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

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Abstract: *Mergers and acquisitions (M&A) perform a vital role in corporate finance by enabling firms achieve varied objectives and financial strategies.In Kenya banks have been merging with the goal of improving their financial performance. Studies done on mergers and acquisitions have not conclusively established whether or not banks benefit from mergers. Therefore this study aims at establishing the effect of mergers and acquisitions on financial performance of commercial banks in Kenya. The study will be guided by the following objectives; to find out the effect of asset growth, shareholders value and synergy on the financial performance of merged banks in Kenya. The study adopted a causal research design. It adopted a census method which involved studying all the 6 merged banks from the year 2010 to 2017. The study used secondary data from published audited annual reports of commercial banks and banking supervision annual reports. Descriptive and inferential statistics were used to analyse data at 5% significance level. The study found out that the mergers and acquisitions had a positive impact on shareholders' value and assets of the merged or acquiring banks in Kenya.*

Keywords: *Acquisitions, Asset growth, Financial Performance, Mergers, Shareholders' value, Synergy*

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I. Introduction

The world today is going through a lot of changes that are being influenced by the forces of globalisation and technological changes and as a result firms are facing intense competition. To counteract these challenges and explore the opportunities, firms are adopting various strategic alternatives like mergers and acquisitions, strategic alliances and joint ventures. The mergers and acquisitions strategy has stood out among many firms as the most popular among firms seeking to establish a competitive advantage over their rivals (Kumar, 2009). In today's economy mergers and acquisitions is being increasingly used worldwide with the major objective of working with other companies that can be more beneficial than working alone in the market, this has resulted to increases in equity and shareholders wealth as well as assets of the merged firms, it has also enabled the firm to reduce their operating costs [1].

Acquisition create corporate synergies which may result in more efficient management, improved production techniques and exploitation of increased market power [2]. [3] defined merger as the coming together of two or more firms to become one big frim, while acquisition is the takeover or purchase of a small firm by a big firm which are both pursuing a keen purpose, while [3] defined acquisition as an act of acquiring effective control by one company over assets or management of another company without any combinations of companies.According to Kouser [4] the target company shareholders will be willing to sell their stock to the acquiring company when there is high prospectus of higher than normal gains from the sale or when they know that their firm may not survive alone, while the acquiring firms shareholders will be willing to pay a price even if high to acquire a target firm when they expect that such a purchase would be beneficial to them in the long run. In Kenyan context M&A of banks is not exactly a recent phenomenon. As early as 1989, Kenya witnessed the merger of nine insolvent financial institutions to form the consolidated bank of Kenya limited. This incorporation was under the financial sector reform program established by the Government with the objective of taking over and restructuring various troubled institutions. In 2005, the 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[5]. Subsequently, Kenyan banks were set for consolidation to meet the deadline to boost minimum core capital. This made several licensed institutions, mainly commercial banks to merge their operations or one institution acquiring another institution's operations so as to meet the minimum core capital. Also it would lead to increased levels of share capital, expansive distribution network, decreased operating expense and to benefit from best global practices.

1.1 Purpose
The main purpose of this study is to establish the effect of mergers and acquisition on financial performance of commercial banks in Kenya. The study seeks;

i. To establish the effect of asset growth on financial performance of commercial banks in Kenya
ii. To determine the effect of synergy on financial performance of commercial banks in Kenya
iii. To find out the effect of shareholders' value on financial performance of commercial banks in Kenya.

II. Review Of Literature

2.1 Mergers and Acquisitions
Merger is the corporate combination of two or more independent business corporations into a single enterprise, usually the absorption of one or more firms by dominant one. A merger may be accomplished by one firm purchasing the other firms assets with cash or its securities or by purchasing the other shares or stock by issuing its stock to the other firms' shareholders in exchange for the shares of the acquired firm. Mergers and acquisitions can be categorised into three types. These include; horizontal, vertical and conglomerate merges [6] Acquisition occurs when one entity takes ownership of another entity's stock equity interest or assets. It's the purchase of one business or company by another company or business entity. The acquisition target can be identified through avenues such as market research, trade expos or sent up from internal business units among others. Mergers and acquisitions can be classified as friendly or hostile [7]. When this transaction is undertaken in a friendly manner, the board and management of the target companies agrees to the transaction, while a hostile deal is one that puts the offer against the wishes of the target, since the board or management refuses to offer. M&A deals can be classified as domestic or cross border. A cross border M& A deal involves two firms located in different economies or two firms operating within one economy but belonging to different countries [7]. In domestic M&A deals the firms involved originate from one country and operate in that economy or country.

2.1.1 Synergy
Synergy is the concept that when two firms combine the resulting institution acquires a greater value than the sum of the previous firms and this is the argument advanced often to justify mergers. According to [8], synergy is achieved when the costs of the combined firm are less than the sum of those of the individual firm, attributing to reduction in economies of scale and scope. Synergy is the creation of a whole greater than simple sum of its parts, it is the concept that the value and performance of two or more companies combined will be greater than the separate individual parts. Pandey [3] describes synergy as "two plus two equals five" phenomenon. Three major types of synergy benefits are operating, financial and managerial synergies. Operating synergy can be implemented through revenue enhancement or cost reducing measures while financial synergy refers to the impact of a corporate merger or acquisition on the costs of capital to the acquiring firm or the merging partners hence firms can obtain cheaper capital.Synergy or the potential financial benefit achieved through combining of companies is often the driving force. Shareholders will benefit if a company's post merger share price increases due to synergetic effect. The expected synergy is achieved through increased revenues, combined talent from both firms' employees, technology and cost reduction [9].

2.1.2 Asset Growth
This is the increase in a firm's assets that can be achieved by merger and acquisition, after merger the acquiring firm takes control of the target asset and so manages its assets and those of the target, this leads to an increase in its assets after the merger [1]. The managers when buying the assets must understand how the asset can be expected to behave in future. High and stable growth rate is the obviousdesired outcome by management.

2.1.3Shareholders Value
Shareholders value is the value delivered to shareholders because of management's ability to grow sales, earnings and free cashflow over time [3]. Acompany's shareholder value depends on strategic decisions made by senior management including the ability to make wise investment and generate a health return on investment. If the value is created over a long term the share price increases and the company can pay larger cash dividends to shareholders. Increasing shareholders value increases the total amount hence the shareholders equity section of the balance sheet. This can be calculated as assets minus liabilities which equals to stakeholders equity. If management makes decision to increase net income each year, the company can either pay a larger cash dividends or retain earnings for use in the business. When a company's earnings increases, the earnings ratio increases and investors can view the company as more valuable.

2.2 Financial Performance

Financial performance refers to the process of measuring the results of a firm's policies and operations in monetary terms. It is used as a measure of a firm's overall financial health over given period of time. Institutions have various measures of financial performance. However, the common measures of financial performance are the Return on Assets and Return on Equity. Return on equity is a financial ratio that refers to how much profit a company earns compared to total amount of shareholders equity invested in the firm [3]. Return on equity reflects how effectively a firm's management is using shareholders' funds, the higher the return on equity the more effective the management is utilising the shareholders capital.

2.3 Theoretical Framework

This portion covers theories that are relevant to mergers and acquisition so as to get a deeper knowledge and understanding of the concept.

2.3.1 Efficiency Theory

This theory states that mergers will only occur when they are expected to generate enough realisable 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 is not positive it is suggested that the target firms owners would not sell or submit to the acquisition and if the gains are negative to the bidders owners, the bidder would not complete the deal. Efficiency theory predicts value creation with positive returns both to the acquirer and the target [10].

2.3.2 Synergy Theory

[11], proposed the synergy theory which holds that firms' managers achieve efficiency gains by combining an efficient target with their business and then improving the target performance. Buyers recognise specific complementaries between their business and their target. Thus, even though the target is already performing well it should perform even better when its combined with its complementary counterpart, the buyer firm. This theory implies that target firms' perform well both before and after mergers.

2.3.3 Hubris Theory

[12] hypotheses that managers commit errors of over optimism in evaluating acquisition opportunities due to excessive pride or hubris. He argues that a particular bidder may not learn from past mistakes in valuation of target firm and may be convinced that the valuation is correct. Therefore the takeover phenomenon is as a result of hubris on the part of bidders. The over bearing presumption that their valuation is correct and can never be wrong. This theory assumes a strong form of market efficiency.

2.3.4 Agency Theory

[11] suggested that value destroying merger are driven by the managers incentive to grow the firm beyond its optimal size. In some circumstances the agency problem might force managers to engage in merger and acquisition, separation of ownership and control. The agency problem occurs when managers want to increase their value at the expense of the acquirers shareholders benefit. Agency problem can stimulate competition among companies but cannot be eliminated by the competition and the gains to the target shareholders increase. According to [13] good managers run firms with efficient incentive and monetary systems which work to ensure that corporate policy is focussed on maximising the value. [11]argues that the problem is how to motivate managers to disgorge the cash rather than investing below the cost of capital or washing it away on organizations inefficiencies. The theory then suggests that to deal with this problem a firm should employ debt for this would limit the firms' spending in order to avoid default risk. Thus usage of debt has a positive effect on profitability.

2.4 Empirical Review of Literature

[14]studied the effect of synergy on financial performance of merged financial institutions in Kenya. Their study found out that there was a positive relationship between financial performance of the financial institution, operating synergy and financial synergy and thus there was a significant improvement in performance after mergers.

[15]studied the effect of mergers and acquisitions on financial performance of commercial banks. The study found that mergers and acquisitions raised the shareholders' value of the merged banks

[16]studied the effect of acquisition on financial performance of non listed banks in Kenya. The study indicated that there was a significant improvement in the performance of non listed banks which merged as compared with non listed ones which did not merge.

[17]examined the effect of mergers and acquisition on the performance of companies listed at the Nairobi securities exchange. The results of the study indicated that there was a positive improvement in the return on equity of the companies involved in acquisition.
[8]carried out a study on merger restructuring and financial performance of commercial banks in Kenya. She found that mergers and acquisition did not affect the post acquisition financial performance of commercial banks in Kenya.
[13]carried out a study on the effect of mergers on financial performance of insurance companies in Kenya. He established that mergers and acquisitions had no effect on profitability, capital adequacy and long term solvency of the acquiring firm.
[2]conducted a study on the impact of acquisition on the financial performance of commercial firms in Kenya. The findings indicated that corporate acquisitions do not affect the financial performance of corporate firms

III. Research Methodology

3.1 Research Design

The study adopted causal research design which involves the investigation of cause-and-effect relationships. According to [18] causal research design shows the relationship between variables.

3.2 Target Population

A target population is the specific group that a particular study is interested in researching on. The population of this study was made up of 6 commercial Banks in Kenya which had successfully completed mergers and acquisitions from the year 2010 to the year 2016 [5].

3.3 Sampling Procedure and Sample Size

The study adopted a census whereby the entire population was studied this comprised of 6 commercial banks which were involved in mergers and acquisitions. A census was preferred due to the low number of elements in the target population and it provides high level of accuracy [15].

3.4 Data Collection

The study used secondary data from published audited annual reports of commercial banks, Central Bank of Kenya, Banking Supervision Annual Reports, financial statements and cash flow statements of the 6 commercial banks from the year 2010 to 2016. From the financial statement return on equity and earnings per share are computed as measures of performance.

3.5 Data Analysis

The data was collected, cleaned, edited, coded and fed into excel before being imported to SPSS for analysis. Descriptive statistics was used in terms of mean, standard deviation, frequency, percentages, mode and median. Inferential statistics was also used to draw inferences about the cause effect relationship between mergers and acquisitions and financial performance of commercial banks by the use of a regression model.

3.6 Regression Model

The following regression model was developed for the purpose of this study:

1. $Yit = \beta o + \beta_1 X_{1t} + \beta_2 X_{2t} + \beta_3 X_{3t} + e$

Y=Financial Performance (ROE)
βo= constant
β1, β2, β3= Regression coefficients.
X_{1t}=Asset Growth (change in assets)
X_{2t}= Shareholders Value (Earnings Per Share)
X_{3t}=Synergy (operating costs)
e= Error term.

IV. Results

4.1 Multicollinearity Tests

It refers to a situation in which two or more explanatory variables in a multiple regression model are highly linearly related. It was measured using variance inflation factor.

Table 1 Multicollinearity Test

Variable	Tolerance	Variance inflation factor
Asset	0.001	1.3243
Operating	0.001	1.5773
EPS	0.005	1.9941

The variance inflation factor for operating expense, assets and earnings per share of the commercial banks before the merger were 1.5773, 1.3243 and 1.9941 which are less than 10, this shows that they are not highly collinear and there exists no multicollinearity problem with data.

4.2 Autocorrelation

It is a measure of the degree of similarity between a given time series and a lagged version of itself over successive time intervals [15]. Durbin Watson is used to detect the presence of autocorrelation. There is presence of autocorrelation when Durbin Watson statistic is greater than 4.

Table 2 Autocorrelation Test

R	R Square	Adjusted Square	Std. Error of the Estimate	Durbin- Watson
.712	.653	.689	4.35261	2.339

Durbin Watson for the commercial Banks after the merger was 2.339 which shows there is no autocorrelation.

4.3 Correlation Analysis

It is used to measure the strength of the relationship between variables. Pearson correlation was used to determine the correlation coefficient.

Table 3 Correlation

Variables		Asset	Operating	EPS	ROE
Asset	Pearson correlation	1			
	Sig	0.000			
Operating	Pearson	0.999	1		
	Sig	0.000	0.000		
EPS	Pearson	0.925	0.938	1	
	Sig	0.295	0.325	0.511	
ROE	Pearson	0.705	0.675	0.489	1
	Sig	0.024	0.018	0.000	0.511

4.3.1 Correlation between Asset Growth and Financial Performance

Asset growth was measured by change in value of assets of the banks in Kenyan shillings, the correlation coefficient indicates a fairly strong correlation of 0.705 between asset growth and financial performance after merger and acquisition.

4.3.2 Correlation between Synergy and Financial Performance

Synergy was measured by percentage change in operating expenses of the commercial bank in percentage, there is a moderate positive correlation between ROE and operating expenses of 0.675 after merger and acquisition.

4.3.3 Correlation between Shareholders Value and Financial Performance

Shareholders value was measured by the earnings per share of the commercial banks, there is a weak positive correlation of 0.489 between ROE and EPS after merger and acquisition.

4.4 Regression Analysis before Merger and Acquisition

It was used to establish the relationship between the independent and the dependent variable.

Table 4 Regression Analysis before Merger and Acqusition

Variables	Unstandardised coeffecients		Standardised Coefficients		
Variables	B	Std Error	Beta	T	Sig
Constant	-22.834	82.498			0.828
Asset	-0.001	0.004	-12.189	-0.290	0.820
Operating	44.287	144.124	12.960	0.307	0.810
EPS	11.761	35.094	0.618	0.335	0.794

The study established that before the merger and acquisition; synergy, asset growth and shareholders value had no significant effect on the financial performance of the commercial banks. This is shown on the table 4 above by P values that are greater than 5%.

4.5 Regression Analysis after Merger and Acquisition

Table 5 Regression Analysis after Merger and Acquisition

	Unstandardized Coefficients		Standardised Coefficients		
Variables	B	Std Error	Beta	T	Sig
Constant	-164.358	0.015		0.032	0.000
Asset	15.730	0.005	22.860	0.008	0.002
Operating	-16.826	0.003	-23.221	0.006	0.015
EPS	4.160	0.002	1.136	0.004	0.004

4.5.1 Effect of Asset Growth on Financial Performance of Commercial Banks

The hypothesis that asset growth has no significant effect on financial performance was tested using t-test. According to Table 5 above a unit increase in asset growth will result to a 15.73 increase in financial performance. Asset growth was measured using change in value of assets and had a significant value of 0.002 which is below the 5% significance level. This results to the rejection of the null hypothesis that asset growth has no significant effect on financial performance of commercial banks

4.5.2 Effect of Synergy on Financial Performance of Commercial Banks

The hypothesis that synergy has no significant effect on financial performance was tested using t-test. According to Table 5 above a unit increase in synergy will result to a 16.286 decrease in financial performance. Synergy was measured using operating expenses and had a significant value of 0.015 which is below the 5% significance level. This results to the rejection of the null hypothesis that synergy has no significant effect on financial performance of commercial banks

4.5.3 Effect of Shareholders Value on Financial Performance of Commercial Banks

The hypothesis that shareholders value has no significant effect on financial performance was tested using t-test. According to Table 5 above a unit increase in firm size will result to a 4.16 increase in financial performance. Shareholders value was measured using earnings per share and had a significant value of 0.04 which is below the 5% significance level. This results to the rejection of the null hypothesis that shareholders value has no significant effect on financial performance of commercial banks.

Table 6 Anova

Model		Sum of Squares	Mean Square	F	Sig.
	Regression	3.540	1.180	0.197	.000
	Residual	.000	0.000		
	Total	3.540			

ANOVA was used to check whether asset growth, synergy and shareholders value have a significant effect on financial performance. From Table 6 above the P value is 0.000 (less than 0.05) this means the independent variables have a significant effect on the dependent variables.

4.6 Regression Equation

The following regression equation shows the relationship between the independent variables and the dependent variable.

$Yit = -164.358 + 22.860X_{1t} + 1.136X_{2t} - 23.221X_{3t}$

Where Yit=Financial performance, X_{1t}= Asset growth, X_{2t}= Shareholders value, X_{3t}= Synergy.

The equation above means that holding asset growth, shareholders value and synergy at a constant zero, the profitability of firms listed in the NSE will stand at 164.358. According to the equation therefore, a unit increase in asset growth would result to an increase in financial performance by a factor of 22.860; a unit increase in shareholders value would result to an increase in financial performance by a factor of 1.136 and a unit increase in synergy would result to a decrease in financial performance by a factor of 23.221. The independent variables were tested for significance using t-test and the results shown in Table 5Asset growth, shareholders value and synergy all had p values of less than 0.05 therefore the independent variables are significant.

V. Conclusion

The study concluded that asset growth, synergy and shareholders value had a significant effect on the financial performance of commercial banks. They all had a significant value of less than 5%. After merger and acquisition commercial banks increased their performance as measured by ROE therefore firms that want to increase their assets can consider a merger, also firms that would want to maximise their shareholders value can consider a merger and acquisition. The operating costs are also expected to decrease after a merger and acquisition and this would eventually lead to better performance. These findings are consistent with synergy theory which says that firms combine through a merger or an acquisition in order to improve on their performance.

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