

**EFFECTS OF MERGERS AND ACQUISITIONS ON STOCK RETURNS  
OF INSURANCE COMPANIES IN KENYA**

**BY**

**LARRY OGETO BANGE**

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## **DECLARATION**

**STUDENT**

I declare that this is my original work and has not been submitted to any other University or institution for accreditation.

**SIGN**.....

**DATE:** .....

**LARRYOGETO BANGE**

**REG. NO: D61/74260/2014**

This Research Project has been submitted for examination with my approval as the University supervisor

**DR. MIRIE MWANGI**

**SENIOR LECTURER, DEPARTMENT OF FINANCE AND ACCOUNTING**

**SCHOOL OF BUSINESS**

**UNIVERSITY OF NAIROBI**

**SIGN:** .....

**DATE:** .....

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## **DEDICATION**

I would like to dedicate this project to my wife Emily Bisieri, my daughter Natalie Ogeto, my parents David Bange and Jerusha Bosibori as well as my siblings Esther, Juliet and Miriam; they have always encouraged and supported me to achieve my academic goals.

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## **LIST OF ABBREVIATIONS**

<b>AKI</b>	Association of Kenya Insurers
<b>CAARs</b>	Cumulative Average Abnormal Returns
<b>CAK</b>	Competition Authority of Kenya
<b>CAPM</b>	Capital Asset Pricing Model
<b>CBK</b>	Central Bank of Kenya
<b>CMA</b>	Capital Markets Authority
<b>CPI</b>	Consumer Price Index
<b>et al.</b>	And others
<b>GDP</b>	Gross Domestic Product
<b>IRA</b>	Insurance Regulatory Authority
<b>M&amp;As</b>	Mergers and Acquisitions
<b>NSE</b>	Nairobi Securities Exchange
<b>ROA</b>	Return on Assets
<b>ROE</b>	Return on Equity
<b>UAP</b>	Union des Assurances De Paris
<b>UK</b>	United Kingdom
<b>USA</b>	United States of America

## **ABSTRACT**

Many firms engage in mergers and acquisitions to achieve synergy, gain tax advantages, increase liquidity, gain access to funds and above all achieve growth and diversification. Numerous mergers have taken place in the Kenyan insurance industry. The objective of this study was to investigate the effects of mergers and acquisitions on the stock returns of insurance companies in Kenya. The target population of the study was the 55 licensed insurance companies in Kenya while the sample was based on the 7 insurance companies that engaged in mergers and acquisitions between January 2012 and December 2015. The study adopted a descriptive research design and an event study methodology to determine the effect of a merger announcement on the stock returns of insurance companies. The event window was 60 days that is 30days before and after the merger. Data was collected using secondary sources and analysis was done using the SPSS statistical package. ANOVA test was applied on the variables at 5% significance level. Findings on regression analysis revealed that the coefficients of determination differed across the window periods. The coefficient of determination R was 0.0177 and 0.233 in the pre and post-merger period. This is an indication that merger and acquisition announcements triggered a change in the stock returns by 17.7% and 23.3% in the pre and post-merger period respectively. The findings revealed that a merger and acquisition announcement triggers a significant change in the stock returns in the post-merger period in comparison to the premerger period. The study recommends that the management of insurance companies in Kenya should effectively leverage on mergers and acquisitions to enhance share returns of their companies and thus achieve the shareholder objective of wealth maximization. The Competition Authority of Kenya should also formulate sound policies, rules and regulations in relation to merger and acquisition of firms in Kenya.

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

Mergers and acquisitions is a corporate strategy used by businesses globally to grow and expand and it has attracted the attention of researchers worldwide (Goyal and Joshi, 2011). A lot of research on mergers and acquisitions has been done in the United States since the 18<sup>th</sup> century whereas in Europe it emerged in the 19<sup>th</sup> century (Focarelli, Paneta and Salleo, 2002). The main motive behind M&As is to gain synergy which refers to the additional gains realized by the merged entity. The value of the merged entity is higher than the value of the stand-alone firms (Baldwin, Gorecki, Caves, Dunne & Haltiwanger, 1998). Firms also engage in mergers and acquisitions to gain tax advantages, increase liquidity, gain access to funds, achieve growth and diversification.

The motives behind Mergers and acquisitions have been categorized into three: Synergy, Agency and Hubris. According to the synergy hypothesis firms realize additional benefits as a result of engaging in mergers and acquisitions (Ross, Westerfield & Jordan, 2010). In the long run, the firm will achieve the shareholder objective of wealth maximization. The hubris hypothesis also known as managerial overconfidence argues that managers are overconfident and end up making wrong acquisition decisions (Adams & Buckle, 2003). This hypothesis is similar to the winners curse which occurs in auctions with incomplete information. Under managerial self-interest hypothesis, managers engage in mergers and acquisitions to gain their own selfish interest at the expense of the

shareholder's interest (Mitchell & Lehn, 1990). For instance if a company is highly liquid, managers are likely to spend the cash on unproductive projects instead of paying dividends to shareholders (Servaes, Lang, & Walking, 1991).

### **1.1.1 Mergers and Acquisitions**

Borys and Jemison (1989) define a merger as the consolidation of two entities into one and an acquisition as the purchase of one company by another where the acquirer maintains control. According to Gaughan (2002), a merger is the transfer of assets and liabilities of one company to another whereby one company ceases to exist. An acquisition occurs when a company acquires a controlling interest in another company (Scott, 2003).

A merger is a combination of two or more firms into an existing firm or new firm. The combination of operations can be done through merger by absorption or merger by establishment. In an absorption merger, all the assets of one or more companies are transferred to the absorbing company and the absorbed companies are dissolved afterwards since they form part of the acquirer. While in a merger by establishment, two or more entities of similar size are dissolved and merged into a completely new company for instance the merger of JP Morgan Chase and Daimler Chrysler (Chunlai, Chen and Findlay, 2003).

According to Kovacich and Halibozek (2005) in an acquisition or takeover, a company that seeks to acquire interest in another company is called an acquirer whereas the acquired firm is called a target. There are two types of acquisitions: friendly and hostile acquisitions.

Hostile acquisitions are also known as takeovers and the target is opposed to the acquisition while in friendly acquisitions there is usually a negotiation process.

Mergers are categorized into three: horizontal, vertical and conglomerate. Horizontal mergers take place between two competitors offering similar products or services for instance two insurance companies. Vertical mergers occur between two firms which have a buyer seller relationship for example an insurance company acquiring a brokerage firm while conglomerate mergers occur when companies are involved in unrelated business (Chunlai, Chen and Findlay, 2003).

### **1.1.2 Stock Returns**

Stock return is defined as a gain or loss on a security held by an investor for a specific duration. It comprises of dividend as income component plus capital gains. Dividend is the proportion of a company's net income that is distributed to the shareholders while capital gains refer to the earnings realized by the investor on selling an asset such as common stock. Capital gain is arrived at by computing the difference in price of stock over two periods divided by the purchase price (Jordan and Fischer, 2002).

Foster (1986), argues that stock returns are more or less the same as stock prices. An efficient stock market discloses new information on stock prices thus resulting in stable and accurate valuation of the stock prices of the firms. Stock valuation is dependent on information hence managers will tend to disclose private information to the capital markets to rectify misvaluations (Velashani & Mehdi, 2008). A stock return is also defined as the

gain realized as a result of growth in stock prices and it is the rationale behind investment in stocks (Jeyanthi and William, 2010). Effects of M & A activities on stock returns can best be analyzed by using an event study methodology around the announcement date. The abnormal return is computed by getting the difference between the actual and expected stock returns where the actual return is the post event price of a firm on an event date while the expected return is the pre-event price.

### **1.1.3 Effects of Mergers and Acquisition on Stock Returns**

M & As have a positive impact on the stock returns of the target firm before announcement of the takeover and a few weeks prior to the takeover. Jensen and Ruback (1983) examined 13 studies on returns around takeover announcements and their findings reveal an average increase in return of 30% and 20% to target stockholders in successful tender offers and mergers respectively.

The effects of M&As on stock returns is also dependent on the within border and across border deals. The impact is marginally negative on acquiring firms when the deal is done within the border while for the target firm its largely positive. This boosts the stock returns and hence creates value for the shareholders of the target company (Cummins and Weiss, 1993). Cross industry consolidation between banks and insurance also results in wealth gains to bidders due to synergies attributed to economies of scale, economies of scope and the geographic comparative advantage (Fields, Fraser and Kolari, 2004).



One of the motives of M&As in insurance is to pool uncorrelated risk. For example property-liability companies underwrite multiple businesses hence reducing insolvency risk through diversification of its exposures across the different lines of business. As a result of the diversification effect, the portfolio risk of the merged businesses will be reduced (Merton and Perold, 1993).

Mergers & Acquisitions have synergistic effects which results in improved managerial efficiency, increased market power, improved production techniques and lower income volatility (Shepherd, 1982). Teece (1980) argues that M&As result in improved revenue and minimum costs incurred due to sharing of resources for instance the brand name, systems, expertise and joint production of outputs. In the long run, this boosts the stock performance of the insurer.

Cummins and Weiss (1993) assert that consolidation enables insurers to achieve economies of scale through reduction of costs thus boosting profitability and the stock returns of the merged entity. On the contrary, as firms merge managerial monitoring becomes more complex thus management expenses will rise. Agency problems will also arise due to managers engaging in activities to meet personal interests at the shareholders' expense (Easterbrook, 1984; Berger and Ofek, 1995). Therefore, this will affect the performance of the merged entity negatively. Performance of acquiring insurers is dependent on the expertise and efficiency of its management staff. On the other hand, mergers driven by agency and hubris affect performance negatively while mergers based on maximizing the shareholder wealth boost performance.

#### **1.1.4 Insurance Companies in Kenya**

The insurance industry in Kenya is regulated by the IRA. At the moment there are 55 licensed insurance companies comprising of 15 conducting Long term Insurance, 26 general insurance, 11 composite and 3 reinsurers. It is the best developed insurance market in East Africa with a penetration level of 3% which is considered low compared to the world average of 6.28%. To boost the insurance penetration, IRA developed measures such as professional training of the sales agents, localization of marine insurance, development of a micro insurance policy and authorizing of new distribution channels (IRA Report, 2016).

Insurance premiums grew by 14% in the 1<sup>st</sup> quarter of 2017 in comparison to 9.6% for the previous year. This was majorly as a result of 24% and 9% growth in the long term and general business respectively. The insurance premium contributed by the long term and general business was Kes 21billion and Kes42billion of the total premium. Investments grew by 9.5% from Kes 398.85billion in 2016 to 436.53billion in 2017 (IRA Report, 2017).

Recent local mergers and acquisitions include Britam's acquisition of 99% of the shares in Real Insurance in a deal worth Kes 1.4 billion. In March 2015, Pan Africa Insurance holdings acquired 51% stake in Gateway insurance in a deal of Kes 561million. Old Mutual acquired 23.3% stake of UAP for Kes 8.9billion in 2014. Barclay Africa acquired 63.3% shares in First Assurance. In 2013, Morocco's Saham acquired Mercantile Assurance and rebranded it as Saham (IRA Report, 2014).

The insurance industry is experiencing challenges key among them fraudulent claims. It is estimated that 20% and 15-20% of motor insurance and medical claims are fraudulent. Other issues include: delay in claim settlement, a poor reputation, professional misconduct and insufficient knowledge on the benefits of insurance. Statistics has shown that fraud eats up 25% of insurance premium thus reducing demand for insurance (IRA Report, 2017).

## **1.2 Research Problem**

Firms engage in M & As with the expectation of realizing benefits. Healy et al, (1992) assert that a merged entity performs better after the merger. Gugler et al. (2002) also argues that generally mergers boost the profitability of the merged entity. On the contrary, studies conducted by Ravenscraft and Scherer (1999) show that profitability of the target firm declines after the merger. This is as a result of corporate restructuring where some managers are declared redundant, loose their jobs or are demoted. Thus Ravenscraft argues that industry performance and M&As are negatively correlated.

Gugler et al. (2002) conducted a study on post-merger effects internationally. The findings revealed that profitability increases while sales of the merged entity declines in countries such as U.S.A, and UK. However, in Newzealand, Japan, Australia and Canada profitability declines while sales increases after the merger. Desai, Joshi and Trivedi (2013) conducted a research in India on mergers and acquisitions in the gas and oil sectors. The findings showed that in the short-term M&As do not increase profit margins and maximize shareholder wealth but additional gains are realized by the merged entity in the long term.

Moffet and Naserbakht (2013) conducted a study on the behavior of stock prices following announcement of M&A for both acquirers and targets for the period 2000 to 2010. An event study methodology was adopted and the findings reveal that M&A announcements generated positive actual returns for the acquirer and the target banks.

Khan (2011) studied the effects of M&As on financial performance of 35 banks in India during the post liberation period. Secondary data was collected from published annual reports and Bombay stock exchange sites. Financial parameters for instance Gross Profit margin ratios, Return on equity as well as statistical tool independent t test were applied in analyzing data. The results showed that M&As have a positive effect on operating performance.

Constantine (2008) conducted a study on the effect of announcement of M&A on share prices on 11 firms listed at Nairobi Securities Exchange in the period 1997 to 2006. The study adopted an event study methodology and the findings reveal that majority of companies stock returns did not realize a major response to merger and acquisition announcements. Mitema (2014) studied the effect of M&A announcement on value creation of insurance companies in Kenya. The study adopted a descriptive research design to establish the association between M & As and value creation. Data analysis was done using an event study methodology. The findings show a positive relationship between M&A and value creation.

Yusuf (2016) examined the post-merger financial health of Jordanian industrial sectors with a sample of 7 firms involved in financial restructuring deal in the period 2000 to 2014. The study was analyzed by collecting data from annual published financial statements using financial ratios and statistical technique parametric t test. Results showed there was insignificant improvement in the liquidity, profitability and market share in the selected manufacturing firms.

Joash and Njangiru (2015) studied the impacts of M&As on financial performance of merged commercial banks in Kenya between 2000-2014. Primary data was collected using questionnaires. Statistical tools such as co-efficient of correlation were used in the study that concluded that the shareholder's value of the acquiring firm increased post-merger.

Miyienda (2015) in his study on effects of M&As on financial performance of merged insurance companies in Kenya between 2002 and 2012 collected secondary data from AKI database, public disclosures and annual reports of the respective companies and analyzed using financial ratios and paired T-test. The results revealed that financial performance improved post-merger.

Mboroto (2012) in his study on effects of M & As on the financial performance of merged petroleum companies in Kenya between 2000 and 2012, collected Secondary data from published financial statements, NSE and annual statements of accounts. Data was analyzed using financial ratios and the paired t test. The results revealed that performance improved post-merger.

Locally, studies on M & As have been conducted in past periods and findings showed that performance of the merged entity improved post-merger. The studies majorly focussed on the impact of mergers and acquisition on financial performance in different industries. Very few studies have been done on the impact of M&A announcement on the stock returns on banks and firms listed at the NSE but none has been done for insurance companies. Thus this study sought to establish the impact of M&As on stock returns of insurance companies in Kenya.

### **1.3 Research Objective**

To investigate the effects of mergers and acquisitions on the stock returns of insurance companies in Kenya.

### **1.4 Value of the Study**

This study is important to the regulator, scholars, shareholders, managers and policyholders. To the regulator, IRA, the study would be significant since it can observe current trends and give a future outlook on M&As in the insurance industry. It can also aid in formulation of policies in relation to regulation of mergers and acquisitions. Scholars/researchers can carry out further studies based on gaps identified and recommendations given in this study. It can also help to gain further insights in the field of mergers and acquisitions.

This study would be of great significance to the shareholders. It will be used to assess whether M & A s would lead to increased efficiencies, increase market share, diversify risk

and above all maximize the shareholder's wealth. It would also help shareholders to widen their knowledge when faced with decisions on mergers and acquisitions. To the corporate Managers, the study would be used to determine whether mergers and acquisitions would improve efficiency and value of the firm. Policyholders would also benefit from this study since they would be interested to invest in companies that have successfully merged and are financially stable.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter outlines the theoretical review, determinants of stock returns, empirical studies, conceptual framework and summary of literature review.

#### **2.2 Theoretical Review**

This section discusses the theories that motivate firms to engage in mergers and acquisitions. The theories outlined are Synergistic Mergers theory, Agency theory, Managerial Hubris, Corporate Control, Free Cash flow and Tax Preference theory.

##### **2.2.1 Synergistic Mergers Theory**

The major aim of mergers and acquisition is to achieve synergy. This theory states that, the market value of the merged firm is higher than the sum of the individual values (Baldwin, Gorecki, Caves, Dunne & Haltiwanger, 1998). Additional gains are achieved as a result of firms engaging in mergers and acquisitions (Ross, Westerfield and Jordan, 2010). Three types of synergies are realized as a result of M&As; Operational, financial and managerial synergy. Operational synergy arises from factors such as economies of scope and scale. In the long term costs are reduced and revenues increase due to sharing systems, distribution channels and brand names (Teece, 1980). Financial synergy is realized by establishing an internal capital market. Weston (1970) argues that merging firms create a larger internal capital market hence leading to an efficient allocation of resources. Lastly the target firm



is likely to realize managerial synergies if the managers of the acquirer firm possess excellent management skills.

Efficiency is also improved due to adoption of a different culture which is defined as a set of ideas, philosophies, values, beliefs and assumptions (Schein, 1985). Nevertheless, there are instances where imposition of a corporate culture can result in resistance which will take a while for members of both firms to adjust. A clash of corporate cultures has resulted in sale of approximately a third of all acquisitions in five years (Stallworthy and Kharbanda1988).

### **2.2.2 Agency Theory**

This theory was advanced by Jensen (1986) and argues that there should be separation of ownership and control. A principal-agent relationship exists between shareholders and management. The shareholders are the principals while the managers are agents. The main objective of shareholders is to maximize wealth while management will engage in activities that will meet their personal interests at the shareholder's expense.

Jensen and Murphy (1990) in some instances managers may reward themselves attractive pay perks through unsuccessful projects at the shareholders expense. Managers engage in takeover to make themselves indispensable to the firm (Shleifer and Vishny, 1989). They benefit from such takeovers due to the pride and prestige associated with working for big companies (Jensen 1986, Stulz 1990). Agency conflict arises due to managers engaging in personal interests which are against the shareholder's objective of wealth maximization.

An example is a situation where there is extra cash flow and managers spend it on unbeneficial projects instead of paying dividends to the shareholders (Jensen, 1986).

### **2.2.3 Managerial Overconfidence Theory (Hubris Hypothesis)**

This theory was advanced by Roll (1986), it states that M&As are formed due to poor managerial decisions. Managers of the bidding firm make wrong evaluation of the target on the presumption the valuations are accurate. Due to overconfidence the bidder overpays and as a result the bidders suffer losses while the target shareholders achieve gains. During periods of high market stock valuations, managers make wrong acquisition decisions since they suffer from Hubris. Although during periods of stock market booms, the market allows the acquisition announcements such acquisitions earn negative abnormal returns in the long term (Bouwman, Fuller and Nain 2003).

Rau and Vermaelen (1998) researched on the association between firm level valuation and the performance of acquiring shareholders in the long-run. Their findings revealed that acquisitions formed based on hubris destroy shareholder value and bidders perform poorly. Conversely, in firms with high book to market ratios managers make wise acquisition plans thus increasing the shareholder value.

### **2.2.4 Free Cash flow Theory**

This theory is closely related with the agency theory. It argues that management is interested in bonus schemes hence will not distribute the cash flow to shareholders in form of dividends. This will reduce the resources under their watch and will not increase their

personal wealth. Management would thus prefer to use such monies with the intent of expanding the firm through takeover despite negative returns earned from such projects (Jensen, 1986).

Mortis (2007) argues that firms holding excess cash flow are easy targets for takeover. The excess cash flow is attributed to managerial inefficiency since they prefer to increase their personal wealth at the shareholders' expense. Easterbrook (1984) further argues that management of such firms will utilize the excess cash flow to fund the takeover to avoid close monitoring by the stock market.

### **2.2.5 Corporate Control Theory**

Jensen and Ruback (1983) define corporate control as the right to determine the management of corporate resources; that is the power to hire, fire and compensate senior management. They argue that on acquisition of a target firm by a bidder, the control rights of the target firm are transferred to the board of directors of the acquiring firm. This theory was introduced by (Manne, 1965) and argues that bidders can replace inefficient managers who pursue personal interests against the shareholders' objective of wealth maximization.

On replacing the pre-merger management with an efficient management, the shareholder value increases. Hasbrouk, 1985 and Palepu, 1986 argue that hostile takeovers ought to be monitored amongst firms performing poorly and with weak internal control systems. Managers in such firms are bound to resist takeover attempts since they are inefficient and act as a stumbling block to improved performance.

### **2.2.6 Tax Preference Theory**

This theory states that M & As may take place due to tax concerns. Profitable firms pay high tax rates and management of such firms may acquire a loss making firm to gain from the accumulated losses which can be utilized to avoid the company from paying taxes instead of carrying them forward to the future. Thus high net worth investors would prefer a firm with a low pay out dividend since it is not subject to high taxes (Brigham et al, 2004).

This theory further argues that a low dividend payout ratio triggers an increase in the stock price and a decline in the cost of capital hence boosting the value of the firm. It is based on the presumption that dividends are taxed at a higher rate in comparison to capital gains. Conversely, dividends are taxed immediately unlike taxes on capital gains which are delayed until the stocks are sold. Investors who enjoy tax advantages on capital gains would thus prefer companies that retain their earnings instead of paying them out as dividends (Farsio et al., 2004).

### **2.3 Determinants of Stock Returns**

A stock return is defined as the gain realized as a result of growth in stock prices and it is the rationale behind investment in stocks (Jeyanthi and William, 2010). In a stock market, there are two types of investors; bullish and bearish investors. The Bullish investors invest with the anticipation of a rise in stock prices while the bearish investors are pessimistic regarding the financial market conditions and thus trade in stocks cautiously. Both investors keep an eye on the stock movements with the intention of maximizing returns

(Mehwish, 2013).The determinants of stock returns are: Interest rates, exchange rate, inflation and money supply.

### **2.3.1 Inflation**

Johnson (1972) refers to inflation as the constant increase in general price levels. Increase in inflation has a ripple effect on other sectors of the economy for instance exchange rates, interest rates, unemployment and the stock markets. CPI and GDP deflator are the common measures of inflation with the former measuring consumer prices while the latter measures inflation in the economy.

Fisher (1933) argues that stock returns have a positive relationship with the performance of a company. An increase in the inflation rate will result in a decline in the firm earnings consequently affecting the stock prices and the stock market returns. Stock returns are dependent on the long run profitability of a company. The returns will increase on the speculation the company will perform well in the future and decline incase the company performs dismally.

Fluctuation in the inflation rate causes a lot of uncertainty in the business environment thus posing challenges for firms to forecast on revenues and costs which affects investments thus resulting in a decline in the economic output and eventually a firm's stock price. Inflation is can either be expected or unexpected. The latter type of inflation is disastrous as it leads to inefficiency in the economy and redistribution of wealth between trading partners.

### **2.3.2 Interest Rate Levels**

According to Browne and Hoyte (1995), interest earnings are dependent on interest rate levels, the higher the interest rate the higher the investment earnings, Insurers with high interest earnings perform well and are financially stable. Its a significant source of revenue for insurers. Interest rate is one of the major variables that affect stock returns. It is defined as the cost of capital and a discount factor in valuation models and has a significant impact on the costs, profitability and Net Present Value of future cash flows. Studies done by Nissim and Penmman (2003) on the relationship between interest rates and stock returns reveal that interest rates are negatively related to stock returns. On the contrary there are arguments that suggest that interest rate does not have a significant impact on the stock returns. According to Bernanke and Gertler (2001) monetary authorities ought to adjust the interest rates pegged on stock price fluctuations.

High interest rates increase the cost of debt of a company and thus reduce profitability and the amount of dividends distributed to shareholders. In addition, an increasing trend on interest rates causes investors to trade their high risk stocks with bonds since they yield high interest rates (Fama and French, 1992). The level of interest rate plays a crucial role in mobilization of financial resources therefore boosts economic growth and development In capital intensive industries interest rate has a significant impact on risk.

### **2.3.3 Exchange Rate**

Benita and Lauterbach (2004) argue that exchange rate volatility has an impact on company profitability, price stability and a nation's stability. The exchange rate movements also have an impact on the balance of trade in the economy and a firm's output level. There are two exchange rate models which explain the relation between exchange rate and stock returns: stock oriented model and the flow oriented model.

According to the stock oriented model, the exchange rate compares supply and demand for securities. Therefore currency volatility has a great impact on the price movements of the financial assets held. Depreciation of the local currency vis a vis the US dollar increases returns on the US dollar and prompts investors to transfer investment from stocks (domestic assets) to US dollar assets. Therefore depreciation in a local currency has a negative effect on stock market returns (Branson and Frankel, 1983). On the other hand, the flow oriented model posits a decline in stock prices reduces liquidity and wealth of local investors which in turn reduces interest rates consequently increasing the capital outflow and triggers depreciation of the local currency (Dornbusch and Fisher, 1980)

A study conducted by Hsing (2011) in the Johannesburg stock exchange reveals that stock returns and the exchange rate have a positive relationship. Other studies conducted by Cheng' et al. (2011) and Bailey and Chung (1995) on exchange rate fluctuations, political risk and stock returns on the Taiwan and Mexican stock exchange also show a positive relationship between stock returns and the exchange rate.

### **2.3.4 Money Supply**

Money supply is used to evaluate the level of liquidity in the economy and thus its fluctuation is bound to affect the investment decisions of personal and corporate investors. According to Pearce and Roley (1984) unexpected announcements in monetary policy have a major effect on stock returns. On the other hand, Jain (1988) argues that announcements regarding money supply and CPI are closely linked with stock price volatility.

An increase in the money supply causes an increase in interest rates hence a decline in the stock prices. This is attributed to the fact that the inflation rate has a positive relationship with the growth rate of money (Fama, 1981). On the contrary the negative effect of money supply is countered by money growth and as a result increases cash flows and stock returns (Mukherjee and Naka, 1995).

### **2.4 Empirical Studies**

Mantravadi and Reddy (2008) studied the effects of M&As on operating performance in different Indian industries. The study was based on a sample of 118 public limited industries and traded companies during the period 1991 to 2003. Financial ratios in terms of profitability and return on investment were used to analyze the data obtained from annual published financial reports. The study found variations in results in different industries. There was a positive effect on financial performance in the banking and finance industries and a significant decline in financial performance in the chemical, pharmaceuticals, textiles and electrical industries after the merger.



Yusuf (2016) examined the post-merger financial health of Jordanian industrial sectors with a sample of 7 firms involved in financial restructuring deal in the period 2000 to 2014. The study was analyzed by collecting data from annual published financial statements using financial ratios and statistical technique parametric t test. Results showed there was insignificant improvement in the liquidity, profitability and market share in the selected manufacturing firms.

Moctar and Chen (2015) evaluated the impact of M&As on financial performance of commercial banks in West Africa. In their case study sample size two groups of banks selected that underwent mergers and acquisitions in economic community of West African states. Secondary data was collected through annual financial statements and analyzed using financial ratios. It was concluded that financial performance is negatively affected by M&As. In addition, the study revealed that financial performance could not be achieved in the short-term.

Khan (2011) studied the effects of M&As on financial performance of 35 banks in India during the post liberation period. Secondary data was collected from published annual reports and Bombay stock exchange sites. Financial parameters for instance Gross Profit margin ratios, Return on equity as well as statistical tool independent t test were applied in analysing data. The results showed that M&As have a positive effect on operating performance.

Constantine (2008) conducted a study on the effect of announcement of M&A on share prices on 11 firms listed at Nairobi Securities Exchange in the period 1997 to 2006. The study adopted an event study methodology and the findings reveal that majority of companies stock returns did not realize a major response to merger and acquisition announcements. Mitema (2014) studied the effect of M&A announcement on value creation of insurance companies in Kenya. The study adopted a descriptive research design to establish the association between M&As and value creation. Data analysis was done using an event study methodology. The findings show a positive relationship between M&A and value creation.

Joash and Njangiru (2015) studied the impacts of M&As on financial performance of merged commercial banks in Kenya in the period 2000 to 2014. Primary data was collected using questionnaires. Statistical tools such as co-efficient of correlation were used in the study that concluded that the shareholder's value of the acquiring firm increased post-merger.

Mboroto (2012) in his study on effects of M&As on the financial performance of merged petroleum companies in Kenya between 2000 and 2012, collected Secondary data from published financial statements, NSE and annual statements of accounts. Data was analysed using financial ratios and the paired t test. The results revealed that performance improved post-merger.

Ndung'u (2011) carried out a study on effects of M&As on the financial performance of 16 commercial banks in Kenya between 1999 and 2005. Secondary data was obtained from the NSE, CBK, published facts, figures and reports for the period under study. The study was analysed on the basis of the mean and T-test. The findings revealed that profitability, solvency and capital adequacy improved post- merger.

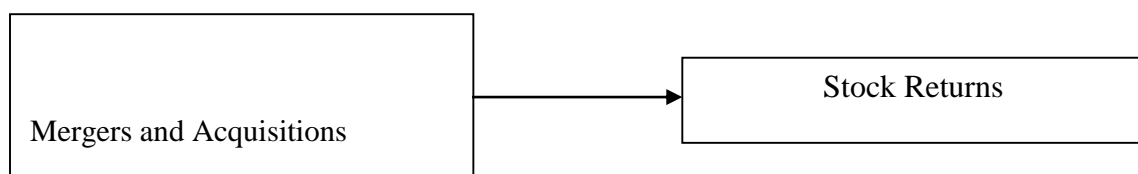
Lole (2012) carried out a study on effects of M&As on financial performance of insurance companies in Kenya. Secondary data was obtained from the audited financial statements. The findings showed that performance improved in the post-merger period. Miyienda (2015) studied effects of mergers and acquisitions on the financial performance of merged insurance companies in Kenya between 2002 and 2012. Secondary Data was collected from AKI database, public disclosures and annual reports of the respective companies and analysed using financial ratios and paired T-test. The results revealed that financial performance improved post-merger.

## 2.5 Conceptual Framework

Conceptual framework is defined by Huberman (1994) as a diagrammatic representation of the main things to be studied; key factors, concepts or variables and the key presumed relationships among them. The objective of this study was to determine the effect of merger on stock returns. The independent and dependent variable being M&As and stock returns respectively.

### **Independent variables**

### **Dependent variable**



## **Figure 2.1: Conceptual Framework**

### **2.6 Summary of Literature Review**

The impact of M & As on stock returns of an entity is based on the motives behind the merger. According to the synergy hypothesis, additional gains are realized when firms engage in M & As (Jensen & Ruback, 1983). If a firm enters into a merger with the intention of achieving synergy, this is likely to improve its performance. In addition, if corporate control theory is exercised the firm will create value thus achieve the shareholders objective of wealth maximization.

Conversely, engaging in M & As with the intention of achieving personal interests at the shareholders expense will lead to agency conflicts hence a decline in performance of the company. For example managers of a highly liquid firm spend cash on unsuccessful projects instead of paying dividends to shareholders alternatively, rewarding themselves with attractive perks at the shareholders costs. In the long run the shareholders will not meet their objectives.

Many scholars have studied the effects of M & As on financial performance in different industries and the findings are inconclusive and varied hence the need for further research. For instance Mantravadi and Reddy (2008) carried out a study in different industries in India and the findings revealed an improved performance in the financial services industry

a declined performance in chemical, pharmaceuticals, textiles and electrical industries after the merger.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter shows the methodology applied to complete the study. Section 3.2 covers the research design Section 3.3 reviews the population and sample of the study, Section 3.4 presents the data collection, Section 3.5 covers data analysis, Section 3.6 covers the diagnostic tests, Section 3.7 covers the analytical model, while Section 3.8 shows the test of significance.

#### **3.2 Research Design**

Is a plan that aids the researcher to achieve the intended results by obtaining the relevant information. A descriptive research design was used to determine the effects of mergers and acquisitions on stock returns of insurance companies in Kenya.

#### **3.3 Population and Sample**

Population refers to the total collection of objects that have similar characteristics which are observable (Mbwesa, 2006). Cooper and Schindler, (2001) define population as total number of objects, elements on which the researcher intends to study, test and make conclusions based on the information gathered. The population of this study comprised of the 55 insurance companies in Kenya. A sample refers to the particular elements in a population on which the researcher will study, test, analyse and give findings (Kothari, 2006). The sample for this study comprised of recently merged insurance companies in Kenya in the period January 2012 to December 2015(Refer to Appendix 1).

### **3.4 Data Collection**

Is a means by which information is obtained from the selected subjects of an investigation (Creswell, 2002). This study used secondary data which was collected from Insurance regulatory authority (IRA), Nairobi Securities Exchange, Association of Kenya Insurers (AKI), Competition Authority of Kenya (CAK), Capital markets authority (CMA) as well as individual companies and published audited financial statements of the merged entities.

### **3.5 Data Analysis**

The study adopted an event study methodology to establish the behavior of stocks around the M&A announcement dates. It's a methodology that is widely used to determine the impact of M&As on stock price behavior (Brown & Warner, 1980). The impact was assessed by the cumulative average abnormal returns (CAARs) during the event window. A positive CAAR is an indication that M&As have a positive impact on stock returns while a negative CAAR implies a negative impact on the stock returns.

### **3.6 Diagnostic Tests**

Diagnostic tests were conducted to test on the accuracy of the data. The test applied include multicollinearity, Autocorrelation and Normality Test. Multicollinearity was tested using Variance of Inflation Factor VIF, Normality Test was tested using Skewness and Kurtosis while Autocorrelation Test was done using Durbin-Watson Statistics.

### 3.7 Analytical Model

The event window concerns the pre-announcement, announcement and post announcement period defined as  $t_n$ ,  $t_0$  and  $t_{n-1}$  respectively. The  $n$  is identified as 60 days. The data collected was used to compute expected daily returns using the single-index market model equation as indicated by equation (1) below:

$$R_{it} = a_i + b_j R_{mt} + u_{it} \dots \dots \dots (1)$$

Where:

$R_{it}$  is Expected daily returns of stocks  $i$  at time  $t$

$R_{mt}$  is Daily value-weighted market returns (NSE20 index)

$U_{it}$  is Return residual for stock  $i$  at time  $t$  with zero mean

$a$  and  $b$  are Regression coefficients and constants determined by simple regression using daily data over the window period.

The daily returns for each stock (or index) was calculated according to equation (2) below:

$$R_{it} = \ln (P_{it}/P_{it-1}) \dots \dots \dots (2)$$

Where:

$R_{it}$  is daily return of stock  $i$  at time  $t$

$\ln$  is the natural Logarithm

$P_{it}$  is the Price of stock  $i$  at time  $t$

The market model is then used to estimate the returns which are used to device the cumulative abnormal returns (CAR) over the event window so as to test the price effect of



the mergers and acquisitions. The abnormal returns (AR) were estimated using equation (3) below:

$$AR_{it} = R_{it} - (a_i + b_i R_{mt}) \dots\dots\dots(3)$$

The cumulative abnormal returns (CAR) were computed for all days within the window period. The use of CAR is common in event study methodology (Brown and Warner, 1980)

CAR for firm i was obtained using equation (4) below:

$$CAR_i (T-30, T+30) = \sum_{T-30}^{T+30} AR_{it} \dots\dots\dots (4)$$

### 3.8 Test of Significance

ANOVA test was used to establish significance of the variables of the study. The test was done at 5% level of significance.

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## CHAPTER FOUR

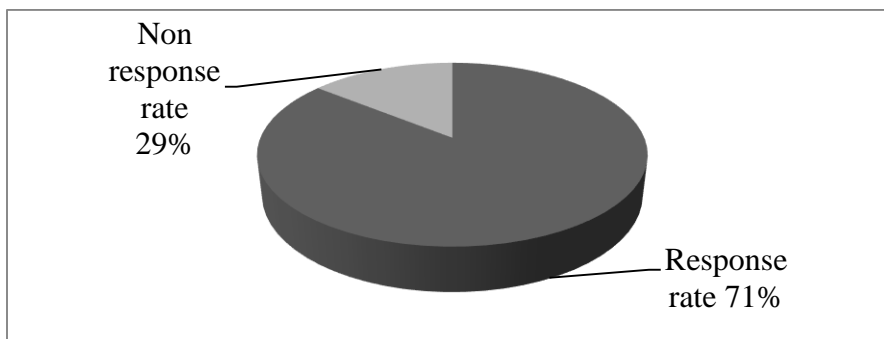
### DATA ANALYSIS, RESULTS AND DISCUSSIONS

#### 4.1 Introduction

This chapter presents the findings of the analysed data in terms of the stock returns of insurance companies that engaged in mergers and acquisitions between January 2012 and December 2015. Descriptive statistics and the event study methodology were adopted to establish the effect of M&A announcement on the stock returns of insurance companies. Data was mainly collected from secondary sources and analyzed using the SPSS statistical technique. The findings were presented using Tables, pie charts and graphs.

#### 4.2 Response Rate

The sample of the study comprised of the 7 insurance companies that engaged in mergers in the period 2012 to 2015 as illustrated in appendix 1. Out of the total sample of 7 entities the researcher was able to obtain data for 5 entities. This represents a 71% response rate which according to Mugenda and Mugenda (2003) is sufficient for data analysis and presentation. The response rate is indicated in Figure 4.1.



**Figure 4.1: Response Rate**

### 4.3 Diagnostic Tests

The researcher carried out Multicollinearity Test, Normality Test and Autocorrelation before regressing the data. The findings are indicated in subsequent sections.

#### 4.3.1 Multicollinearity

The researcher utilized Variance Inflation Factor VIF to test for multicollinearity in the dataset. See Table 4.1

**Table 4. 1: Multicollinearity**

Model	Collinearity Statistics	
	Tolerance	VIF
NSE 20 Share Index Return	.320	1.21

**Source: Research Findings**

From the findings, the VIF was 1.21 with a Tolerance of 0.320. Usually, VIF of between 1 to 10 and Tolerance of less than 1 indicates no Multicollinearity in the data set. The data set was therefore suitable for regressing NSE Share 20 index against share returns.

#### 4.3.2 Normality Test

The researcher used Skewness and Kurtosis to test Normality of the data set. The findings are indicated in Table 4.2

**Table 4. 2: Normality Test**

	N	Skewness		Kurtosis	
		Statistic	Std. Error	Statistic	Std. Error
Share Returns	30	-.214	.427	-.484	.833
NSE 20 Share Return	30	-1.992	.427	1.979	.833
Cumulative Abnormal Returns	30	-.904	.427	2.104	.833

**Source: Research Findings**

From the findings, Share returns had Skewness of -0.214 and Kurtosis of -0.484, NSE 20 Share index return had Skewness of -1.992 and Kurtosis of 1.979 while CAR had -0.904 with Kurtosis of 2.104. Values of Kurtosis and Skewness close to 0 indicate the dataset is normally distributed. Since most of Skewness and Kurtosis values are close to 0, this indicates that observations in the dataset were normally distributed.

#### **4.3.4 Autocorrelation**

Durbin Watson Statistics was used in determining autocorrelation of the data set. See Table 4.3

**Table 4. 3: Autocorrelation**

<b>Model</b>	<b>Durbin-Watson</b>
1	1.899

**Source: Research Findings**

From the findings, the value for Durbin-Watson was 1.899. Values of Durbin-Watson between 0 and 4 show no Autocorrelation in the dataset. Based on the findings, the data had no autocorrelation and thus suitable for regressing.

#### **4.4 Descriptive Statistics**

The study adopted descriptive statistics which was applied both in the pre and post-merger period to establish the effect of mergers and acquisitions on the stock returns of insurance companies in Kenya. The findings are described in the subsequent sections.

#### 4.4.1 Pre-Merger Descriptive Statistics

The table below presents the minimum, maximum, mean and standard deviation of the study variables 30 days prior to the merger or acquisition.

**Table 4.4: Pre-Merger Descriptive Statistics**

	<b>N</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
Share returns	30	-.01	.02	-.0001	.00743
Return on NSE 20 Index	30	-.04	.01	-.0023	.00900
CAR	30	-.05	.02	-.0024	.01387

**Source: Research Findings**

The findings reveal that the mean of share returns before the mergers or acquisition was -0.0001, standard deviation 0.00743, while the minimum and maximum returns were -0.01 and 0.02 respectively. The mean for the NSE 20 share index return, was -0.0023, standard deviation 0.00900, minimum return -0.04 and a maximum return of 0.01. The value of mean for the cumulative abnormal returns was -0.0024, standard deviation 0.01387, minimum return of -0.05 and a maximum return of 0.02.

#### 4.4.2 Post-Merger Descriptive Statistics

The post-merger period relates to 30 days after the merger announcement. The findings on the effect of M&As in this period are presented in Table 4.2 below:

**Table 4.5: Post-Merger Descriptive Statistics**

	<b>N</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
Share Returns	30	-.03	.02	-.0030	.00914
Return on NSE 20 Share index	30	-.02	.01	.0016	.00499
CAR	30	-.03	.02	-.0014	.01066

**Source: Research Findings**

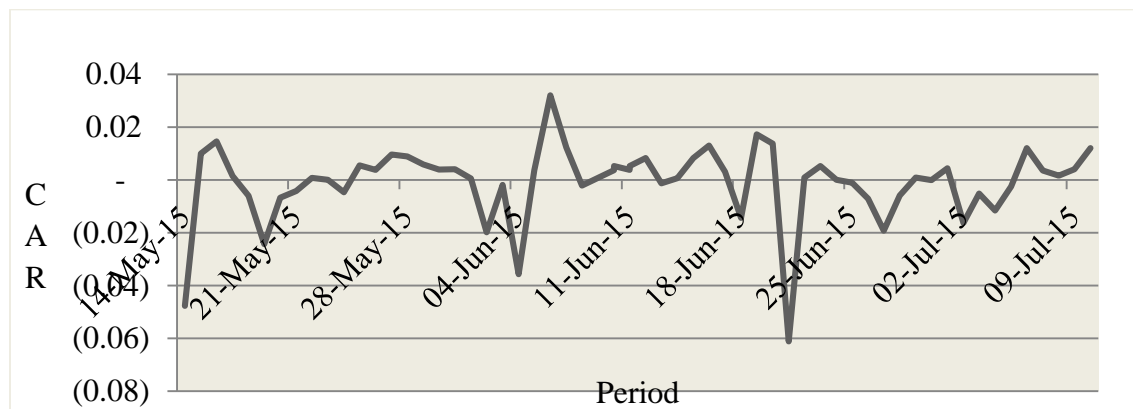
In the post-merger period share returns had a mean of -0.0030, standard deviation of 0.00914, minimum return of -0.03 and a maximum return of 0.02. NSE 20 share index had mean of 0.0016, standard deviation of 0.00499, minimum return of -0.02 and maximum return of 0.01. The cumulative abnormal returns had a mean of -0.0014, standard deviation of 0.01066, minimum return of -0.030 and a maximum return of 0.02.

#### 4.5 Cumulative Abnormal Returns for Individual Insurance Companies

In this section, the researcher graphically illustrates the abnormal returns of studied insurance companies that engaged in mergers and acquisitions between January 2012 to December 2015.

##### 4.5.1 First Assurance Ltd

Barclays Africa acquired a 63.3% stake in First assurance around 10<sup>th</sup> of June 2015. The movement in CAR for First Assurance is shown in Figure 4.2 below



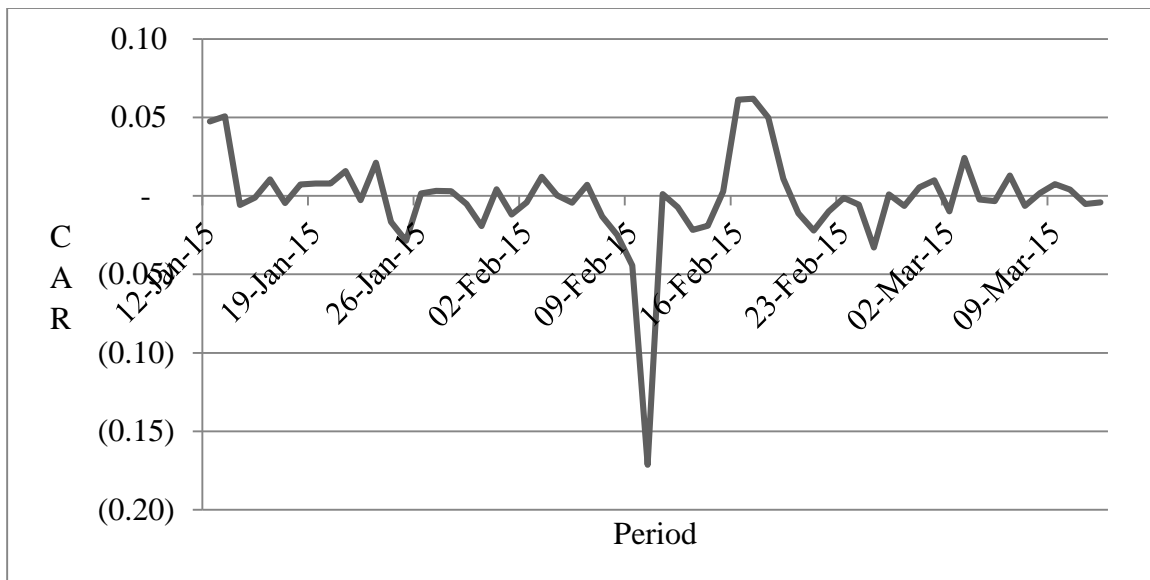
Source: Research Findings

Figure 4.2: First Assurance Ltd

From the findings, the movement of cumulative abnormal returns for First Assurance Ltd over the widow period was erratic. The target First assurance realized abnormal returns of more than 0.02 a few days prior to the acquisition while in the post mergers it realized negative abnormal returns of about 0.06. This clearly indicates that mergers and acquisitions have an effect on share returns.

#### 4.5.2 Metropolitan Life Assurance

Metropolitan Life Insurance acquired a 66% in Canon Assurance Life Assurance in 2015. The merger took place at around 10<sup>th</sup> of February 2015. The movement of the cumulative abnormal returns is indicated in Figure 4.3.



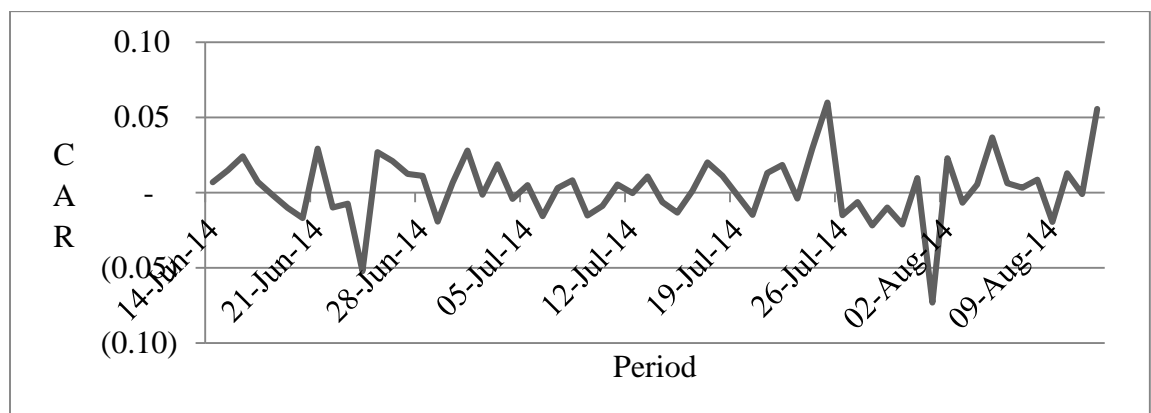
Source: Research Findings

Figure 4.3: Metropolitan Life Assurance

The movement in CAR is generally erratic. A negative return of slightly above 0.15 was realized on the event date implying mergers and acquisitions have an effect on share returns.

#### 4.5.3 UAP Old MUTUAL

UAP acquired a 23.3% stake in Old Mutual in 2014 to form Old MUTUAL. This happened around July 2014. A summary of the CAR is shown in Figure 4.4. below.



Source: Research Findings

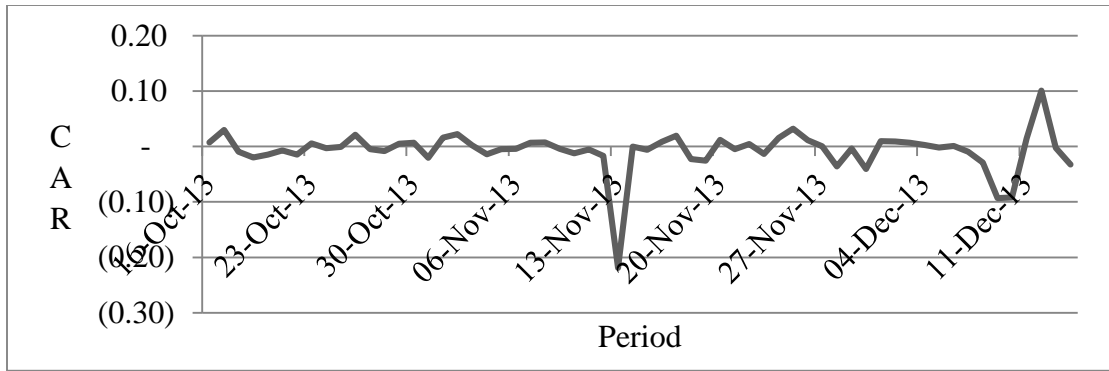
Figure 4.4: UAP Old MUTUAL

Based on the findings above the cumulative abnormal returns fluctuated by a small margin both before and after the event date hence the merger had an insignificant effect on the stock returns.

#### 4.5.4 Britam General

Britam acquired 99% of shares in Real insurance in 2013 forming Britam General. The acquisition took place around 14<sup>th</sup> of November 2013. The movement of the cumulative abnormal returns over the window period is shown in Figure 4.5 below.





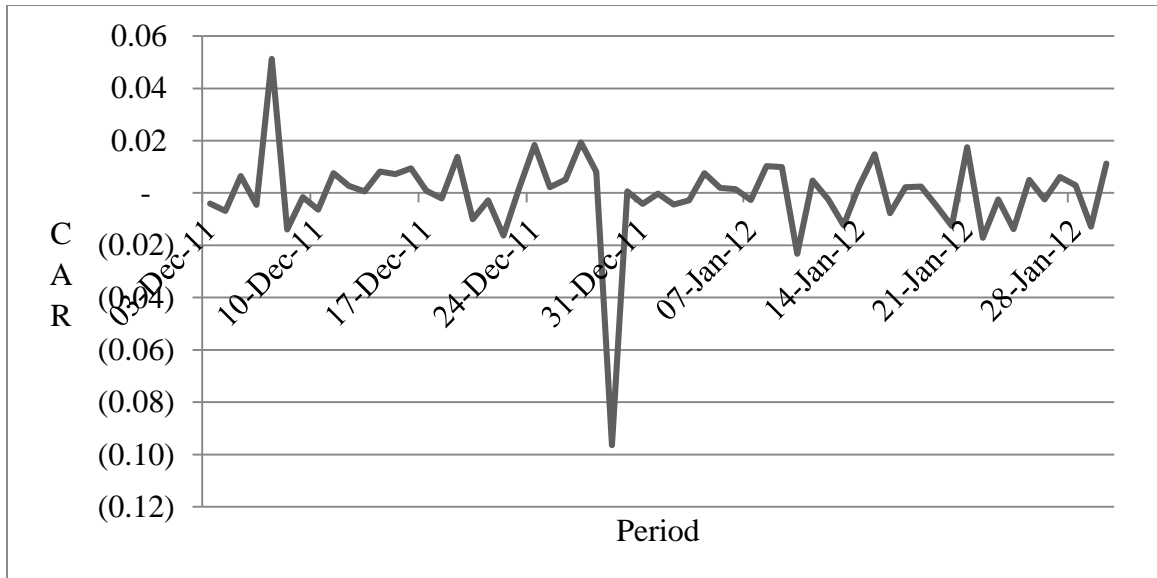
**Source: Research Findings**

**Figure 4.5: Britam General**

The findings reveal that the movement of CAR has been stable across the window period. The highest negative returns of slightly more than 0.20 was realized a day prior to the event date implying the acquisition had an effect on stock returns.

#### **4.5.5 ICEA Lion**

ICEA Insurance merged with Lion Assurance to form ICEA Lion. Finalization of this took place around 1st Jan 2012. A summary of the cumulative abnormal returns is shown in Figure 4.6. below



**Source: Research Findings**

**Figure 4.6: ICEA Lion**

From the findings, the movement of share returns has been stable across the window period thus the merger did not have an effect on the stock returns.

#### **4.6 Regression Analysis**

The researcher computed expected daily returns using the single-index market model that was in form of simple regression analysis. The findings before and after M & A; are indicated in subsequent sections.

##### **4.6.1 Pre-Merger and Acquisition**

The researcher did regression analysis to establish the effect of M & As on share returns.

The findings are illustrated in Table 4.3 below

**Table 4.6: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.421	.177	.148	.00686

**Source: Research Findings**

The coefficient of correlation R in Pre-merger and acquisition period is 0.421 showing moderate positive relationship between mergers & acquisitions and share returns of insurance firms. The coefficient of determination R square is 0.177, implying that M&As triggered a 17.7% changes in share returns of insurance firms prior to the merger or acquisition.

**Table 4.7: ANOVA**

	Sum of Squares	df	Mean Square	F	Sig.
Regression	.000	1	.000	6.035	.020 <sup>b</sup>
Residual	.001	28	.000		
<b>Total</b>	<b>.002</b>	<b>29</b>			

**Source: Research Findings**

The ANOVA findings at 5% level of significance indicates an F calculated value of 6.035 while F critical is 4.2. Since F calculated is greater than F critical, this shows that the overall regression model was significant in predicting the relationship between the study variables.

**Table 4.8: Regression Coefficients**

	Unstandardized Coefficients		Standardized	t	Sig.
	B	Std. Error	Coefficients Beta		
(Constant)	.001	.001		.583	.564
Pre NSE 20 Index	.347	.141	.421	2.457	.020

**Source: Research Findings**

The established regression equation is

$$R_{it} = 0.001 + 0.347R_{mt}$$

Where:

$R_{it}$  is Expected daily returns of stocks  $i$  at time  $t$

$R_{mt}$  is Daily value-weighted market returns (NSE20 index)

Regression coefficients are indicated in Table 4.8. All factors held constant, returns on share returns in the pre-merger would be at 0.001. The beta is 0.347 with p value  $0.020 < 0.05$ . This shows that pre-mergers and acquisitions had a significant positive effect on share returns of insurance firms.

#### **4.6.2 Post-Merger and Acquisition**

The researcher further carried out regression analysis in the post-merger and acquisition period. The findings are indicated in subsequent sections.

**Table 4.9: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.482 <sup>a</sup>	.233	.205	.00814

**Source: Research Findings**

In the post-merger period, the coefficient of correlation R was 0.482 showing that mergers and acquisitions had moderate and positive relationship with share returns of insurance companies. The coefficient of determination R square was 0.233 an indication M&As triggered a 23.3% change in share returns of insurance firms post-merger.

**Table 4.10: ANOVA**

	Sum of Squares	df	Mean Square	F	Sig.
Regression	.001	1	.001	8.493	.007 <sup>b</sup>
Residual	.002	28	.000		
<b>Total</b>	<b>.002</b>	<b>29</b>			

**Source: Research Findings**

The findings of ANOVA at 0.05 level of significance shows F calculated value of 8.493 while F critical was 4.2. F calculated is greater than F critical, this implies that the overall regression model was a significant predictor of the relationship between post-merger and acquisitions in relation to share returns of insurance firms.

**Table 4.11: Regression Coefficients**

	Unstandardized		Standardized	t	Sig.
	Coefficients		Coefficients		
	B	Std. Error	Beta		
(Constant)	-.002	.002		-1.032	.311
Post NSE 20 Index	-.883	.303	-.482	-2.914	.007

**Source: Research Findings**

The resultant equation becomes:

$$R_{it} = -0.002 - 0.883R_{mt}$$

Where:

$R_{it}$  is Expected daily returns of stocks  $i$  at time  $t$

$R_{mt}$  is Daily value-weighted market returns (NSE20 index)

This shows that all factors constant, share returns in the post-merger period would reduce by 0.002. A unit decrease in market returns determined by NSE 20 share index would lead to 0.883 increases in share returns in the post-merger period of the window period.

The Beta coefficient was -0.883 compared to 1 of the market, showing that securities of insurance firms were theoretically less volatile than the market during post-merger acquisitions. The negative beta shows inverse relationship between mergers and acquisitions in view of the stock returns of insurance companies in Kenya. The p value  $0.007 < 0.05$ , showing that the relationship between post mergers and acquisitions in relation to stock returns of insurance companies in Kenya; was statistically significant.

#### **4.7 Discussion of the Findings**

The NSE 20 share index had a mean of -0.0023 and 0.0016 for the Pre and post-merger period respectively. This implies the merger announcement triggered a change in the stock returns in the post-merger period as compared to the pre-merger period. On the other hand based on cumulative abnormal returns, First Assurance realized the highest positive abnormal returns of more than 0.02 a few days prior to the acquisition. Metropolitan Life assurance realized the highest negative returns of slightly 0.15 on the event date an indication that Mergers and acquisitions have effect on share returns. This finding contradicts Constantine (2008) who established that majority of company stocks were not affected by merger and acquisition announcements.

Findings on regression analysis revealed that the coefficients of determination differed across the window periods. The coefficient of determination R was 0.0177 and 0.233 in the pre and post-merger period. This is an indication that merger and acquisition announcement triggered a change in the stock returns by 17.7% and 23.3% in the pre and post-merger period respectively. Besides the announcement had a significant impact on the stock returns in the post-merger period as compared to the pre-merger period. The coefficient of correlation R, during the pre-merger and acquisition period was 0.421 showing a moderate positive relationship between M&As and share returns of insurance firms. While in the post mergers and acquisition period the value for coefficient of correlation increased to 0.482. This finding is consistent with the Mitema (2014) who established that M & A and value creation have a positive relationship.

In regard to betas and significance, the study established a beta of 0.347 and p value 0.020 which is less than 0.05 during the premerger window. This shows that pre-mergers and acquisitions had a significant positive effect on stock returns of insurance firms. This finding concurs with Khan (2011) who showed that M & As have a positive effect on operating performance. In the post-merger window, the beta coefficient was -0.883 compared to the market risk of 1, showing that securities of insurance firms were theoretically less volatile.

The negative beta shows an inverse relationship between mergers and acquisitions on the stock returns of insurance companies in Kenya. This inverse relation is in line with Moctar and Chen (2015) who concluded that financial performance is negatively affected by M & As. The p value 0.007 is less than 0.05, implying that the effect of merger and acquisition on stock returns of insurance companies in the post-merger window was statistically significant.

Based on Analysis of Variance ANOVA, pre mergers and acquisition had an F calculated value of 6.035 while the post-merger period had F calculated value of 8.493. At degrees of freedom (1, 28), F critical was 4.2 for both periods. This implies the regression models used across the window period were significant predictors of the relationship between the study variables. The models were significant because their F calculated values were all greater than F critical values at 5% level of significance.



## **CHAPTER FIVE:**

### **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Introduction**

The chapter presents the summary of findings, conclusion, recommendations of the study, limitations of the study and suggestions for further studies. The main objective of the study was to determine the effect of mergers and acquisitions on the stock returns of insurance companies in Kenya. The research adopted an event study methodology and relied on secondary sources of data.

#### **5.2 Summary of the Findings**

Findings for this study reveal shareholders reacted more to stock returns in the post-merger period as compared to the premerger period. The cumulative abnormal returns fluctuated in both periods an indication shareholders reacted differently to merger and acquisition announcements. The value of coefficient of correlation R was higher after the merger compared to a few days prior to the merger. This implies the M&A announcement triggered an increase in stock returns post-merger.

On the other hand the coefficient of determination R square was 17.7% and 23.3% in the pre and post-merger period respectively. This is an indication the merger and acquisition announcement triggered an increase in the stock returns by 23.3% after the merger. Shareholders reacted to the merger and acquisition in both periods but the impact was

significant post-merger. The significance is confirmed by p values which were less than 0.05 in both periods.

Based on Analysis of Variance ANOVA, pre mergers and acquisition had an F calculated value of 6.035 while the post-merger period had F calculated value of 8.493. At degrees of freedom (1, 28), F critical was 4.2 for both periods. This implies the regression models used across the window period were significant predictors of the relationship between the study variables. The models were significant because their F calculated values were all greater than F critical values at 5% level of significance.

The beta coefficients across the window period varied in strength and direction. Assuming a market beta of 1, the study established that pre-merger period had a weak but positive beta which was less than 1; in the post-merger period however, beta was negative and slightly higher than the one in the pre-merger period. This shows that there was an inverse relationship between post-merger acquisitions and share returns and a direct relationship between pre-merger acquisitions and share returns.

### **5.3 Conclusion**

Announcement of a merger and acquisition triggers a change in stock returns around the event date. In this study the findings reveal that stock returns increase in the post-merger window period in comparison to the premerger period. This is illustrated by the change in R<sup>2</sup> Square from 17.7% to 23.3%. The coefficient of correlation R also increased from 0.421 to 0.482 post-merger. This is an indication that there is a moderate positive relationship

between M&As and stock returns. Mantravadi and Reddy (2008) studied the effects of M&As on operating performance in different Indian industries and established a positive effect on financial performance in the banking and finance industries and a significant decline in financial performance in the chemical, pharmaceuticals, textiles and electrical industries after the merger.

Shareholders react differently to mergers and acquisition announcement consequently affecting the stock returns of the merged entity. The share prices may either rise or slump and this brings about either positive or negative returns to shareholders. According to the Synergistic Mergers Theory, the major aim of mergers and acquisition is to achieve synergy. This theory states that, the market value of the merged firm is higher than the sum of the individual values (Baldwin, Gorecki, Caves, Dunne & Haltiwanger, 1998). Additional gains are realized as a result of firms engaging in mergers and acquisitions thus achieving the shareholder objective of wealth maximization (Ross, Westerfield and Jordan, 2010).

The beta coefficients in both periods were less than 1, an indication that securities of insurance firms were theoretically less volatile. The negative beta in the post-merger period shows there is an inverse relationship between M&A and stock returns. Shareholders increase their shares when a merger has been announced, but this is not sustainable post-merger. In conclusion, mergers and acquisitions had an effect on the stock returns on the merged insurance companies but the impact was significant post-merger. These findings contradicts with Yusuf (2016) who examined the post-merger financial health of Jordanian

industrial sectors and showed there was insignificant improvement in the liquidity, profitability and market share in the selected manufacturing firms.

#### **5.4 Recommendations of the Study**

Management of insurance firms should engage in mergers and acquisitions with the intention of achieving the shareholder objective of wealth maximization. This is in line with the synergy theory which stipulates that the value of the combined entity is higher than the value of the standalone firms. Merged entities enjoy economies of scale and scope thus will minimize on costs and boost returns.

The Competition Authority of Kenya should formulate sound policies, rules and regulations on mergers and acquisitions of firms in Kenya to avoid instances where firms engage in M&As against the shareholders wish. Punitive measures should thus be taken against managers who engage in mergers to achieve personal interests at the shareholders expense. On the other hand there should be full disclosure of information on announcement of the merger to enable the bidding firm make a rational acquisition decision.

The top management of Nairobi Security Exchange NSE and the Capital Market Authority CMA should sensitize the listed firms on the importance and positive effects of engaging in mergers and acquisitions. In addition the national government through Kenya Revenue Authority KRA should offer incentives to the merged entities in the first few years into the merger deal. This will encourage more firms to enter into mergers and acquisitions which

in the long run will boost the stock market performance and in turn the economic growth of the nation.

### **5.5 Limitations of the Study**

The research was narrow and focused on the effect of mergers and acquisitions on stock returns; it did not explore other aspects of financial performance for instance the effect on profitability, Return on Equity, Return on Assets, market share etc. Besides the study was based on a short window period of 60 days hence the findings may not be sufficient to determine the effect of mergers and acquisitions on the stock returns.

There was also a challenge in getting data for all insurance companies that had merged in the stipulated period thus giving a response rate of 71%. Some insurance companies are not listed in the NSE hence getting data was a challenge. Secondary data was collected from NSE publications and financial statements of the merged entities. However, this is subject to prejudice as opposed to primary data which gives firsthand information.

This study measured Performance of the stock returns against the NSE 20 Share index. This is an aggregate of returns of 20 blue chip companies listed at the NSE. This could give different findings compared to returns benchmarked against the NASI and NSE 25 share index.

## **5.6 Suggestions for Further Studies**

The current study focused on the merged entities in the Kenyan Insurance industry, further studies should be done on the effect of mergers on stock returns across the border. Further studies should also be done on the effect of stock returns in other industries e.g. the airline industry, manufacturing industry, agricultural industry and financial services industry. The current study used a short window period of 60 days, studies should be done in future using a longer window period of say 120 days so as to establish the long run effect of mergers on stock returns.

Further studies should also be conducted to determine the impact of macro-economic variables on stock returns around the event date. For instance the impact of the exchange rate, interest rates, inflation and money supply on stock returns before and after the merger announcement. Studies should be done to establish the impact of financing mergers and acquisitions using stocks. Future studies should look into the impact of mergers and acquisition on the company's market share and factors which influence the success of mergers.

The current study focused on a sample of 7 insurance companies that had merged in the period 2012 to 2015. This is a small sample size hence the findings may not be conclusive. Further studies should be carried out on all insurance companies that have engaged in mergers so as to give a conclusive and up to date status on the effect of mergers on stock returns. This will also help to monitor the trend on mergers and acquisitions in the Kenyan insurance industry.

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## APPENDIX

### APPENDIX I: LIST OF MERGERS & ACQUISITION BETWEEN 2012 AND

2015

Name of Insurance Company	Insurance Company Merged with	Name after The Merger	Year of Merger or Acquisition
ICEA Insurance	Lion Assurance	ICEA Lion	2012
Britam Insurance	Real Insurance	Britam General	2013
Saham Group	Mercantile Insurance	Saham	2013
UAP Ltd	Old Mutual Ltd	UAP Old MUTUAL	2014
Metropolitan Life Insurance	Canon Life Assurance	Metropolitan Life insurance	2015
First Assurance	Barclays Africa	First Assurance	2015
Pan Africa Assurance	Gateway	Pan Africa Life	2015

**SOURCE: IRA REPORT**

**APPENDIX II: AVERAGE DATA USED FOR THE STUDY**

<b>Share returns</b>	<b>Return on NSE 20 Index</b>	<b>CAR</b>
0.001663477	0.000354497	0.002018
0.018950142	0.000704786	0.019655
0.00704862	-0.001045765	0.006003
-0.005070741	0.001763584	-0.00331
0.008813905	-0.000932898	0.007881
-0.005527081	-0.00644397	-0.01197
-0.00397824	-0.002502031	-0.00648
0.009564611	-0.003097941	0.006467
0.001143762	-0.000448815	0.000695
0.006176578	-0.004105372	0.002071
-0.006976432	-0.000492445	-0.00747
0.011317799	9.57636E-05	0.011414
-0.000391344	0.001874225	0.001483
-0.001751715	0.00331169	0.00156
0.005022559	0.000832366	0.005855
-0.006166415	-0.000319348	-0.00649
0.00645042	0.002239292	0.00869
0.005493808	0.002300164	0.007794
-0.005782168	0.001666381	-0.00412
-0.004870607	-0.000615496	-0.00549
-0.003497326	-0.000650598	-0.00415

-0.004914796	0.000716969	-0.0042
-0.004199419	0.006017745	0.001818
0.006134969	0.003512392	0.009647
0.004640121	0.001665403	0.006306
-0.004882067	0.001947545	-0.00293
-0.004452285	-0.02008303	-0.02454
-0.005398789	-0.000981445	-0.00638
-0.011962687	-0.040783347	-0.05275
-0.014353831	-0.01674536	-0.0311
-0.001785987	-0.000281802	-0.00207
-0.00303832	0.001778588	-0.00126
-0.00168644	0.002713732	0.001027
-0.004912985	0.001088062	-0.00382
-0.003586563	0.0032639	-0.00032
0.010995772	0.00537675	0.016373
0.002203972	0.008981791	0.011186
0.002811117	0.009835192	0.012646
0.004902458	-0.002914726	0.001988
0.002383733	0.001425467	0.003809
-0.009344163	0.004544035	-0.0048
0.003893881	0.006090553	0.009984
0.001215805	-0.002802368	-0.00159
-0.004387852	-0.002235818	-0.00662

-0.010230307	-0.003132319	-0.01336
-0.008978381	-0.001809753	-0.01079
-0.007786245	0.000822044	-0.00696
0.001787435	0.000901385	0.002689
-0.017907947	0.004281879	-0.01363
0.001529187	0.005097724	0.006627
-0.007562442	0.008175262	0.000613
-0.003154574	0.000259844	-0.00289
0.001229247	-0.00025427	0.000975
-0.006795197	0.00351662	-0.00328
-0.028267763	0.008104134	-0.02016
-0.012806285	0.000163577	-0.01264
0.000967949	0.000915632	0.001884
0.022214405	-0.00093542	0.021279
0.000647249	0.000744914	0.001392