

**THE EFFECT OF THE SEPARATION OF LIFE ASSURANCE AND GENERAL
INSURANCE ON THE FINANCIAL PERFORMANCE OF INSURANCE
COMPANIES IN KENYA**

BY

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DECLARATION

I hereby declare that this project is my own work and effort and that it has not been submitted anywhere for any award.

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This research project has been submitted for examination with my approval as the University supervisor.

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DEDICATION

To my mum whose deep spirituality, counsel and natural beauty of character are ever
source of joy to me

And to Shaun for persevering when mum was too busy for you

ABSTRACT

Mergers and demergers are resorted to as managerial strategies in the management of organizations for many reasons. However, the main objective, other than survival of the business, is generation of better returns as compared to those before the merger or demerger. In Kenya, the insurance industry opted to demerge composite insurance providers into those that deal in general and life insurance separately. The objective of this study was establishing the effect of the splitting of life assurance and general insurance on the profitability of insurance companies in Kenya. This was done through the use of event study method with the assumption that such an event generates reaction from both within or without the organization. The event in this study was the announcement of the separation of life insurance from general insurance business by the insurance companies in the study. A time span of nine year was used to conduct the analysis. The data used for the study were the annual earnings before interest and tax (EBIT) and the annual book values of assets of the insurance companies from their yearly financial records obtained from the Association of Kenya Insurers (AKI) and the Insurance Regulatory Authority (IRA). These were used to generate the returns that were used for the analysis. The findings indicate that there was no statistically significant difference between the patterns of returns after the splitting of the insurance companies. This is deduced from the fact that the Z statistic was -0.03 which is less than 1.96 which is the Z-critical at 95 % confidence level. This indicated that there was no statistically significant difference between returns before and after the demergers. The study, therefore, recommends that Splitting of insurance companies should be done only as a method safeguarding the funds of those in the life insurance industry, but not as a mechanism of generating extra income. It is also recommended that insurance companies should come out strongly to improve the attitude of stakeholders towards them and that splitting should be coupled with policies to ensure operational efficiency if better returns are to be realized.

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LIST OF ABBREVIATIONS

- ACAR - Average Cumulative Abnormal Return
- AKI - Association of Kenya Insurers
- CAPM - Capital Asset Pricing Model
- CAR - Cumulative Abnormal Return
- IRA - Insurance Regulatory Authority
- M&A - Mergers and Acquisitions
- PSV - Passenger Service Vehicles
- ROA - Return on Assets
- ROE - Return on Equity
- ROI - Return on Investment
- SAR - Standardized Abnormal Returns
- USA - United States of America

CHAPTER ONE

INTRODUCTION

1.1 Background

Insurance refers to an agreement where, for an agreed payment called the premium, one party agrees to pay to the other a defined amount upon the occurrence of a specified loss. This defined claim payment amount can be a fixed amount or it can be a reimbursement of all or a part of the loss that has occurred. The party agreeing to pay for the loss occurring is called the insurer while the person to be paid is the insured or the beneficiary. The loss for which the insurer agrees to pay the beneficiary should it occur is called a risk. The amount paid in case a loss occurs is called the claim or the benefit. All the conditions covering the contract between the insurer and the insured are contained in a document called a policy (Anderson & Brown, 2005).

Insurance is generally divided into life and non-life (general) insurance. A life insurance contract is a long term contract. In life insurance the risk is death and it is certain. The only uncertainty concerning death is when it will take place. General insurance refers to the property and liability insurance. General insurance covers non-life risks like fire, marine, or miscellaneous insurance whether carried separately or in combination. Fire insurance covers stationary property. Marine insurance covers mobile property. Bonding is a special coverage that guarantees the performance of the contract by one party to another. Casualty coverage includes accident and health insurance besides the above mentioned categories. Miscellaneous Insurance business means all other general insurance contracts including motor insurance. In general insurance, the insured event may or may not take place (Hussain, 2011)

1.1.1 Financial Performance

“Performance” is a term which means ‘to do’, ‘to carry out’ or ‘to render’. This term refers to the act of performing; execution, accomplishment, fulfillment, among others. In broader sense, performance refers to the accomplishment of a given task measured against some accepted standards of accuracy, completeness, cost, and speed. Performance is a general term applied to a part or to all the conducts of activities in an organization over a period of time often with reference to past or projected cost efficiency, management responsibility or accountability or the like. Performance is used to indicate firm’s success, conditions, and compliance (Kohler, 1985).

“Financial performance” simply refers to the act of performing financial activity. Financial performance is the degree to which financial objectives are being achieved or have been accomplished. It refers to the process of measuring the results of a firm's policies and operations in monetary terms. Financial performance is also used to measure a firm's overall financial health within given period of time for comparison similar firms across the industry or to compare industries or sectors in aggregation (Meigs, 1978).

According to Malik (2011) profitability is one of the most important objectives of financial management. Among others, one goal of financial management is to maximize the owners’ wealth, and, profitability is a very important determinant of performance. Companies should channel funds and indemnify the losses of other sectors in the economy in a profitable manner.

1.1.2 Separation of General and Life Insurance

The current global trend is to have insurance companies separate their life insurance sections from general insurance sections so that the two are registered as different insurance companies. This has been turned into law in many countries as a requirement for licensing. In Uganda, for instance, only those firms with separate general and life insurance businesses were to be licensed as from 2012. This separation of insurance business lines was seen as the only way Uganda could promote life insurance (Kimbowa, 2012).

No business is profitable without controlled risk taking and managing them effectively. Consequently, the management of risk is a core function for all types of business though approaches may be different. In the insurance business, the two main schools of thought of risk management are the silo approach which focuses to manage risk in isolation and the alternative approach of managing all risks in a single and holistic framework. Due to the high levels of risk in the general insurance in many countries, insurance companies have resorted to the use of the silo approach. This has led to the separation of general insurance from life so as to tackle risk in general insurance in isolation (Nocco & Stulz, 2006).

1.1.3 Relationship between the Separation and Profitability

According to portfolio management theory by Markowitz (1952), there is close relationship between risk and return. Exposing investments to higher levels of risk is only justified if there is a commensurate return for the extra risk exposure. Due to risk

aversion nature of investors, a risk that makes a portfolio to unnecessarily earn lower returns should be dropped from the portfolio or its weight reduced or managed as a standalone asset. In such a situation, it is expected that returns will be higher than before the change. In line with the Markowitz postulation, it is expected that the returns of the insurance companies after the separation is significantly higher than the returns before the separation.

Studies have shown the M&A activity can affect the profitability of a firm. Some studies using stock price data have shown that abnormal gains are realized by the shareholders of acquired firms. However, there are other motivations for merger such as creating monopoly power, tax savings, undervaluation of assets, management empire-building, the displacement of inefficient managers, and creation of synergies. Whichever way one looks at them, the actions to merge or demerge are taken as strategies to increase the profits of firms and/or control risk.

1.1.4 Insurance Companies in Kenya

In Kenya the split of insurance into life and general was not only a managerial trend, but a step in compliance with Insurance Act, Cap 487, revised 2010, which requires all composite companies to have separate entities. The new law stipulates that no person shall transact the business of life insurance and non-life insurance as a composite company. It is expected that by 2015 there will be no composite insurance companies (Kimbowa, 2012).

In a report by Turana (2010) the separation was carried out to allow for specialization in service delivery with each area focusing on their competence. Further, these changes were in response to the regulatory requirements of the Insurance Regulatory Authority (IRA) for the separation of the two insurance business lines as part of the reforms in the Kenyan insurance industry.

According to Association of Kenya Insurers (2013) there are 46 insurance companies who make up its membership. The 46 members, there are 44 insurance companies and 2 locally incorporated reinsurance companies licensed to operate in Kenya. Among the licensed insurance companies, 20 are general insurers; seven are long term insurers while 16 are composite insurers. Composite insurers cover both life and general insurance.

The insurance industry has in the past decade witnessed rapid growth. Despite the impressive growth in written premiums with increased incomes, the perception towards need for insurance has remained poor and penetration has remained low. The main reason for the poor perception of the industry has been negative market sentiment following closure of at least 5 insurance providers over the past 5 years due to insolvency arising from high claims (Standard Investment Bank, 2013).

A report by AKI (2011) acknowledges that the East African insurance industry is currently undergoing a period of rapid change concerning separation of life insurance from general insurance. This is largely driven by the amendments to insurance regulation in Kenya, and East Africa to disallow composite insurers from operations. In Kenya only

the reinsurer is allowed to be a composite insurer. All composite insurers are expected to have separated by 2015. By 2011 report, only three of the ten major composite insurers had demerged and the rest were yet to demerge.

1.2 Research Problem

The three theories, namely, portfolio theory (Markowitz, 1952), contingency theory (Donaldson, 1995) and industry change theory (McGahan, 2004) posit that separation of a business into two separate entities dealing in different product is driven by the need to mitigate risk and gain higher returns within the dynamics of the strategic environment of the business. The expectation is that a firm should experience higher profitability after taking such measure.

Currently the insurance companies in Kenya are under legal requirement separating their life assurance from general insurance as opposed to having them together in a composite insurance company. This move is supposed to help the insurance firms mitigate risk that has led to the collapse of some insurance companies that were operating as composite companies. Further, such an action is meant to help realize profit and survival (AKI, 2010).

Empirical studies done by Cusatis, Miles & Woolridge (1993), Kirchmaier (2003) and Veld & Merkoulova (2009) found that such separations demergers brought about higher profitability among the firms that had undergone demergers. However, the degree of

profitability was higher for larger firm than it was for smaller firms and was higher for the spin-off firm than the parent firm. In general, separation brought higher profitability.

On the contrary, other studies like Semadeni & Cannella (2011), Dasilas (2010) and Njenga (2004) found mixed results. Semadeni & Cannella (2011) found that profitability could only depend on the nature of relationship the spin-off company had with the parent. Dasilas (2010) found that the parent company lost profitability. On the local scene Njenga (2004) found separation had no effect on profitability. Other studies, in fact, found that mergers, which are the reverse of separation, led to higher profitability. Other than the studies giving mixed findings concerning the effect of separation on the profitability of firms, none of the studies was conducted on insurance companies in Kenya that decided to separate life insurance from general insurance. This left a research gap since the findings of the industries studied by the researchers cited above may not be expressly assumed to apply to the insurance industry in Kenya. This study filled the research gap by answering the question: what was the effect of the separation of life insurance from general insurance on the profitability of the insurance companies in Kenya?

1.3 Research Objective

This study aimed at establishing the effect of the splitting of life assurance and general insurance on the financial performance of insurance companies in Kenya.

1.4 Value of the Study

This study will be important through providing an update of the knowledge concerning the splitting of life and general insurance. The splitting was done as a strategic and legal reaction to the environmental dynamics where it was costly and dire to have general and life insurance combined. However, it is not known how the profitability of the insurance companies reacted to this change. This research will give an insight on how profits reacted to the splitting in Kenya. Scholars will find this research as evidence to further arguments and research that will find the evidence relevant.

The insurance companies themselves will find this study quite useful for it will provide a scientific analysis into the results brought about by the separation of life and general insurance. This study will either justify the separation or provide an evidence based critique of that strategy. In fact, the study is an evaluation of the contribution of the splitting to the bottom line of the insurance companies that undertook the policy as required by the Kenyan law.

To other insurance companies in other countries this study will provide an understanding of the merit of splitting composite insurance companies into those that deal with life and general as separate insurance. They will, therefore, know how to deal with such issues and come up with better ways of separation.

CHAPTER TWO LITERATURE REVIEW

2.1 Introduction

This chapter provides the literature review of this study. The chapter discusses three theories behind performance of firms after demergers. These theories are: portfolio theory, game theory and contingency theory. Further, the chapter discusses past empirical studies concerning the demergers and their effect on profitability.

2.2 Review of Theories

This subsection discusses the three theories explaining the thought behind the separation of life insurance from general insurance.

2.2.1 Portfolio Theory

The portfolio theory in its modern form was formalized by Markowitz (1952). It is a theory that provided a widely used explanation of the connection between risk and return. This theory expressed return as the expected return of a set of investments while risk was expressed as a standard variation in the expected returns from the set of assets or portfolio. The manipulation of the contents of the assets has bearing on the returns and risks. The model can be used to explain the separation of life assurance and general insurance as a perceived approach that could mitigate risk while retaining or improving returns.

The model by Markowitz (1952) was improved and later came the Capital Asset Pricing Model (CAPM). The CAPM offers powerful and intuitive model that helps in predicting how to measure risk and the relation between expected return and risk. The CAPM says that the risk of a set of assets should be measured relative to a comprehensive market portfolio. The risk return behavior can help the investor manipulate assets to come up with desirable returns and risk levels.

This theory is related to this study since general insurance is more risky than life assurance in Kenya according to AKI (2010) it became necessary to separate general and life insurance to safeguard the interests of the safer life insurers and avoid any resultant melt down of the insurance sector. This manipulation of assets to control risk and return can be explained using the portfolio theory.

2.2.2 Contingency Theory

Contingency theory is attributed to Donaldson (1995). The main argument of contingency theory is that best practices depend on the contingencies of the given situation. Contingency theory suggests that managerial steps to be taken over an issue depend upon the dynamics surrounding the issue to be acted on. These dynamics are called contingencies. While contingency theory may sound simplistic, the contingencies on which decisions depend can be a very complex. Contingency theorists try to identify and measure the conditions under which things will likely occur.

A contingency is a relationship between two phenomena. If one phenomenon exists, then a conclusion can be drawn about another phenomenon. Contingencies can be internal or

external and the nature of the relationships among the contingencies will affect management action. Among the external contingencies are: purpose or goals, people, tasks, technology, and organizational structure. These internal contingencies operate within the external contingencies which are divided into: technological, political, sociocultural, economic and ecological (Carlisle, 1976).

This theory is relevant to this study since it suggests that strategic actions taken by the insurance industries to separate general insurance from life insurance depended upon internal and external contingencies among the providers of insurance. Issues like profitability, survival, customer sentiment, the legal environment, global trends in insurance, competition, risk etc forced insurance companies to take the steps of the separation (Donaldson, 1995).

2.2.3 Industry Change Theory

This model was put forth by McGahan (2004). The model is important for analyzing and understanding industrial change so as to make intelligent investments within an organization. However, it is not always a simple activity to obtain this knowledge and companies frequently misread clues and generate false conclusions. McGahan suggests that it is necessary to have a true visualization of the direction of the industry on a long-term, high-level basis. After studying organization in the USA for over ten years, focusing on the effect of industry structure on business profitability and investor returns, McGahan concluded that there are of four distinct trajectories of evolution of industry: radical; progressive; creative and intermediating.

In the radical trajectory, a firm assesses what threats there might be to its core assets and activities. If the analysis shows that both the core assets and activities are in some way threatened the firm should first try to estimate how present these threats are to its existing ways of conducting business. The firm should then come up with a combination of suggested actions. In the radical trajectory of evolution the managers of the firm should develop a strategy for either exiting the business in the long term and or decide where its current assets and activities could be deployed in another industry or try to leapfrog the evolution of the industry by diversifying away from it (Bresnahan & Greenstein, 1999).

If the industry analysis reveals that the firm is operating in an industry, where it is evolving alone, the progressive trajectory could be considered for aligning the firm's strategy. In the progressive trajectory, the firm develops a system of interrelated and defensible activities. The firm can then rest assured that there are not imminent threat to its core assets and its core activities. However if the analysis showed that the firm is not among the leaders in this industry, the firm should look for how it can become the leader in the market, or see how it can create a unique system of activities that matches the other players. The firm could also look for a related or emerging industry where it can build up a new activities and assets (McGahan (2004).

Having concluded from industrial analysis that its core assets are threatened by obsolescence, a firm can follow the creative change trajectory. The firm should first assess how quickly its core assets are decreasing and determine which business segments they can be used protect its competitive position from those in which its position is

eroding quickly. The firm should assess the threat, find out where it stems from and possibly discover a way how to generate new core assets and see how it can acquire the new assets (McGahan, 2004).

In response to threatening changes in the business environment, the firm can follow the intermediating trajectory. In this approach the firm decides to follow the less risky option of pursuing short term profits while avoiding investments that could later prevent it from ramping down its commitments. The firm must, further, come to grasp with how the new competing methods are changing its business model. In response, the firm must find new ways of selling and buying its products, while considering ramping down its existing structure (Bresnahan & Greenstein, 1999).

This theory is relevant to this study because it provides theoretical explanation to the motivation behind separating life assurance from general insurance. General insurance had become a threat to the insurance firm due to the coverage given to the then highly risky PSV industry. This theory suggests that the actions taken to restructure the industry could have followed any of the four trajectories presented by the theory (Tranaes, 2009).

2.3 Reasons for Demergers

The reasons why firms demerger vary from the hard reasons of inability to reach profit goals and financial synergies (Quah & Young, 2005) to soft issues like lack of cultural and strategic fit, cultural clashes, inadequate communication and planning, lack of human resource involvement, training, talent and key employee retention and ownership issues

(Waldman & Javidan, 2009). Additionally, the human capital is an essential asset in an organization and yet the most difficult to integrate in an M&A process. The cultural issues that follow are sometimes underestimated and if not well addressed might become an obstacle for successful integration and safeguarding shareholder value (Reuss, 2011).

Epstein (2004) listed seven reasons for M&A failures as misaligned strategic vision, strategic fit, insufficient due diligence, pre-merger planning, post-merger integration and the external environment. Other issues pointed out by Fang, Fridh & Schultzberg (2004) are: disparities in strategy, organization, corporate finance, international business, negotiation, culture, history, and diplomatic issues.

2.4 Review of Empirical Literature

Cusatis, Miles & Woolridge (1993) analyzed the performance of a sample of 146 demergers that took place between 1965 and 1988. The analysis per company covered periods of at least six months to three years before and after execution of demerger. Announcement effects were excluded from the research. Their research indicated that both the spin-off companies and the parents offered significantly positive abnormal returns for up to three years after the spin-off announcement date. The study showed that demergers brought about improvement in profitability.

Kirchmaier (2003) conducted a study to examine security price reactions to European demergers. Demergers are considered European if the parent company was located in one of the countries in the European Economic Area. The time period under investigation was

between 1989 and 1999. The sample consisted of 48 firms in total of which 38 demergers were either completed or were in the process of being completed, five demergers were classified as technical demergers while the remaining five demergers were announced but were never completed. The study established that there was significant positive long-term value creation. In particular, in year 2 after the demerger this was found for the spin-off but not for the parent firm. However, the study did not tell whether, in total, net value was higher than the original pre-demerger company.

Veld & Merkoulouva (2009) reviews the literature on the factors that influence the wealth effects associated with the announcements of corporate spin-offs or demergers. The study was a meta-analysis to summarize the findings of 26 event studies on spin-off announcements. This study found a significantly positive average abnormal return of 3.02% during the event window. Returns were found to be higher for larger spin-offs the study also found that spin-offs that were later completed were associated with lower abnormal returns than non-completed spin-offs.

Stephan (2012) conducted a study whose purpose was to analyze whether research spin-offs from either research institutes or universities, had greater innovation capabilities than comparable knowledge-intensive firms created in other ways. The study used a sample of 1,800 firms from high-innovative sectors. Propensity score matching was used to create a sample of control firms comparable to the group of spin-offs. The paper found that 123 research spin-offs had more patent applications and more radical product innovations on average than other similar firms that were not spin-offs. The results showed that superior

innovation performance in research spin-offs' could be explained by their high level of research cooperation activities and by their urban location effects.

Semadeni & Cannella (2011) examined the performance implications of the parent-child relationship in post spin-off. The study applied the transaction cost and agency theories in their study. The study was done on 142 firms that had spun-off between 1986 and 1997. The study examined how oversight and ownership by the parent firm influenced stock market performance after spin-off. It was found that while child firms benefitted from some links to the parent, having too many links was negatively related to performance.

Dasilas (2010) investigated the wealth effects of 239 spin-off announcements that took place between January 2000 and December 2009 in the USA and Europe. The study first explored the short-term stock price behavior of firms that had announced a spin-off. The study also investigated the operating performance of parent firms and their subsidiaries in the pre-spin-off and post-spin-off period. The results reveal a strong positive market reaction of 3.47% on the spin-off announcement date. Consistent with previous studies, we find that firms disposing unrelated businesses reaped significant abnormal returns. The operating performance dramatically deteriorated in the post spin-off period for parent firms.

On the local Kenyan scene Njenga (2004) conducted a study which aimed at establishing whether there was any benefit or erosion of wealth in emerging co-operative societies in Thika, Maragwa and Murang'a Districts of Central Kenya. The researcher studied

minutes, annual reports, liquidation reports and audited financial statements for periods covering two years before and two years after the split. 12 societies of which six were in each category of merged and demerged society were studied. The study concluded that in almost every aspect, from cost savings, higher sales and even payment to members, there was no advantage in splitting the societies.

Wanguru (2011) conducted a research to determine the effects of mergers on the profitability of companies in Kenya. The research focused on the financial performance of the Kenyan companies that had merged between 2004 and 2008. Seven companies of which three that merged in 2004, two in 2005 and two in 2006 were studied. The profitability of each of the companies was compared for the three years before and three years after the merger. The study found that the mergers had no definite positive effect on the profitability of companies in Kenya.

Mwalukumbi (2011) also conducted a study whose objective was to establish whether M&A lead to an increase in profitability of commercial banks in Kenya. To achieve this data from 20 banks out of 70 that had undergone M&A were analyzed for a period of 10 years. The study used secondary data from published audited annual reports. Three profitability performance indicators were used. These were earning per share, return on assets and return on equity. The findings were mixed as some banks indicated improved profitability while in others the profitability weakened.

2.5 Summary of Literature Review

From the literature review it is expected that there should be better profitability after demerger because among the reasons for demerger is the possible lack of financial synergies that generate higher profits. However, empirical literature finds no straight answer as to whether profitability improves after demerger. Some studies find improvement; others find no change; while some find deterioration in profit. Further, the studies have not been able to address the demergers in the insurance industry in Kenya where companies that were composite had to be split into separate companies dealing separately in life and general insurance. This leaves research gaps that need to be filled.

CHAPTER THREE RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the methodology that was used to conduct the study. It specifies the research design, target population, data collection method and how analysis of the data was done.

3.2 Research Design

This study was an event study since it is investigating whether there is a connection between splitting life and general insurance and profitability. The event in this study was the decision to split an insurance company in such a manner that life insurance and general insurance are separate firms. Fama et al. (1969) define an event study as a means of measuring the impact of a specific economic event on the value of the firm. The usefulness of such a study comes from the fact that the effect of an event will be reflected immediately in the performance of an organization. The event study has many applications in the field of Economics and Finance. Examples where the methodology has been used include mergers and acquisitions, earnings announcements, issues of new equity and announcements of macro-economic variables such as trade deficits among others.

This methodology has been widely used in finance to study the price reactions to any economic events of interest (Barasa, 2008). In this method cumulative average of a given

variable for a given period before the event are compared to averages of the variable in a given period after the event.

MacKinlay (1977) outlines the procedures of conducting an event study. First, there is definition of the event of interest and identify the period over which the profits the firm will be examined. Secondly, the researcher determines the selection criteria for inclusion of a given firm in the study. Thirdly, the researcher appraises the event's impact using a measure of the abnormal profits. Once a normal performance model has been selected, the parameters of the model must be estimated using a subset of data known as the estimation window. The testing framework for the abnormal returns is then designed. Presenting the empirical results is the next step which is finally followed by interpretation and conclusions.

For an insurance company to be part of the study, it must have conducted the splitting at latest in 2010 in order to have enough observations after the splitting. The abnormal profit was the difference between the ex-split profits over the event window. The normal profits were the profits expected if there was no split. This research is similar to that done by Mwanicha (2012) who investigated the effect of mergers on the profitability of organizations in Kenya.

3.3 Target Population

The nine insurance companies that are members of the Association of Kenya Insurers and underwent demerger make up the population of this study. The companies are listed in the Appendix 1.

3.4 Sample

The sample for this study was all the nine insurance companies that have separated their life insurance business from their general insurance business. However, data for only five companies were available for analysis.

3.5 Data Collection

The data used was secondary data from the insurance companies in the sample. The data required for this study were the annual earnings before interest and tax and book values of assets at least four years before splitting and at least two years after splitting. These would enable the calculation of ROA. According to Petersen & Schoeman (2008) ROA is a good indication of the operational efficiency of an organization and it is better than ROE and ROI since ROE and ROI are only a measure of equity holder returns and the potential growth on their investment. In this study, the efficiency of operations before and after splitting is of great interest, therefore, justifying the choice of ROA.

3.6 Data Analysis

The event window consisted of nine years, that is, four years before the splitting; one year during the split decision and implementation and four years after the splitting. A period of four years prior to demerger was used to estimate the market model and parameters. The returns on Assets for a company i in year t were found using the model:

$$R_{it} = \frac{EBIT_{it}}{Total\ Assets_{it}} \times 100$$

The return for all the eight insurance companies that separated (referred to as the return of the market) was found by the model:

$$R_{mt} = \frac{\sum_{i=1}^{i=8} EBIT_{it}}{\sum_{i=1}^{i=8} Total\ Assets_{it}} \times 100$$

The relationship between the returns of a company before demerger were got by the regression model below so as to find the values of α and β for each of the companies.

$$R_{it} = \alpha_i + \beta_i R_{mit} + e_{it}$$

Where

R_{it} = The rate of return on assets of firm i in year t

R_{mit} = The rate of return of the market in year t

α_i = The intercept term

β_i = The sensitivity of the ROA of company i to market return

e_{it} Error term with $E(e_{it}) = 0$

The regression model was used to make projections of returns of the companies after demerger. The abnormal returns were estimated by the model below. Here the return for a company will be the total return of the two post demerger firms together as if they were one company.

$$AR_{it} = R_{it} - (\alpha_i + \beta_i R_{mit})$$

Where α_i and β_i are ordinary least squares parameter estimated for each firm above and AR_{it} are abnormal returns earned by a firm after adjusting for the normal return. The test statistics were used to assess whether the average cumulative abnormal return are significantly different from zero. Standardized abnormal returns (SAR) were computed using Mackinlay (1977) model as follows:

$$SAR_{it} = \frac{AR_{it}}{SD_i}$$

In which AR_{it} is the abnormal return of company i in year t while SD_i is the standard deviation of the abnormal returns of company i . The standardized abnormal returns were cumulated over the event window period to derive a measure of the cumulative abnormal return (CAR). The average standardized cumulative abnormal return across n firms will be computed over the event window period. The test statistic will be used to determine whether the average cumulative abnormal return is significantly different from its expected value as follows:

$$Z = ACAR_t \times n^{0.5}$$

If significant, at 95% confidence level the cumulative abnormal return will be assumed to measure the average effect of the split on the return of the n firms.

CHAPTER FOUR DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the data and provides the interpretation of the findings from the analysis. It starts with data analysis showing the summary statistics and regression results and ends with the determination of whether the changes in ROA were different after split of the studied insurance companies. The data is presented and then analyzed in comparison with other similar studies.

4.2 Data Analysis and Findings

4.2.1 Return on Assets

Return on Assets (ROA) was the variable used for the analysis of the effect of splitting (demerger) on the financial performance of the insurance companies in Kenya. ROA for the period before split was found simply as EBIT expressed as percentage of the book values of assets in a given year. The returns of the companies after split were found by expressing the sum of their EBIT as a percentage of the sum of book values of their asset. The process for each of the companies is as shown in the tables put in Appendices II, III, IV, V and VI. The summarized results from the calculations are as presented in Table 4.1 below. The market return was captured by the weighted mean return for the five firms. The market returns are as presented in the second column of Table 4.1. Other than the sharp drop to returns of 1.85 % and -0.96 % in 2008 and 2009 respectively, the returns of the insurance companies had been on an upward trend starting with 3.17 % in 2004 to 5.94 % in 2012. The highest market return was 7.46 % in 2010.

Table 4.2: Summary of Returns (in Percentage)

YEAR	MARKET	BLUE SHIELD	HERITAGE	UAP	ICEA	CIC
2004	3.17	5.11	4.36	14.86	1.21	4.69
2005	4.16	13.85	4.76	12.82	1.77	1.28
2006	4.10	14.72	5.29	10.31	1.53	-0.35
2007	3.89	3.98	6.22	12.26	2.03	1.30
2008	1.85	6.05	2.85	2.94	1.19	4.80
2009	-0.96	-38.97	-8.54	0.84	1.32	3.75
2010	7.46	10.53	6.93	4.05	11.02	6.63
2011	5.08	10.92	10.82	7.83	3.64	6.26
2012	5.94	11.45	10.82	11.19	4.01	9.64

(Source: Research Findings)

4.2.2 Summary Statistics

Table 4.2 presents the summary statistic of the returns of the market and the five insurance companies used in this study. The mean return rate of the insurance market of the companies that demerged was 3.86 % ($\sigma = 2.41$ %). The maximum return was 7.46 % realized in 2010 while the lowest return was -0.96 in 2009. The mean return for BlueShield was 4.08 % ($\sigma = 16.61$ %). The maximum for BlueShield was 14.72 % in 2006 while the minimum was -38.97 % in 2009. For Heritage, the mean return was 5.07 % ($\sigma = 5.67$ %). The maximum return was 10.82 % in 2011 while the minimum was -8.54 % in 2009. In UAP the mean return was 8.81 % ($\sigma = 4.65$ %). The minimum return was 0.84 % in 2009 while the maximum return was 14.86 % in 2004. ICEA recorded a mean return of 3.51 % ($\sigma = 3.51$ %). The maximum return was 11.02 % in 2010 and the minimum rate was 1.21 % realized in 2004. For CIC the mean rate was 4.26 % ($\sigma = 3.14$ %). Its maximum return was 9.64 % in 2012 while the minimum rate was -0.35 % realized in 2006.

Table 4.3: Summary Statistics (in Percentage)

Variable	Mean	Minimum	Maximum	Std. Dev.
Market	3.86	-0.96	7.46	2.41
BlueShield	4.08	-38.97	14.72	16.61
Heritage	5.07	-8.54	10.82	5.67
UAP	8.81	0.84	14.86	4.65
ICEA	3.51	1.21	11.02	3.13
CIC	4.26	-0.35	9.64	3.14

(Source: Research Findings)

4.2.3 Company Alphas and Betas

Table 4.2 provides the regressed values of α and β for each of the companies. The alphas are the constant terms while betas are the coefficient terms. The values of α and β were found by conducting a regression with the returns for each company before split as the dependent variable while the market rate was the independent variable. This was done for each company separately and the results for each company are as presented in Table 4.2.

As shown in Table 4.2 the constant term α for Blue Shield was 3.159 which means the company would realize a return of 3.159 % irrespective of market performance. The coefficient was statistically significant, $t_\alpha = 4.869, p < 0.05$. The coefficient was 0.109 which positive and statistically significant, $t_\beta = 2.915, p < 0.05$, this means that as the market return increases by 1 %, the return increases by 0.109 %. The regression was significant and the variation in the return of the company was strongly explained by the variation in market return, $F = 8.497, p < 0.05, R^2 = 0.630$.

The constant term for Heritage was -4.036 this indicates that the company makes losses of 4.036 % irrespective of market performance. However, the value was not statistically significant, $t_\alpha = -2.056, p > 0.05$. The coefficient term was 2.554. This indicates that

an increase of 1 % in the market would lead to a 2.554 % rise in the returns of Heritage. The coefficient was statistically significant, $t_{\beta} = 4.239$, $p < 0.05$. The regression was statistically significant and the variation of return of the company was strongly explained by the variation in the market return, $F = 17.971$, $p < 0.05$, $R^2 = 0.818$.

Table 4.4: Regression Values for α and β for each Company

	BLUE SHIELD	HERITAGE	UAP	ICEA	CIC
α	3.159	-4.036	2.183	0.441	9.744
β	0.109	2.554	2.588	0.883	-2.137
t_{α}	4.869	-2.056	0.381	0.217	3.982
t_{β}	2.915	4.239	1.602	1.791	-3.094
p_{α}	0.005	0.109	0.728	0.837	0.028
p_{β}	0.033	0.013	0.207	0.133	0.054
F	8.497	17.971	2.566	3.207	9.571
p_F	0.033	0.013	0.207	0.133	0.054
R^2	0.630	0.818	0.461	0.391	0.761

(Source: Research Findings)

The constant term for UAP was 2.183, this indicates that the company makes returns of 2.183 % irrespective of market performance. However, the value was not statistically significant, $t_{\alpha} = 0.381$, $p > 0.05$. The coefficient term was 2.588. This indicates that an increase of 1 % in the market would lead to a 2.588 % rise in the returns of UAP. The coefficient was statistically significant, $t_{\beta} = 1.602$, $p > 0.05$. The regression was not statistically significant and the variation of return of the company was not strongly explained by the variation in the market return, $F = 2.566$, $p > 0.05$, $R^2 = 0.461$.

The constant term for CIC was 9.744. This indicates that the company makes returns of 9.744 % irrespective of market performance. The value was statistically significant, $t_{\alpha} = 3.982$, $p < 0.05$. The coefficient term was -2.137. This indicates that an increase

of 1 % in the market would lead to a 2.137% drop in the returns of CIC. The coefficient was statistically significant, $t_{\beta} = -3.094$, $p < 0.05$. The regression was statistically significant and the variation of return of the company was not strongly explained by the variation in the market return, $F = 9.571$, $p < 0.05$, $R^2 = 0.761$.

4.2.4 Projected, Actual and Abnormal Returns after Split

For each of the company, the regression model was used to project the expected returns of the company by substituting the returns of the market in the company specific model for the years after the splitting. The projected returns are presented in column three of Table 4.3. Column four of the table shows the realized returns of each company. These returns were found as weighted averages of returns of the split companies on weighted on the book values of their assets in a given year. The abnormal returns can also be referred to as the return above the normal expected returns. In this case these abnormal returns were found by subtracting the projected returns from the actual returns and tabulated in column five of Table 4.3.

Table 4.5: Company Projected, Actual and Abnormal Returns (%)

COMPANY	YEAR	PROJECTED	ACTUAL	ABNORMAL
BLUE SHIELD	2011	3.71	10.92	7.21
	2012	3.81	11.45	7.65
HERITAGE	2010	15.01	6.93	-8.09
	2011	8.95	10.82	1.88
	2012	11.13	10.82	-0.31
UAP	2009	-0.29	0.84	1.13
	2010	21.49	4.05	-17.43
	2011	15.34	7.83	-7.51
	2012	17.55	11.19	-6.36
ICEA	2011	4.93	3.64	-1.29
	2012	5.68	4.01	-1.67
CIC	2009	11.79	3.75	-8.04
	2010	-6.19	6.63	12.82
	2011	-1.12	6.26	7.37
	2012	-2.94	9.64	12.59

(Source: Research Findings)

4.2.5 Standardized Abnormal Returns and the Test

Table 4.4 presents the standardized abnormal returns and the test for significance. The abnormal returns are simply found by subtracting the projected returns from the actual returns. For all the companies together, the abnormal returns are standardized by dividing them by their standard deviation. The standardized abnormal returns (SAR) are presented in the second column of Table 4.4. The average cumulative abnormal returns is the sum of the standardized abnormal returns and was found as -0.01 . The Z-statistic was found to be -0.02 . This value was less than $Z_{0.95} = 1.96$ indicating that the value of the returns after splitting was not significantly different from the returns before the split.

Table 4.6: Standardized Abnormal Return and Test

ABNORMALS	SAR
7.21	0.84
7.65	0.89
-8.09	-0.94
1.88	0.22
-0.31	-0.04
1.13	0.13
-17.43	-2.03
-7.51	-0.88
-6.36	-0.74
-1.29	-0.15
-1.67	-0.19
-8.04	-0.94
12.82	1.50
7.37	0.86
12.59	1.47
$\alpha = 8.57$	$ACAR = -0.01$
	$Z = -0.02$
	$Z_{0.95} = 1.96$

(Source: Research Findings)

4.3 Interpretation of the Findings

The findings of this study are that the Z -statistic was less than the critical value of Z at 95% confidence level. This indicates that the returns of the split firms were not sensitive to the split at all. This can only mean two things. The first is that the splitting did not improve the performance of the insurance industry in any significant way despite ensuring that the savings of the safer life insurance clients were saved from the effect of the other riskier classes of insurance.

Secondly, it means that the splitting did not stimulate more investment from those who invest in insurance. The market did not respond positively to the changes in the insurance industry. The attitudes of the insurers and the insurance firms themselves did not change at all. The splitting can therefore be termed inconsequential with respect to profit generation among the insurance industry.

The findings of this study seem to support those of Njenga (2004) who did a similar study among cooperatives in Thika, Maragwa & Murang'a Districts of Central Kenya. Using minutes, annual reports, liquidation reports and audited financial statements for periods covering two years before and two years after the split, he study concluded that in almost every aspect, from cost savings, higher sales and even payment to members, there was no advantage in splitting the societies.

These findings do not agree with those of Cusatis, Miles & Woolridge (1993) who analyzed the performance of 146 demergers that took place between 1965 and 1988. Their research indicated that both the spin-off companies and the parents offered significantly positive abnormal returns for up to three years after the spin-off announcement date. The study by Cusatis, Miles & Woolridge (1993) showed that demergers brought about improvement in financial performance.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Theoretical prediction is that there are several reasons as to why mergers and demergers are resorted to as managerial strategies in the management of organizations. However, the main objective, other than survival of the business, is generation of better returns as compared to those before the merger or demerger. The insurance industry in Kenya, in response to the threats from the highly risky insurance business sections opted to separate the safer life business from the riskier business.

This research was designed to find out the performance of the insurance companies after the split. This was done through the use of event study method with the assumption that such an event generates reaction from both within or without the organization. The returns of the organization after the split are an embodiment of market and internal reaction to the changes in strategy. The event in this study was the announcement of the separation of life insurance from general insurance business by the insurance companies in the study.

The findings indicate that there was no difference between the patterns of returns even after the splitting of the insurance companies. This is deduced from the fact that the Z statistic was -0.03 which is less than 1.96 which is the Z-critical at 95 % confidence level. This indicated no statistical difference between returns before and after splitting.

5.2 Conclusion

The study established that among the insurance companies that separated life insurance from general insurance, returns patterns did not significantly change from the patterns before the splitting. It is, therefore, concluded that the strategy of splitting the insurance businesses is not causing improvement in the returns of the industry though it may reduce the level of risk exposure of the safer life insurance business.

The study also shows that the market did not respond in any way to the splitting of the insurance companies. Returns are usually taken as an embodiment of the information about a company. If information is bad, the returns drop. If information is good, the returns improve. However, this reaction is within the context of the reaction time. No change in returns would mean either the reaction has not taken effect or that the information is not important to the market at all.

The study also concludes that the operational efficiency of the insurance companies did not improve. The variable used in the analysis is the ROA. ROA is an indicator of the operational efficiency of a company or any organization. Based on ROA, which did not significantly change from the ROA of the period before the split, it is concluded that the operational efficiency of the organizations did not change. If the splitting was aimed to achieve better operational efficiency, then this has not become a reality in the firms that conducted the split.

5.3 Recommendations

The following recommendations arise from the findings of this study. Splitting of insurance companies should be done only as a method safeguarding the funds of those in the life insurance industry, but not as a mechanism of generating extra income. Splitting should be coupled with other strategies if the performance of the insurance industry in Kenya is to realize improvement.

Insurance companies should come out strongly to improve the attitude of stakeholders towards them. The fact that the market did not seem to react to the splitting of insurance business indicates that the market does not seem to care what goes on in the insurance business. This is not a good sign since it could indicate that the market does not expect a lot from the insurance industry.

Insurance companies should couple the splitting with policies to ensure operational efficiency. This study indicates that the operational efficiency did not improve even after the splitting and that's why the ROA did not realize significant changes even after the splitting.

5.4 Limitations of the Study

The study aimed at establishing whether there was a significant difference between the returns of insurance companies after separating life from general insurance. Though, the study found no change, it was based on the assumption that the pattern of returns after the splitting can, to a great extent be attributed to the splitting. This is a limitation since this

study has not provided proof that the returns after the splitting are attributable to the splitting.

Returns, being an embodiment of information about a company and about how the market interprets the information, measure the reaction of the stakeholder to the splitting of the insurance companies. In this study, the splitting seems not to have any effect on the attitude of the market towards insurance companies. A change in attitude would have been realized through a change in the returns. Insurance companies should couple the splitting of their companies with activities that will motivate positive attitude from the insurance market. In addition to this, internal restructuring should be done in order to improve internal efficiency to drive profitability. Splitting alone is not enough.

5.5 Suggestions for Further Research

A study can be done in more than one industry to make enrich the findings and provide more room for stronger generalizability. This is because the findings of this study are focused on few insurance companies. A study with a wider population will be more informing and will give more generalizable results. Such a study can be repeated when most of the insurance companies have completed the splitting process.

The response to mergers and demergers is usually context based, that is, it depends on the type of market under which the organizations being studied operate. As such, a study can be conducted within the wider East African region focussing on the East African

Community countries in order to find results that can help provide material information to the unified insurance industry in the community.

A study can be done to establish how much of the changes or lack of changes in returns can be attributed to the splitting. This study has not been able to provide empirical evidence that the pattern of returns after the split is due to the splitting. Such a study would be useful in order to explain precisely how splitting affects returns in the insurance industry.

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APPENDICES

Appendix I: List of Insurance companies that Demerged in Kenya (Source: Association of Kenya Insurers, 2013)

Company	Year of Demerger
1. AIG/ALICO Insurance Company	2006
2. Blue Shield Insurance Company	2010
3. CFC/Heritage Insurance Company	2010
4. Co-operative Insurance Company	2009
5. Corporate Insurance Company	2010
6. ICEA Lion Insurance Company	2011
7. Pan Africa Life Assurance Company	2004
8. Pioneer Life Assurance Company	2010
9. UAP Insurance Company	2010

Appendix II: Calculation of the Returns of Blue Shield

		BLUESHIELD	R(B)	SHIELD LIFE	R(BL)	Return (%)
2004	EBIT	95831	5.11			5.11
	Total Assets	1875102				
2005	EBIT	370034	13.85			13.85
	Total Assets	2672143				
2006	EBIT	400932	14.72			14.72
	Total Assets	2723429				
2007	EBIT	123599	3.98			3.98
	Total Assets	3108969				
2008	EBIT	197300	5.11			5.11
	Total Assets	3262882				
2009	EBIT	-825661	-38.97			-38.97
	Total Assets	2118533				
2010	EBIT	367824	10.53			10.53
	Total Assets	3494455				
2011	EBIT	367824	14.17	-27557	-5.30	10.92
	Total Assets	2596037		520245		
2012	EBIT	477525	11.41	81438	11.74	11.45
	Total Assets	4186280		693390		

(EBIT and Assets in Ksh, Returns in Percentage)

Appendix III: Calculation of the Returns of Heritage

		Heritage	R(H)	Heritage Life	R(L)	Return
	EBIT	151,737	4.36			4.36
2004	Total Assets	3,477,048				
	EBIT	183,626	4.76			4.76
2005	Total Assets	3,854,526				
	EBIT	236,839	5.29			5.29
2006	Total Assets	4,477,799				
	EBIT	281,454	6.22			6.22
2007	Total Assets	4,522,164				
	EBIT	127,501	5.11			5.11
2008	Total Assets	4,467,270				
	EBIT	(432,572)	(8.54)			(8.54)
2009	Total Assets	5,063,098				
	EBIT	278,539	6.93			6.93
2010	Total Assets	4,021,461				
	EBIT	486,664	12.29	160,253	7.94	10.82
2011	Total Assets	3,959,224		2,017,761		
	EBIT	664,098	13.74	243,317	6.85	10.82
2012	Total Assets	4,833,748		3,551,722		

(EBIT and Assets in Ksh, Returns in Percentage)

Appendix IV: Calculation of the Returns of UAP

		UAP	R(UAP)	UAP Life	R(UAP-L)	Return
2004	EBIT	522,110	14.86			14.86
	Total Assets	3,514,650				
2005	EBIT	529,415	12.82			12.82
	Total Assets	4,128,261				
2006	EBIT	691,883	10.31			10.31
	Total Assets	6,709,326				
2007	EBIT	888,247	12.26			12.26
	Total Assets	7,245,725				
2008	EBIT	228,295	5.11			5.11
	Total Assets	7,763,743				
2009	EBIT	181,300	2.80	(109,328)	-5.13	0.84
	Total Assets	6,464,008		2,133,210		
2010	EBIT	446,273	6.22	(47,964)	-1.81	4.05
	Total Assets	7,179,275		2,647,637		
2011	EBIT	1,171,611	15.14	(336,534)	-11.50	7.83
	Total Assets	7,739,194		2,927,380		
2012	EBIT	1,504,247	14.10	211,670	4.54	11.19
	Total Assets	10,668,546		4,667,465		

(EBIT and Assets in Ksh, Returns in Percentage)

Appendix V: Calculation of the Returns of ICEA

		ICEA	R(ICEA)	ICEA Life	R(ICEA-L)	Return
2004	EBIT	150,140	1.21			1.21
	Total Assets	12,436,579				
2005	EBIT	236,468	1.77			1.77
	Total Assets	13,367,230				
2006	EBIT	225,020	1.53			1.53
	Total Assets	14,723,538				
2007	EBIT	389,932	2.03			2.03
	Total Assets	19,205,226				
2008	EBIT	243,361	5.11			5.11
	Total Assets	20,419,473				
2009	EBIT	300,113	1.32			1.32
	Total Assets	22,784,300				
2010	EBIT	385,123	11.02			11.02
	Total Assets	3,494,455				
2011	EBIT	630,482	14.85	398,609	1.66	3.64
	Total Assets	4,246,650		24,039,085		
2012	EBIT	633,383	7.08	912,340	3.09	4.01
	Total Assets	8,950,974		29,570,517		

(EBIT and Assets in Ksh, Returns in Percentage)

Appendix VI: Calculation of the Returns of CIC

		CIC	R(CIC)	CIC Life	R(CIC-L)	Return
2004	EBIT	52,502	4.69			4.69
	Total Assets	1,118,598				
2005	EBIT	18,321	1.28			1.28
	Total Assets	1,435,468				
2006	EBIT	(5,834)	(0.35)			-0.35
	Total Assets	1,657,105				
2007	EBIT	31,653	1.30			1.30
	Total Assets	2,438,669				
2008	EBIT	145,504	5.11			5.11
	Total Assets	3,028,650				
2009	EBIT	130,762	3.75			3.75
	Total Assets	3,489,482				
2010	EBIT	277,276	6.63			6.63
	Total Assets	4,184,092				
2011	EBIT	660,536	8.68	34,690	0.99	6.26
	Total Assets	7,607,207		3,506,034		
2012	EBIT	930,028	10.84	297,697	7.17	9.64
	Total Assets	8,576,260		4,153,501		

(EBIT and Assets in Ksh, Returns in Percentage)

Appendix VII: Summary of Returns (%)

YEAR	MARKET	BLUE SHIELD	HERITAGE	UAP	ICEA	CIC
2004	3.17	5.11	4.36	14.86	1.21	4.69
2005	4.16	13.85	4.76	12.82	1.77	1.28
2006	4.10	14.72	5.29	10.31	1.53	-0.35
2007	3.89	3.98	6.22	12.26	2.03	1.30
2008	1.85	5.11	5.11	5.11	5.11	5.11
2009	-0.96	-38.97	-8.54	0.84	1.32	3.75
2010	7.46	10.53	6.93	4.05	11.02	6.63
2011	5.08	10.92	10.82	7.83	3.64	6.26
2012	5.94	11.45	10.82	11.19	4.01	9.64

(Returns in Percentage)

Appendix VIII: Calculation of Market Return

		BLUE SHIELD	HERITAGE	UAP	ICEA	CIC	TOTAL	Mkt Rt (%)
2004	EBIT	95831	151737	522110	150140	150140	1069958	3.17
	Assets	1875102	3477048	3514650	12436579	12436579	33739958	
2005	EBIT	370034	183626	529415	236468	236468	1556011	4.16
	Assets	2672143	3854526	4128261	13367230	13367230	37389390	
2006	EBIT	400932	236839	691883	225020	225020	1779694	4.10
	Assets	2723429	4477799	6709326	14723538	14723538	43357630	
2007	EBIT	123599	281454	888247	389932	389932	2073164	3.89
	Assets	3108969	4522164	7245725	19205226	19205226	53287310	
2008	EBIT	197300	127501	228295	243361	243361	1039818	1.85
	Assets	3262882	4467270	7763743	20419473	20419473	56332841	
2009	EBIT	-825661	-432572	71972	300113	300113	-586035	-0.96
	Assets	2118533	5063098	8597218	22784300	22784300	61347449	
2010	EBIT	367824	278539	398309	385123	385123	1814918	7.46
	Assets	3494455	4021461	9826912	3494455	3494455	24331738	
2011	EBIT	340267	646917	835077	1029091	1029091	3880443	5.08
	Assets	3116282	5976985	10666574	28285735	28285735	76331311	
2012	EBIT	558963	907415	1715917	1545723	1545723	6273741	5.94
	Assets	4879670	8385470	15336011	38521491	38521491	1.06E+08	

(EBIT and Assets in Ksh, Returns in Percentage)