EFFECT OF MERGERS ON FINANCIAL PERFORMANCE OF FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

BY

CATHERINE NJERI KIARIE

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DECLARATION

I, the undersigned declare that this is my original work and has not been presented to any other institution or forum for any other award prior to this declaration.

Signature: ……………………………… Date: …………………………………...

Catherine Njeri Kiarie - D61/75953/2012

This project paper has been submitted for examination with approval and advice as the university supervisor

Signature: ……………………………………Date: …………………………..………

Ms . Zipporah Onsomu.

This project paper has been submitted for examination with approval and advice as the university Research Supervisor,

Signature: ……………………………………Date: …………………………..………

Herrick Ondigo,

Chairman, Department of Finance and Accounting,

School of Business, University of Nairobi

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DEDICATION

This research Project is dedicated to my parents Mr and Mrs Kiarie, my sisters Ciku and Alice, my brothers, my friends Maria, Nyawira, Rosylind, Moses and Mercy for their support.

ABSTRACT

The objective of the study is to determine the relationship between mergers and financial performance. To try and shed more light on this, this study sought to determine the effect of mergers on financial performance of NSE listed companies in Kenya. The research adopted a descriptive design to determine the relationship between mergers and financial performance. The population for this research was all the firms that have undergone mergers and are listed in the NSE. There were total of 15 companies listed on the NSE that had engaged in merger. However for this research, only companies studied those that merged between 1997 and 2013 are considered. The study used secondary data to be obtained from available financial statements of listed companies that have engaged in a merger in Kenya. Event analysis design was used to analyze the data. Four years before and after the merger were analyzed. Dividend per share (DPS) earnings per share (EPS), return on equity (ROE) and return on assets (ROA) were analyzed to determine the effect of merger on financial performance. The study found that mergers affect the share returns of merging firms listed at the NSE. Mergers have significant positive effect on DPS where merging of listed companies lead to increase in DPS. The study also finding that mergers have positive and significant effect on EPS where EPS before the merger was found to be declining but started to rise immediately after the merger. Increase in EPS implies improved performance of the company. The study also found that mergers have significant effect on ROA where mergers were found to enable merging firms to better utilize their assets in generating income. However, mergers have insignificant effect on ROE. The ROE remains statistically unchanged even after the merger. The study recommends that firms (listed/unlisted) having weak capital base or having challenges in generating income to merge with similar firms and create synergies so as to enjoy economies of scale and improve their share returns and hence maximizing shareholders wealth which is the general objective of profit making companies.

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EMH	Efficient Market Hypothesis
EPS	Earnings per Share
GDP	Gross Domestic Product
M&A	Mergers and Acquisitions
NSE	Nairobi Securities Market
ROA	Return on Asset
ROE	Return on Equity
RWT	Random Walk Theory
SPSS	Statistical Package for Social Sciences
P/E Ratio	Price Earnings Ratio

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

A merger is the combination of two or more companies in a creation of a new entity or formation of a holding company (Gaughan, 2002; Jagersma, 2005). Mergers are strategic alliances between two or more companies, where the partners in the alliance seek to add to their competencies by combining their resources with those of other firms with a commitment to reach an agreed goal (Brouthers et al., 2008). The reasoning behind any corporate merger is that two companies are better than one because they increase shareholder value over and above that of the two separate firms (Sharma, 2009).The primary motivation for most mergers is to increase the value of the combined enterprise, (Brigham and Ehrhardt, 2002).When the value of the combined enterprise increases, the shareholders wealth also increases. Other motives behind mergers and acquisitions are economies of scale, increase in market share and revenue, taxation, synergy, geographical and other diversification.

Mergers have been undertaken in efforts to improve organization performance due to the benefits they are believed to carry along. Improving financial performance through mergers is mainly considered a management strategy. Management considers mergers to reduce costs and expenses and maximize shareholder value. The Efficiency Theory shows that mergers have a positive impact on the organization performance. The efficiency theory states that mergers are executed to achieve net gains from synergies (Trautwein, 1990). The efficiency gains accrue from operating synergies which are achieved through the transfer of knowledge, economies of scale and economies of scope. These synergy gains are not generic in nature but rather peculiar to two specific firms coming together (Mueller and Sirower, 2003). The Hubris Hypothesis on the other hand shows that mergers might have a negative impact on the organization. According to the managerial hubris hypothesis, even if managers try to maximize the value of the firm, they might overestimate the value of what they buy because of hubris (Roll, 1986). Hubris theory provides a psychological-based approach to explain mergers. It states that the management of the acquiring firm overrates their ability to evaluate potential merger targets. Managerial hubris resurfaces in a competitive auction in which the firm with the highest bid closes the deal. The risk of potential failure, due to overrated acquisition price which significantly exceeds the fair value of the target company, increases in an auction.

Nairobi Securities Exchange is the Africa's fourth largest stock exchange in terms of trading volumes, and fifth in terms of market capitalization as a percentage of GDP. With regard to companies listed in stock exchange in Kenya, the relevant legal framework on mergers is the Capital Markets Act, of the Laws of Kenya. Most mergers have taken place in the banking sector. This is due to the increase in the minimum operating capital from kes 250 million to kes 1 billion, that was passed on by the Central Bank of Kenya in 2008. Most of the listed companies, for example, Diamond Trust Bank bank, CFC Stanbic bank, I & M bank, Pan Africa Insurance, Total Kenya, among others saw an increase in share price after the merger.

1.1.1 Mergers

Hax and Majluf (1996) define mergers as a means of establishing the organizational purpose in terms of its long term objectives, action programs and resource allocation. A major obstacle faced by organizations seeking to merge or acquire others has been that of identifying the business area in which a firm should participate in order to maximize its long-term profitability. Majority of mergers are friendly and are recommended by the directors and shareholders of both companies (Hill and Jones 2001). Thus, mergers involve friendly restructuring of the assets and resources for the companies involved in the combination (David, 1997).

Mergers have been popular methods of increasing the size and value of firms in modern times. This may either be through absorption or through consolidation. Absorption is a combination of two or more companies into an existing company. Consolidation occurs when two companies combine together to form a new enterprise altogether, and neither of the previous companies remains independently. All companies except one lose their separate identities in a merger through absorption. The acquired company transfers its assets, liabilities and shares to the acquiring company. Mergers are distinguished by the relationship between two or more firms that are merging. Horizontal mergers occur between two or more firms that are in direct competition and share the same product lines and market. Vertical mergers occur where a firm merges with its customer or supplier. Conglomerates occur where two or more firms that have no common business area merge (Pandey, 2008). There are various reasons for mergers and acquisitions, which include: Gaining a competitive advantage where companies merge in order to increase market share for their products, or gain a better distribution network; reduction of operation costs, therefore operating on economies of scale; expansion in research and development of opportunities, leading to efficiency in the production; diversification of products and services.

1.1.2 Financial Performance

Financial performance refers to the measure of how well a firm can use assets from its primary mode of business and generate revenues. In addition Financial Performance is essentially a measure of an organizations financial health over a given period of time, used to compare similar firms across the same industry or to compare industries or sectors in aggregation. In Mergers financial performance of firms is determined by evaluating the following; profitability, liquidity and solvency. Profitability shows the extent to which a company has being efficient in its operations or gauges a company's operating success over a given period of time. In this study, three measures of financial performance are employed which include Return on Asset (ROA), ROE and Earning per Share.

Financial performance of a company is represented on the company's financial statements. Financial statements are a collection of reports about an organization's financial results, condition, and cash flows. Financial statements statement is an organized collection of data according to logical and consistent accounting procedures. Its purpose is to convey an understanding of some financial aspects of a business firm. It may show a position at a moment of time as in the case of a Balance Sheet, or may reveal a series of activities over a given period of time, as in the case of an Income Statement. Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Gaul, 2011).

1.1.3 Mergers and Financial Performance.

Firth (1979) suggests that benefits from mergers were unique and could only have been achieved by those two particular firms combining.The potential economic benefits of Mergers and Acquisitions are changes that increase value that would not have been made in the absence of a change in control (Pazarkis et al., 2006). These changes in control are potentially most valuable when they lead in the redeployment of assets, providing new operating plans and business strategies.

The motives behind mergers are to improve revenues and profitability, faster growth in scale and quicker time to market, and acquisition of new technology or competence. This is largely the reason why merger and acquisition are perceived as effective methods of improving corporate performance. The effect of mergers on financial performance of a company can either be in the short run or in the long run. The short run performance focuses on abnormal returns. That is, deduct the returns investors could have earned by investing in the market as a whole. Based on the short run performance, target firm shareholders are the big winners, earning significant, positive, abnormal returns. Acquiring firms shareholders are the losers earning zero or negative abnormal returns. The combined entity seems to be slightly better off (Bouwman, Fuller and Nain, 2003).

The long run financial performance studies of the acquiring firm for 3 to 5 years after the acquisition announcement show that certain acquirers significantly underperform their peers in the long run. Long run studies also focus on abnormal performance not relative to the market but relative to non-acquiring peers of the acquiring firms (Bouwman, Fuller and Nain, 2003).

1.1.4 Nairobi Securities Exchange

NSE is the 4^{th} largest securities market in Africa. It was founded in 1954. According to the Nairobi Securities Exchange (2014), there are 64 listed companies on the NSE. There are 63 companies listed on the Main Investment Segment and one company listed on the Growth Enterprise Market Segment. The segments on the NSE include Agriculture; Automobiles and Accessories; Banking; Commercial and Services;

Construction and Allied; Energy and Petroleum; Insurance; Investment; Manufacturing and Allied; Telecommunication and Technology and Growth Enterprise Market Segment.

Kenya saw an increase in mergers and acquisitions activity during the period 2001 to 2013. Since the Competition Authority became operational in 2011, it has determined more than 50 merger applications. This is in comparison to the six-year period between 2005 and July 2011 during which there were 68 mergers notified to the Monopolies and Prices Department, the predecessor of the Competition Authority (Mutulu, 2014) . The activity has been in a wide array of sectors including banking, insurance, engineering and construction, petroleum, floriculture, information, communication and technology (ICT), and mining, among others. There are a number of mergers that have taken place in Kenya and they include CFC Stanbic Bank mergers, National Bank of Kenya, I & M Bank, Pan African insurance, Co-operative bank of Kenya, Kenya Commercial Bank, Diamond Trust Bank, Equity Bank, Total Kenya, Access Kenya, East Africa Breweries Limited, CMC and Kenol Kobil.

1.2 Research Problem

Straub (2007) argues that mergers are performed in the hopes of realizing an economic gain. Some of the potential advantages of mergers include achieving economies of scale, combining complementary resources, garnering tax advantages, and eliminating inefficiencies. Mergers are aimed at improving profits and productivity of a company. Simultaneously, the objective is also to reduce expenses of the firm (Heyner, 2007). Mergers have also been found to lead to cost cuts and increased revenues. Some mergers have been occasioned by the need to meet the increasing minimum core capital requirements and to enhance the institutions’ market share in the local banking environment. However, merger failures are not uncommon. These failures may harm the companies, tarnish their credibility in the market, and ruin the confidence of their shareholders. According to Kwoka (2002), mergers have often failed to add significantly to the value of the acquiring firm's shares. Loderer and Martin (1992) studied 304 mergers and 155 acquisitions that took place between

1965 and 1986 and observed a negative but insignificant abnormal return over the five subsequent years after the mergers.

The first wave of bank mergers in Kenya occurred in 1997 while the second in 1998 and continues to the present day. Some mergers have been occasioned by the need to meet the increasing minimum core capital requirements and to enhance the institutions' market share in the local banking environment, (CBK 2011). In 2008, the then Finance Minister 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 (Kenyan banks consolidation, 2010). Subsequently, most Kenyan banks had to merge to boost minimum core capital. The local implications on banks of enhanced capital rules abroad following the 2008 global financial crisis also encouraged mergers in the banking sector. Increased competition, profitability, returns and capital adequacy requirements were the key drivers behind banking sector consolidation. Apollo Insurance and Pan Africa Insurance merged to form APA Insurance Company to create more synergies, increase shareholders' wealth and remain competitive in a fast growing insurance industry, highly dominated by multinationals. Kenya oil and Kobil Kenya merged to form Kenol Kobil to increase competition in the oil industry in Kenya.

Lipton (2006) investigated external factors affecting mergers and merger waves by analyzing global M&As from the year 1985 to 2006. The observation was that during 1990s merger-waves, as stock prices and earnings ratios increased, merger volumes increased dramatically globally, hence positive relationship between stock price increase and M&A activities. Kithitu et al (2012) investigated the role of M&As on the performance of Commercial banks in Kenya by analyzing the profitability using ROA and ROE ratios. The findings were that merger resulted to increased profitability with ROA and ROE increasing after the merger. Houston & Ryngaert (1994) examined abnormal returns from four days before the target was initially declared a takeover bank to the announcement day. In their sample of 153 mergers announced between 1985 and 1991, acquirers suffered a loss in value and targets enjoyed a gain. However, there was no significant aggregate effect on the overall value of the two organizations. However these studies do communicate mixed reactions about the effect of mergers and acquisitions on the overall shareholder's wealth. The question that has driven this research on mergers is what effect do mergers have on financial performance of listed companies at NSE?

1.3 Research Objective

To establish the relationship between the financial performance and mergers of firms listed at the NSE.

1.4 Value of Study

Theoretically this study makes an important contribution to the growing body of research on mergers and acquisitions. This research has provided up to date knowledge which is helpful for the University students by providing them extensive knowledge regarding mergers and acquisitions in the Kenyan industry. The findings may be used as a source of reference for other researchers. In addition, academic researchers may need the study findings to stimulate further research in this area and as such form a basis of good background for further researches.

Practically, the research contributes to comparing overall financial performance of the organization before and after a merger or an acquisition has taken place, to find out any positive or negative gains on share returns. The study is therefore of significant importance for the industry and other firms in the industry to recognize the importance of mergers and impacts on company's performance and the synergies achieved through them.

Mergers are of importance to business executives and managers as they make their strategic decisions that could include restructuring. Restructuring decisions are likely to impact current and future returns of a company. Such decisions affect prospective investors as to whether to invest in merged companies and also in which industries. Timing of the stock market conditions is necessary when firms decide to grow through mergers and acquisition since firms can use stocks to settle their merger deals especially during stock market boom because mergers is the fastest way for firms to grow externally. Also shareholders can be able to make informed decisions for or against mergers.

The Capital Markets Authority and Other Regulatory Bodies that are responsible for the licensing, regulation and supervision of operators in the capital markets, including policy formulation, monitoring and evaluation will make informed decisions on the basis of the findings when executing their mandates. This will help the anti-trust authorities in controlling the activities of mergers.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter examines theoretical framework and empirical studies that have been done in the area of effect of mergers on listed companies. The chapter starts with theoretical literature, followed by the determinants of financial performance, and empirical literature on the area of study. The chapter ends with summary of literature review.

2.2 Theoretical Review

The theories identified for this study relate to financial performance and mergers. These theories include; the efficiency theory; the Hubris Hypothesis which states that the management of the acquiring firm overrates their ability to evaluate potential acquisition targets. This managerial over-optimism typically results in erroneous decisions and M&As which are overpriced (Trautwein, 1990); Monopoly theory that views mergers as being planned and executed to achieve market power; Empire-building theory(Marris, 1963), that states that mergers are planned and executed by managers who thereby maximize their own utility instead of their shareholders' value; and Valuation theory approach argues that mergers are planned and executed by managers who have better information about the target's value than the stock market (Steiner, 1975; Holderness and Sheehan, 1985; Ravenscraft and Scherer, 1987).

2.2.1 The Efficiency Theory.

According to the value increasing school, mergers occur, broadly, because mergers generate 'synergies' between the acquirer and the target, and synergies, in turn, increases the value of the firm (Hitt et al., 2001). The theory of efficiency suggests, in fact, that mergers will only occur when they are expected to generate enough realizable synergies to make the deal beneficial to both parties; it is the symmetric expectations of gains which results in a friendly merger being proposed and accepted**.** If the gain in value to the target was not positive, it is suggested, the target firm's owners would not sell or submit to the acquisition, and if the gains were negative to the bidders' owners, the bidder would not complete the deal. Hence, if we observe a merger deal, efficiency theory predicts value creation with positive returns to both the acquirer and the target. Banerjee and Eckard (1998) and Klein (2001) evidence this suggestion**.**

Chatterjee (1986), criticized this theory by concluding that, it should be possible to distinguish between operative synergies or efficiency gains achieved through economies of scale and scope and allocate synergies or collusive synergies resultant from increased market power and an improved ability to extract consumer surplus when commenting on value creation in mergers. According to Houston et al., (2001) operating synergies are the more significant source of gain.

2.2.2 Hubris Hypothesis

According to the managerial hubris hypothesis, even if managers try to maximize the value of the firm, they might overestimate the value of what they buy because of hubris (Roll, 1986). This is particularly true in waves of consolidation, when managers blindly follow the markets and change their beliefs on conglomeration versus strategic focus or when multiple bidders compete for the same target. Managers also could underestimate the cost of post-merger integration or overestimate their ability to control a larger institution. Thus, a transaction that is believed to benefit the acquirer could simply be a poor strategic decision where benefits are overestimated or costs are underestimated. The result is that shareholders of the acquiring firm lose from the deal because the market reacts to the mistake of the acquiring firm's manager.

Thaler (2000) criticized the hubris theory and concluded that the behavioral economic tradition literature has established over and over again that human beings are not good at optimization of any kind, and has urged development of a more realistic set of assumptions on which to build economic theories.

2.2.3 Monopoly Theory

According to the monopoly theory, mergers are realized in order to achieve a monopoly through increased market power. It is an explanation of horizontal and conglomerate mergers. Market power can be accomplished through the deliberate reduction of supply, cross-subsidizing products and deterring potential market entrants (Trautwein, 1990; Rodermann, 2004). These benefits are also referred to as collusive synergy (Chatterjee, 1986) and competitor interrelationships (Porter, 1985).

Jensen (1984) criticized the monopoly theory. He studied effects of merger announcements, free cash flow hypothesis and merger cancellations on competitors' stock. Under the monopoly theory competitors' stocks should rise upon an announcement and drop if the merger is challenged or cancelled. Since competitors' stocks do not fall on the two latter events Jensen (1984) rejects the monopoly theory.

2.2.4 Empire-building Theory

According to this theory, mergers are planned and executed by managers who thereby maximize their own utility instead of their shareholders' value. (Marris, 1963) suggested that cross border mergers are often little more than agency driven attempts to grow the firm beyond its optimal size, designed to maximize managerial power or prestige, or to build empires (Rhoades, 1983; Ravenscraft and Scherer, 1987).This approach has its roots in the original study on the separation of ownership and control in the corporation (Berle and Means, 1933). The main justification of managerial motives is the principal-agent theory which seeks to explain that a firm's management that is, the agent, may pursue personal objectives which are different from those of the shareholder that is, the, principal. Personal objectives may be the desire to enhance personal reputation, to increase financial compensation and to accomplish a lasting legacy also known as empire building (Trautwein, 1990). As these goals are often linked to with the size of the firm, managers may resort to mergers to grow the company as a means of realizing their personal objectives (Rodermann, 1999).

Eisenhardt (1989) criticized the empire building theory by arguing that in a situation where principal delegates work to the agent, agency relationship develops. Agent's mission is to optimally accomplish principal's interests. In pursuit of the mission, the agent chooses way of doing business which results in certain effects. Principal bears a risk of eventual failure, but also adopts effects of agent's execution of mission reduced for agreed payment to the agent. Level of reward to the agent usually depends on principal's interest in realization of the assigned mission. A benefit, to the agent, in the form of reward represents cost to the principal while agent's effort brings benefits to the principal, with an assumption that higher effort is directly related to better results, and at the same time cost to the agent.

2.2.5 Valuation theory

This approach argues that mergers are planned and executed by managers who have better information about the target's value than the stock market (Steiner, 1975; Holderness and Sheehan, 1985; Ravenscraft and Scherer, 1987). Valuation theory is based on the assumption of inefficient capital markets and asymmetric information. The goal of mergers is to achieve arbitrary value gains between the market value and the valuation of the acquiring firm as a result of unique information about the target company which is only available to the bidder’s management (Rodermann, 1999). Bidders' managers may have unique information about possible advantages to be derived from combining the target's businesses with their own. Or they may have detected an undervalued company that only waits to be sold in pieces.

This hypothesis conflicts with that of an efficient capital market. It has been argued that the two are not incompatible because the EMH only requires that all publicly available information is incorporated in the stock price (Ravenscraft and Scherer, 1987). If the bidder possessed private information about the target's value (excluding synergies at the moment) he would reveal it in his bid. The stock price would climb to reflect the new information leaving the bidder in a winner's-curse situation. In this sense an efficient market does not preclude the existence of undervalued target firms, but only the possibility of capitalizing on revealed private information (Wensley, 1982).

2.3 Determinants of Financial performance

Financial performance refers to the act of performing financial activity. In broader sense, financial performance refers to the degree to which financial objectives being or has been accomplished. It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation**.** Financial

Performance of a company is determined by return on assets; return on equity; macro economic factors such as changes in inflation, exchange rate and interest rate; and EPS.

2.3.1 Return on Asset (ROA)

ROA is a major ratio that indicates the profitability of a company. It is a ratio of Income to its total asset (Khrawish, 2011). It measures the ability of the company management to generate income by utilizing company assets at their disposal. In other words, it shows how efficiently the resources of the company are used to generate the income. It further indicates the efficiency of the management of a company in generating net income from all the resources of the institution (Khrawish, 2011). Wen (2010), states that a higher ROA shows that the company is more efficient in using its resources therefore giving shareholders good value for their money.

2.3.2 EPS Earnings per Share

Earnings per share (EPS) represents the portion of a company's earnings, net of taxes and preferred stock dividends, that is allocated to each share of common stock. EPS can be calculated simply by dividing net income earned in a given reporting period, usually quarterly or annually, by the total number of shares outstanding during the same term. Because the number of shares outstanding can fluctuate, a weighted average is typically used. Earnings per share serve as an indicator of a company's profitability (Lucey, 1991).

2.3.3 Return on Equity

ROE is a financial ratio that refers to how much profit a company earned compared to the total amount of shareholder equity invested or found on the balance sheet. ROE is what the shareholders look in return for their investment. A business that has a high return on equity is more likely to be one that is capable of generating cash internally. Thus, the higher the ROE the better the company is in terms of profit generation. It is further explained by (Khrawish, 2011) that ROE is the ratio of Net Income after Taxes divided by Total Equity Capital. It represents the rate of return earned on the funds invested in the company by its stockholders. ROE reflects how effectively a firm management is using shareholders" funds. Thus, it can be deduced from the above statement that the better the ROE the more effective the management in utilizing the shareholders capital.

2.3.4 External Factors and Macroeconomic Factors

The macroeconomic factors that affect financial performance include changes in inflation, change in interest rate and exchange rate fluctuations. External factors include political stability and international relations. These factors affect performance of all companies in the economy, therefore exposing companies to systemic risk. Interest rate is the rate of borrowing, or can also be defined as the cost of money. Currency exchange rate on the other hand is the rate that can be converted from one currency to another currency. For instance, an increase in inflation and interest rate results to low profitability which in return results to poor financial performance for the company. On the contrary, low inflation rate, a stable currency, good international relations and political stability in a country results to increase in companies' income which results to increased profitability.

2.4 Empirical Review

Hannan and Wolken (1989) conducted a study on the returns to bidders and targets in the mergers and acquisition in the banking industry in the US. The objective was to establish the value-weighted abnormal returns experienced in 43 deals announced between 1982 and 1987. The finding was that, on average, total shareholder value was not significantly affected by the announcement of the deal. Also, one determinant, target capitalization, cross-sectionally influenced expected synergistic gains. Target capital was negatively related to the change in total value.

Mitchell and Lehn (1990) studied stock price reactions to acquisitions during the period 1982-1986. One sample was composed of firms that became targets of takeovers after they had made acquisitions. A control group consisted of acquiring firms that did not subsequently become targets of takeover bids. The stock prices of acquirers that became targets declined significantly when they announced acquisitions. The stock prices of acquiring firms that did not become subsequent targets increased significantly when they announced acquisitions. The findings were that for the entire sample of acquisitions, those that were subsequently divested had significantly negative returns. On the other hand acquisitions that were not subsequently divested had significantly positive returns

Houston and Ryngaert (1994) examined abnormal returns from four days before the target was initially declared a takeover candidate (by any bank) to the announcement day. In their sample of 153 mergers announced between 1985 and 1991, acquirers suffered a loss in value and targets enjoyed a gain. However, there was no significant aggregate effect on the overall value of the two organizations. The amount of value that was created was highest when acquirers were strong pre-merger performers and when substantial overlap existed. This relationship of value creation with the degree of overlap is consistent with the market expecting mergers best suited for improved efficiency and/or increased market power to experience the greatest level of post-merger benefits.

Saple (2000) studied the Diversification, Mergers and their Effect on Firm Performance: A Study of the Indian Corporate Sector. The findings were that the target firms were better than industry averages while the acquiring firms had lower than industry average profitability. Overall, acquirers were high growth firms which had improved the performance over the years prior to the merger and had a higher liquidity

Pazarskis et al. (2006) examined empirically the impact of mergers and acquisitions on the operating performance of Mergers & Acquisitions involved firms in Greece. Using financial, accounting and confidential questionnaire response data, the post-acquisition performance of fifty Greek companies listed on the Athens Stock Exchange that executed at least one merger or acquisition in the period from 1998 to 2002 is evaluated on the basis of certain non-financial characteristics and financial characteristics (a set of seven selected financial sectors). The study showed strong evidence that the profitability of a firm that performed M & As is decreased due to the merger or acquisition event.

Saboo and Gopi (2007) investigated the impact of mergers on the operating performance of acquiring firms by examining some pre-merger and post-merger financial ratios of these firms and determined the differences in pre-merger and post-merger financial ratio of the firms that went for domestic acquisitions and firms that opted for international/cross-border acquisitions. The results suggest that there are variations in terms of impact on performance following mergers, depending on the type of firm acquired-domestic or cross border. The main finding shows that merger have had a positive effect on key financial ratios of firms acquiring domestic firms while a slightly negative impact on the firms acquiring cross-border firms.

Gopalaswamy, Charya and Malik (2008) conducted a study on stock price reaction to merger announcement in India security market. The objective of the study was to examine the effect of merger announcement on both target and acquirer companies' stock prices. An event study methodology was used and secondary data collected from the market. A sample of 25 firms was selected from Bombay Stock Exchange and National Stock Exchange which met the requirement that both target and acquirer are listed. The finding was that there was upward trend in stock prices few days prior to announcement this may due to anticipation of merger or leakage of information.

Muia (2010) studied the determinants of growth of firms through M&A in Kenya's firms listed on the Nairobi Securities Exchange. Bidder characteristics, industry variables and market variables were examined. Profitability, industry concentration, sales growth, stock market index, and GDP growth were assumed to be the major factors influencing growth of firms through mergers and acquisitions in Kenya. The main type of data used for analysis was secondary. For this purpose, eleven years (1999 to 2009) data for six listed firms in financial and industrial sectors was collected and analyzed. The findings were that profitability was the most significant variable in predicting growth of firms through mergers and acquisitions in Kenya. Industry concentration, stock market index and GDP growth were equally influential but to a lesser extent. Sales growth was the least influential variable. The study concluded that firms be encouraged to embrace M&A growth strategy in corporate finance especially when pursuing the profitability and wealth objectives.

Kinyua (2011) conducted a research on the information content of mergers and acquisitions on financial performance of oil companies in Kenya. This study took on a causal research design. In this study the target population was the oil companies in

Kenya with keen interest on those that have gone through mergers and acquisition. The process of data collection involved self administered drop and pick questionnaires distributed to management and employees of the oil industries involved. The use of audited accounts enhanced the data received from 27 respondents. The findings was that there was a clear indication of the firms performing better financially after the resulting merger and acquisition.

Mahmood et al, (2012) studied the impact of merger and acquisition on post-merger performance of the acquired company in Pakistan. It covered a sample of 8 companies which passed through merger and acquisition phase in Pakistan during the year 2000-2002. Most of the merger companies of this study belonged to the banking and others to pharmaceutical industry. All the sample companies were listed on Karachi Stock Exchange. Impact of merger and acquisition on share price of these companies had been observed through event study. The finding was that positive changes had resulted in the share price of five companies and negative impact in the share price of the two companies had been found one month after the merger. Moreover, no change in the price of one company had been found. Overall, the results indicated that M&A positively affected the share price of companies.

Njuguna (2012) studied the effects of mergers and acquisitions on the financial performance of petroleum companies in Kenya. The study was limited to a sample of companies listed on the Kenyan market that merged or acquired between the years 2002-2012. Data was collected from the NSE annual statement of accounts and financial reports of the firms. Comparisons were made between the mean of 3-years pre-merger and 3-years post-merger financial ratios, while the year of merging is exempted. The finding was that mergers have insignificant effect on the overall financial performance of petroleum firms in Kenya. Also, there was improvement in the firms' performance after the merger took place.

Rahim and Pok (2013) examined the short-term wealth effect of M&A in Malaysia and also examined the factors that affect short-term shareholders wealth during M&A announcement. A sample of 180 targets and 196 bidding companies during the period 0f 2001 and 2009 were analysed. The findings were that there were positive market reactions by both target and bidding shareholders towards M&A announcement. However, target shareholders earned significantly higher than bidding shareholders. However, the impact on the target and bidding shareholders was different. Relative size negatively affected bidding shareholders wealth and target had higher ROE.

Fatima and Shehzad (2014) examined the impact of M&A on financial performance of banks in Pakistan. Ten banks that had merged between the years 2007 and 2010 were selected as a sample for analysis. Financial ratios that were used for analysis included profit after tax, ROA, ROE, debt to equity and EPS. The findings were that ROE was the only ratio affected by M&A and that other ratios had no impact on the financial performance of the banks.

2.5 Summary of Literature Review

The findings from empirical studies by Rahim and Pok (2013); Mahmood et al (2012); Gopaalaswamy, Charya,and Malik, (2008);Fatima and Shehzad (2014); provide evidence on the positive impact of mergers on the financial performance of companies in terms of profitability and increase in share prices. Kinyua (2010), Njuguna (2012) and Muia (2010) conducted a research on impact of mergers on firms in Kenya and the findings were that mergers resulted to an increase in share prices and profitability after a merger. However, findings on studies done by Hannan and Wolken (1989), Mitchell and Lehn (1990) and Houston and Ryngaert (1994) findings were that there was no significant aggregate effect on the overall value of the two organization. However these studies do communicate mixed reactions about the effect of mergers on the overall financial performance of the merged firm. Present study is an attempt to examine the effects of mergers on financial performance on listed companies at Nairobi Securities Exchange.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets out various stages and phases that were followed in the study. The chapter highlights the following subsections; research design; population of the study; data collection method and; data analysis and the analytical model that will be used in this study.

3.2 Research Design

The research adopted a descriptive design in order to determine the relationship between mergers and financial performance. A survey research design was also used since not all firms were studied. Survey research can be specific and limited, or it can have more global, widespread goals. If the limitations are understood, they can be a useful tool in developing a more focused study. Survey research design can yield rich data that lead to important recommendations in practice and thereby be able to depict the effect of merger on financial performance of companies listed on the NSE.

3.3 Population of the Study

The population for this research was all the firms that had undergone mergers and are listed in the NSE. There are a total of 15 companies listed on the NSE that have engaged in merger by 2014. However for this research, only companies that merged between 1997 and 2013 were considered. Therefore only 10 companies which include CFC Stanbic Bank Ltd, Kenya Commercial Bank Limited, APA insurance ltd and Kenol Kobil ltd will be considered. A census survey will be conducted.

Table 1: List of companies at the NSE that have merged between 1997 and 2013

Institution	Merged with	Current Name	Date approved
CFC Bank Ltd.	Stanbic Bank Ltd.	CFC Stanbic Bank Ltd.	2008
Savings and Loan (K) Limited	Kenya Commercial Bank Limited	Kenya Commercial Bank Limited	2010
Pan Africa General insurance	Apollo Insurance	Pan Africa Insurance ltd	2003
Kenya oil	Kobil petroleum ltd	Kenol Kobil	2008
NIC Bank ltd	African mercantile	NIC Bank	1997
DTB Bank ltd	Premier Savings & finance	DTB Bank ltd	1999
NBK Ltd	Kenya National Capital	NBK kenya Ltd	1999
Total Kenya ltd	Elf Oil K Ltd	Total Kenya Ltd	2001
Standard Chartered ltd	Standard Chartered Financial Services	Standard Chartered Bank ltd	1999
Barclays Bank of Kenya	Barclays Merchant Finance ltd	Barclays Bank of Kenya	1999

Source: Capital Market Authority

3.4 Data Collection Method

This study was based on secondary data to be obtained from available financial statements of listed companies that have engaged in a merger in Kenya. These statements were accessed through the respective company websites, Central Bank of Kenya, Capital Markets Authority and the Nairobi Securities Exchange. Data from financial statements includes; Earnings per Share, Return on Equity, Return on Assets, Dividend per Share and Turnover to Total Assets Ratio. Data from Central Bank of Kenya include inflation rate and change in interest rate. The duration considered for this study will be 4 years before and after the merger has taken place. Data was collected from Annual Statement of Accounts and Financial Reports of the firms and comparisons made between the post mergers cumulative abnormal returns.

3.5 Data Analysis

Event analysis was used to determine whether the event “merger” had significant effect on financial performance. An event study is a statistical method to assess the impact of an event on the value of a firm. For example, the announcement of a merger between two business entities can be analyzed to see whether investors believe the merger will create or destroy value. The basic idea is to find the financial performance attributable to the event being studied by adjusting for the return that stems from the price fluctuation of the market as a whole. As the event methodology can be used to elicit the effects of any type of event on the direction and magnitude of stock price changes, it is very versatile (MacKinlay 1997; McWilliams & Siegel, 1997).

The study used accounting ratios to analyze the financial performance of the companies’ mergers under study. For the pre-merger period, ratios for the already listed company which was the acquirer was examined so as to get an indication of the relative performance of the acquirer. For the post merger period, the focus of the analysis was on the combined institution. The data was analyzed four years before the mergers and four years after the merger to determine if the merger had significant effect on financial performance .In order to establish the relationship among the different variables in the study, t-test at 5 % significance level analysis was conducted on the DPS, EPS, ROA and ROE indicators. The average mean of each of the variables DPS, EPS, ROA and ROE was presented graphically, four years before the merger, year of merger and four years after the merger. This was to compare the trend of performance before the merger and performance after the merger. The mean and standard deviation of each variable before and after the merger was computed and comparison made. T- value for each variable was computed to determine if the effect was significant or not.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter provides various sections. Section 4.2 provides data analysis; section 4.3 relationship among study variables and 4.4 presents discussion of findings.

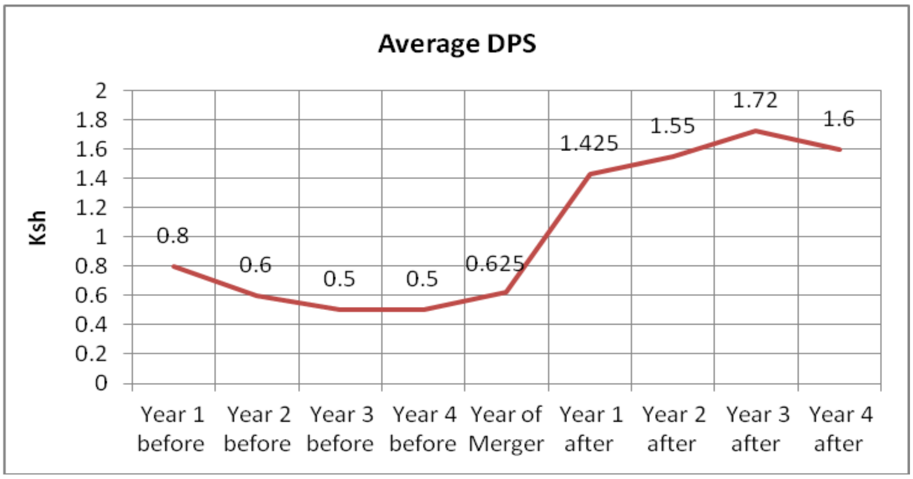
4.2 Data Findings Analysis

The data was analyzed four years before the mergers and four years after the merger to determine if the merger had significant effect on financial performance In order to establish the relationship among the different variables in the study, t-test at 5 % significance level analysis was conducted on the DPS, EPS, ROA and ROE indicators. The mean and standard deviation of each variable before and after the merger was computed and comparison made. T- Statistic value for each variable was computed to determine if they were significant or not.

4.2.1 Effect of Mergers on Dividend per Share

As shown in figure 4.1 below, the average dividends per share were reducing years before the merge on average for all studied firms. On the year of the merger, DPS increased from 0.5 per share on average to 0.625 to 1.425 in first year after the merger, to 1.55 in second year of the merger, to 1.72 in year three after the merger and reducing to 1.6 in the fourth year of the merger. Dividend per share increased 42.5% from one year before the merger and one year after the merger.

Figure 4.1: Average Dividend per Share

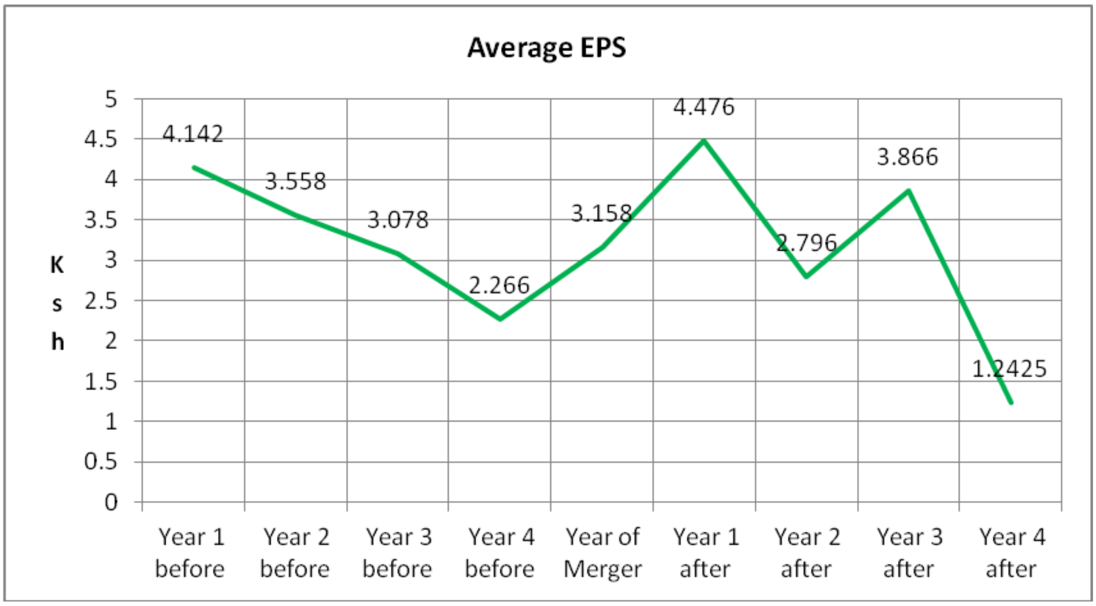


Source: Research Findings

4.2.2 Effect of Mergers on Earnings per Share

The trend on EPS before the merger was declining to Ksh. 2.266 one year before the merger. However, after the merger, earnings started to rise to Ksh. 3.158 in the year of the merger to 4.476 one after the merger after which the same started to decline in second year of the merger to 2.796, rose to 3.866 in year three of the merger and reduced to Ksh. 1.2425 in year four after the merger. Clearly, it can be seen that the merger had positive effect on EPS. The results are shown in figure 4.2 below.

Figure 4.2: Average Earnings per Share

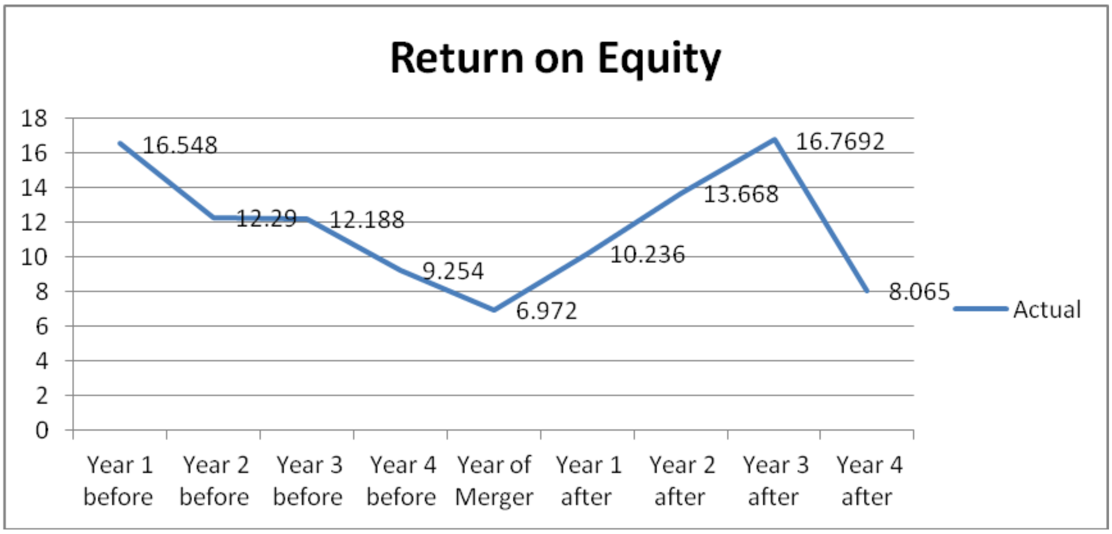


Source: Research Findings

4.2.3 Effect of Mergers on Return on Equity

As shown in figure 4.1 below, the average ROE were reducing years before the merge on average for all studied firms. On the year of the merger, ROE increased from 6.972 per share on average to 10.236 to 13.668 in second year after the merger, to 16.7692 in third year of the merger reducing to 8.065 in the fourth year of the merger. The results are shown in figure 4.3 below.

Figure 4.3: Actual average ROE

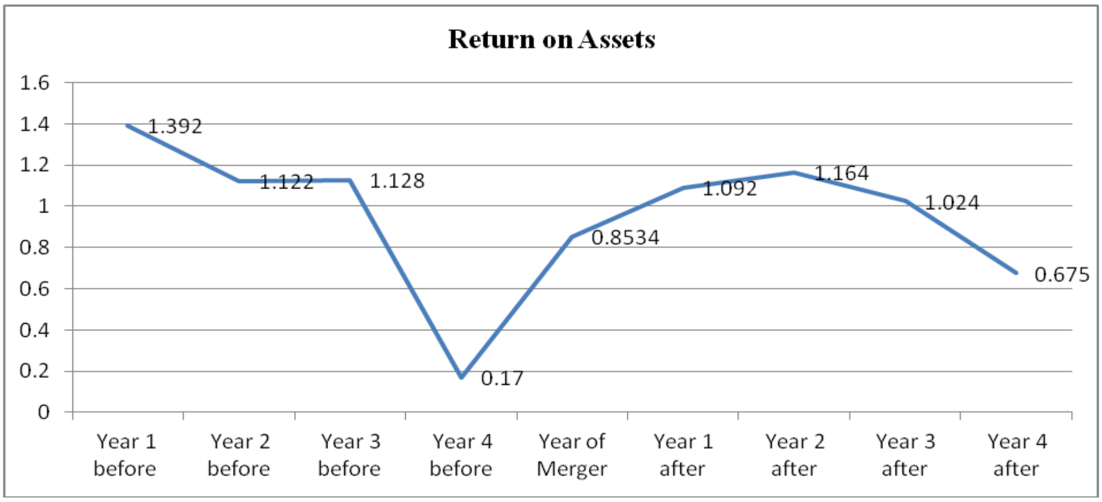


Source: Research Findings

4.2.4 Effect of Mergers on Return on Assets

As shown in figure 4.1 below, the average ROA were reducing years before the merge on average for all studied firms. On the year of the merger, ROA increased from 0.17 per share on average to 0.85 to 1.092 in first year after the merger, to 1.164 in second year of the merger, to 1.024 in year three after the merger and reducing to 0.675 in the fourth year of the merger.

Figure 4.4: Actual Average ROA



Source: Research Findings

4.3 Relationship among Study Variables

In order to establish the relationship among the different variables in the study, t-test at 5 % significance level analysis was conducted on the DPS, EPS, ROA and ROE indicators. The mean and standard deviation of each variable before and after the merger was computed and comparison made. T-statistic value for each variable was computed.

Table 4.1: Ratio Analysis Table

	Mean Before Merger	Std Deviation Before merger	Mean After Merger	Std Deviation After merger	T- value	Decision
DPS	0.6	0.141421	1.384	0.437284	2.649876	Effect significant at 5%
EPS	0.261	0.793281	3.1077	1.227388	3.245265	Effect significant at 5%
ROA	0.953	0.536966	1.96168	0.197301	3.082201	Effect significant at 5%
ROE	12.57	3.00248	11.14204	4.053508	-0.19255	Effect not Significant at 5%

4.4 Interpretation of Findings

As shown in table 4.1 above, merger had significant effect on post merger financial performance of merged firms except ROE. The pre merger mean DPS was 0.6 with a standard deviation of 0.1414 while the post merger DPS was 1.38 and standard deviation of 0.4373. The t-test obtained was 2.65 which was higher than critical at 1.96 significance level implying that the effect was significant.

The premerger mean EPS was 0.261with a standard deviation of 0.7933 while the post merger EPS was 1.2274 and standard deviation of 1.2274. The t-test obtained was 3.2453 which was higher than critical at 1.96 significance level implying that the effect was significant.

The premerger mean ROA was 0.953 with a standard deviation of 0.537 while the post merger ROA was 1.96168 and standard deviation of 0.197301. The t-test score obtained was 3.082201 which was higher than critical at 1.96 significance level implying that the effect was significant.

Mergers had insignificant effect on ROE since t-test value obtained was -0.1926 which was less than critical T at 1.96 significance level interval and hence implying that mergers had no significant effect on ROE .

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents summary of findings as discussed in chapter four and interpretations of the data analysis, conclusions and recommendations based on the findings. The aim of the study was to establish the relationship between the financial performance and mergers of firms listed at the NSE.

5.2 Summary

The study sought to establish the relationship between mergers and financial performance of firms listed at the NSE. Secondary data relating to four years after and before the merger was obtained and analyzed using event study methodology. The ratios analyzed included dividend per share (DPS), earnings per share (EPS), return on equity (ROE) and return on assets (ROA). The literature review encompasses the theories to be reviewed, the determinants of financial performance as well as the empirical review of related studies.

From the findings of data analysis, mergers have significant positive effect on DPS where merging of listed companies lead to increase in DPS. The rise on DPS could be out of the need to create investors confidence and synergy related to mergers. Merging companies have reducing dividend per share before the merger but the same increase in the year of the merger and continue to rise thereafter.

Mergers have positive and significant effect on earnings per share (EPS) where EPS before the merger was found to be declining but started to rise immediately after the merger. The rise in EPS is due to the economy of scale and the benefits that come with merging. Increase in EPS implies improved performance of the company.

Mergers have significant positive effect on ROA where merging of listed companies lead to increase in ROA. However, mergers have insignificant effect on ROE. The return on equity remains statistically unchanged even after the merger.

5.3 Conclusions

Based on the study findings, the study concludes that merger of listed companies affects the financial performance in either negatively or positively. Mergers have significant positive effect on DPS where merging of listed companies lead to increase in DPS. The rise on DPS could be out of the need to create investors confidence and synergy related to mergers. Merging companies have reducing dividend per share before the merger but the same increase in the year of the merger and continue to rise thereafter.

The study also concludes that mergers have positive and significant effect on earnings per share (EPS) where EPS before the merger was found to be declining but started to rise immediately after the merger. The rise in EPS is due to the economy of scale and the benefits that come with merging. Increase in EPS implies improved performance of the company.

The study also concludes that mergers have positive but insignificant effect on return on equity. This implies that as a result of merger, the return on equity remains statistically unchanged. However, mergers lead to increase in ROA even if the effect is minimal. Finally, the study concludes that mergers have significant effect on return on assets. This implies that through mergers, companies are better able to utilize their assets in generating income.

5.4 Recommendations

Following the findings from the analysis of the listed companies that have undergone mergers in Kenya, the study recommends that firms (listed/unlisted) having weak capital base or having challenges in generating income to merge with similar firms and create synergies so as to enjoy economies of scale as this will improve their financial performance, share returns and hence maximizing shareholders wealth which is the general objective of profit making companies.

The study also recommends that those firms facing operational constraints should to consolidate their energies by resorting to merger so as to improve their performance as the merger is not just for the best interest of the shareholders and also managers which will not be achieved when the firm is operating separately on its own.

Therefore mergers ought not to be seen as a loss of control on managers or loss of ownership but a strategy of achieving better performance.

The study also recommends that those firms facing low EPS and low DPS should consolidate their energies by resorting to merger so as to improve their performance as the merger for the best interest of the shareholders.

The study also recommends that the merging firms to adequately assess the merging decisions and to know the firms to merge with so as to increase shareholders wealth. Effect of mergers on financial performance was found to vary from firm to firm implying that there are specific factors that may be responsible achievement of better results. Firms should only merge with those firms which will bring synergy.

5.5 Limitations of the study

The study used secondary data alone for analysis and making of conclusions. The information used was not specifically released for use in research but for other reasons. The information obtained was also not adjusted for accounting differences between the firms which implies that the study findings are limited to the accuracy of the information provided.

The mergers on listed companies were found to happen on varied years. No adjustment of financial information provided was adjusted for changes in the value of money. Earnings of for example one shilling ten years ago had more value than a shilling ten years after due to changes in price levels in the country. For effective comparison of the information, adjustment for changes in money value over years would have been essential.

Another key challenge related to data collection where getting over 10 years historical data was challenging. The researcher had to rely on multiple sources to obtain all the required information an exercise that was time consuming. This was also because the number of firms merging at NSE is not as many to enable targeting more recent merging events.

5.6 Areas for Further Research

The same study should be conducted per segment of the NSE to find out whether the results are consistent across all sectors or industries. It would be interesting to find out whether some sectors firms share returns is usually more in some segments than other segments. On the same note, further study can be done using case study and determine the specific factors responsible over the performance/share returns after mergers.

This study only dealt with firms listed at NSE. Further study should be done to determine the effect of mergers on financial performance of unlisted firms. This will be interesting to find out whether the performance of listed companies could have been window dressed to lie to the market of better expected performance due to the merger.

Further study can be done on the effect of mergers on financial performance but not only using secondary data but to combine both primary and secondary data. Primary data can provide useful insights that may not be captured by secondary data. It could be that the change in performance as a result of merger is not as a result of merger alone but other measures that were adopted concurrently with the merger.

There are many challenges facing the formation of mergers. A study can also be carried out to establish the challenges on formation of mergers and why many firms had not formed mergers despite the advantages got from formation of the mergers. Finally, the model developed accounted for only a small portion of changes in share returns. Further study is therefore recommended but to include other key determinants of financial performance so as to provide a more accurate prediction model.

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APPENDICES

Appendix I: List of companies at the NSE that have merged between 1997 and 2013

Institution	Merged with	Current Name	Date approved
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Kenya oil	Kobil petroleum ltd	Kenol Kobil	2008
NIC Bank ltd	African mercantile	NIC Bank	1997
DTB Bank ltd	Premier Savings & finance	DTB Bank ltd	1999
NBK Ltd	Kenya National Capital	NBK kenya Ltd	1999
Total Kenya ltd	Elf Oil K Ltd	Total Kenya Ltd	2001
Standard Chartered ltd	Standard Chartered Financial Services	Standard Chartered Bank ltd	1999
Barclays Bank of Kenya	Barclays Merchant Finance ltd	Barclays Bank of Kenya	1999

Source: Capital Market Authority

Appendix II: Research Data

Row Labels	Year 1	Year 2	Year 3	Year 4 after	Year 1 after	Year 2 afta	Year 3 after	Year 4
DPS	0.8	0.6	0.5	1.6	1.425	1.55	1.72	0.5
EPS	4.142	3.558	3.078	1.2425	4.476	2.796	3.866	2.266
ROA	1.392	1.122	1.128	0.675	1.092	1.164	1.024	0.17
ROE	16.548	12.29	12.188	8.065	10.236	13.668	16.7692	9.254