly comprises substandard assets. Therefore, it is right to conclude that the size of a bank's credit portfolio affects its profitability either positively or negatively, depending on its composition of loans.

2.4 Empirical Review

In assessing the overall effects of a merger and acquisition, it is also useful to examine the impact of such transactions on an acquirer's existing establishments (or the establishments it owned before it purchased additional plants), which can be thought of as "incumbent" plants.

In contrast to plants that were acquired, existing plants of the acquiring firm experienced a slight increase in productivity in the years before the acquisition, rising to 1.7% above the norm for comparable plants in the year of acquisition. However, there are statistically insignificant changes in the productivity of "incumbent" establishments, in the aftermath of a merger or acquisition. Thus, the merger or acquisition does not appear to reduce or enhance the productivity of incumbent plants, even though acquired plants experience significant productivity gains. Following the convention in the literature (McWilliams and Siegel, 2000), these regressions include controls for firm size (total firm employment), risk (the debt/asset ratio of the firm), and research and development investment.

From the studies reviewed, a lot of research work had been carried out in regard to mergers and acquisition, both locally and internationally.

Agrawal, Jaffe, and Mandelker (1992) studied post merger performance. They developed a larger sample of 937 mergers and 227 tender offers. Their sample included firms smaller than those of the Healy et.al (1992), which focused on the 50 largest mergers. They used data analysis method of historical data. They adjusted for size effect and for beta-weighted market returns. They found that shareholders of acquiring firms experienced a wealth loss of about 10% over the five years following the merger completion.

Kiplagat (2006) researched on the effects of mergers on financial performance of companies listed at the NSE. The population used in this study was 48 companies listed on the Nairobi Stock Exchange and a sample of 20 listed companies was contacted. It consisted of 10 companies that merged and 10 that never merged and were continuously in operation for the period counterparts were merged. Kiplagat concluded that concluded that mergers improved the performance of companies listed at the NSE

Nyagah (2007) studied doctor's perception of mergers & acquisitions in the pharmaceutical industry in Kenya. The population of interest in this study comprised of medical doctors in Nairobi and a sample size of 50 doctors was considered fairly adequate and representative. In his findings, respondents strongly agreed that merged pharmaceutical companies in Kenya were profit and market oriented. They also agreed

that the companies were domineering and arrogant .However, they disagreed with the fact that merged pharmaceuticals companies are caring partners.

Maranga (2010) studied the effects of mergers and acquisitions on cost and scale efficiency of the combined commercial banks in Kenya. His population of interest comprised of 25 commercial banks that had merged between the period January 1994 to June 2009. His observations centered on a five year period before and 5 years period after merger. He used T-test to test changes in efficiency scores between pre merger and post merger periods. His findings were that firms which engaged in take over of subsidiaries had no significant changes in level of their cost efficiency after mergers. He also observed that some merged firms demonstrated significant declines in their cost efficiency that would most likely be attributed to factors such as overstaffing due to combined workforce, long learning curve of management on how to best use technology to reduce costs and increased operational cost occasioned by the intergartion of operations of two independent institutions. More over, cost efficiency does not necessarily translate to profit efficiency as staff may not be able to generate revenues to off set their expenses that are fixed in nature. After merger and acquisition, some commercial banks continued to realize profit against declining cost efficiency and relatively low profit efficiency because they were key players in lending to government through low risk treasury bonds and bills from which they realized good returns. He concluded that, the issue of human capital is very crucial in first stages of merger and sound management planning is required for mergers to succeed.

Ndura (2010) researched on the effects of mergers on financial performance of insurance companies in Kenya. Secondary data was used from publications from the Association of Insurers of Kenya. He studied the financial performance of six insurance companies by studying four years of four companies and three years of two companies before and after merger between the period 1995 to 2005. The study concluded that mergers had no positive effect on the profitability of insurance companies in Kenya as profitability either remained the same as before merger or deteriorated in first four years after merger. He also added that mergers had no effect on the level of capital adequacy and long term solvency of merged insurance companies. However, one of the limitations of his study is that he did not take into consideration the external factors to the insurance industry such as the economic environment, cultural differences among others that may affect the activities of merged companies in general.

Mukele (2006) conducted a survey of the factors that determined the choice of mergers & acquisition partners in Kenya, Wangui (2007) did a survey of mergers & acquisitions experiences by commercial banks in Kenya while Muthiani (2008) researched on cross cultural perspective of mergers and acquisitions: the case of Glaxosmithkline Kenya PLC. To the best of the researcher's knowledge, the previous studies have not conclusively determined the effects of mergers and acquisitions on the financial performance of the commercial banks in Kenya.

2.5 Summary

In summary, mergers and acquisitions as an inorganic mode of growth took any of the following types of business combinations (Shimizu et al., 2004); Vertical Integration - Combination of two businesses in the same industry but at different levels in the process of producing and selling a product. Secondly, horizontal Integration - This is a combination of two or more firms in similar type of production, distribution or area of business. Examples were combination of two book publishers or two luggage manufacturing companies to gain dominant market share. Finally, conglomerate mergers or take-over's combination of businesses in unrelated or indirectly related industry e.g. an insurance company taking over food processing company.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This section describes the methodology that was used; discusses the research design, the target population, data collection and data analysis procedure that was used in conducting the study.

3.2 Research Design

This was an event study. An event study is designed to investigate the effect of an event on a specific dependant variable. It is therefore appropriate in carrying out a statistical assessment of the impact of a merger on the value of the firm (Dimson & Marsh, 1986). The event as well as the pre and post-event windows have to be identified before the methodology can be employed.

This involved a review of the firm's performance during the premerger period and comparing this with the performance after the merger. This study collected data on the firms' profitability for a three year period before the merger and compare this with the profitability of the same firms for a period of three years after the merger.

3.3 Target Population and Sample Size

A population is defined as a complete set of individuals, cases or objects with some common observable characteristics (Mugenda & Mugenda, 2003). The target population for this study will

be the four medium commercial banks that were involved in merger and acquisition in the period between 2002 and 2011 (see Appendix I). This population is considered as it provided purposeful information on synergistic motive of merged commercial banks to penetrate new geographical markets, for increased liquidity of firms and to speed up growth of firms and how these have impacted on their financial performance. Sampling was through stratified and purposeful sampling techniques.

Sufian (2004) talked about the efficiency effect of mergers and acquisitions of banks in Malaysia. For this purpose, Malaysian commercial banks were taken to analyze the technical efficiencies during the merger year, pre-and post merger period. Results suggested that during the sample period, Malaysian banks had exhibited a commendable overall efficiency level of 95.9% suggesting minimal input waste of 4.1%. The study also found that scale inefficiencies dominate pure technical efficiency in Malaysian banking post merger. It was also observed that the post merger program was successful and results suggest that the small size Malaysian banks have benefited the most from merger program but large Malaysian banks are still facing scale inefficiency problem from merger program. Following this observation, the three large peer banks in the target population were excluded from the study as they may not give substantial results that can be generalized in the industry. The Central Bank of Kenya has classified all commercial banks into three categories namely; large peer group comprising banks with market share above 5%, medium peer group with market share above 1% but below 5% and small peer group with market share below 1%. This classification was used to identify the sample. Three large peer banks in the population were not included in the study.

3.4 Data Collection

According to Ngechu, (2004) there are many methods of data collection. The choice of a tool and instrument depends mainly on the attributes of the subjects, research topic, problem question, objectives, design, expected data and results. This is because each tool and instrument collects specific data. This study was facilitated by the use of secondary data from the published financial statements of target sample and publications from the Central Bank of Kenya to give insight to the profitability and performance of the merged banks.

3.5 Data Analysis and Presentation

Profitability is a bank's first line of defense against unexpected losses. Although banking institutions have become increasingly complex, the key drivers of their performance remain earnings, efficiency, risk taking and leverage. These performance indicators have been chosen since they simplify the comprehension of the financial statements. They are a good indicator of changes in the financial condition of the business. Ratios provide data for inter-firm comparison. This study captured performance of firms for three years before merger period and three years after merger period of merged banks between years 2002 and 2011. Performance was measured by analyzing the sample banks' total liabilities to total asset, shareholder's funds to total assets and total income to total asset ratios for three years before merger period and three years after merger period. This period is chosen as previous studies have focused on periods prior to year 2005 and in addition many studies have recommended that more studies in future should carry out longer period analysis for say ten year period. Statistical arithmetic mean, averages and percentages were used in data analyses.

Both qualitative and quantitative analysis was combined to compile a report for this study. Bank performance was analysed in terms of its capacity to generate sustainable profitability.

Measures of Performance

Financial ratios are the useful indicator of the firm's performance and financial health. The study compared total liabilities/ total assets, shareholders' funds/total assets and total income/ total assets of merged banks. The study analyzed financial performance three years before and three years after the merger. The ratios were computed from published audited balance sheets and from the Central Bank of Kenya Handbooks.

Total Liabilities/ Total Assets

The ratio of a bank's total liabilities to total assets provides an its liquidity. It gives an indication of what portion of the banks liabilities is covered by its assets. A low ratio shows that the bank has a solvency threshold.

Shareholders' Funds/Total Assets

This is a measure of capital adequacy level. This ratio is an indication of how well depositors are protected in the event of the bank winding up. A high ratio shows a high level of protection.

Total Income/ Total Assets

Measures the banks earning capacity relative to its asset base reveals its gross rate of return on total assets. A higher ratio implies that the bank's assets are engaged in more productive ventures and thus improved profitability.

CHAPTER FOUR

DATA ANALYSIS AND RESULTS

4.1 Introduction

This section presents results of the performance for merged Kenyan commercial banks from the year 2002 to 2011. The data was obtained from the financial statements four Medium commercial banks that were involved in merger and acquisition in the period between 2002 and 2011 and was used to compute the ratios used as proxies to measure performance. The study analyzed financial performance two to three years before the merger and two to three years after the merger. Below are the study findings.

4.2 Statistical Analysis

4.2.1 Prime Bank merger

To evaluate the post merger performance of acquiring firms with reference to commercial banks in Kenya, this study begun by looking at both the pre and the post merger performance of Prime Bank for the period between the years 2005 and 2010.

The merger occurred in the year 2008. Below is the summary of their financial performance for the three years both before and after the merger.

Table 4. 1: Descriptive Statistics for Prime Bank for the period between the years 2005-2010

	Years before Merger			Years after merger		
	2005	2006	2007	2008	2009	2010
Total income/Total assets	10.01	9.27	9.27	10.17	10.17	9.72
Total liabilities/ total assets	89.91	87.39	86.11	84.58	87.07	87.99
Shareholders' funds/Total Assets	25.00	25.50	25.50	26.00	27.00	27.40

From the descriptive statistics in table 4.1 above, the average total income to assets ratio three years prior to the merger for Prime Bank was 9.5167. However after the merger, the average total income to assets ratio for the years 2008-2010 increased significantly and was 10.02. The study therefore found out that Prime Banks' merger positively influenced the growth in the total income to assets ratio of the bank. This could be attributed by increase in the assets portfolio of the bank culminating from the merger. The merger was also found to increase the income base of the bank.

Frank et al. (1991) and Healy et al. (1992) found positive developments in the merged firms and therefore this study's findings collates with previous research.

On the total liabilities to total assets ratio, the average for the three years before the merger was 87.8033. The average total liabilities to total assets ratio decreased to 86.5467 three years after

the merger. This implies that the merger had a significant negative influence on the banks liabilities. The mean of the shareholders' funds/total assets of the firm showed a considerable increase over the years which infers that mergers tend to increase the bank's profitability as shown in figure 4.1 below.

Descriptive Statistics for Prime Bank for the period between the years 2005-2010

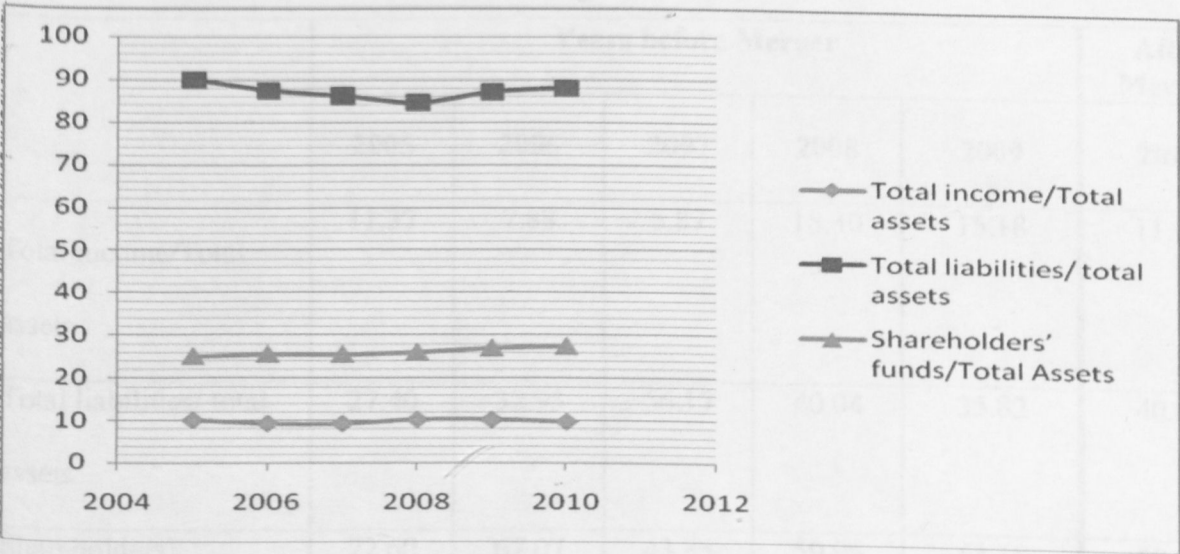


Figure 4. 1: Descriptive Statistics for Prime Bank for the period between the years 2005-2010

From the figure above, the shareholders funds/total assets ratio showed a small increase during the year of the merger. This means that the merger had a positive influence on the shareholders funds/total assets ratio.

According to Trautwein (1990), the shareholder is the main beneficiary from a merger. This is as a result the efficiency and the wealth created by the generation of synergies from the two firms. This study therefore supports previous studies.

4.2.2 Jamii Bora Bank merger

To establish the post merger performance of acquiring firms with reference to Jamii Bora and City Finance Bank, the researcher observed the total income/total assets ratio, total liabilities/total assets ratio, and the shareholders' funds/total assets ratios for three years prior to and three years after the merger. Below are the discussions of the findings.

Table 4. 2: Descriptive Statistics for Jamii Bora for periods before and after the merger

	Years before Merger					After Merger
	2005	2006	2007	2008	2009	2010
Total income/Total assets	11.37	7.88	5.87	18.30	15.18	11.15
Total liabilities/ total assets	27.40	32.93	56.17	40.04	35.82	40.80
Shareholders' funds/Total Assets	72.60	67.07	43.83	59.96	64.18	59.20

The bank merged in the year 2010. Below are the summary of their financial performance for the six years period. From table 4.2 above, it can be established that the total income/total assets ratio was reducing significantly prior to the merger.

Table 4.2: Descriptive Statistics for Jamii Bora for the period between the years 2005-2010

Descriptive Statistics for Jamii Bora for the period between the years 2005-2010

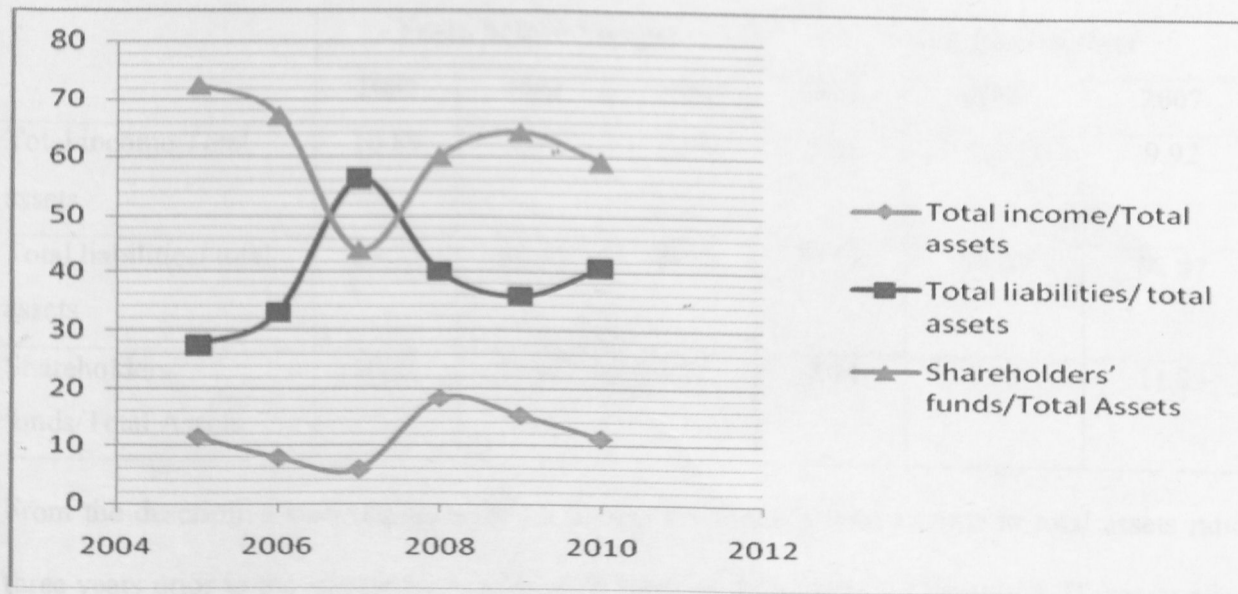


Figure 4. 2: Descriptive Statistics for Jamii Bora for the period between the years 2005-2010

The figure above shows the financial performance of Jamii Bora Bank for the period 2005-2010. The total liabilities to total assets ratio decreased after the year 2007. This was also followed by positive change in shareholders' funds to total assets ratio. However this can only be explained by other factors outside the study as data for three years after Jamii Bora merger was not available.

4.2.3 Commercial Bank of Africa merger

This bank merged in the year 2005. Below are the summary of their financial performance for the three years before and three years after the merger.

Table 4. 3: Descriptive Statistics for Commercial Bank of Africa for periods before and after the merger

	Years before Merger			Years after merger		
	2002	2003	2004	2005	2006	2007
Total income/Total assets	10.89	9.66	7.43	8.40	9.00	9.92
Total liabilities/ total assets	89.75	89.35	90.28	92.26	90.07	88.87
Shareholders' funds/Total Assets	10.25	10.65	9.72	7.74	9.93	11.23

From the descriptive statistics in table 4.3 above, the average total income to total assets ratio three years prior to the merger for Commercial Bank of Africa was 9.326666667. However after the merger, the average total income to assets ratio for the years 2005-2007 dropped slightly to 9.106666667. The study therefore found out that Commercial Bank of Africa' merger had a negative influence on the growth of the total income to assets ratio. This could be attributed by increased sharing of the assets portfolio by the large staff of the bank culminating from the merger. The merger was however found to increase the total liabilities/ total assets ratio of the bank. The average total liabilities/ total assets ratio of the bank prior to the merger was 89.79333 which increased to 90.4 as a result of the merger.

Descriptive Statistics for Commercial Bank of Africa for the period between the years 2005-2010

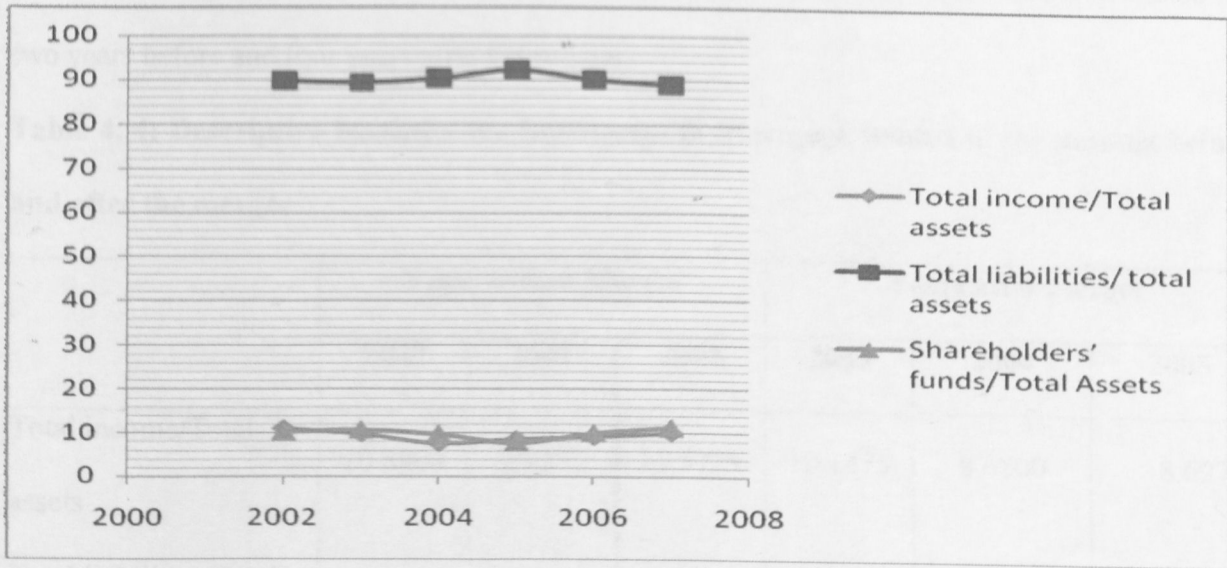


Figure 4. 3: Descriptive Statistics for Commercial Bank of Africa for the period between the years 2005-2010

The merger therefore had a positive influence on the banks liabilities. The mean of the shareholders' funds/total assets of the firm showed a slight decrease immediately after the merger which infers that the Commercial Bank of Africa merger impacted negatively to the bank's profitability as shown in figure 4.3 above.

This supports studies by Dodd (1980) and Asquith (1983) who reported negative bidder returns from the day of takeover announcement to the outcome announcement. Kaplan and Weisbach (1992) found that 44% of target companies purchased are eventually divested, and they classify about one third to one half of the divestitures as unsuccessful.

4.2.4 Investment & Mortgage Bank Ltd merger

This bank merged in the year 2002. Below are the summary of their financial performance for two years before and four years after the merger.

Table 4. 4: Descriptive Statistics for Investment & Mortgage Bank Ltd for periods before and after the merger

	Years before Merger			Years after merger		
	2000	2001	2002	2003	2004	2005
Total income/Total assets	10.8300	7.7250	11.5775	10.1475	8.6800	8.6975
Total liabilities/Total assets	86.0825	84.4150	85.7200	86.8200	87.9450	89.0625
Shareholders' funds/Total assets	49.4825	46.93	50.1050	43.5150	45.4725	48.0150

According to the findings, the average total income/total assets ratio two years before the merger was 6.185. After the merger, the average total income/total assets ratio increased to 9.775625. This means that the merger had a significant positive relationship with growth in the total income of the bank. Figure 4.4 below shows the trend line for growth in the total income/total assets ratio of the bank.

Descriptive Statistics for Investment & Mortgage Bank Ltd for the period between the years 2000-2005

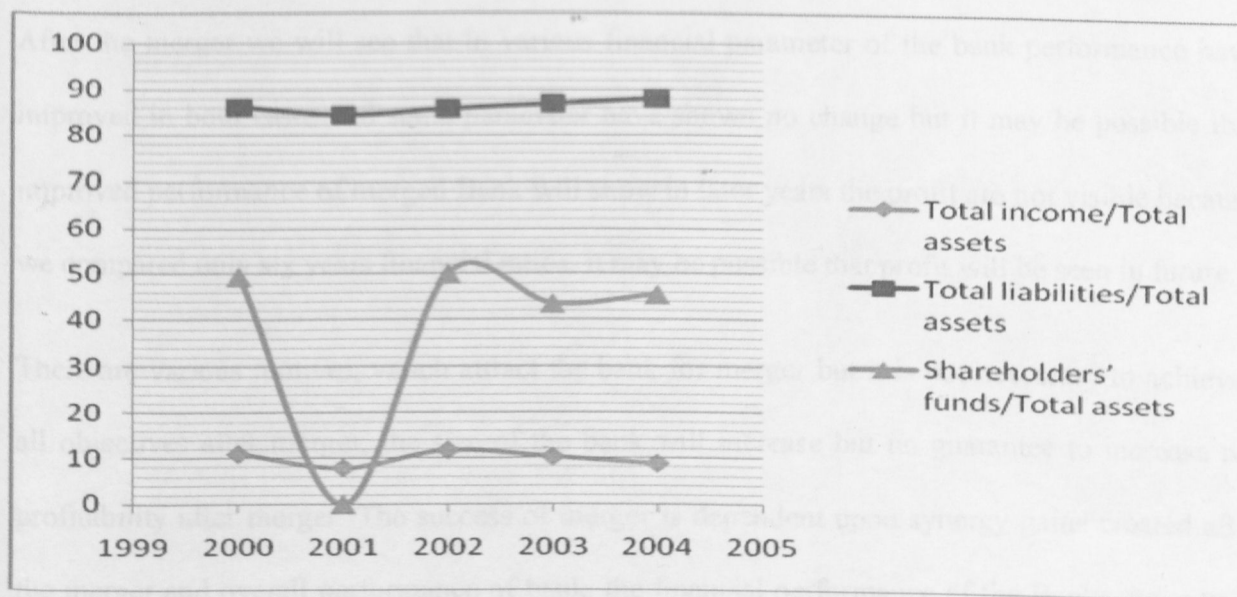


Figure 4. 4: Descriptive Statistics for Investment & Mortgage Bank Ltd for the period between the years 2000-2005

From the available statistics, the average total liabilities/ total assets ratio for the bank two years before the merger was 85.24875, while the average shareholders' funds/total assets ratio was 49.4825. After the merger in 2002, the average total liabilities/ total assets ratio for the bank increased to 87.386875 while the average shareholders' funds/total assets ratio decreased to 46.776875.

These study findings contrast studies by Trautwein (1990), that the shareholder is the main beneficiary from a merger. According to Weston et al (2004), more than two-thirds of large merger deals failed to create value for shareholders in the medium term.

The sharp decline in shareholders' funds/total assets ratio for Investment & Mortgage Bank Ltd is therefore acceptable since mergers are not always successful in the medium term.

4.3 Discussion Of Findings

After the merger we will see that in various financial parameter of the bank performance have improved in both cases and some parameter have shown no change but it may be possible that improved performance of merged Bank will show in later years the profit are not visible because we compared only six years financial ratios, it may be possible that profit will be seen in future.

There are various motives, which attract the bank for merger but it is not necessary to achieved all objectives after merger, the size of the bank will increase but no guarantee to increase net profitability after merger. The success of merger is dependent upon synergy gains created after the merger and overall performance of bank, the financial performance of the Banks have been improved after the merger and was affected positively, the reaction comes out in terms of total liabilities/ total assets, shareholders' funds/total assets and total income/ total assets of merged banks. But in the case of the Commercial Bank of Africa, the financial ratios were not positively affected by merger and show no relation between pre and post merger performance and may required due time for showing profitability. Finally the Kenyan Banking Sector has used merger and acquisitions as a tool to expand and global recognition. Sick bank survived after merger, enhanced branch network, rural reach, increase market share and improve infrastructure all achieved through merger and acquisitions. For the level of high competition this strategy is also appearing as a mode of survival in the present market.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

From the analysis and data collected, the following discussions, conclusions and recommendations were made. The responses were based on the objectives of the study.

5.2 Summary

The main objective of the study was to evaluate the post merger performance of acquiring firms with reference to commercial banks in Kenya. The study was conducted in three stages namely: Collection of the data required, calculation and tabulation of the variables under the study, analysis and interpretation.

The study focused on finding the relationship existing between the dependent variable, performance and the independent variable, merger. The data was collected through verification of the financial statements on the bank and the merger information available in CBK Handbooks. The data were interpreted using financial ratios which are total liabilities/ total assets, shareholders' funds/total assets and total income/ total assets ratios of merged banks. For Commercial Bank of Africa, Jamii Bora Bank and Prime Bank, the financial ratios were compared three years before and three years after merger while data for Investment and Mortgages Bank was compared for two years before and four years after merger.

5.3 Conclusions

It is helpful for survival of weak banks by merging into larger bank. This study shows the impact of mergers and acquisitions in the Kenyan banking sector and researcher took four cases for the study as sample to examine whether merger led to a profitable situation or not. For this a comparison between pre and post merger performance in terms of total liabilities/ total assets, shareholders' funds/total assets and total income/ total assets ratios, the general result was improved performance of the acquiring bank.

5.3 Limitations of the Study

This study was undertaken to test whether the industry type has an impact on the outcome of merger for the merging firm, in terms of impact on operating performance. The results from the analysis of pre- and post-merger operating performance ratios for the acquiring firms in the sample showed that there was a differential impact of mergers. The study concludes that there was a general increase in performance after the merger. Some indicator such as total income to total assets showed a general increase in three banks and slight decrease in one bank. The total liabilities/ total assets showed a decrease over the years in two banks and increase in the other two banks while shareholders' funds to total asset ratio indicated an increase in two banks and slight decrease in two banks. The study concludes that an increase in merging generally leads to positive performance of acquiring firm.

5.4 Recommendation

Due to time constraints, the study may have not captured the true picture of post merger performance and there is need for further research in the area for longer period analysis for say

20 year period to capture the true performance of merged banks. Also the study was limited to one industry and the findings may not be generalized in other industries in Kenya.

In conclusion, highly indebted firms may not necessarily be having a low value. Consequently, firms with low debt may not necessarily be having a low value. Therefore firms with low debt and those with high debt may be subjected to bankruptcy which the case is different when merged.

5.5 Limitations of the Study

The data was intended to use data for merged commercial for a longer period. However, this was not achieved due to limited information. The data available was only for four banks. Accessibility of information for more companies could have resulted in better results being obtained.

The period covered is only three years before and three years after merger. A longer period could possibly have yielded better and more reliable results.

Interpreting the financial statements was problematic. Insufficient details are given concerning what banks long term debt. There was ambiguity as to whether preference shares should be treated as debt or equity.

The study only focused on one industry and result may not be generalized to other industries in Kenya due to their differences in operations and industrial environment.

The study has ignored the impact of possible differences in the accounting methods adopted by different companies in the sample.

The study has also not used any control groups for comparison (industry average or firms with similar characteristics).

The small sample size was used to analyse post merger performance of commercial banks in Kenya. This may not be a good representative of merged bank.

5.6 Suggestions for Further Research

To improve on this study, it is suggested that a similar study should be carried out over a long period of time so as to obtain more reliable findings. If possible more banks should be included in the sample so as to increase reliability on the results. Merger and Acquisition is the useful tool for growth and expansion in the Indian banking sector.

Researcher suggests, for future research in this area could be the study of impact of merger only on acquiring banks by comparing pre and post merger performance and take more banks to a larger sample concerning a longer time period for the study which would have given better result.

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Appendix 1: List of Merged Commercial Banks

Sr. no.	Name of bank	Year of merger
1	Consolidated Bank of Kenya Ltd	1989
2	Credit Agricole Indosuez	10.11.1994
3	Transnational Bank Ltd.	28.11.1994
4	Bank of Baroda (K) Ltd.	02.12.1994
5	First American Bank (K) Ltd.	05.09.1995
6	Bank of India (Africa) Ltd.	15.11.1995
7	Stanbic Bank Kenya Ltd.	05.01.1996
8	Ambank Ltd.	15.01.1996
9	Delphis Bank Ltd.	17.01.1996
10	Commercial Bank of Africa Ltd	26.01.1996
11	Trust Bank (K) Ltd.	07.01.1997
12	NIC Bank Ltd.	14.06.1997
13	Giro Commercial Bank Ltd.	24.11.1998

14	Guardian Bank Ltd.	24.11.1998
15	Diamond Trust Bank (K) Ltd.	12.02.1999
16	National Bank of Kenya Ltd.	24.05.1999
17	Standard Chartered Bank (K) Ltd.	17.11.1999
18	Barclays Bank of Kenya Ltd.	22.11.1999
19	Habib Bank A.G. Zurich	30.11.1999
20	Guardian Bank Ltd.	03.12.1999
21	Paramount Universal Bank	11.01.2000
22	Kenya Commercial Bank Ltd.	21.03.2001
23	Citibank NA	16.10.2001
24	Southern Credit Banking Corp. Ltd.	07.12.2001
25	Co-operative Bank of Kenya Ltd	28.05.2002
26	Investment & Mortgage Bank Ltd.	01.12.2002
27	Commercial Bank of Africa Ltd	01.07.2005
28	EABS Bank Ltd	31.10.2005

29	Prime Bank Ltd.	01.01.2008
30	CFC Stanbic Bank Ltd.	01.06.2008
31	Kenya Commercial Bank Limited	01.02.2010
32	Jamii Bora Bank Ltd.	11.02.2010
33	Equatorial Commercial Bank Ltd	01.06.2010

Acquisitions

	Dubai Bank Ltd.	01.04.2000
	Bank of Africa Bank Ltd.	30.04.2004
	Ecobank Bank Ltd.	16.06.2008

Source: Banking Supervision Report 2011.