THE EFFECT OF MERGERS AND ACQUISITIONS ON THE FINANCIAL PERFORMANCE OF INSURANCE FIRMS IN KENYA

BY

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DECLARATION

I declare that this research project is my own work and it has not been submitted for any degree or examination in any other University.

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Signature…………………… **Date…………………………**

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

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DEDICATION

I dedicate this research project to my family members who assisted me and encouraged me throughout the entire Masters of Science in Finance course.

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ABBREVIATIONS

AKI Association of Kenya Insurers

CBK Central Bank of Kenya

CMA Capital Markets Authority

IRA Insurance Regulatory Authority

M&A Mergers and Acquisitions

ABSTRACT

Mergers and acquisitions continue to enjoy importance as strategies among insurance companies for achieving growth. However, their success in creating shareholder value remains contested. The objective of this research project is to establish the effect of mergers and acquisitions on the financial performance of insurance firms in Kenya. This study took on a causal research design. Causal research design is consistent with the study's objective which is to determine the effect of mergers and acquisition on financial performance of insurance companies in Kenya. The study was limited to a sample of pair that merged/acquired between the years 2002-2012. The data required was drawn from Association of Kenya Insurers database, public disclosures and annual reports of the respective companies. Comparisons were made between the mean of 3-years pre-merger/acquisition and 3-years post-merger/acquisition financial ratios. Excluded from the sample is M&A deals that were pending or non-binding, vertical mergers that have no competitive effects, as well as acquisitions of a minority interest. Using financial ratio analysis and paired t- test, the study reveals that mergers/acquisitions have significant effect on the overall financial performance of insurance firms in Kenya. Also, there is improvement in the firms' performance after the merging/acquisition takes place. Overall, the research found mergers and acquisitions on profitability and financial performance in general. The study recommends that insurance companies seeking growth should seek to consolidate their establishments through M&A's. Mergers and acquisitions enable insurers to expand their pool of policyholders and reduce underwriting risk more rapidly than other growth strategies hence creating value.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The rise of merger activity worldwide has been eminent in that with increased competition, technological advances together with increased globalization, businesses are looking for ways to remain competitive as well as achieve non - organic growth (Radović, 2008). Organizations are striving for strategies that are not too costly, risky and technologically advanced in order to become reputable along with a vision to maximize market share and future growth (Christensen, 2013). Global markets have continuously experienced increased M&A's over the last decade. Various reasons have driven firms to undertake in M&A's. According to Mboroto (2013), growing business confidence, consumer demand and improving economic conditions in the region have whetted business executive's appetite for firms in the technology, mining and financial services sectors.

The Kenyan insurance industry is a vital part of the entire financial system. Apart from commercial banks, insurance companies contribute significantly to financial intermediation of the economy. As such, their success means the success of the economy; their failure means failure to the economy (Ansah-Adu, Andoh, and Abor, 2012; and Agiobenebo and Ezirim, 2002). Mergers and acquisitions are continuously being adopted for progressive company competitiveness by expanding market share and also to diversify the company's portfolio as a risk management strategy. Additionally, to enable

companies penetrate to new geographical markets to support growth by capitalizing on economies of scale and increase on customer base among other reasons (Kemal, 2011). The logic behind any corporate merger is the synergy effect; two is better than one. Martynova and Oosting (2007) state that the overarching reason for combining with another organization is that the union will provide the attainment of strategic goals in a cheaper and quicker way rather than on its own. Organizations that are able to merge stand in a better position to flexibility, leverage competencies, share resources and create opportunities that otherwise will be inconceivable.

Companies believe that by either merging or acquiring another company, the performance would be better than a single entity. This is attributed by the fact that shareholder value would effectively be maximized (Sharma, 2009). Acquisitions bring operational efficiencies which may arise from economies of scale, production economies of scope, consumption economies of scope, improved resource allocation like moving to an alternatively less costly production technology, improved use of information and expertise, a more effective combination of assets and improvements in the use of brand name capital (Piaskoki, 2004).

Recent corporate M&A's activity witnessed in the Kenyan economy is a sign that companies are increasingly accepting this takeover option as a means towards developing their corporate strategies either in the country or in the industry (Onyuma and Inoti, 2014). Besides, the move towards regional integration has indeed sparked a flurry of cross regional expansion as a means of increasing regional presence M&A's is a critical

vehicle in facilitating corporate growth, productivity and absolute organizational performance (Botchway, 2010).

1.1.1 Mergers and Acquisitions

Kovacich and Halibozek (2005) describe an acquisition also known as a takeover, or buyout or a purchase business combination as a situation where one company known a predator or acquirer takes over another company known as the target firm cease to exist. A firm that seeks to acquire another firm is known as the acquiring company, and the one that it seeks to acquire is known as the target company. Lole (2012) states that in most acquisitions, one firm (usually the lager of the two) simply decides to buy another company, negotiate a price with the management of the target firm, and then acquire the target company.

Nakamura (2005) asserts that an acquisition takes place when a company attains all or part of the target company's assets and the target remains as a legal entity after the transaction whereas in a share acquisition a company buys a certain share of stocks in the target company in order to influence the management of the target company. In acquisitions, one firm proposes the purchase of another firm in the same industry, where if it accepts, it becomes subject to the acquirer's management (McLaughlin, 2010).

There are many motives behind M&A's in line with achieving organizational strategy. According to Myers and Marcus (2002), managers believe their firm will have a competitive edge by being bigger and through economies of scale an organization is able

to lower cost per unit of output. Mergers and acquisitions are intended to add shareholder value through economies of scale. The combined company can often reduce duplicate departments or operations hence lowering the costs of the company relative to theoretically the same revenue stream, thus increasing profit (Boff and Herman, 2001).

Another motivation for M&A's is synergy. Synergies can be operational, financial or managerial. Karenfort (2011) argues that company will have synergy benefits when the value of the combined firm is greater than the stand alone valuation of the individual firm and acquisitions produce synergy, hence better use of complementary resources leading to geographical or other diversification. This smoothens the earning of a company, which over the long term smoothens its stock price, giving conservative investors more confidence in investing in the company (Marks and Marvis, 2011). Other motivations to merge include increase customer base, gain access to funds, tax advantages, and growth.

1.1.2 Financial Performance

Healy and Ruback (1992) define financial performance as the measure of how well a firm can use assets from its primary mode of business and generate revenues. In addition, financial performance is essentially a measure of an organizations financial health over a given period of time, used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Lole (2011) states that the fundamental aim of M&A's is the generation of synergies that can, in turn, foster corporate growth, increase market power, improve production efficiencies, boost profitability, and improve shareholders' wealth.

There are many different ways to measure a company's financial performance. For example, cash flow based measures, stock based measures and accounting based measures. Companies' performance can be evaluated by way of performing analytical reviews. Ratio is the simple mathematical statement of the relationship between two items listed in financial statements (Akguc, 1995). Through ratios, it is possible to measure the power of the company's liquidity, solvency and its profitability.

Profitability reflects a companies' ability to manage their economic exposure to unexpected losses. This ratio represents the potential impact on capital and surplus of deficiencies in reserves due to financial claims (Adams and Buckle, 2000). Three measures of profitability are employed which include; Return on Asset, Gross Profit Margin and Earning before Tax. Liquidity refers to the degree to which debt obligations coming due in the next twelve months can be paid from cash or assets that will be turned into cash (Mwangi and Murigu, 2015). Measures of liquidity employed include; Current ratio and Quick ratio. Moreover, solvency indicates a company's ability to meet long-term obligations when due and measures the long term financial strength of a firm (Laitinen, 2000). Solvency is best conducted via Total Debt ratio and Total Assets ratio.

However, studies depict a different picture on the results of M&A's involving failures and poor financial returns. Researchers have indicated that approximately 70-80% of M&A's does not create significant value above the annual cost of capital (Bruner, 2002). Even conservative estimates place M&A's failure rates at approximately 50% or higher for nearly four decades (Coffey, Garrow and Holbeche, 2003). Despite this, the rise of

merger activity worldwide has been eminent and continues to increase at a phenomenal rate climbing from $1.9 trillion in 2004 (Susan Cartwright and Schoenberg, 2006).

1.1.3 Effects of Mergers and Acquisitions on Financial Performance

Mergers and acquisitions are used in improving company's competitiveness and gaining competitive advantage over other firms through gaining greater market share, broadening the portfolio to reduce business risk, entering new markets and geographies, and capitalizing on economies of scale (Saboo and Gopi, 2009). The success of any mergers is defined by the core competences generated to create value or enhance value. It is measured using the parameters such as market attractiveness, competitive positioning because of cost leadership and product differentiation. This results in the long-term profit sustainability and the creation of shareholders wealth (Hildebrandt, 2005).

Financial performance is a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation or firms performance across time; in this case before and after acquisition (Mboroto, 2012). Varieties of measures can be used to examine the impact of M&A's on overall financial performance of an entity, where measures might be accounting measures-based, market measures-based, mixed measures, or qualitative measures-based.

The potential economic benefits of M&A's are changes that increase value that would not have been made in the absence of a change in control (Pazarkis et al. 2006). These changes in control are potentially most valuable when they lead in the redeployment of assets, providing new operating plans and business strategies. Accordingly, Baldwin (1998) argues that merged firms may also increase their bargaining power over suppliers by pooling their prices and forcing suppliers to sell their supplies to the combined firm.

The definition of success may vary, but any activity that fails to enhance shareholders interest and value cannot be deemed as a success (Hildebrandt, 2005). A long-term decline in shareholder wealth after a M&A can term the combination process to be a failure (Straub, 2007). Managers of firms undertaking mergers and acquisitions often anticipate an improvement in production efficiency. However, profitability still remains the most influential variable in determining growth of firms through M&A in Kenya. The main motive behind M&A's is to improve revenues and profitability (Gachanja, 2013).

1.1.4 Insurance Firms in Kenya

According to an IRA annual report released in the year (2014), the market comprises of 49 operating insurance companies. 25 companies conduct non-life insurance business only, 13 conduct life insurance business only while 11 are composite (both life and non-life). There are 198 licensed insurance brokers, 29 medical insurance providers (MIPs) and 5,155 insurance agents. Other licensed players include 133 investigators, 108 motor assessors, 25 loss adjusters and 24 insurance surveyors.

Strategic acquisitions have been evident in the Kenyan insurance market. In Kenya, examples of notable mergers and acquisitions include the merger of Lion of Kenya Insurance Company and Insurance Company of East Africa to form ICEA LION Group, the merger of Apollo Insurance Company Ltd, and Pan Africa Insurance Company to form APA Insurance (2003). As competition picks and underwriters seek to raise efficiency; increased uptake of insurance resulting from a growing middle class seeking social security, high returns, combined with the nascent oil and gas sector has attracted international investors into the market as well as aiding strategic alliances aimed at greater growth (Kenya Insurance Industry Report, 2014).

The insurance industry as a whole in Kenya is experiencing various challenges key among them being negative market sentiment following closure of at least five insurance providers over the past five years due to insolvency arising from high claims (Ndung'u, 2012). However, the penetration of insurance in Kenya is estimated at 2.92%. Emerging risks such as Micro insurance, oil & gas and initiatives such as adoption of alternative distribution channels (bancassurance) and use of technology are improving insurance penetration level in Kenya (Kenya Insurance Credit Rating Report, 2015).

Also, the industry continues to embrace information technology, research and innovation, thereby expanding its capacity to exploit the existing untapped insurance market. While this is likely to see sustained cost pressures, together with an improvement in the regulatory environment this is expected to enhance insurance penetration (Kenya Insurance Credit Rating Report, 2014).

1.2 Research Problem

The concept of M&A's on the effect of financial performance of companies has received significant attention from scholars in the various areas of business due to mixed results. It is of primary concern of virtually all business stakeholders in any sector since financial performance is an ingredient to organizational health and ultimately its survival. High performance reflects management effectiveness and efficiency in making the use of a company's resources and this contributes to the economy at large (Ansah-Adu, Andoh, and Abor, 2012; Batra, 1999; and Barney, 1991).

The insurance industry is a vital part of the entire financial system. Apart from commercial banks, insurance companies contribute significantly to financial intermediation of the economy. As such, their success means the success of the economy; their failure means failure to the economy (Ansah-Adu, Andoh, and Abor, 2012; and Agiobenebo and Ezirim, 2002). Merger is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long term profitability (Bert, 2003).

Yeh and Hoshino (2002) examined the effects of acquisitions on the firm's operating performance using a sample of 86 Japanese corporate acquisitions between 1970 and 1994. The successfulness of acquisitions was tested based on efficiency, profitability and growth. The results of their study indicated a significant downward trend on profitability and sales growth.

Additionally, their study results showed an insignificant downward trend in productivity. According to their conclusions, acquisitions have a negative impact on firm performance in Japan.

Lole (2012) conducted a study set out to investigate the effects of mergers and acquisition on the financial performance of the insurance industry in Kenya. The study took a causal research design in order to determine the effects of mergers on financial performance. The performance measures used were based on long-run profitability, stability, leverage and liquidity. According to the study, M&A's were positively correlated with financial performance after the merger. A unit increase in underwriting ratio and decrease in management expense ratio lead to an increase in application of financial performance on underwriting ratio at the expense ratio. Overall mergers and acquisition and financial performance coefficients were significant indicating firms performed better financially after the resulting merger and/ or acquisition. This research study will attempt to fill a gap in academia by investigating the effects of mergers and acquisitions on the financial performance of insurance firms in Kenya.

1.3 Research Objective

The objective of this study is to establish the effects of mergers and acquisitions on the financial performance of insurance firms in Kenya.

1.4 Value of the Study

Firstly, it has the ability to create awareness in the general public about the M&A's and its possible effects on the growth and performance of the firms indulged and also the challenges they face. Scholars who are interested in advancing the theoretical studies discussed herein and engaging in further research in this field will be able to investigate any gaps and also make great contributions to the already existing study theories either in critique or complement.

To the regulator i.e. Insurance Regulatory Authority, the study will enable the organization to understand how better to mitigate the risks that engrosses the insurance industry in Kenya.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The subsequent literature review seeks to integrate issues regarding theories to be reviewed and the empirical review of related studies. Secondary materials such as books, journals and articles which carry precious research work on the study topic are analyzed.

2.2 Theoretical Review

This section looks into the theories on M&A's. It looks at the different schools of thought of different scholars and how they view M&A's. Some of the theories that lead to M&A's include: Differential efficiency theory, synergistic merger theory, free cash flow theory, corporate control theory and oligopoly theory.

2.2.1 Differential Efficiency Theory

Weston et al. (2001) suggests that there are firms with below average efficiency or that are not operating up to their potential. Firms in similar kinds of business activity would most likely be the potential acquirers. This is because the firms evidently depict potential and the acquiring company has the resources and the management know-how to better their performance. However, a difficulty would arise when the acquiring firm overestimates its impact on improving the performance of the acquired firm. This may result in the acquirer paying too much for the acquired firm.

According to Essay (2013), it is particularly beneficial when a company decides to take over other company in the same industry because than it would mean that company can expand without spending lot of money by utilizing the resources more efficiently Therefore, this theory suggests that firms that are less efficient will be acquired by more efficient firms in the hope that they will meet their potential hence improving efficiency.

2.2.2 Synergistic Mergers Theory

Synergistic mergers theory holds that firm managers achieve efficiency gains by combining an efficient target with their business and then improving the target's performance. Synergies can be operational, financial or managerial. Buyers recognize specific complementarities between their business and that of the target. Thus, even though the target is already performing well, it should perform even better when it is combined with its complementary counterpart, the buyer firm (Economic Research Service, 2010).

For example, financial synergy occurs as a result of the lower costs of internal financing versus external financing. A combination of firms with different cash flow positions and investment opportunities may produce a financial synergy effect and achieve lower cost of capital. Tax saving is another considerations. When the two firms merge, their combined debt capacity may be greater than the sum of their individual capacities before the merger (Managementor, 2015).

Merger and acquisitions are expected to raise future cash flow and increase firm value by synergy in operating and financing either due to increase economic of scale by enlarging the firm size, or due to increase economic of scope as a result of specific combination advantage between the merged firms (Cherie, 2014).

2.2.3 Free Cash Flow Theory

This theory prompts the need to improve financial performance of firms through mergers and acquisitions. The excess of free-cash flows is often considered as a result of management inefficiency. Companies that hold high free-cash flows are frequent targets in hostile takeovers. On the acquirer side, managers believe in the superior quality of their investment decisions, relative to those of the shareholders (Mortis, 2007).

Diverting free cash flow from shareholders allows managers to avoid having to use capital markets when in need of new capital; i.e. it allows them to avoid the monitoring associated with new equity issues. Moreover, by diverting free cash flow managers can increase the size of the company, thereby enhancing their power and their earning ability, and reducing take-over risk (Easterbrook, 1984).

2.2.4 Oligopoly Theory

Within the framework of an oligopolistic market, mergers could also result from what that can be described as a behavior of "oligopolistic reaction" (Knickerbocker, 1973). Oligopolistic reaction is "a corporate behavior by which rival firms in an industry composed of a few large firms counter one another's moves by making similar moves

themselves" (Knickerbocker, 1973). Thus, if two firms in an oligopolistic industry merge, others might react by merging in turn independently of whether shareholders will gain or lose as a result.

This behavior of oligopolistic reaction could cause a chain of mergers to take place, and therefore can then help explaining the empirical evidence that seem to show that mergers happen in waves (Mboroto, 2012). In the case of Insurance firms in Kenya, various industry players are engaging in mergers and acquisition in a bid to improve financial performance. Consequently, rival firms are engaging in mergers and acquisition deals as their competitors in order to realize these oligopolistic goals.

2.3 Determinants of Financial Performance

Financial performance is a measure of an organization's earnings, profits, appreciations in value as evidenced by the rise in the entity's share price. In insurance, performance is normally expressed in net premiums earned, profitability from underwriting activities, annual turnover, returns on investment and return on equity (Mwangi and Murigu, 2015). Determinants of financial performance can be external or internal. Internal factors can include a firm's capital and ownership structure while external factors include inflation and interest rates (Mirza and Javed, 2013).

2.3.1 Profitability

Insurance companies’ profitability is influenced by both internal and external factors. According to Mwangi and Murigu (2015), whereas internal factors focus on an insurer’s specific characteristics, the external factors concern both industry features and macroeconomic variables. The firm-specific factors include; leverage which is measured by the ratio of total debt to equity (debt/equity ratio). This ratio shows the degree to which a business is utilizing borrowed money. It reflects insurance companies' ability to manage their economic exposure to unexpected losses. This ratio represents the potential impact on capital and surplus of deficiencies in reserves due to financial claims (Adams and Buckle, 2000).

Mergers increase or reduce the gains of the two merging firms from what they would have been if they had not been merged. The main motivation why mergers take place is the ability of managers taking advantage of profits. Successful mergers increase the profitability of the combined company. A different perspective of the impact of mergers about profitability emphasizes selection from the capital market (Larsson and Finkelstein, 1999).

2.3.2 Liquidity

Liquidity refers to the degree to which debt obligations coming due in the next twelve months can be paid from cash or assets that will be turned into cash. Insurance liquidity is the ability of the insurer to fulfill their immediate commitments to policyholders without having to increase profits on underwriting and investment activities and/or liquidate

financial assets. The cash and bank balances are to be kept sufficient to meet the immediate liabilities towards claims due for payment but not yet settled (Chaharbaghi and Lynch, 1999).

Mergers also influence the liquidity shocks. Researcher explains that "firm level diversification" results in improved liquidity. Therefore, one of the motives of the acquiring company to undertake the merger is to merge with a company which has a healthy liquidity position with low or non-existent financial leverage (Picone, 2011).

2.3.3 Age of a Company

According to Mwangi and Murigu (2015), older firms are more experienced, have enjoyed the benefits of learning, are not prone to the liabilities of newness, and can therefore enjoy superior performance. Older firms may also benefit from reputation effects, which allow them to earn a higher margin on sales. On the other hand, older firms are prone to inertia, and the bureaucratic ossification that goes along with age; they might have developed routines, which are out of touch with changes in market conditions, in which case an inverse relationship between age and profitability or growth could be observed (Shiu, 2004; and Demirgüç- Kunt and Maksimovic, 1998).

2.3.4 Equity Capital

Equity capital which is the capital raised from owners in the company, is the residual claimant or interest of the most junior class of investors in assets, after all liabilities are paid; if liability exceeds assets, negative equity exists (Mwangi and Murigu,2015). In an

accounting context, shareholders' equity (or stockholders' equity, shareholders' funds, shareholders' capital) represents the remaining interest in the assets of a company, spread among individual shareholders of common or preferred stock; a negative shareholders' equity is often referred to as a positive shareholders' deficit.

More capital influx will enable the firm to expand and open new branches, steady stream of capital to cover gaps created by growth-related expenses, which in turn may lead to growth and possibly would be accompanied by economies of scale and hence improved financial performance (Lee, 2008; and Hansen, 1999).

2.4 Empirical Evidence

The impact of M&A's on subsequent performance has been widely studied with extensive literature. The fact that researchers have not reached unanimous results, continue to argue over methodical issues, and find widely found negative results unsettling, have made the topic popular among academics. Whether merged organizations achieve expected performance could be the critical question examined by all researchers.

Yeh and Hoshino (2002) evaluated the effects of mergers and acquisitions on firms' operating performance using a sample of 86 Japanese corporate mergers between 1970 and 1994. His study was based on the effect on efficiency, profitability, and growth. The study proxy total productivity as an indicator of the firm's efficiency, return on assets and return on equity as measures of profitability, and sales and growth in employment to index for firm's growth rate. It was realized that there was insignificant negative change

in productivity, significant decline in profitability, significant adverse effect on sales growth rate, and merger caused downsizing in the workforce.

Ramaswamy and Waegelein (2003) studied the long-term post-acquisition performance of companies involved in mergers and acquisitions activity in Hong Kong. The study comprised of 162 firms for a period of 15 years (1975 – 1990) and the analysis covered a five years pre and post-acquisition period. According to their conclusions, there was a significant positive improvement of the post-acquisition performance as compared to the pre-acquisition. However, they observed that the post-acquisition performance was significantly tied to the relative sizes of the firms coming together; firms acquiring relatively bigger firms took longer times to digest them. They also found out that conglomerate acquisitions tended to bring in better post-acquisition results than acquisitions of firms in the same industry.

Ndora (2010) studied the effects of mergers and acquisitions on the financial performance of insurance companies in Kenya. A sample of six insurance companies that had merged between the year 1995 and 2005 were used from a population of 42 registered insurance companies in the country as at that time. To measure financial performance, profitability ratios, solvency ratios as well as capital adequacy ratios were computed for the firms. Information for five years before and after the merger was compared and the results tabulated.

The findings indicated increased financial performance by the firms for the five years after the merger than it was five years before the merger. It was concluded that mergers and acquisition would result to an increase in the financial performance of an insurance company.

Wanguru (2011) did a study on the effects of mergers and acquisition on the profitability of commercial banks in Kenya. An analysis of the profitability of the banks for five years before and after the merger was conducted. A population of 33 banks that had merged between the period 1994 and 2010 were used. Profitability was measured in terms of return on asset (ROA) and return on equity (ROE). The findings were compared and the results tabulated for the years of study. It was observed that on average, the firm's profitability increased for the five year period prior the merger than before. The study concluded that mergers and acquisition for commercial banks lead to increased profitability for the resultant firm.

Lole (2012) conducted a study set out to investigate the effects of mergers and acquisition on the financial performance of the insurance industry in Kenya. The study took a causal research design in order to determine the effects of mergers on financial performance. The performance measures used were based on long-run profitability, stability, leverage and liquidity. According to the study, M&A's were positively correlated with financial performance after the merger.

A unit increase in underwriting ratio and decrease in management expense ratio lead to an increase in application of financial performance on underwriting ratio at the expense ratio. Overall mergers and acquisition and financial performance coefficients were significant indicating firms performed better financially after the resulting merger and/ or acquisition.

Mboroto (2013) studied the effect of mergers and acquisitions on the financial performance of petroleum firms in Kenya. This was by conducting an industry analysis of the petroleum sector in Kenya. The study was limited to a sample of pair companies listed on the Kenyan market that merged/acquired between the years 2002-2012. Comparisons were made between the mean of 3-years pre-merger/acquisition and 3-years post-merger/acquisition financial ratios, while the year of merging/acquisition was exempted. The analysis and results showed that petroleum firms performed better in the post- merger/acquisition era as compared to the pre-merger/acquisition era. This was supported by the fact that merging/acquisition had a significant impact on the ROA.

Odhiambo (2014) conducted a study on the operating performance of the listed companies at the Nairobi Securities Exchange after going through the cross border merger and acquisition and comparing their performance before and after the merger thus deriving their values pre and post merger or acquisition.

The analysis for this study was based on operating measures in relation to Kenyan based acquiring companies. An event study methodology was taken to evaluate the abnormal performance following a cross border merger or an acquisition. This study thus concluded that cross border mergers and acquisitions improves the financial performance of acquiring companies.

Gitonga, Inoti and Owino (2014) conducted a study on the effects of acquisitions on the financial performance of the acquiring companies in Kenya. Purposive sampling procedure was used to select a sample of all the acquisitions involving listed acquiring companies. Three years pre and post-acquisition financial statements of the acquiring company were examined. Key financial ratios were computed and used to determine the company’s pre and post-acquisition financial performance. From the findings, corporate acquisitions do not affect the financial performance of the acquiring company.

2.4.1 Summary of Literature Review

There are several theories that explain the rationale for mergers and acquisitions. Although M&A enjoy importance as strategies for achieving growth, their success in creating value remain contested. Literature from past studies reveals that the findings from most researchers have not reached a common conclusion. Owning to these inconclusive results, the present study is an attempt to examine the effects of mergers on financial performance of insurance companies in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets out various stages and phases that will be followed in completing the study. The research methodology entails the descriptive research design to be employed, population and sample size of the study, data collection and analysis techniques, and the analytical model to be utilized in the study.

3.2 Research Design

The research will adopt a descriptive research design in order to determine the relationship between mergers and acquisitions and the financial performance of insurance firms in Kenya. By using a descriptive study, the research will able to depict, whether mergers and acquisitions do have an impact on the financial performance of insurance firms in Kenya.

3.3 Population Size

Cooper and Schindler (2001), define a population as the total collection of elements about which we wish to make some inferences. The population of this study will comprise 3 mergers in Kenyan insurance firms between 2000 and 2012 To be consistent with takeover theories, where a takeover must involve a change in the ownership of a firm, I

excluded from the sample M&A deals that were pending or non-binding, vertical mergers that have no competitive effects, as well as acquisitions of a minority interest.

3.4 Data Collection

Bryman and Bell (2007) states that common sources of secondary data for social science include censuses, surveys, organizational records and data collected through qualitative methodologies or qualitative research. The data required will be drawn from Association of Kenya Insurers database, public disclosures and annual reports of the respective companies.

3.5 Data Analysis

Financial ratios of each firm will be collected three years pre – and three years' post-M&A. Three years' time window is selected because of the effect of other economic factors could distort the result for longer time span and sample size shrink significantly particularly for cross-border mergers. Change of performance is measured as the difference between three-year average mean of ratios before the merger and three years mean average of ratios after the merger. Insurance ratios and profitability ratios were used in analyzing the effects of M&A on financial performance of the sampled insurance companies operating in Kenya. Such Insurance ratios were; Loss Ratio, Expense Ratio. Profitability ratio that was calculated and analyzed was the return on assets ratio.

3.5.1 Ratio Analysis Approach

$$\text{Loss Ratio} = \frac{\text{Loss Adjustment Expenses}}{\text{Premium Earned}}$$

$$\text{Expense Ratio} = \frac{\text{Management Expenses}}{\text{Premium Earned}}$$

$$\text{Return on Asset Ratio} = \frac{\text{Loss Adjustment Expenses}}{\text{Premium Earned}}$$

3.5.2 Test of Significance

To establish the strength of the model, a two tailed paired sample t test, at 5% level of significance, will be used to test statistically significant differences of means between the pre-acquisition and post acquisition event variables. Statistical analysis will then be completed using SPSS software package.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter entails the data analysis, relationship among the study variables as well as results of the analysis. The data analysis method utilized is the ratio analysis, descriptive research design as well as the statistical t-test research design. In addition, the relation between variables is determined by performing a correlation between the variables and finally the results of the analysis are discussed.

4.2 Data Analysis

To be consistent with takeover theories, M&A deals that were pending or non-binding, vertical mergers that have no competitive effects, as well as acquisitions of a minority interest were excluded. In order to arrive at a logical conclusion, financial ratios in the pre-merger/acquisition and post-merger/acquisition era are compared. The selected financial ratios for each company in the sample over a 3-years period before Merging/Acquisition and 3-years after Merging/Acquisition, the Merging/Acquisition exercise are summed up, and the mean for each financial ratio are calculated the study excludes the year merger/acquisition took place because it usually includes recognition of a number of a typical event which distorts comparison.

The study also established the association between pre-merger or acquisition performance by using a paired t-test statistic which was used to determine whether an association existed between these two variables in the population or if there is a difference between these two variables.

4.3 Relationship among Study Variables

These are the ratios calculated after consolidating the individual insurance companies' financial figures before the merger and after the merger. The ratios calculated were the underwriting ratio, Return on assets ratio and expense ratio.

Table 4.1: Expense Ratio

Company	Before Merger	After Merger	Difference
Apollo and Pan Africa	0.253	0.155	(0.098)
ICEA + Lion of Kenya	0.19	0.072	0.53
Real + Britam	0.122	0.053	0.069
Mean	0.188	0.09	

Source: Researcher's own findings

Table 4.2: Underwriting Profit (Loss) Ratio

Company	Before Merger	After Merger	Difference
Apollo and Pan Africa	0.075	0.15	0.03
ICEA + Lion of Kenya	0.127	0.162	0.04
Real + Britam	0.068	0.07	0.03
Mean	0.09	0.12	

Source: Researcher's own findings

Table 4.3: Return on Assets

Company	Before Merger	After Merger	Difference
Apollo and Pan Africa	0.06	0.09	0.03
ICEA + Lion of Kenya	0.14	0.068	(0.07)
Real + Britam	0.052	0.06	0.08
Mean	0.08	0.07	

Source: Researcher's own findings

4.3.1 Descriptive Statistics

Descriptive statistics are calculated for the sample of insurance firms in the years before the completion of merger and acquisition and after the completion of the merger.

Table 4.4: Before Merger

Variables	N	Mean	Median	Std. dev	Variance	Min	Max
Expense Ratio	3	0.188	0.19	0.03	0.001	0.122	0.064
UWR Profit or loss	3	0.09	0.13	0.07	0.003	0.123	0.135
Return on Assets	3	0.08	0.14	0.05	0.003	0.124	0.133

Source: Researcher’s own findings

Table 4.5: After Merger

Variables	N	Mean	Median	Std. dev	Variance	Min	Max
Expense Ratio	3	0.09	0.072	0.05	0.003	0.138	0.148
UWR Profit or loss	3	0.12	0.162	0.07	0.05	0.077	0.086
Return on Assets	3	0.07	0.068	0.02	0.002	0.057	0.06

Source: Researcher’s own findings

4.3.2 Correlation Analysis

In order to establish the relationship among the different variables in the study, Pearson correlation analysis was conducted on the Expense ratio, underwriting profit (loss) ratio, return on assets ratio and liquidity ration indicators. M&A’s demonstrate a statistically significant relationship to ratio at the 95% confidence interval.

Table 4.6: Correlation of Variables

	Expense Ratio	UWR Ratio	ROA Ratio
Expense Ratio	1		
UWR Ratio	0.39993	1	
ROA Ratio	0.35934	0.877595	1

Source: Researcher's own findings

4.3 Results of Mean Ratios

Table 4.7: Ratio Analysis Table

Financial Ratio	Pre-Merger/Acquisition	Post-Merger/Acquisition	T Value
Expense Ratio	0.188	0.09	2.350875*
UWR Ratio	0.09	0.12	-0.63275*
ROA Ratio	0.08	0.07	2.23857**

Source: Researcher's own findings

(*) Denotes significance at 0.05 significance level

(**) Denotes insignificant at 0.05 significance level

4.4 Discussion of Research Findings

According to table 1, there are statistically significant differences between pre- and post-M&A for expense ratio. Results show to the mean expense ratio, it decreased from 0.188 before the merger to 0.09 after the merger.

Therefore, based on the expense ratio after M&A, the difference can be regarded to be statistically significant. Overall, it can be deduced that Merging/Acquisition has had a significant effect on the financial performance of firms.

According to table 2, the mean underwriting profit ratio increased from 0.09 before the merger to 0.12 after the merger and the increment can be regarded to be statistically significant. The ratio expresses how profitable a company's' policies have been after deduction of costs of issuing the policies. A unit increase in underwriting ratio and decrease in management expense ratio would lead to an increase in financial performance. This means there was a significant difference in the underwriting profit ratios before and after acquisition.

According to table 3, the mean return on assets increased from 0.08 before the merger to 0.07 after the merger. There is an insignificant decrease in management efficiency in employing available assets to generate earnings. This decrease only makes sense when a higher ratio is more favorable to investors because it shows that the company is more effectively managing its assets to produce greater amounts of net income. Overall, it can be deduced that Merging/Acquisition has had an insignificant effect on the financial performance of insurance firms.

According to table 4, the results for are for regression analysis. The analysis shows a statistically significant positive impact of merger and acquisition to insurance firm's performance after the merger.

Expense Ratio decrease significantly, Underwriting profit increased insignificantly and return on assets increase significantly. Overall, it can be deduced that Merging/Acquisition has had a significant effect on the financial performance of insurance firms.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The essence of this chapter is to give an overview of the entire project, make significance conclusions based on the findings of the study, make recommendations, limitations of the study and finally suggestion for further research in regards to the effects of mergers and / or acquisitions on the financial performance of insurance companies in Kenya.

5.2 Summary of Findings

The idea to investigate the outcome of mergers and /or acquisitions of the financial performance of insurance companies in Kenya was informed by their increasing number in the insurance sector in Kenya. The insurance industry (Kenya's included) is a vital part of the entire financial system since it contributes significantly to financial intermediation of the economy. Rather than being used as strategic tool, it is important to establish the impact of M&A's as such, their success means the success of the economy; their failure means failure to the economy.

The literature review encompasses the theories to be reviewed, the determinants of financial performance as well as the empirical review of related studies. The estimation methods utilized are financial ratio analysis method and in order to determine and test the correlation ratio between the dependent variable and each independent variable.

Therefore, by analyzing the results from these findings of the t test and level of significance, it was possible to depict the relationship of financial performance based on mergers and acquisitions.

5.3 Conclusion

The main objective of the study was to determine the effect of mergers and acquisitions on the financial performance of insurance companies in Kenya. The overarching reasons for mergers and acquisitions are that they are aimed at amplifying efficiency, enhancing competitive advantage, achieving synergy and improving firm value. With increased competition, desire to embrace information technology, research and innovation, Statutory demands for a stronger capital base and solvency margins, risk management and untapped insurance market, organization that are able to position themselves strategically in terms of pursuing profitability, liquidity and solvency will be in a better position.

The study was carried out to determine whether improvements occur after the merger and acquisition are undertaken. The analysis and results show that insurance firms performed better in the post- merger/acquisition era as compared to the pre-merger/acquisition era. This is supported by the fact that merging/acquisition had a significant impact on the ROE which is more that a profitability measure which is the overall standard measure of financial performance due to the statistical significance.

Evidence obtained supported and confirmed the relationship between mergers and financial performance where it was found out that there was a marginal increase in various variables with a strong relationship.

5.4 Recommendations

Insurance companies apply different strategies to come up with decisions that account for part of the profit before tax. For example, in the financial year 2010/2011, those insurance companies that invested in fixed income securities in capital markets performed better that those that invested in the money market. It is also worthy to note that losses paid by insurance companies reduce the ROE and they vary from insurance company to another.

5.5 Limitations of the Study

The research investigated the financial performance of insurance companies in Kenya that had undergone a merger/ or an acquisition. The population of this study comprised 3 mergers in Kenyan insurance firms between 2000 and 2013. To be consistent with takeover theories, where a takeover must involve a change in the ownership of a firm, I excluded from the sample M&A deals that were pending or non-binding, vertical mergers that have no competitive effects, as well as acquisitions of minority interest. A research should be done for those all mergers including acquisitions of minority interest and mergers with no competitive effects and a comparison done to offer better information to scholars and stakeholders.

The study took on a causal research design which was to determine the relationship between merger/acquisition and financial performance. It is difficult to isolate the effects of merger and acquisition from other external forces like exchange rates and oil prices that could have contributed to the changes in financial performance.

Also, not many insurance companies have undergone mergers and acquisition during the study period. In addition to that, majorities were acquired by foreign companies making it hard to find information and as a result this led to selection of a small sample size, thus the results may not be very conclusive.

5.6 Suggestions for Further Research

The current study focused on insurance companies in Kenya. Further research in other sectors like manufacturing and IT that have engaged in mergers and acquisitions should be embarked on so as to obtain further insights. Also, the study should be conducted using different methodology based on stock performance in order to offer different approach towards the same problem thus enhancing the clarity of the findings by eliminating the influence of other forces affecting financial performance.

Future research could extend the analysis to a more recent sample of acquisitions, to ensure that our results are robust across different time periods. The insurance industry in Kenya is experiencing a change in regulations governing their operations. This change in regulation may result in increased mergers and acquisitions. Research could be extended to the effect of value creation following implementation of the new regime.

Finally, further research can be conducted on the effects of mode of financing on mergers and acquisitions in terms of equity financed mergers, cash financed mergers or stock financed mergers.

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APPENDICES

Appendix 1: Merged Insurance Companies in Kenya between 2003 – 2013

The merger of general businesses of Apollo Insurance Company Ltd, and Pan Africa Insurance Company to form APA Insurance (2003).

The merger of ICEA Company Ltd, and Lion of Kenya to form ICEA LION Group (2012).

The merger of Real Insurance Company Limited and Britam Insurance Company Ltd in (2014).

Appendix II: APA Insurance Companies' four year financial performance synopsis

All figures in Shs millions	1999	2000	2001	2002
Apollo Insurance (General)				
Gross written premium	378	413	512	583
Management Expenses	99	105	135	189
Underwriting profit /(loss)	7	26	22	-14
Profit before taxation	25	39	14	8
Total Assets	897	1004	1400	1950
Pan Africa General Insurance				
Gross written premium	536	563	593	454
Management Expenses	110	110	134	117
Underwriting profit /(loss)	-28	-113	-106	-47
Profit before taxation	30	-65	-152	-15
Total Assets	1007	1250	1425	1550
Apollo & Pan Africa General Consolidated				
Gross written premium	914	976	1,105	1,037
Management Expenses	209	215	269	306
Underwriting profit /(loss)	-21	-87	-84	-61
Profit before taxation	55	-26	-138	-7
Total Assets	1904	2254	2825	3500
Underwriting Profit (Loss) Ratio	-6.18%	1.40%	9.50%	15.5%
Expense ratio	22.87%	22.04%	24.36%	29.51%
Return on Assets Ratio	2.7%	6.5%	4.7%	7.2%
Underwriting profit (loss) ratio	-2.30%	-8.91%	7.60%	5.88%

All figures in Shs millions	2004	2005	2006	2007
APA Insurance Limited				
Gross written premium	1,407	1,504	2,008	2,356
Management Expenses	231	257	301	339
Total Assets	2,440	3,024	5,907	6,490
Profit before taxation	44	459	811	1004
Expense ratio	16.42%	17.09%	14.99%	14.39%
Return on Assets ratio	2%	15%	13.7%	15.4 %

ICEA LION Insurance Ltd Four year financial performance Synopses

All figures in Shs millions	2008	2009	2010	2011
ICEA Insurance Co. Ltd (General)				
Gross written premium	2647	2750	2808	3255
Management Expenses	523	612	754	832
Underwriting profit /(loss)	12	21	18	-14
Premiums Earned	2000	3161	3643	4670
Profit before taxation	2343	3001	3861	6304
Total Assets	21521	23540	26294	32127
Expense Ratio	26%	19.3%	21%	17.8%
Underwriting Profit (Loss) Ratio	4.7%	3.2%	13%	22%
Return on Assets Ratio	10.8%	12.8%	15%	14.5%

Real and Britam Insurance Three year financial performance Synopsis.

Gross written premium	1314	1499	1924	2329
Management Expenses	95	124	135	175
Underwriting profit /(loss)	16	25	11	22
Premiums Earned	30	-65	-152	-15
Profit before taxation	572	361	602	727
ICEA Lion Insurance Company Limited	2011	2012	2013	2014
Gross Written Premium	3745	4889	5352	6134
Management Expenses	257	275	350	575
Premium Earned	2245	2458	2671	3212
Profit before taxation	1340	1857	2535	3650
Total Assets	27658	33689	41699	44554
Expense Ratio	6.7%	5.6%	7%	9.3%
Underwriting Profit (Loss) Ratio	6.5%	7.6%	14%	27%
Return on Assets Ratio	5%	6%	6.2%	8.2%

Source: ICEA Lion Insurance Company Limited (2008) Annual Report Accounts

Real and Britam Insurance Three year financial performance synopsis

All figures in Shs millions	2010	2011	2012
Real Insurance (General)			
Gross written premium	2475	2994	3908
Management Expenses	825	949	787
Underwriting profit /(loss)	15	22	26
Profit before taxation	67	106	200
Total Assets	2870	3240	4160
Britam Insurance			
Gross written premium	4333	5583	6761
Management Expenses	525	600	624
Underwriting profit /(loss)	153	415	489
Profit before taxation	1037	1151	1597
Total Assets	21423	20588	29961
Premium Earned	3754	4936	5956
Expense Ratio	13.9%	12.1%	10.5%
Return on Assets	4.8%	5.6%	5.3%
Underwriting profit (loss)	4%	8.4%	8.2%
Real + Britam Insurance Ltd	2014	2015	2016
Gross written premium	14045	10942	9,563
Management Expenses	696	715	824
Profit before taxation	3212	3856	4216
Total Assets	45,590	64321	68443
Premium Earned	11,792	14415	16575
Expense ratio	6%	5%	4.9%
Return On Assets	7%	6.5%	4.15%
Underwriting profit (loss) ratio	4.9%	6.7%	8.7%

Source: IRA Statistic and Insurance company's' Accounts.