EFFECT OF MERGERS AND ACQUISITIONS ON THE FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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DECLARATION

I declare that this research Project is my original work and has not been presented for a degree in any other university.

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This Research Project has Been Submitted for Examination with My Approval as The University Supervisor

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Thank you all.

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DEDICATION

This study is dedicated to myself.

“Knowledge is like a garden: if it is not cultivated, it cannot be harvested. Unknown

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LIST OF ABBREVIATION

ROA: Return on Asset

ROE: Return on Equity

I &M : Investment and Mortgage

CAAR: Cumulative Average Abnormal Return

GDP: Gross Domestic Product

EBIT: Earnings before Interest and Tax

ABSTRACT

Mergers and acquisition refers to where two or more companies combine corporate resources to operate as a unit with an aim of improving their performance. Previous study on this topic give conflicting findings on how firms performance react to merger and acquisition The objective of the study is to investigate the effects of merger and acquisition on the financial performance of financial institutions in Kenya. The study adopted a descriptive study design using event study model to analyse the relationship existing between the accounting ratios (ROA and ROE) as measures of financial performance. The study found that that merger and acquisition events results into either increase or decrease in the financial performance. Abnormal financial performance was calculated for the pre and post-merger period. The cumulative abnormal average return (CAAR) for all the banks involved in the study found ROA to be 5.274, thus concluding that merger and acquisition positively affect financial performance. However, the CAR for ROE found -1.823 as a result of the variability of the extreme negative performance of Equatorial Commercial bank. This leads to the conclusion that merger and acquisition event results into an increase in financial performance of the companies. The study recommends that management teams need to take advantage of the benefits of mergers and acquisitions. However, analysis need to be done when choosing a firm to merge with or a company to acquire in order to ensure that the merger exercise will add value to the firm competitive advantage.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The changes in the business operating environment in relation to competition and the regulatory and economic capital required to operate in an industry, several licensed institutions, mainly commercial banks, have had to merge (combine their operations in mutually agreed terms) or one institution takes over another's operations (acquisitions). The reasons behind the merger transactions are basically gaining market share, competitive advantage, improving financial performance and risk and product diversifications (Akinbuli & Kelilume, 2013). With the global financial crises, it is noticeable that mergers and acquisitions have considerably increased. Corporations employed such combination not only for the sake of competitiveness but to maintain a firm foothold in the industry as well. This has led to the significant transformation in the business landscape (Tajalli & Shehzad, 2014).

Business Organizations are established to achieve certain corporate objectives including corporate growth and increase in financial performance. A profit is a major yardstick by which the success of a business firm is measured. Given that business organizations operate in a dynamic macroeconomic environment such growth is threatened in periods of volatile economic instabilities (Weston & Copeland, 1989). Authors such as Shleifer and Summers (1988) argue that take-overs are largely motivated by the opportunity they offer to renege on implicit labour contracts and to reduce or eliminate extra-marginal wage payments. A corporate merger or acquisition can have a profound effect on a company's growth prospects and long-term outlook. But while an acquisition can transform the acquiring company literally overnight, there is a significant degree of risk involved, as mergers and acquisitions (M&A) transactions overall are estimated to only have a 50% chance of success (Tajalli & Shehzad 2014).

1.1.1 Mergers and Acquisitions

Gaughan (2007) defines merger as ‘a combination of two or more corporations in which only one corporation survives’. He further stated that the acquiring company assumes the assets and liabilities of the merged firm. Okonkwo (2004) noted that a merger may be achieved through an acquisition, in this case, the shareholders of the acquired company are paid off and the acquirer becomes the owner of all or a substantial part of the assets of the acquired company. According to Sudarsanam (2003), terms such as ‘merger’, ‘acquisition’, ‘buyout’ and ‘takeover’ are used interchangeably and are all part of the M&A parlance, but was quick to point out the differences when he described merger as the process where corporations come together to combine and share their resources to achieve common objectives with the shareholders of the merged firms still retaining part of their ownership and this may sometimes lead into a new entity being formed while acquisition resembles more of an arm’s-length deal, with one firm purchasing the assets or shares of the other and the shareholders of the acquired firm ceasing to be owners of the new firm.

Moctar and Xiaofang (2014) define merger as the combination of two or more organizations into one larger organization. Such actions are commonly voluntary and often result in a new organizational name (often combining the names of the original organizations). An acquisition, on the other hand, is the purchase of one organization by another. Such actions can be hostile or friendly and the acquirer maintains control over the acquired firm (Indhumathi, Selvam & Babu, 2011). Mergers and acquisitions differ from a consolidation, which is a business combination where two or more companies join to form an entirely new company. Mergers and Acquisitions refer to the change in ownership, business mix, assets mix and alliance with the view to maximize shareholders‟ value and improve firm performance. One of the main elements of improving company performance is the boom in mergers and acquisitions (Pazarkis et al, 2006).

Mergers and Acquisitions are important as they lead to combining corporate resources, but only if it results in a competitive advantage. Some of the benefits are rapid access to technology and products, an extended customer base, an enhanced market position and a stronger financial position. Another importance of mergers and acquisitions is access to an expanded installed base of customers. This not only provides an opportunity for sales of existing products to a larger group of customers, but also provides a greater base for future product sales. In addition, consolidated companies can own a greater share of market, which gives them a substantial competitive advantage. Mergers and acquisitions also benefit companies wanting to reposition themselves in the market. By adding capabilities to their product offerings, companies can rapidly expand their market coverage and modify their market position (Mboroto, 2012).

In Kenya, merger and acquisition is a strategy that has been widely used by companies that intend to grow their asset value and increase their market share. Since year 2000 to 2014, a total of 19 companies have engaged in either a merger and/or acquisition. Some of the financial institutions that have merged with other firms include; CFC Stanbic, Paramount Universal Bank, Kenya Commercial Bank Ltd., Citibank NA, Southern Credit

Banking Corp. Ltd., Co-operative Bank of Kenya ltd, Investment & Mortgage Bank Ltd., Commercial Bank of Africa ltd, EABS Bank ltd, Prime Bank Ltd., Kenya Commercial Bank Limited, Jamii Bora Bank Ltd., Equatorial Commercial Bank Ltd. Dubai Bank Ltd. Other companies that have acquired others include; Bank of Africa Bank Ltd., Ecobank Bank Ltd., Guaranty Trust Bank (Kenya) Ltd, K-Rep Bank Ltd and Equatorial Commercial Bank Ltd among others (CBK, 2014).

1.1.2 Financial Performance

Financial performance refers to the overall measure of a firm's financial health position over a given period of time, and is used to measure the efficiency of the firms utilization of its assets to generate revenues (Pandey, 2008). The financial performance of a company can also be rated against the performance of similar firms across the same industry or to compare sectors in aggregation. In the contemporary business environment, financial ratio analysis is used as the key performance measure to ascertain whether the business is viable. Most organizations consider profitability as the measure of their financial performance. The level of profitability is determined by the gross profit margin, which measures how much money the firm makes after deducting the direct costs of sales; and the earnings before interest and tax (EBIT) margin.

1.1.3 Effects of Mergers and Acquisitions on Financial Performance

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 and acquisitions are to improve financial performance in form of 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 (Mboroto 2013). A study conducted in Pakistan, in which the impact of merger and acquisition on post-merger life of company captured indicated positive changes have resulted in the share price of five companies and negative impact in the share price of the two companies have been found one month after the merger. Moreover, no change in the price of one company has been found. Overall, the results indicate that M&A positively affect the share price of companies. (Fatima and Shehzad 2014)

A study by Girma et al (2011) indicated that there is an increase of £300-400 in the mean operating profit per employee of the acquiring companies three and four years after acquisition, a result that is robust to the type of estimator used. They investigated this impact further by breaking the merger effect into that deriving from related and from unrelated acquisitions. These results indicate that although both merger types impact positively on profits, the timing, and magnitude of these effects differs. The point estimates are higher and the impact on financial performance is more immediately felt if a firm acquires a target in the same industry division. Based on these researches therefore, we can infer that mergers and acquisition would positively impact financial performance of an organization.

1.2 Research Problem

Mergers and acquisition is a corporate finance strategy has been considered to be one of the best strategies for firms that desire growth and increased profitability. A number of researches conducted on accounting data to measure the effect of takeover on operating performance in long and short run argue that any benefit arising from acquisition will eventually be reflected on the company's financial performance records (Tuch & O'Sullivan, 2007). A study by Marembo (2011) that looked at the impact of mergers and acquisition on the financial performance of 32 commercial banks in Kenya established that the returns on assets and returns on equity of the firms both improved as the assets of the company improved after the merger or the acquisition. Similar findings were made by Adebayo and Olalekan (2012 investigated the impact of merger and acquisition on commercial banks performance in Nigeria.

A study is conducted by Muia & Fidelis (2012) in Kenya to examine some market and industry variable as a determinant of merger and acquisition and their impact on the growth of business. The study found out that industry concentration, sales growth, stock market index and GDP growth determines growth of firms through mergers and acquisitions but to a lesser extent. The study concludes that firms be encouraged to embrace M&A growth strategy in corporate finance especially when pursuing the profitability and wealth objectives.

Despite the numerous studies on mergers and acquisition, there has been conflicting findings on the effect of merger and acquisition on the financial performance of companies in Kenya. This study thus seeks to fill this gap, by investigating the effect of merger and acquisition on the financial performance of financial institutions in Kenya. The research question that the study seeks to answer is: What is the effect of merger and acquisition on the financial performance of financial institutions in Kenya?

1.3 Research Objective

To investigate on the effects of merger and acquisition on the financial performance of financial institutions in Kenya.

1.4 Value of the Study

This research will highlight the merger impacts on the performance of organizations and their shareholders. It was of significant importance for the industry and other firms in the industry to recognize the importance of mergers and acquisitions and impacts on company's performance and the synergies achieved through them.

This research will also be helpful to managers and executives as it will provide them an in-depth analysis of the relationship between merger and performance level. This study would particularly be helpful to the following stakeholders: corporate stockholders and managers, investors, academe, government, brokers, consultancy firms, investment banks, business partners, creditors, customers and the public in general.

This research will provide up to date knowledge which wasalso helpful for the University students by providing them extensive knowledge regarding mergers and acquisitions in the industry.

This piece will also act as basis for reference for further studies in the area of mergers and acquisitions.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The subsequent literature review seeks to integrate issues regarding theories to be reviewed, Firm profitability and growth, and determinants of firm profitability.

2.2 Theoretical Review

This study will majorly focus on three theories that lead to mergers and acquisitions revolve, they include free cash flow theory, oligopolistic reaction theory and size and return to scale theory. These theories are explained in detail below.

2.2.1 Free Cash Flow Theory

A major explanation why firms pay dividends is the free cash flow hypothesis (Jensen, 1986), which explains dividends as a means to mitigate agency cost of free cash flows. The free cash flow hypothesis is primarily based on the argument that there is a conflict of interest between managers and shareholders. That is, rather than act in shareholders' best interests; managers could allocate the firm's resources to benefit themselves (Thanatawee, 2011). An implication of the free cash flow hypothesis is that cash-rich firms that are mature with scarce investment opportunities tend to have overinvestment problem. Thus, a dividend increase announcement by these firms should be accompanied with a positive stock market reaction since it is a signal to shareholders that management will not wastefully use corporate cash flows **(**Buusa, 2015**)**.

One way managers can divert free cash flows from dividends is by issuing debt and thus binding themselves to pay out future cash. This theory prompts the need to improve financial performance of firms through mergers and acquisitions. Return on shareholder equity is affected when managers divert the free cash flow from dividends thus affecting the financial performance of a company. This is because return on equity measures a corporation's profitability by revealing how much profit a company generates with the funds invested by shareholders (Mboroto 2012).

2.2.2 Oligopolistic Reaction Theory

An oligopolistic reaction is a concept from economics introduced by Frederick T. Knickerbocker (1973) that explain why firms follow rivals into foreign markets. He defines oligopolistic reaction as a corporate behaviour by which rival firms in an industry composed of a few large firms counter one another's moves by making similar moves themselves (Knickerbocker, 1973). Thus, if two firms in an oligopolistic industry merge, others might react by merging in turn (Cantwell, 1992), independently of whether shareholders will gain or lose as a result. This behaviour of oligopolistic reaction could cause a chain of mergers to take place, and therefore can then help explaining the empirical evidence that seem to show that mergers happen in waves. In the case of petroleum firms in Kenya, various industry players are engaging in mergers and acquisition in a bid to improve financial performance. Consequently, rival firms are engaging in mergers and acquisition deals as their competitors in order to realize these oligopolistic goals (Mboroto 2012).

2.2.3 Size and Return to Scale Theory

Actually, when industrial structure is described by firm size, the number of firms and their shares in the market, Increasing Return to Scale (IRS) is a crucial factor that determines the structure (Fan, et al, 2006). Benefits of size are usual source of "synergies". This refers to the positive incremental net gain associated with the combination of two firms through a merger or acquisition. Suppose firm A acquires firm B for cash. The synergy or total gain in value to the shareholders of A and B is Synergy = VAB - [VA + VB]. If the synergy is *positive*, then the combination of the two firms (VAB) is more valuable than the sum of the separate firms. As learnt from the first principles of finance, the value of an asset is the present value of its discounted Future cash flows. The cash flows from synergy are: ΔCFt = CFABt - [CFAt + CFBt]. If positive, then the combined firm results in greater cash flow than the Sum of the separate firms. If no value is created through the combination of A and B, i.e. synergy = 0, then the merger is a zero-sum game and the gain to B shareholders is equal to the cost to A shareholders. If VAB > VA + VB, then both parties may benefit. In terms of economies of scale the average costs decline with larger size. Large firms are more able to implement specialization. A combined firm may operate more efficiently than two separate firms. A firm can achieve greater operating efficiency in several different ways through a merger or an acquisition. Economies of scale relates to the average cost per unit of producing goods and services. If the per unit cost of production falls as the level of production increases, then an economy of scale exists. When companies merge, overheads are reduced and operational efficiency is improved since there is a sharing of central facilities such as corporate headquarters, top management, staff and computer services. Through economies of vertical integration; vertical mergers make it easier to coordinate closely related operating activities.

2.3 Determinants of Financial Performance

There are bank specific internal factors as well as the external factors which influence the financial performance of organizations. The internal determinants are within the scope of the organizations and can be manipulated by the organizations to improve their performance. These factors include capital size, size and composition of credit portfolio, size of deposit liabilities, interest rate policy, state of information technology, risk level, management quality, labor productivity, bank size, and ownership among others (Dang, 2011). Some of the determinants are discussed below.

2.3.1 Capital Adequacy

Capital refers to the amount of fund available to finance and sustain the organizations business operations and act as a cushion in case of adverse situation (Athanasoglou et al. 2005). In relation to banks, capital is one of the banks specific determinants of profitability. Banks capital creates liquidity for the firm since customer deposits are often most fragile and prone to bank runs. According to Dang (2011), the adequacy of capital is valued based on capital adequacy ratio (CAR), which indicates the internal strength of the bank to resist losses during crisis and to increase their investment for better financial performance. Capital adequacy ratio is considered directly proportional to the resilience of the bank to crisis situations. It also has direct effect on the financial performance, particularly profitability of the organizations by facilitating its expansion to risky but profitable ventures or areas (Sangmi and Nazir, 2010).

2.3.2 Asset Quality

Company’s asset includes among others; current asset, fixed asset, credit portfolio, and other investments. These assets which may be directly proportional to the age of the firm directly affect the firm’s profitability (Athanasoglou et al., 2005). In the case of banks, the loan book constitute major asset that generates the major share of the banks income. The quality of loan portfolio determines the profitability of banks, noting that the highest risk facing banks are the losses generated by delinquent loans (Dang, 2011). In this respect, non-performing loan ratios are determinants of asset quality. Therefore, low nonperforming loans to total loans ratio shows that the good health of the portfolio a bank and asset quality of an organization can be improved through merger and acquisition.

2.3.3 Management Efficiency

Management efficiency is a key internal determinant of the organizations financial performance. It is denoted by different financial ratios such as; total asset growth, earnings growth rate, and loan growth rate, which can all be improved through merger and acquisition. Efficient management of operating expenses also points to the ability to improve profitability since costs are minimized. The ability of the management to utilize its resources efficiently, maximize income, and reduce the operating costs can be assessed by financial ratios such as operating profit to income ratio and the expense to asset ratio (Athanasoglou et al. 2005).

2.3.4 Macroeconomic Factors

These refer to external factors in the macro environment such as economic policy stability, Inflation, Gross Domestic Product, Interest Rate and Political instability, which affect the performances of organizations. For instance, the trend of GDP impacts on the demand for banks asset, such that decline in the GDP growth results into the fall in demand for credit, which in turn negatively impact the profitability of banks (Athanasoglou et al., 2005).

2.4 Event Study Model

Event study model is a method performed on a security that has undergone a noteworthy catalyst incident, and has accordingly changed in value as a result of that occurrence (MacKinlay, 1997). Such events may include corporate event like company mergers and acquisitions, announcement of earnings, announcement of stock split, announcement of IPO, announcement of rights issue and announcement of planned capital investments among others. Such announcements either have positive or negative effects on the security prices or may cause abnormal negative or positive financial performance. This is based on the assumption that markets react to information promptly and accurately (Fama et al, 1969).

2.5 Empirical Review

2.5.1 Global Evidence

Akinbli and Kelilume (2013) did a study on the effects of mergers and acquisition on corporate growth and profitability of Nigeria and the results support the idea that mergers and acquisitions are not a prima facie solution to the problem of financial distress in corporate organizations. This is especially so when mergers are regulatory imposed than business environment driven. The study further found that while mergers and acquisitions can drive growth and profitability in some organizations, operating efficiency suffers at least in the short-term in the post-merger and acquisition corporate entity. The evidence also shows that mergers and acquisitions provided only a temporary solution to financial distress and no solution at all to operating indiscipline.

Adebayo & Olalekan, (2012) measured the impact of merger and acquisition on commercial banks performance in Nigeria, by using the sample of ten merged banks out of 24. They conducted a survey by filling questionnaire and also use ratios of sample banks. They have generated three hypothesis and applied correlation and t-test and their result shows that EPS has significant relation in pre and post-merger it also improved the capitalization of banks and the overall performance increased after merger.

Girma et al (2011) did a study on the impact of mergers and acquisitions on profitability and employee remuneration in UK manufacturing industry and the results indicated that both profitability and wages rise following acquisition, and firms that merge within the same industry division experience larger increases in profitability and pay their workers higher wages than those engaged in unrelated acquisitions. Fatima and Shehzad (2014) did a study on the analysis of Impact of Merger and Acquisition of Financial Performance of Banks in Pakistan and the results indicated that that only at 5% level of significance only ROE is affected by the merger and acquisition and other ratios have no impact from this strategy.

2.5.2 Local Evidence

Marembo (2011) investigated the impact of mergers and acquisition on the financial performance of commercial banks in Kenya. Using a sample of 27 banks that had merged, the analysis established that following the merger or the acquisition, the both ROA and ROE of the companies improved as the assets of the company improved. From the regression analysis conducted, the post-merger/acquisition findings showed that the financial institutions became more financially sound and profitable after the merger/ acquisition as the market share of the new company improved significantly.

Ndora (2010) studied the effects of mergers and acquisitions on the financial performance of insurance companies in Kenya. The study used a sample of six insurance companies that had merged between the year 1995 and 2005 from a population of 42 registered insurance companies. Performance information for five years before and after the merger was compared under the variables of financial performance, solvency ratios, profitability ratios, as well as capital adequacy ratios analyzed. The findings found an increase in financial performance by the firms for the five years after the merger than it was five years before the merger. This led to a conclusion that mergers and acquisition would result to an increase in the financial performance of an insurance company.

Marangu (2007) studied the effects of mergers and acquisition on financial performance of non-listed commercial banks in Kenya. The research focused on the profitability of non - listed banks which merged for a period between 1994 to 2001. Using four measures of performance including; profit, shareholders equity/total assets, return on assets, and total liabilities/ total assets, the results of the data analysis showed that three measures of performance: profit, Return on Assets and shareholders' equity/total assets had values above the significance level of 0.05 with exception of total liabilities/total assets. This study concluded that there was significant improvement in performance for the non-listed banks which merged compared to the non-listed banks that did not merge within the same period.

2.6 Research Gap

Despite the numerous studies on mergers and acquisition both globally and locally as discussed earlier, this study notes that there is conflicting findings on the effect of merger and acquisition on the financial performance of financial institutions in Kenya. For instance, the finding by Akinbli and Kelilume (2013) that M&A only provided a temporary solution to financial distress but no solution at all to operating indiscipline differs from the findings by Fatima and Shehzad (2014) that stated that only ROE is affected by the M&A. These two findings also conflict with the findings by Marembo (2011), Ndora (2010) and Marangu (2007), which concluded that M&A results to an increase in the financial performance of an insurance company. This study thus seeks to fill this gap, by investigating the effect of merger and acquisition on the financial performance of financial institutions in Kenya. The findings will add to the body of knowledge in the effect of M&A on financial performance and will seek to reduce the conflicting findings on this topic of study.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The research methodology entails the research design, data collection and analysis techniques to be utilized in the study.

3.2 Research Design

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

3.4 Data Collection

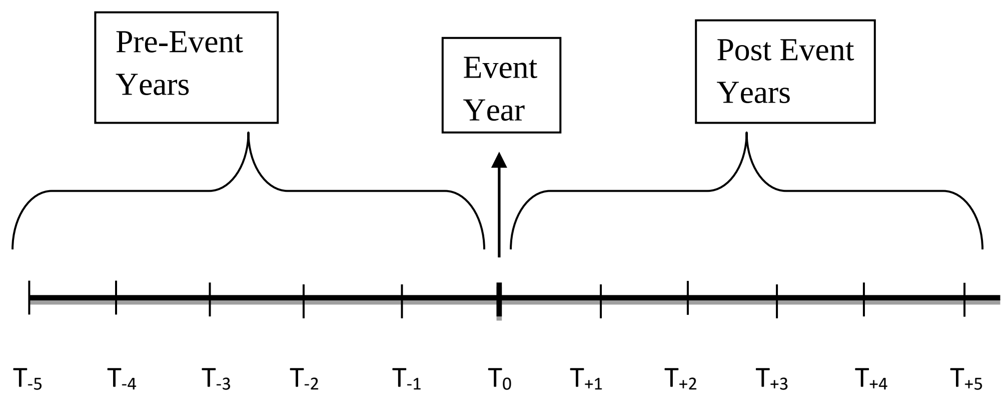
Secondary data related to the gross revenue, return on assets, return on equity, return on investment and the profit margins around the event study period was collected from the financial records of the financial institutions identified for the study. The data was also collected from the bank supervision report documents from the Central Bank of Kenya. The data collected was time series which covered five years before the merger and five years after the merger. The event model is outlined below;

Step 1: Identification of the event of interest

The event of interest is the effect of mergers and acquisitions on the financial performance on companies in Kenya. The researcher analyzed the mergers and acquisitions that took place from year 2000 to 2014.

Step 2: Definition of the event window

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



Step 3: Identification of the Sample of firms included in the study

This study used a sample of 9 financial institutions that engaged in a merger or acquisition between year 2000 and 2014 (Appendix I). The financial performance of the companies were analysed to determine whether the merger events strategy had an effect on the financial performance of the firms.

Step 4: Analyzing financial performance during the event period

The researcher first computed the financial performance (ROA, ROE) for the 5 year period before the event, then computed the financial performance for the 5 year period after the event.

3.5 Data Analysis

To establish the effect of mergers and acquisitions on the financial performance of companies in Kenya, the researcher used an event model to analyse the financial performance that examine the relationship existing between the accounting ratios (ROA, and ROE) results from the firm's financial statements and the bank supervision reports as expressed through the financial performance. The researcher examined how financial performances of the firms identified for this study are influenced by the mergers and acquisitions exercise. In order to carry out such an analysis the research used frequency tables, charts and bar graphs to interpret and presented data.

1.5.1 Analytical Model

This was done using the following steps;

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

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

Where:

R_i = Financial performance on company i

P_1 = Financial return after merger date

P_0 = Financial return before merger date

D_1 = Any income received over the period

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

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

ARit = Rit – Rmt……………………………………………Equation 2

Where;

ARit = Abnormal financial performance on company i at time t;

Rit = Actual financial returns on company i at time t;

Rmt = Expected Returns.

Step three;

Calculation of cumulative abnormal financial performance, this was done by adding all the abnormal returns for the event window (t-5 to t+5).

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The objective of the study was to investigate the effects of mergers and acquisition on the financial performance of financial institutions in Kenya. To meet this objective, data on the ROE, ROA and EPS of the companies that engaged in a merger and acquisition between the 2000 and 2014 were collected and analysed to determine whether there was a difference in the financial performance as measured by ROA, ROE and EPS within the window period of 10 years. This section uses descriptive statistics to outline the movement of stock returns.

4.2 Descriptive Statistics

The study analysed the abnormal financial performance and cumulative abnormal financial returns attributed to the merger and acquisition events for all the financial institutions included in this study. This was done by analysing the accounting ratios realised before the event, compared with the results after the event.

4.2.1 Commercial Bank of Africa 2005

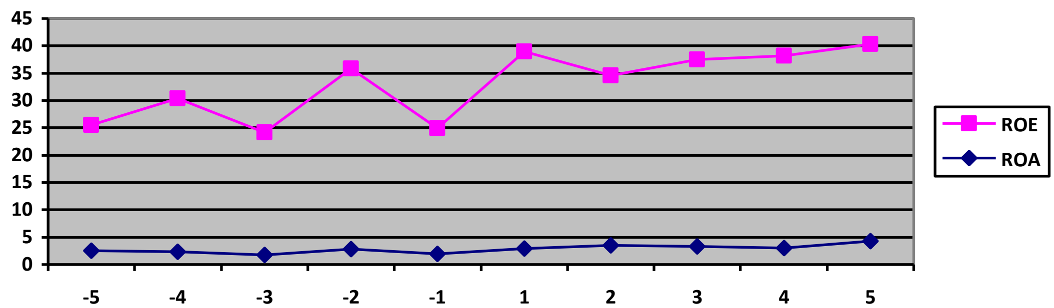
The performance of Commercial Bank of Africa after merger with First American Bank ltd showed marginal increase in the return on assets and return on equity. ROA increased from 1.94 in 2004 at T_{-1} to 2.9, 3.5, 3.3, 3.0 and 4.24 at $T_{1,}$ T_2 T_3 T_4 T_5 respectively. Similar trend was also recorded by the ROE that recorded steady rise from 22.95 on T_{-1} to 36.1, 31.03, 34.2, 35.2 and 36.06 at $T_{1,}$ T_2 T_3 T_4 T_5 respectively. Further analysis also found that an average actual return of ROA was 3.39 higher than 2.29 expected return. This gives an abnormal average ROA on 1.1. Similarly, average ROE for the period after the merger was 34.52 higher than the expected return before the merger of 25.88. Therefore, it is concluded that the merger positively affected the financial performance of commercial bank of Africa as measured by the ROA and ROE.

Table 1: Changes in ROA/ROE for Commercial Bank of Africa

	Pre-merger Period					Post-Merger Period				
	2000	2001	2002	2003	2004	2006	2007	2008	2009	2010
ROA	2.55	2.34	1.8	2.8	1.94	2.9	3.5	3.3	3.0	4.24
ROE	23.01	28.02	22.4	33.02	22.95	36.10	31.03	34.2	35.2	36.06

Source: Research Data

Figure 1: Commercial Bank of Africa ROA & ROE



Source: Research Data

4.2.2 Prime Bank 2008

The financial performance of Prime Bank as measured by ROA and ROE also recorded a positive trend after the merger with Prime Capital & Credit Ltd. ROA increased from 2.2 at T_{-1} to 2.33, 2.37, 3.07, 2.7, 3.8 at T_1, T_2 T_3 T_4 T_5 respectively, giving an average financial performance of 2.85 after the merger, which is higher than the 1.66 recorded before the mer4ger. ROE on the other hand increased substantially from 16.45 at T_1 to

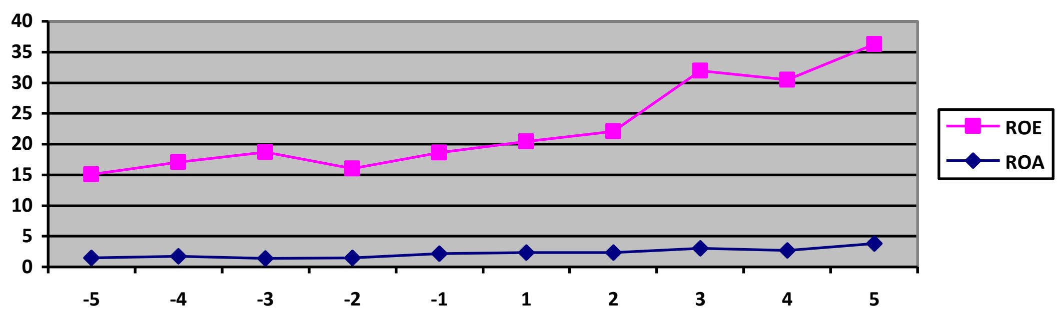
18.09, 19.74, 28.88, 27.8, and 32.5 at T_1, T_2 T_3 T_4 T_5 respectively. This resulted in an higher average ROE of 25.4 after the merger compared to 15.43 before the merger.

Table 2: Changes in ROA/ROE of Prime Bank 2008

	Pre-merger Period					Post-Merger Period				
	2003	2004	2005	2006	2007	2009	2010	2011	2012	2013
ROA	1.5	1.71	1.4	1.5	2.2	2.33	2.37	3.07	2.7	3.8
ROE	13.56	15.33	17.32	14.51	16.45	18.09	19.74	28.88	27.8	32.5

Source: Research Data

Figure 2: Prime Bank ROA & ROE



Source: Research Data

4.2.3 CFC Stanbic Bank Ltd 2008

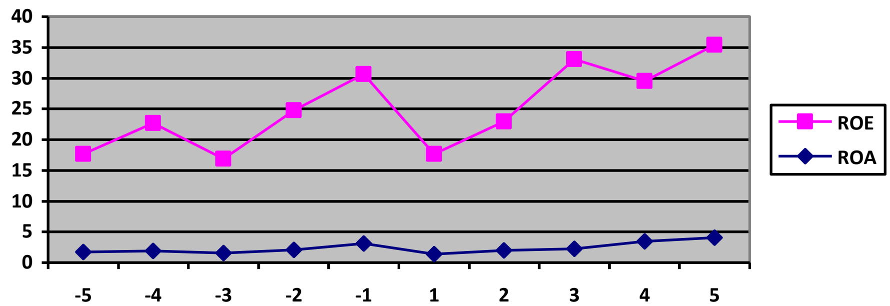
Financial performance of CFC Stanbic first experienced a dip on the first year after the merger T_1, and then recorded a steady increase. ROA recorded an average return of 2.63 after the merger, higher than 2.08 before the merger. Equally, ROE recorded a higher average return on 25.08 after the merger compared to 20.46 before the merger. The analysis concludes that the merger led to increase in financial performance of CFC Stanbic.

Table 3: Changes in ROA/ROE OF CFC Stanbic Bank Ltd

	Pre-merger Period					Post-Merger Period				
	2003	2004	2005	2006	2007	2009	2010	2011	2012	2013
ROA	1.76	1.91	1.54	2.1	3.1	1.35	1.96	2.23	3.5	4.1
ROE	15.86	20.77	15.36	22.7	27.59	16.3	20.96	30.82	26.0	31.3

Source: Research Data

Figure 3: CFC Stanbic ROA & ROE



Source: Research Data

4.2.4 Changes in ROA/ROE Equatorial Commercial Bank Ltd

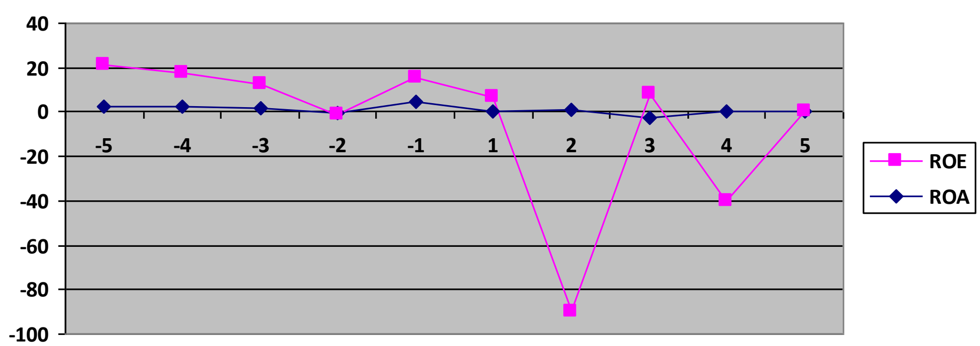
As shown by table 4 and figure 4, the Equatorial commercial bank recorded mixed financial performance before and after its merger with Southern Credit Banking Corporation Ltd. For instance ROA recorded 2.54, 2.3, 1.4 , -0.2, and 1.69 at T_{-5} T_{-4} T_{-3} T_{-2} and T_{-1} respectively, and then recorded 0.55, -4.6, 1, and -2.78 at $T_{1,}$ T_2 T_3 T_4 respectively. The average ROA after the merger was -1.46, which is lower than the 1.29 recorded before the merger. The same trend was recorded by the ROE that recorded an average ROE of -28.42 after the merger compared to 30.89 before the merger. This means that merger negatively affected the financial performance of the ECB.

Table 4: Equatorial Commercial Bank Ltd. 2010

	Pre-merger Period					Post-Merger Period			
	2005	2006	2007	2008	2009	2011	2012	2013	2014
ROA	2.54	2.3	1.4	-0.2	1.69	0.55	-4.6	1	-2.78
ROE	18.83	15.24	10.89	-1.2	10.51	5.91	-90.8	11.1	-39.9

Source: Research Data

Figure 4: Equatorial Commercial Bank Ltd ROA & ROE



Source: Research Data

4.2.5 Changes in ROA/ROE KCB Ltd. 2010 Merger

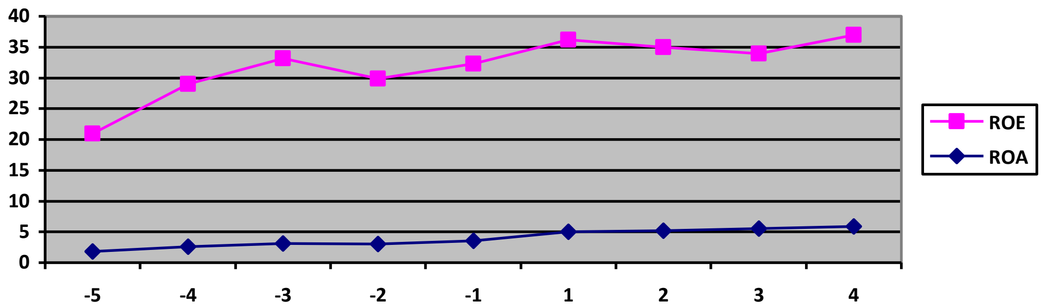
Analysis of the financial performance found a marginal increase in the ROA of KCB after the merger, with an average ROA of 5.4 after the merger compared to 3.07 before the merger. ROE on the other had increased immediately after the merger then slowed down at T_2 and T_3 before it increased again at T_4. Despite the mixed performance, ROE after the merger was still higher at 30.09 compared to 28.06 before the merger. This analysis finds that the merger positively impacted the financial performance of KCB.

Table 5: Kenya Commercial Bank Limited 2010

	Pre-merger Period					Post-Merger Period			
	2005	2006	2007	2008	2009	2011	2012	2013	2014
ROA	1.83	2.6	3.1	3.0	3.57	4.98	5.2	5.5	5.93
ROE	19.15	26.44	30.07	26.9	28.69	31.18	29.8	28.4	31

Source: Research Data

Figure 5: Kenya Commercial Bank ROA & ROE



Source: Research Data

4.2.6 Changes in ROA/ROE for National Bank

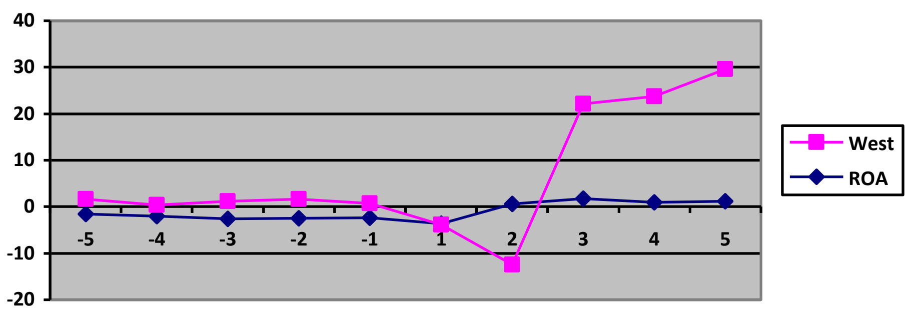
Before the merger, the analysis on table 6 and figure 6 show that National Bank reported negative ROA. However, this trend chanced after the merger where ROA recorded marginal positive growth. On the other hand ROE reduced at T_1 and T_2 then increased sharply and T_3 then steadily after T_4 and T_5. This is an indication the merger event positively affected the financial performance of the company.

Table 6: National Bank Ltd 2000

	Pre-merger Period					Post-Merger Period				
	1994	1995	1996	1997	1998	2000	2001	2002	2003	2004
ROA	-1.6	-1.98	-2.6	-2.5	-2.4	-3.63	0.64	1.7	0.92	1.24
ROE	3.26	2.36	3.78	4.12	3.27	-0.19	-13.13	20.4	22.84	28.32

Source: Research Data

Figure 6: National Bank ROA & ROE Source: Research Data



Source: Research Data

4.2.7 Changes in ROA/ ROE for KCB 2001

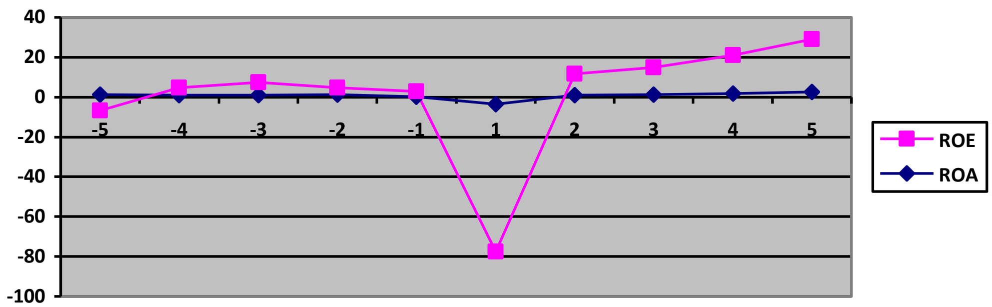
The ROA of KCB after merging with Kenya Commercial Finance Co. in 2001 slightly dipped to 0.47 compared 0.96 before the merger. This was caused by the sharp decline in returns at T_1 before the performance stabilized. Similar reaction was experienced by the ROE that dipped substantially after the event then increased sharply thereafter.

Table 7: Kenya Commercial Bank 2001

	Pre-merger Period					Post-Merger Period				
	1996	1997	1998	1999	2000	2002	2003	2004	2005	2006
ROA	1.23	1.08	1.069	1.245	0.19	-3.5	.093	1.32	1.83	2.6
ROE	-7.95	3.625	6.3	3.48	2.65	-74.1	10.6	13.5	19.2	26.44

Source; Research Data

Figure 7: Kenya Commercial Bank 2001 ROA & ROE



Source: Research Data

4.2.8 Changes on ROA/ROE for I & M Bank

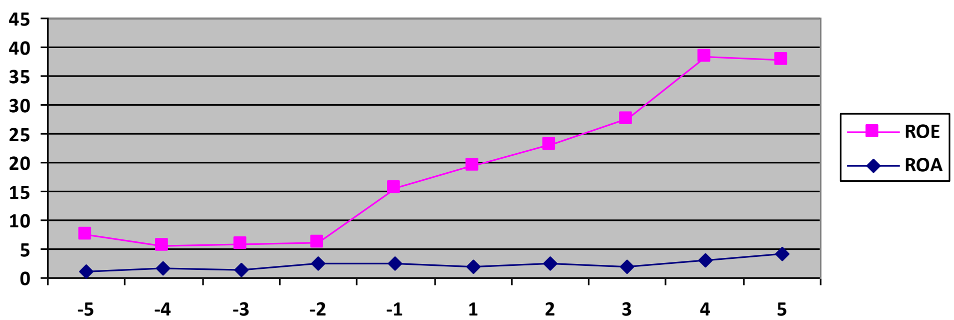
Analysis of the effect of merger on I & M Bank showed that both ROA and ROE recorded higher positive growth in the post-merger period. For instance the ROA reported 1.2, 1.7, 1.3, 2.49, and 2.57 at T_{-5} T_{-4} T_{-3} T_{-2} and T_{-1} respectively and then recorded 1.84, 2.37, 2, 3.1, and 4.3 at $T_{1,}$ T_2 T_3 T_4 and T_5 respectively. This gives an average ROA of 2.72 in the post event period and 1.85 in the pre-event period. ROE values showed significant growth from 3.58 at T_{-2} to 12.88 , 17.5, 20.6, 25.5, 35.1 and 33.47 at $T_{-1,}$ $T_{1,}$ $T_{2,}$ $T_{3,}$ T_4 and T_5 respectively. This gives an average ROE of 26.43, much higher than the 6.22 reported during the pre-event period. The analysis thus finds that the merger event positively influenced the financial performance.

Table 8: Investment & Mortgage 2002

	Pre-merger Period					**Post-Merger Period**				
	1997	1998	1999	2000	2001	2003	2004	2005	2006	2007
ROA	1.2	1.7	1.3	2.49	2.57	1.84	2.37	2	3.1	4.3
ROE	6.25	3.84	4.57	3.58	12.88	17.5	20.6	25.5	35.1	33.47

Source: Research Data

Figure 8: I & M Bank ROA & ROE



Source: Research Data

4.2.9 Changes in ROA/ROE for Southern Credit Banking Corp. Ltd

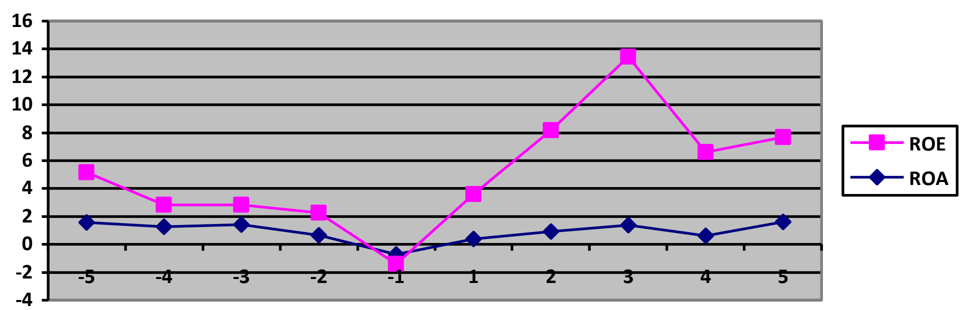
The financial performance as measured by ROA and ROE show that both the ROA and ROE increased steadily for the first three years after the merger then dipped on the fourth year followed by a marginal increase on the fifth year. The Average ROA was calculated as 0.98 after the event, slightly higher than 0.84 recorded in the pre-merger period. The Average ROE in the post event period is 6.91, much higher than the 1.5 in the pre-event period.

Table 9: Southern Credit Banking Corp. Ltd. 2001

	Pre-merger Period					Post-Merger Period				
	1996	1997	1998	1999	2000	2002	2003	2004	2005	2006
ROA	1.57	1.25	1.42	0.65	-.0.7	0.4	0.92	1.37	0.62	1.6
ROE	3.6	1.6	1.42	1.6	-0.7	3.2	7.25	12.07	5.98	6.07

Source: Research Data

Figure 9: Southern Credit Banking Corp ROA & ROE



Source: Research Data

4.3 Summary and Interpretation of Findings

In order to understand the effect of merger and acquisition on the financial performance of commercial banks in Kenya, average ROA and average ROE were calculated for the pre and post-merger period as represented in table 10 below. It was noted that merger and acquisition results into either increase or decrease in the financial performance. Other than Equitorial Commercial bank which recorded a reduction on ROA and ROE, and Kenya Commercial bank 2001 merger that recorded a negative in ROE, all the other nine banks reported increased ROA and increased ROE. This leads to the finding that merger and acquisition event results into an increase in financial performance of the companies. Abnormal financial performance was calculated for the pre and post-merger period. The cumulative abnormal average return (CAAR) for all the banks involved in the study found ROA to be 5.274, thus concluding that merger and acquisition positively affect financial performance. However, the CAR for ROE found -1.823 as a result of the variability of the extreme negative performance of Equitorial Commercial bank.

Table 10: Results of Abnormal Returns

Institution	Pre- Merger		Post-Merger		CAAR	
	ROA	ROE	ROA	ROE	ROA	ROE
CBA	2.29	25.88	3.39	34.52	1.1	8.64
Prime Bank	1.66	15.43	2.85	25.4	1.19	9.97
CFC Stanbic Bank Ltd	2.08	20.46	2.63	25.08	0.55	4.62
Equatorial Commercial Bank	1.29	30.89	-1.46	-28.42	-2.75	-59.31
KCB Ltd. 2010 Merger	3.07	28.06	5.4	30.09	2.33	2.03
National Bank	-2.16	2.54	0.174	11.65	2.334	9.11
KCB 2001 Merger	0.96	1.621	0.47	-0.882	-0.49	-2.503
I & M Bank	1.85	6.22	2.72	26.43	0.87	20.21
Southern Credit Banking Corp. Ltd	0.84	1.5	0.98	6.91	0.14	5.41
CAR					5.274	-1.823

Source: Research Data

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter outlines the summary and conclusion of the results of the effects of mergers and acquisitions on financial performance of commercial banks. The chapter also gives the recommendations to the stakeholders and for future research.

5.2 Summary

This analysed the effect of mergers and acquisition of financial performance of nine commercial banks that engaged in a merger of acquisition between year 2000 and 2014. In all the companies, financial performance as measured by ROA and ROE either reduced or increased after the merger event. Out of the nine banks engaged in the study, only Equatorial Commercial bank recorded a reduction on both ROA and ROE, and Kenya Commercial bank 2001 merger recorded a negative in ROE. All the remaining seven banks reported increased ROA and increased ROE. This finding leads to the conclusion that the changes in financial performance were attributed to the merger or acquisition.

Analysis of the average abnormal returns also indicate that for the event period (t-5 to t+5), eight out of the nine recorded positive ROA leading to a positive cumulative abnormal average return for 5.274. On the other hand CAAR for ROE was found -1.823. Despite the fact that only two banks recorded negative ROE, Equitorial Commercial bank recorded an extremely big loss of -59.31. This wide dispersion resulted in the negatice CAAR.

5.3 Conclusion

The study aimed at investigating the effect of mergers and acquisition on financial performance of commercial banks. It was found that except for two companies, there was positive movement of financial performance during the post-merger period. This study therefore, concludes that mergers and acquisitions generally results into increase in financial performance of the firma. This study is consistent with other local studies such as Marembo (2011), Ndora (2010) and Marangu (2007), which concluded that M&A results to an increase in the financial performance of firms.

5.4 Recommendations for Policy

Based on the findings of this study, management teams need to take advantage of the benefits of mergers and acquisitions, especially the potential of increasing financial performance. However, analysis need to be done when choosing a firm to merge with or a company to acquire in order to ensure that the merger exercise will add value to the firm. This may help minimise the huge losses such as that experienced by Equatorial Commercial bank as analysed in this study. In addition to improving operation and sustaining failing businesses, manager need to consider merging with or acquiring other firma in order to improve their competitiveness and financial standing. This is because of the ability to improve the market share, value and quality of asset, liquidity, especially with the new proposal to raise minimum capital for banks to Ksh. 5 billion.

5.5 Limitations of the Study

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

5.6 Areas for Further Research

Study on merger and acquisition needs to be done in future, but with the focus on the asset combinations that are likely to produce positive results after merger and acquisition. This will help identify the attributes managers need to look at when choosing companies to merge with or acquire.

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APPENDIX I: LIST OF MERGERS ACQUISITION BETWEEN 2000 AND 2014

Institution	Merged with	Current Name	Date approved
Universal Bank Ltd	Paramount Bank Ltd.	Paramount Universal Bank	11.01.2000
Kenya commercial Bank	Kenya Commercial Finance Co.	Kenya Commercial Bank	21.03.2001
Citibank Na	ABN Amro Bank Ltd.	Citibank NA	16.10.2001
Bullion Bank Ltd.	Southern Credit Banking Corp. Ltd.	Southern Credit Banking Corp. Ltd	07.12.2001
Co-operative Merchant Bank Ltd	Co-operative Bank Ltd	Co-operative Bank of Kenya Ltd.	28.05.2002
Biashara Bank Ltd.	Investment & Mortgage Bank Ltd.	Investment & Mortgage Bank Ltd	01.12.2002
First American Bank Ltd	Commercial Bank of Africa Ltd.	Commercial Bank of Africa Ltd.	01.07.2005
East African Building Society	Akiba Bank Ltd.	EASBS Bank Ltd	31.10.2005
Prime Capital & Credit Ltd	Prime Bank Ltd	Prime Bank Ltd	01.01.2008
CFC Bank Ltd	Stanbic Bank Ltd	CFC Stanbic Bank Ltd.	01.06.2008
Savings and Loan	Kenya commercial	Kenya Commercial	01.02.2010

(K) Ltd	Bank Limited	Bank Limited	
City Finance Bank Ltd.	Jamii Bora Kenya Ltd.	Jamii Bora Bank ltd.	11.02.2010
Equatorial Commercial Bank Ltd	Southern Credit Banking Corporation Ltd	Equatorial Commercial Bank Ltd	01.06.2010

ACQUISITIONS

Institution	Acquired by	Current name	Date approved
Mashreq Bank Ltd.	Dubai Kenya Ltd.	Dubai Bank Ltd	01.04.2000
Credit A Indosuez (K) Ltd. gricole	Bank of Africa Kenya	Bank of AFRICA Bank Ltd	30.04.2004
EABS Bank Ltd.	Ecobank Kenya Ltd.	Ecobank Bank Ltd.	16.06.2008
Fina Bank Ltd	Guaranty Trust Bank Plc	Guaranty trust Bank (Kenya) Ltd	08.11.2013
K-Rep Bank Ltd	Centum ltd	K-Rep Bank Ltd	29.10.2014
Equitorial Commercial Bank ltd	Mwalimu Sacco Society ltd	Equatorial Commercial Bank Ltd	31.12.2014